



## Foreign Trade Zone – Related Programs

### Final Report

# Canada/US Comparison of Foreign Trade Zone (FTZ) Related Programs & Policies

Under Contract with  
Transport Canada – Strategic Policy  
Value-Added Gateway Project

31 March 2009



Virtuosy Consulting  
Box 8115 Station T  
Ottawa, Ontario, K1G 3H6, Canada

## Acknowledgements

The report was written by David Stambrook (President-Virtuosity Consulting). The study was done under the direction of Virginia Leung (Transport Canada – Value-Added Gateway Project), with the support of Lara Peters, and benefited from discussion with various Government of Canada officials:

Transport Canada:

John Higginbotham  
Stephen Van Dine  
Virginia Leung  
Lara Peters

Canada Border Services Agency:

Ingrid Berger  
Yvon Pellerin  
Gil Roy  
Charles Allain

Finance Canada:

Rainer Nowak  
Andrew Otto

Canada Revenue Agency:

John Sitka  
Patrick McKinnon  
Jeff Frobel

The Consultant thanks the various officials who offered their critiques and suggestions.

The report is the work of Virtuosity Consulting and does not indicate Government of Canada endorsement of its contents.

The author can be contacted at: [virtuosityconsulting@sympatico.ca](mailto:virtuosityconsulting@sympatico.ca)

### Disclaimer

This report reflects the views of Virtuosity Consulting only and does not necessarily reflect the official views or policies of Transport Canada. It should be noted that Finance Canada did not approve nor endorse the tax-related portions of this report. With respect to GST/HST, the information in this report does not replace the law found in the *Excise Tax Act* and its Regulations. It is provided for general information purposes only.

Neither Transport Canada, nor its employees, makes any warranty, express or implied, or assumes any legal liability or responsibility for the accuracy or completeness of any information contained in this report, or process described herein, and assumes no responsibility for anyone's use of the information. Transport Canada is not responsible for errors or omissions in this report and makes no representations as to the accuracy or completeness of the information.

Transport Canada does not endorse products or companies. Reference in this report to any specific commercial products, process, or service by trade name, trademark, manufacturer, or otherwise, does not constitute or imply its endorsement, recommendation, or favouring by Transport Canada and shall not be used for advertising or service endorsement purposes. Trade or company names appear in this report only because they are essential to the objectives of the report.

References and hyperlinks to external web sites do not constitute endorsement by Transport Canada of the linked web sites, or the information, products or services contained therein. Transport Canada does not exercise any editorial control over the information you may find at these locations.

## 1. Executive Summary

### Background

Transport Canada – Value-Added Gateway Project (Strategic Policy) has commissioned various studies pertaining to the concept of the ‘value-added gateway’ and how to generate more economic benefit (i.e. employment, gross domestic product) from international trade movements through Canada’s gateways (e.g. international ports, airports, land crossings).

TC-Strategy Policy hosted a workshop in 2008 on this topic, a federal interdepartmental caucus, and various Deputy Minister-level meetings with federal departments. Several near-term initiatives were identified from this work, including a review of Canadian and international experiences with *Foreign Trade Zones* (FTZ) or comparable programs dealing with customs duties (and related tax) exemption and deferral schemes.

### Study Goal

The objective of the study is to understand and compare existing Canadian programs/policies and related US programs/policies pertaining to Foreign Trade Zones (FTZ) and export-oriented processing or distribution activities, with a view to better marketing existing Canadian duty (and related tax) relief and deferral programs and policies.

### Concept of a Foreign Trade Zone (FTZ)

Foreign Trade Zone (FTZ) features around the world typically include:

- ***Advanced Infrastructure*** – superior quality infrastructure including land, office space, utilities, logistics services, business services and other similar facilities;
- ***Flexible Regulations*** – streamlined customs process with less bureaucracy and red-tape, often involving assistance from a single-window service provider in order to obtain necessary permits and applications;
- ***Beneficial Location*** – FTZ are often used during outsourcing away from the ‘higher cost’ final market to ‘lower cost’ offshore locations;
- ***Export Oriented*** – for production of goods destined for export outside of the host country; and
- ***Incentives*** – to attract jobs and investment to an FTZ through:
  - exemption and/or deferral of customs duties;
  - grants for developing and employing local human resources;

- exemption and/or deferral of sales and value-added taxes; and
- other tax incentives (e.g. lower corporate income tax than the host county i.e. outside the FTZ).

According to International Labour Organization (ILO) estimates, there were more than 3,500 FTZ in 130 countries worldwide in 2007, employing more than 66M people. A World Bank evaluation of trade support measures found that FTZ were effective in several developing countries, even though FTZ programs are generally considered to be a 'second-best' policy relative to 'first-best' policies that fundamentally restructure a country's tariff, export promotion or import facilitation/Customs processing structures.

FTZ-type programs must not be considered an 'export subsidy', defined as a 'financial contribution by a government or any public body within the territory of a World Trade Organization (WTO) member which confers a benefit'. Export subsidies are prohibited under the WTO-Agreement on Subsidies and Countervailing Measures (SCM). Prohibited export subsidies include: subsidies contingent (in law or in fact) on export performance, and local content subsidies contingent on the use of domestic over imported goods. Other forms of export subsidies are not prohibited but may be 'actionable' in a WTO-dispute resolution mechanism.

### **US-Foreign Trade Zone (FTZ) Program**

The US-FTZ Board is a branch of the US-Commerce department and has been the regulator of US-FTZ since their establishment in 1934. There have been numerous changes in legislation and regulation, especially during the 1980s when US value-added (i.e. labour, overhead, profit) was excluded from the calculation of value of goods for the purpose of assessing duty payable on goods released into the US-domestic economy.

There are two types of US foreign trade zones: general-purpose zones and special-purpose subzones.

**General-Purpose Zones (GPZ):** operate under public utility principles under the sponsorship of a corporation granted authority by the US-FTZ Board and supervised by US-Customs. General-purpose zones are usually located in industrial parks or in seaport and airport complexes with facilities available for use by the general public; and

**Special-Purpose Subzones:** subordinate to a particular GPZ, and typically a part of a single company's operations used for their exclusive use. Subzones are single-purpose sites for operations that cannot be feasibly moved to, or accommodated in, a general purpose zone (e.g. oil refining and automobile manufacturing).

In 2007, there were 382 approved US-FTZ (126 GPZ and 256 subzones) of which 161 were in active use. Annual shipments in 2007 from US-FTZ were US\$502B with employment of 300,000. However, the value of export shipments was only US\$32B (6%) and the ratio of FTZ exports-to-imports was only 22%, indicating that the focus of the FTZ program was

clearly more on import-facilitation than on export-facilitation. Close to 5% of US-imports flow through FTZ.

Technically, a US-FTZ is *not* considered to be within the US-Customs territory. An FTZ-operator must use an Inventory Tracking System to track and account for all goods in an FTZ and provide goods to be removed from the zone, including:

- 1) location of merchandise;
- 2) zone status of the goods;
- 3) beginning balance, receipts, removals and current balance of goods in inventory;
- 4) any destruction, scrap, waste, and by-products; and
- 5) cost or value of the goods.

Benefits from operating within a US-FTZ include:

1. ***Duty Exemption***: on imported goods to an FTZ that are subsequently exported;
2. ***Duty Deferral***: on imported goods to an FTZ that are subsequently entered into the US-domestic market, perhaps in processing form, on which customs duty are payable when goods leave the FTZ and enter US-Customs territory;
3. ***Duty Reduction***: on imported goods to an FTZ that are subsequently processed or manufactured into finished goods and entered into the US-domestic market, on which a lower (possibly zero) duty rate applies compared to the duty rate for the imported goods (i.e. Inverted Tariff<sup>1</sup> benefit);
4. ***Volume Reduction***: no customs duty is payable on the volume of goods that are eliminated due to defect, damage, obsolescence, waste, or scrap within the FTZ-operation;
5. ***Exemption of US-Value-Added*** (e.g. Labour, Overhead, Profit and US-Materials): on US-domestic value-added within the FTZ-operation, for which no customs duty is payable on goods that leave the FTZ and enter US-Customs territory;
6. ***US-Quota Application***: goods may be stored at an FTZ even if they are subject to a US-quota restriction. The goods may be entered into the US-Customs territory when future quota room is available;
7. ***Indefinite Storage***: goods may remain in an FTZ indefinitely, whether or not they are subject to duty;

---

<sup>1</sup> 'Inverted Tariff' refers to a situation where the customs duty structure encourages imports of finished goods rather than component goods. The 'normal' economic rationale is for 'Escalating Tariff', whereby the customs duty structure encouraged imports of component goods and domestic processing of finished goods (i.e. duty rates are higher on finished goods than on components or raw materials).

8. ***Exemption from State Inventory Taxes:*** imported goods held in inventory and goods produced within FTZ which are intended for export are exempt from certain US-State and local *ad valorem* taxes on ‘tangible personal property’;
9. ***Zone-to-Zone Transfers:*** goods can be transferred in-bond from one FTZ to another FTZ within being considered to have entered into US-Customs territory; and
10. ***Streamlining of US-Customs Procedures:*** resulting in direct savings on various US-Customs fees, and cash-flow savings from improved logistics management within the FTZ. These streamlined and simplified US-Customs procedures reduce the time required for customs clearance and support Just-In-Time (JIT) logistics and broader supply-chain management issues.

Generally, the ‘inverted tariff’ savings have been the principal driver of FTZ-benefits over the past 35 years. It should be noted that ‘inverted tariff’ benefits are only available on a ‘case-by-case’ basis and must be authorized by the US-FTZ Board for a specific location and activity that meets a ‘public interest’ test.

It is claimed that a US-distributor should be able to achieve savings from FTZ-operation if they:

- import more than US\$100M per year;
- file more than 1,000 US-Customs entries per year; or
- operate a distribution centre larger than 300,000 ft<sup>2</sup>.

Companies operating within an FTZ may also be eligible for various US-State and local (i.e. county, municipal) government incentives for business and/or industrial development. Historically, various US-State and local governments have engaged in intense competition for proposed automobile transplant factories and also domestic company plants, sometimes offering incentive packages worth US\$10Ms to US\$100Ms. The State of Kentucky reportedly offered Toyota an incentive package worth an estimated US\$323M over 20 years (about half of this in up-front costs) in the mid-1980s.

The US also offers non-FTZ programs for duty deferral and drawback including:

- Customs Bonded Warehouse;
- Temporary In-Bond Shipments; and
- Duty Drawback (i.e. refund).

## Canadian 'FTZ-Like' Programs

The main Canadian 'FTZ-like' program is the Duty Deferral Program (DDP) administered by Canada Border Services Agency (CBSA), which consists of the Duties Relief Program (DRP) and the Customs Bonded Warehouse (CBW) Program. A company must apply to become a participant on a company-site basis under DRP and must be primarily engaged in export-oriented processing or distribution. There is no regulated threshold 'test' and some regional variation in interpretation, but this likely requires more than 70% of revenues to be generated from exports.

In addition to duty relief, the Customs Bonded Warehouse Program provides for the deferral of payment of import duties on imported goods. Relative to the same benefit categories as were reported for US-FTZ, the Canadian DDP/DRP/CBW offers:

1. **Duty Exemption:** on imported goods to a DRP or CBW program participant that are subsequently re-exported, either in the same condition or after being used, consumed or expended in the process of other goods for export (i.e. through 'manufacturing in-bond');
2. **Duty Deferral:** on imported goods to a DRP or CBW participant that are subsequently entered into the Canadian domestic market, either in the same condition or after being used, consumed or expended in the process of other goods for export (i.e. through 'manufacturing in-bond'). Duties and taxes become payable upon formal entry into the Canadian domestic market;
3. **Duty Reduction:** not available; however, comparable relief for an 'inverted tariff' situation may be provided on a permanent or temporary basis through application to Finance Canada;
4. **Volume Reduction:** no customs duty is payable on goods that are determined to be waste or scrap within the DRP and CBW programs. Other CBSA programs provide for the refund of duties paid on defective, damaged or obsolete goods;
5. **Exemption of Canadian Value-Added** (e.g. Labour, Overhead, Profit and Domestic Materials): no additional customs duties (i.e. beyond that owed on imported goods) is payable on finished goods that leave the DRP or CBW site and enter the Canadian domestic market;
6. **Quota Application:** goods may be stored at a CBW site without payment of duties until quotas become available (i.e. duty deferral benefit);
7. **Indefinite Storage:** not available; imported goods must be customs duty paid within four (4) years of the date of import;

8. *Exemption from Inventory Taxes*: not applicable;
9. *Zone-to-Zone Transfers*: goods can be transferred in-bond from one DRP or CBW participant to another without being considered to have entered the Canadian domestic market; and
10. *Streamlining of Customs Procedures*: pre-approval programs (e.g. Customs Self Assessment) are available to facilitate the processing of low-risk goods, and demonstrate that CBSA is working with the trade community to provide flexibility, speed and efficiency.

As can be seen by comparing this list with that for US-FTZ, in most important respects Canada offers comparable treatment and benefits in support of export processing through the DRP and CBW programs, as are currently available under the US-FTZ program.

Canada offers additional customs duty relief programs, including:

- Duty Drawback Program (i.e. refund of duties paid in certain circumstances, e.g. goods re-export); and
- Refund of duties paid (i.e. on goods that have suffered damage, deterioration or destruction, or that are deficient in quantity, of inferior quality, or were not according to order, etc.).

### **Canadian GST Exemption/Deferral Programs**

It has been unfortunate that the bulk of the attention on Canadian 'FTZ-like' programs has focused on the Goods and Services Tax (GST) export-oriented programs rather than the more comparable Duty Relief Programs.

The GST is a broad-based, multi-stage consumption tax which exempts exporters from the requirement to collect GST from buyers of Canadian export sales. The GST is payable on imported goods and domestic supplies of goods that are embodied in finished goods (or distributed goods) for export. However, the system of GST input tax credit means that such GST payments are refundable on a periodic basis. Hence, the GST system is 'neutral' with respect to the use of imported or domestic goods destined for export (perhaps with processing) or destined for the Canadian domestic market.

There are three GST programs that provide targeted cash-flow relief for export-oriented businesses in Canada. The programs are: Export Distribution Centre Program (EDCP), the Exporters of Processing Services Program (EOPS), and the Export Trading House Program (ETH).

It is noted that there are several other federal jurisdictions with multi-level GST/Value-Added Tax (VAT) systems that provide special treatment (e.g., exemption) for imports related to foreign trade zones or in support of specific export activities.

In an effort to better market the existing Canadian ‘FTZ-like’ programs and policies, consideration should be given to better integrating the existing Canadian duty deferral and exemption programs (DRP and CBW) and GST deferral and exemption programs (EDCP and EOPS) to provide a more coherent and simpler set of program instruments.

**2. List of Acronyms**

| <i>Term/Acronym</i> | <i>Definition</i>   |
|---------------------|---|
| ABI                 | Automated Broker Interface  |
| ACE                 | Automated Commercial Environment  |
| AMPS                | Administrative Monetary Penalty System  |
| API                 | American Petroleum Institute  |
| CA                  | Canada  |
| CBP                 | Customs and Border Protection   |
| CBW                 | Customs Bonded Warehouse  |
| CBSA                | Canadian Border Services Agency   |
| CFR                 | Consolidated Federal Register   |
| CRA                 | Canada Revenue Agency   |
| C-TPAT              | Customs Trade Partnership Against Terrorism   |
| DDP                 | Direct Delivery Procedure (US)  |
| DDP                 | Duty Deferral Program (CA)  |
| DRP                 | Duties Relief Program   |
| EDCP                | Export Distribution Centre program  |
| EIA                 | Energy Information Administration   |
| EOPS                | Export-Oriented Processing Services   |
| ETH                 | Export Trading House  |
| EU                  | European Union  |
| FIN                 | Finance Canada  |
| FTA                 | Free Trade Agreement  |
| FTZ                 | Foreign Trade Zone<br>(also known as Free Trade Zone, Special Economic Zone, Export Processing Zone, Free Port) |
| FTZB                | Foreign Trade Zone Board  |
| GAO                 | Government Accounting Office  |
| GATS                | General Agreement on Trade in Services  |
| GDP                 | Gross Domestic Product  |
| GPZ                 | General-Purpose Zone  |
| GST                 | Goods and Services Tax  |
| HMF                 | Harbour Maintenance Fee   |
| HST                 | Harmonized Sales Tax  |
| HTS                 | Harmonized Tariff Schedule  |
| IA                  | Import Administration   |
| ILO                 | International Labour Organization   |

| <i>Term/Acronym</i> | <i>Definition</i>                                     |
|---------------------|---|
| ITA                 | International Trade Administration                    |
| ITS                 | Inventory Tracking System                             |
| JIT                 | Just-In-Time  |
| MFN                 | Most-Favoured Nation                                  |
| MPF                 | Merchandise Processing Fee                            |
| NAFTA               | North American Free Trade Agreement                   |
| NAFTZ               | National Association of Foreign Trade Zones           |
| NPF                 | Non-Privileged Foreign (status)                       |
| NPV                 | Net Present Value                                     |
| <b>NTI</b>          | <b>Non-Taxable Importations</b>                       |
| OECD                | Organization for Economic Cooperation and Development |
| PF                  | Privileged Foreign (status)                           |
| SC                  | Statistics Canada                                     |
| SCM                 | Subsidies and Countervailing Measures                 |
| SME                 | Small and Medium (Sized) Enterprises                  |
| TAP                 | Trade Agreement Parity                                |
| TC                  | Transport Canada                                      |
| TIB                 | Temporary In-Bond                                     |
| TRIMS               | Trade Related Investment Measures                     |
| UK                  | United Kingdom  |
| UN                  | United Nations  |
| UNCTAD              | UN Conference on Trade and Development                |
| US or USA           | United States (of America)                            |
| VAT                 | Value-Added Tax                                       |
| WEP                 | Weekly Entry Procedure                                |
| WEPZA               | World Economic Processing Zones Association           |
| WTO                 | World Trade Organization                              |
| ZR                  | Zone-Restricted (status)                              |

**3. Table of Contents**

**Acknowledgements** ..... 2

**Disclaimer** ..... **Error! Bookmark not defined.**

**1. Executive Summary** ..... 3

**2. List of Acronyms** ..... 9

**3. Table of Contents** ..... 11

**4. Introduction** ..... 13

    4.1. Background ..... 13

    4.2. Study Goals ..... 14

    4.3. Study Outline ..... 14

**5. Concept of a ‘Foreign Trade Zone’** ..... 16

    5.1. Definition of FTZ ..... 16

    5.2. Types of Duty Relief & Cash-Flow Benefits of FTZ ..... 17

    5.3. World Trade Rules & FTZ ..... 18

    5.4. Regional Free Trade Agreements (FTA) & FTZ ..... 19

    5.5. Declining Duty Rates & FTZ ..... 21

**6. US-FTZ Program & Customs Duty Deferral** ..... 22

    6.1. US-FTZ Program ..... 22

        6.1.1 *History of US-FTZ Act & Program* ..... 22

        6.1.2 *Types of US-FTZ* ..... 24

        6.1.3 *Role of US-FTZ Board* ..... 24

        6.1.4 *Volume of US-FTZ Activity* ..... 27

        6.1.5 *Basic Mechanics of FTZ Activity* ..... 28

        6.1.6 *US-FTZ Benefits* ..... 30

        6.1.7 *US-State & Local Incentives* ..... 34

        6.1.8 *Major Users of US-FTZ Benefits* ..... 36

        6.1.9 *NAFTA Article 303 & FTZ* ..... 40

    6.2. US – Other Customs Duty Deferral ..... 41

        6.2.1 *US-Customs Bonded Warehouse* ..... 41

        6.2.2 *US-Customs Temporary In-Bond (TIB) Shipments* ..... 41

        6.2.3 *US-Customs Duty Drawback* ..... 43

**7. CA-Customs Duty Deferral & GST Relief Programs** ..... 45

    7.1. CA – Customs Duty Deferral ..... 45

        7.1.1 *Duties Relief Program* ..... 46

        7.1.2 *Duty Drawback Program* ..... 48

        7.1.3 *Customs Bonded Warehouse Program* ..... 49

        7.1.4 *Freight Forwarders & Consolidators* ..... 52

        7.1.5 *Tariff Relief Through Finance Canada* ..... 53

    7.2. CA – GST/HST Relief Programs ..... 55

|  |                                     |
|--|-------------------------------------|
| 7.2.1 <i>Primer on the Goods and Services Tax (GST)</i> .....                  | 55                                  |
| 7.2.2 <i>Export Distribution Centre (EDCP) Program</i> .....                   | 57                                  |
| 7.2.3 <i>Exporters of Processing Services (EOPS) Program</i> .....             | 61                                  |
| 7.2.4 <i>Export Trading House (ETH) Program</i> .....                          | 63                                  |
| 7.2.5 <i>GST/HST Refunds</i> .....   | <b>Error! Bookmark not defined.</b> |
| 7.2.6 <i>GST/HST Rebates</i> .....   | <b>Error! Bookmark not defined.</b> |
| <b>8. Comparison of Canada/US ‘FTZ-Related’ Programs</b> .....                 | <b>65</b>                           |
| 8.1. Similarities Between Canada/US .....                                      | 68                                  |
| 8.2. Differences Between Canada/US .....                                       | 70                                  |
| 8.3. Overall Assessment .....  | 70                                  |
| <b>Annex 1 – US-FTZ Data</b> .....   | <b>76</b>                           |
| <b>Annex 2 – US-FTZ Case Study – Boston FTZ-#027</b> .....                     | <b>84</b>                           |
| <b>Annex 3 – Other Federal Examples of FTZ-Related GST/VAT Treatment</b> ..... | <b>87</b>                           |

## 4. Introduction

### 4.1. Background

In 2007, the Government of Canada announced a *National Policy Framework for Strategic Gateways and Trade Corridors* which included objective to:

- i) market Canada's gateway advantage abroad;
- ii) integrate Canada's trade and transportation policy directions; and
- iii) create a *systems* approach to investment, planning and policy development.

Transport Canada-Value-Added Gateway Project (Strategic Policy) has commissioned various studies pertaining to the concept of the 'value-added gateway' and how to generate more economic benefit (i.e. employment, gross domestic product) from international trade movements through Canada's gateways (e.g. international ports, airports, land crossings).

TC-Strategy Policy recently hosted an international conference and workshops on this topic, a federal interdepartmental caucus, and various Deputy Minister-level meetings with federal departments. Several 'near-term' initiatives were identified from this work including a review of Canadian and international experiences with *Foreign Trade Zones* (FTZ) or equivalent types of duty/tax exemption and deferral schemes with a view to better marketing existing Canadian policies and programs.

Canada's federal FTZ-related programs include the:

1. ***Duty Deferral Program***: introduced in 1996 to relieve the payment obligation for duties (import and/or export) related to re-exported goods, and defer the payment obligation for import duties on goods bound for the domestic market<sup>2</sup>. As duties have been reduced or eliminated through trade liberalization the duty component has become less significant for most goods<sup>3</sup>.
2. ***Export Distribution Centre Program (EDCP)***: introduced in 2001 to provide cash-flow relief to eligible non-manufacturing, non-producing, export-oriented business that add limited value to goods; by allowing for the import of foreign goods and purchase of Canadian domestic goods on a tax-free (i.e. GST/HST) basis used to sell goods for export<sup>4</sup>.
3. ***Exporters of Processing Services Program (EOPS)***: introduced in 1992 to provide cash-flow relief to eligible export-oriented suppliers of processing services; by

---

<sup>2</sup> Intervistas (2005) p.2

<sup>3</sup> Intervistas (2005) pp.2-3

<sup>4</sup> CRA input 7 May 2009

allowing for the import of foreign goods belonging to unrelated non-residents on a tax-free (i.e. GST/HST) basis for processing and re-export<sup>5</sup>.

There is an immediate need to develop a government-wide understanding regarding the relative benefits and weaknesses of existing Canadian programs/policies related to Foreign Trade Zones (FTZ) compared to similar US programs/policies.

The emphasis is on Canadian federal programs/policies but the comparison with US-FTZ policies/programs will include a summary of examples, including relevant state/local programs/policies, which might point to areas where Canadian provincial/municipal programs/policies could be enhanced.

## 4.2. Study Goals

The study goals are to:

- identify similarities and differences between US and Canadian approaches to FTZ programs/policies at the federal/regional/local levels;
- demonstrate the overall (and comparative to US-FTZ programs) benefits of existing federal FTZ-relevant programs/policies to Canadian export-oriented businesses; and
- provide a profile of typical Canadian firm(s) using these programs (if possible, relative to Canadian firms not using these programs) in order to inform suggestions on how to improve awareness of Canada's programs.

The results of the study will be used immediately by Transport Canada-Value-Added Gateway Project in discussions with other federal departments in the development of more integrated awareness and marketing efforts to promote Canada's FTZ-related programs and policies.

## 4.3. Study Outline

The Study includes:

- a. literature review and synthesis of available government, industry and academic reports, studies, papers and research related to Canadian and US FTZ-relevant programs and policies at the federal, provincial/state and local/municipal levels (using 3-4 examples for the latter two);
- b. a concise comparison of the Canada FTZ-relevant programs and policies to US-FTZ relevant programs and policies based on a review of the literature and available sources of evidence;

---

<sup>5</sup> CRA input 7 May 2009

- c. planning and conduct of interviews with federal officials, current Canadian users/stakeholders (e.g. companies, associations, third-party logistics providers) of FTZ-relevant programs, and specific US users/stakeholders of FTZ-relevant programs to develop an appropriate comparison of Canada/US programs and the actual benefits realized from the use of existing programs and policies; and
- d. development of a comprehensive report and presentation on the Canada/US comparison findings, with recommendations related to the development of a high-level marketing and awareness strategy for consideration by the Client (and other federal departments) to improve business awareness and perception of the benefits of Canadian programs.

Section 5 provides an overview of the concept of a 'Foreign Trade Zone' and the types of duty relief and cash-flow benefits that typically result from their use.

Section 6 presents details on the US-FTZ program and related Customs duty deferral programs that are relevant for the Canada-US comparison.

Section 7 summarizes details on various Canadian tax relief (e.g. GST) and duty deferral programs that are relevant for the Canada-US comparison.

Section 8 highlights the similarities and differences between the Canadian and US FTZ-related programs and policies.

## 5. Concept of a ‘Foreign Trade Zone’

### 5.1. Definition of FTZ

Foreign Trade Zone (FTZ) features around the world typically include<sup>6</sup>:

- **Advanced Infrastructure** – superior quality infrastructure including land, office space, utilities, logistics services, business services and other similar facilities;
- **Flexible Regulations** – streamlined customs process with less bureaucracy and red-tape, often involving assistance from a single-window service provider in order to obtain necessary permits and applications. Often, as well, day-to-day business operations (e.g. labour legislation) is more flexible (within the FTZ) relative to the laws applicable in the host country (outside the FTZ);
- **Beneficial Location** – FTZ are often used during outsourcing away from the ‘higher cost’ final market to ‘lower cost’ offshore locations;
- **Export Oriented** – for production of goods destined for export outside of the host country; and
- **Incentives** – to attract jobs and investment to an FTZ through:
  - exemption and/or deferral of customs duties;
  - grants for developing and employing local human resources;
  - exemption and/or deferral of sales and value-added taxes; and
  - other tax incentives (e.g. lower corporate income tax than the host country i.e. outside the FTZ).

According to International Labour Organization (ILO) estimates, there were more than 3,500 FTZ in 130 countries worldwide in 2007, employing more than 66M people<sup>7</sup>. A World Bank evaluation of trade support measures found that FTZ were effective in several countries (e.g. China, Mexico, Madagascar, Mauritius, Costa Rica, El Salvador)<sup>8</sup>.

The economic development rationale for FTZ is to develop exports and compensate for the adverse effects of policies that penalize the export sector, by designing measures that restore incentive neutrality between production for export and import substitution<sup>9</sup>. The required neutrality of incentives can be achieved by allowing export producers to purchase their inputs and sell their outputs at competitive prices (i.e. granting exporters and their main suppliers duty-free access to inputs, and granting exporters the right to retain all their export proceeds).

<sup>6</sup> Deloitte (2008) p.5

<sup>7</sup> W. Milberg (2007) p.8, citing Singa (2007) for the ILO.

<sup>8</sup> WB-IEG (2006) pp.12, 28, 51

<sup>9</sup> WB-IEG (2006) p.87

Several mechanisms exist for granting duty-free access to exporters for imported inputs, including:

- duty drawback or rebate systems;
- bonded manufacturing warehousing arrangements; and
- geographically separated entities (i.e. foreign trade zones, export processing zones) within which all import trade barriers are excluded.

The obvious alternative to such 'special treatment' programs is to have an economic and trade policies that generally support domestic production through trade liberalization (i.e. low import duty, trade-neutral taxation, trade facilitation in Customs administration).

The rationale for 'limiting' the locational scope of trade liberalization and facilitation in developing countries is partly political and partly social. It is either to target bureaucratic improvements and efficiencies (and suppression of corrupt practices) when there are limited public resources, or to socially limit the influence of foreign capital and management practices on domestic culture. Aspects of these rationales are 'socially protectionist' but also contain the 'infant industry' development justification that it may take targeted experience and success to be achieved before wide-spread applications can be attempted in the broader economy/society<sup>10</sup>. This is especially important when there may be limited worker/management skills and advanced technical/transport infrastructure.

A World Bank study found that FTZ in certain more advanced developing countries (i.e. South Korea, Taiwan) played an important role in knowledge-transfer on a project-by-project basis, but were less prominent at the national level<sup>11</sup>.

## 5.2. Types of Duty Relief & Cash-Flow Benefits of FTZ

Some of the typical incentive benefits offered under FTZ include<sup>12</sup>:

- a) exemption from export taxes;
- b) exemption from duties on imports of raw materials or intermediate goods;
- c) exemption from direct taxes such as profits taxes, municipal and property taxes;
- d) exemption from indirect taxes such as Value-Added Tax (VAT)/Goods and Services Tax (GST) on domestic purchases;
- e) exemption from national foreign exchange controls;

---

<sup>10</sup> The counter-argument has been that FTZ can limit development by acting as a 'pressure valve' for wider social/economic reforms (e.g. China vis-à-vis Hong Kong during 1980s)

<sup>11</sup> D. Mandani (1999) p.6

<sup>12</sup> W. Milberg (2007) p.4

- f) free profit repatriation for foreign companies;
- g) provision of streamlined administrative services especially to facilitate import and export; and
- h) free provision of enhanced physical infrastructure for production, transport and logistics.

Other less transparent features may include: relaxed regulatory environment (e.g. with respect to the enforcement of labour rights and standards, most notably the right to unionize; environmental standards; foreign ownership regulations; and leasing or purchasing of land).

### 5.3. World Trade Rules & FTZ

FTZ are not mentioned explicitly in any World Trade Organization (WTO) Agreement, but export subsidies are in violation of the Agreement on Subsidies and Countervailing Measures (SCM) of the Marrakesh Agreement establishing the WTO<sup>13</sup>.

Developed countries had agreed to a prohibition on export subsidies in the Tokyo Round SCM Agreement concluded in 1979. New to the WTO-SCM Agreement was a phase-out provision for developing countries (to 2011).

An export subsidy is defined in the SCM Agreement as 'a financial contribution by a government or any public body within the territory of a [WTO] Member which confers a benefit'. The Agreement identifies two categories of *prohibited export subsidies*<sup>14</sup>:

- export subsidies are subsidies contingent (in law or in fact) on export performance; and
- local content subsidies are subsidies contingent on the use of domestic over imported goods.

Some export subsidies are not prohibited (e.g. agreed-upon agricultural subsidies), while others are not prohibited but may nonetheless be *actionable subsidies*<sup>15</sup> (i.e. subject to challenge in the WTO dispute resolution mechanism). This mechanism is not invoked

---

<sup>13</sup> W. Milberg (2007) p.31

<sup>14</sup> Examples of *prohibited export subsidies* are: currency retention schemes which involve a bonus to exporters; internal transport and freight charges on export shipments that are more favorable than for domestic shipments; provision of goods and services for export manufacturing more favorable than domestically consumed goods; exemptions or allowances for direct taxes or other charges to exports or for export performance; exemption or remission of export taxes or indirect taxes in excess of those levied on products when sold for domestic consumption; export credit guarantees or insurance at premium rates which are inadequate to cover the long-term operating costs and losses of the insurer; and export credit rates below the cost of funds. From FIAS (2008) pp.54-55

<sup>15</sup> Examples of *actionable subsidies* are those having an adverse effect on international trade, because they either cause injury to the domestic industry of another member country; nullify or impair WTO benefits; or cause serious prejudice to the interests of another member country (e.g. nullify tariff concessions). From FIAS (2008) pp.54-55

automatically but is contingent on one (or more) WTO members filing a complaint against another WTO member<sup>16</sup>.

The World Economic Processing Zones Association (WEPZA) noted in 2001 that a cursory review of member websites revealed that 20 (of 25 reviewed) countries were 'potentially in violation of their WTO commitments'<sup>17</sup>.

There are some implications for FTZ in the General Agreement on Trade in Services (GATS) and the Agreement on Trade Related Investment Measures (TRIMS)<sup>18</sup>. GATS reiterates the Most-Favoured Nation (MFN) principles for services, although some FTZ offer concessions to certain companies for certain activities that may give rise to differential treatment (i.e. within versus outside FTZ) of companies depending on nationality. TRIMS prohibits domestic content requirements, and, while FTZ are not mentioned explicitly, they may be argued to be trade-related investment measures.

The general consensus is that FTZ regimes are consistent with the WTO as long as their benefits are not contingent on export performance, use of local content, or maintenance of a foreign exchange balance; or primarily benefit a specific firm, industry, or other interest. FTZ regimes that have specific incentives linked to export performance (e.g. minimum export requirements, subsidized rent or utilities, or a lower tax on export income) are not compatible with WTO mandates and likely need to be altered<sup>19</sup>.

#### 5.4. Regional Free Trade Agreements (FTA) & FTZ

Regional Free Trade Agreements (FTA), such as the North American NAFTA, may contain provisions limiting duty drawback/exemption schemes that can have significant implications for FTZ programs<sup>20</sup>.

The justification of such a limitation is to avoid 'trade circumvention'<sup>21</sup>, whereby a foreign good (from a country not party to the FTA) is brought into an FTZ in country A, where it may be processed before being exported to country B. If the foreign good were imported directly into country B it would be subject to a duty. By 'diverting' trade to country A and using an FTZ, the foreign component could be brought into country B without payment of duty if there was no limitation on the duty drawback claimed by the FTZ-user in country A.

NAFTA Article 303 (Duty Drawback) applies to goods with non-NAFTA components (on which duty is payable in a NAFTA country) which are included into goods considered to be of NAFTA-country origin. It effectively limits the amount of duty on the imported non-NAFTA goods that can be relieved under duty drawback (or through the US-FTZ program).

---

<sup>16</sup> W. Milberg (2007) p.32

<sup>17</sup> Haywood (2001). Note that some of those potential violations were against prospective (i.e. 2003) commitments.

<sup>18</sup> W. Milberg (2007) pp.33-34

<sup>19</sup> FIAS (2008) pp.54-55

<sup>20</sup> Engman et al (2007) p.5

<sup>21</sup> Engman et al (2007) p.51

Where a good is imported into the territory of a NAFTA-party (e.g. a US-FTZ) pursuant to a duty deferral program and is subsequently exported to the territory of another NAFTA-party (e.g. Canada) or is used as a material in the production of another good that is subsequently exported to the territory of another party, the NAFTA-party from whose territory the good is exported<sup>22</sup>:

- a) shall assess the customs duties as if the exported good had been withdrawn for domestic consumption (i.e. apply the duty rate applicable on the value of the non-NAFTA imported goods as if they had entered the NAFTA country); and
- b) may waive or reduce such customs duties to the extent permitted under NAFTA Article 303 (i.e. the *lesser* of the total amount of customs duties paid or owed on the good on importation into its territory and the total amount of Customs duties paid to another party on the good that has been subsequently exported to the territory of that other party).

*Example:*

South Korean (i.e. non-NAFTA) component valued at US\$1,000 would have US duty rate of 5% if imported into the US (i.e. US Customs payable of US\$50). This component is admitted to a US-FTZ where no duty is paid, and processing into a finished good, valued at US\$10,000 which is to be exported to Canada, where (as a NAFTA-country of origin good i.e. product of USA) it has no Canada duty payable.

- In the absence of NAFTA Article 303, the FTZ-user would normally receive full duty relief (i.e. not have to pay the US\$50 in US-Customs duty on the imported component).
- With NAFTA Article 303, the FTZ-user can only receive a duty drawback (i.e. duty relief) that is the *lesser* of: a) what it would have paid in US-Customs duty payable on the import of the component into the US (i.e US\$50) or b) what it pays to Canada Customs on the import of the finished good into Canada (i.e. US\$0). Therefore, as the lesser of US\$50 and US\$0 is US\$0, the FTZ-user is only eligible to get duty relief of US\$0 (i.e. they must pay the US\$50 in US Customs duty).

The US-National Association of Foreign Trade Zones (NAFTZ) has targeted NAFTA Article 303 as a constraint on benefits flowing from FTZ-status and is attempting to have the restriction on duty drawback/exemption removed through US-legislation<sup>23</sup>. It is unlikely that such a change to an international agreement could be made unilaterally through US-legislation without the agreement of Canada and Mexico.

---

<sup>22</sup> US-ITC (2005)

<sup>23</sup> Conversation with W. Berry (NAFTZ).

## 5.5. Declining Duty Rates & FTZ

As global tariffs continue to fall with successive rounds of WTO agreements (e.g. current Doha Round), the benefits conferred under FTZ related to duty exemption or duty deferral diminish. Much of the ebb and flow of activities that have historically been undertaken under US-FTZ procedures can be traced to the diminishment of benefits as a result of tariff reductions.

The concentration of FTZ-benefits flowing from 'inverted tariff' anomalies in the US Tariff Schedule have been the main driving force behind continued (and expanded) use of the US-FTZ program.

While duty exemption and duty deferral remain the primary focus of FTZ programs, increasingly other aspects of FTZ-procedures are generating a greater proportion of benefits, including<sup>24</sup>:

- streamlined Customs processing procedures;
- exemption or deferral from payment of value-added (VAT)/goods and services(GST)/sales taxes on intermediate inputs, components, materials (imported and domestic) or capital goods used in production of finished goods or services; and
- various other incentives (often offered by regional/local governments) for business investments, infrastructure support for property or facility development, employee hiring or retention of development, and subsidized rates for utilities (e.g. water, electricity).

---

<sup>24</sup> Engman et al (2007) p.17

## 6. US-FTZ Program & Customs Duty Deferral

### 6.1. US-FTZ Program

US-FTZ are designated areas licensed by the Foreign-Trade Zone Board (US-FTZB), in which special customs procedures apply to encourage international trade and facilitate custom duty payments. For the purposes of US-Customs only, the FTZ are considered outside US territory<sup>25</sup> so that goods received are generally not subject to duties, tariffs or quotas (until they leave for domestic or foreign market entry). FTZ allow domestic US-activities involving foreign items to take place as if these activities were outside US-Customs territory for duty payment purposes, thus offsetting advantages available to overseas producers who export into the US, and helping make US operations more competitive in international markets.

#### 6.1.1 History of US-FTZ Act & Program

The US-Congress established the US Foreign-Trade Zone Program in 1934 as an economic development incentive intended to create and retain US jobs and investments and to encourage and facilitate US international trade (i.e. exports and imports). It is important to remember that in 1930, the *Hawley-Smoot Tariff Act* raised US-tariffs to nearly 60% and choked world trade (and thereby deepening and extending the Great Depression). The *FTZ Act* in 1934 was designed, in part, to offset the harmful effects of US-protectionism<sup>26</sup>.

The US-FTZ program has its legal basis in the *Foreign Trade Zone (FTZ) Act* (19 USC 81) and two sets of regulations: the *FTZ Regulations* (15 CFR Part 400) and the *Customs Regulations* (19 CFR Part 146). The *Act* covers the administration and regulation of FTZ, while the *Regulations* provide the technical details concerning their management and customs privileges<sup>27</sup>.

A review of the historical debate surrounding the 1934 introduction of the *FTZ Act* indicates that the potential of FTZ-manufacturers to ‘compete’ (in the US-domestic market) with US-manufacturers (i.e. outside of FTZ) was of concern, and the original policy intent was to promote export and trans-shipment trade<sup>28</sup>. Initially, manufacturing activities were excluded from FTZ. This resulted in very limited activity during the 1930s and 1940s.

The 1950 (‘Boggs’) amendments broadened the scope of FTZ activities to permit manufacturing within zones<sup>29</sup>. Manufacturing enabled the transformation of foreign materials into manufactured goods for export as well as for import to the US domestic market. However, as the full value of the finished goods (e.g. labour, overhead, profit) was incorporated into the assessed value of goods for US tariffs upon entry into the domestic market, there was initially little expansion of FTZ-manufacturing activity<sup>30</sup>.

---

<sup>25</sup> US-Customs Territory includes the 50 US-States, the District of Columbia and Puerto Rico.

<sup>26</sup> Alavi-Thomson (1988) p.205

<sup>27</sup> Otsubo (2005) p.18

<sup>28</sup> Otsubo (2005) pp.22, 24

<sup>29</sup> Otsubo (2005) p.24

<sup>30</sup> FTZ-RC (website) *Foreign-Trade Zone History* p.2

In 1952, an amendment to the FTZ regulation provided for FTZ ‘subzones’ for specialized activities that could not be performed within a ‘general purpose zone’<sup>31</sup>. Subzones are technically subordinate and physically separate areas of general purpose zones. The subzone feature has been the ‘engine of growth’ in US-FTZ and has been responsible for the majority of shipment growth since the 1980s<sup>32</sup>. It allowed the 1950 ‘Boggs Amendment’ authorizing manufacturing to impact on FTZ-activity for existing manufacturing plants which could now gain FTZ-status as subzones<sup>33</sup>.

The evolution of the US-FTZ experience, away from export facilitation towards import facilitation, has been recognized in various annual reports of the US-FTZ Board. It is clear in language used that there is a strong preference for claiming FTZ-advantages related to promoting US-exports, but the significant expansion of FTZ in the 1980s and 1990s was mainly supportive of US-imports<sup>34</sup>. More recently, the advantages of import facilitation have been articulated in terms of maintaining US-producer internationally competitiveness for ‘both export markets and finished-product imports’<sup>35</sup>.

A US-Government Accounting Office (GAO) study in the late-1980s found that ‘it does not appear that the *Act* and its 1950 amendment anticipated the extent to which zones would reduce tariffs (i.e. through the ‘inverted tariff’ benefit) and become a major base for serving domestic markets’<sup>36</sup>. Furthermore, there was a paradox in subzone ‘inverted tariff’ arguments for benefits which were seen as changing the FTZ mandate: ‘although originally created in order to encourage export-oriented trade, in its current form the program provides greater benefits to firms who import more parts’<sup>37</sup>. The US-GAO also questioned whether ‘FTZ status has been of any real consequence in convincing transplant (i.e. foreign automakers) (or tradition domestic manufacturers for that matter) to locate or retain assembly operation in (the US)’<sup>38</sup>.

The ‘explosion’ of US-FTZ activity (mostly destined for the US-domestic market) resulted from the 1980 US-Customs ruling that exempted FTZ-value-added (i.e. labour, overhead, profit) from inclusion into the value of imported for the assessment of US duty rates<sup>39</sup>. Only the value of the foreign non-duty-paid content was assessed for payment of US duty rates.

According to a US-Government official: ‘US-FTZ help *level the playing field* in terms of the business costs associated with importation and customs clearance’ and ‘assist state and local officials to develop their economies by attracting foreign commerce’. By helping US

---

<sup>31</sup> Otsubo (2005) p.24

<sup>32</sup> Otsubo (2005) p.25

<sup>33</sup> US-GAO (1989) p.18

<sup>34</sup> Otsubo (2005) pp.30-31, noting ‘favourable’ commentary in 1989 US-FTZB annual report when the export-to-import ratio increased.

<sup>35</sup> Otsubo (2005) p.32, citing US-FTZB (1996). In a 1984 ruling on a subzone proposal for a bicycle assembly firm, the US-FTZB noted the ‘balance’ required in ‘weighing the arguments of proponents that zone procedures help finished-product industries in their international competitive efforts, against the concerns of component producers that zone procedures encourage imports’ (i.e. of components).

<sup>36</sup> US-GAO (1989) p.2

<sup>37</sup> US-GAO (1989) p.37

<sup>38</sup> US-GAO (1989) p.38

<sup>39</sup> FTZ-RC (website) *Foreign-Trade Zone History* p.3

companies improve their international competitiveness, US-FTZ ‘help retain local business and encourage the development of additional jobs’ and ‘facilitate international trade’<sup>40</sup>.

### *6.1.2 Types of US-FTZ*

A US-FTZ must be located within 60 miles (100km) or 90 minutes travel time from a US-Customs Port of Entry (i.e. sea-port, air-port, road border crossing).

There are two types of zones: general-purpose zones and special-purpose subzones.

**General-Purpose Zones (GPZ):** are operated under public utility principles under the sponsorship of a corporation granted authority by the Foreign-Trade Zones Board and under the supervision of US-Customs. General-purpose zones are usually located in industrial parks or in seaport and airport complexes with facilities available for use by the general public. The ‘grantee’ of general-purpose zone status has the direct relationship with the FTZ Board.

The ‘grantee’ often contracts to an ‘operator’ (or operators) for management of the FTZ. The ‘operator’ sublets FTZ land and facilities to FTZ ‘users’ and usually performs various services as a customs broker, managing the relationship with US-Customs and responsible for filing of declarations and reports on behalf of users; and

**Special-Purpose Subzones:** are subordinate to a particular general-purpose zone, and typically involve all or a part of a single company's operations used for their exclusive use. Subzones are sponsored by a general-purpose zone grantee on behalf of an individual firm (or firms) as the ‘user’. Normally, the firm would act as its own ‘operator’ and maintain a direct relationship with US-Customs. Subzones are single-purpose sites for operations that cannot be feasibly moved to, or accommodated in, a general purpose zone (e.g. oil refining and automobile manufacturing).

### *6.1.3 Role of US-FTZ Board*

Congress established the Foreign-Trade Zones Board in 1934 to license and regulate FTZ. The US-FTZ Board grants general-purpose zone status to qualified public and private entities (e.g. port authorities and city/county economic developers). The US-FTZ Board consists of the Secretaries of Commerce and Treasury. Within the Department of Commerce, the US-FTZ Board is administered as part of the US-Import Administration.

The US-Treasury is responsible for the revenue impact of the FTZ program and overall regulatory policy.

US-Customs and Border Protection (CBP) is part of US-Homeland Security and is responsible for FTZ operational and enforcement duties. The US-Customs Port Director oversees the FTZ as a representative of the US-FTZ Board.

---

<sup>40</sup> Puccinelli (2003) with emphasis added. The author is with the US-FTZ Board (part of the US-Import Administration).

The main function of the US-FTZ Board is to make the initial ‘grant’ of FTZ-status for a general-purpose zone to a ‘grantee’ to operate a FTZ. Generally, grantees are public-type corporations such as cities, counties, port authorities. The FTZ-grantee may enter into a contractual arrangement with one or several operators to manage the FTZ-operations. The process to apply to become an FTZ-grantee can take up to 12 months (for manufacturing activity the process is accelerated to less than 8 months). This has been a paper-based process requiring up to 8 copies of documentation that could run to 3-5” of binders containing thousands of pages. This practice is being discouraged, with an emphasis on quality, relevant information, which will in the future be able to be submitted electronically<sup>41</sup>.

In addition, the US-FTZ Board approves changes or additions to the approved sites (land holdings authorized for FTZ-use), expansion of manufacturing authority, subzone approvals, and application of ‘inverted tariff’ benefits. The US-FTZ Board is working to encourage grantees to remove properties from their approved applications when such properties are no longer being used under FTZ-procedures<sup>42</sup>. There is some reluctance to do this, given the perceived benefits from maintaining ‘potential FTZ-use’ status. However, there is a process to ‘lapse’ FTZ-authorization if a subzone has not been actively used under FTZ-procedures for more than 5 years, or if a GPZ has not been actively used (by a single user) under FTZ-procedures for more than 5 years.

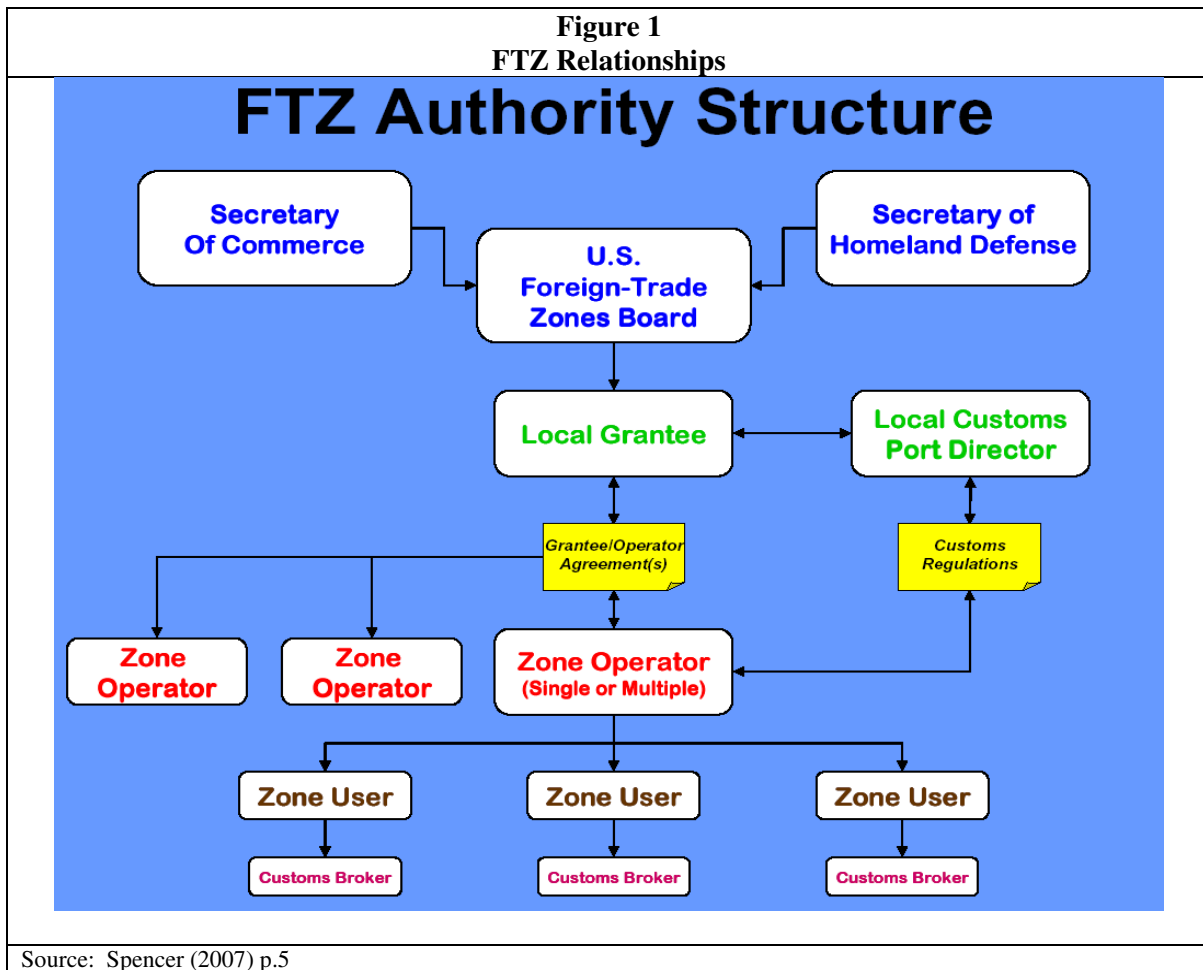
It would appear that about 20 of the total 273 approved GPZ have lapsed, although only 161 were actively in operation in 2007. There have been some situations where property management firms have become FTZ grantees (for the purposes of developing industrial land and sites), but their involvement is now discouraged by US-FTZB.

Figure 1 described the relationships involved in the US-FTZ Board, grantee, operator, user and US-Customs.

---

<sup>41</sup> E. Whiteman (2009) teleconference. Ms Whiteman is with the US-Import Administration (part of US-Commerce department).

<sup>42</sup> E. Whiteman (2009) teleconference.



The US-FTZ Board does not have any direct relationship with the FTZ-operator<sup>43</sup>, who may manage the land, facilities and operations of the FTZ under an agreement with the grantee. The FTZ-operator is, however, the party with whom US-Customs maintains an ongoing relationship. In some cases the operator may be the actual ‘FTZ-user’ (i.e. company engaged in FTZ-operations – this is normally the case for subzones), while in many cases the FTZ-operator may act as a ‘customs broker’ for companies engaged in FTZ-operations. If the operator is acting as customs broker, they must be licensed, and post a bond with US-Customs. An FTZ-operator engaged in ‘entry’ (i.e. movement of goods from FTZ into US-Customs territory) must have a customs license. An FTZ-operator who is only engaged in ‘admissions’ (i.e. movement of goods into the FTZ) does not need to be licensed as a customs broker.

The US-FTZ Board can (under existing legislation) levy fines of up to US\$1,000 per day per violation on grantees, but the administrative mechanism to implement such penalties has never been established. Nor has the grant of an FTZ ever been revoked. Generally, compliance measures have been left to US-Customs, which can ‘suspend’ or ‘terminate’ the ability of an FTZ-operator to conduct activities under FTZ-procedures.

<sup>43</sup> There are a number of large companies who specialize in FTZ-operator roles, including the Rockefeller Group.

Although the FTZ-operator is directly responsible for inventory control and recordkeeping, the grantee is considered by US-Customs to be ultimately liable for any outstanding fines, penalties and/or liquidated damages should the GPZ of subzone operator be unable to pay them<sup>44</sup>.

The FTZ-operator must post an *Operator's Bond* sufficient to cover the potential duty on the type of merchandise admitted. The regulatory minimum bond is US\$50,000. The actual amount is based on the individual discretion of the US-Customs Port Director.

Compliance assessment may result in warnings, penalties or liquidated damages (e.g. money which the operator agrees to pay to compensate for damages, often difficult to determine, to the surety (i.e. person underwriting the operator security bond) arising from a default by the operator in their performance under the bond)<sup>45</sup>.

There are costs associated with operating within a US-FTZ in terms of: filings with the US-FTZ Board for authorization to establish FTZ-operations; other activation fees; systems/software costs for inventory and filing systems; compliance costs; and FTZ-lease fees<sup>46</sup>.

#### 6.1.4 Volume of US-FTZ Activity

In 1980, there were only 35 active US-FTZ (general purpose and subzones)<sup>47</sup>. By 2002, there were 353 US-FTZ (116 general purpose and 237 subzones)<sup>48</sup>. These are shown geographically in Figure 2.

In 1980, annual shipments from US-FTZ were less than US\$3B with employment of about 10,000 engaged in zone activities<sup>49</sup>. By 2002, annual shipments had risen to US\$200B with employment of 320,000<sup>50</sup>. However, the ratio of FTZ exports-to-imports has fallen from 71% (1982) to 22% (2002), indicating that the focus of the FTZ program has been reoriented from export-facilitation to import-facilitation<sup>51</sup>.

Close to 5% of US imports flow through FTZ.

Additional data on US-FTZ operations can be found in Annex 1.

---

<sup>44</sup> FTZ-RC (website) *Foreign-Trade Zone Grantee Responsibilities* p.2

<sup>45</sup> In particular, the operator and surety agree to pay any duties, taxes, and charges found to be due on any merchandise, properly admitted to the zone, which is found to be missing from the zone or cannot be accounted for in the zone; and agree to exonerate the US and its officers from any risk, loss, or expense arising from the operation of the foreign-trade zone or subzone. US-Customs (2008) p.173

<sup>46</sup> McGee (2006) p.12 estimates that certain of these costs are about US\$100,00/year (excluding land/building rental or occupancy costs), with additional first year 'set-up' costs of perhaps a further US\$100,000. Spencer (2007) p.22 estimates that an initial FTZ-approval costs an additional US\$125,000 in consulting fees.

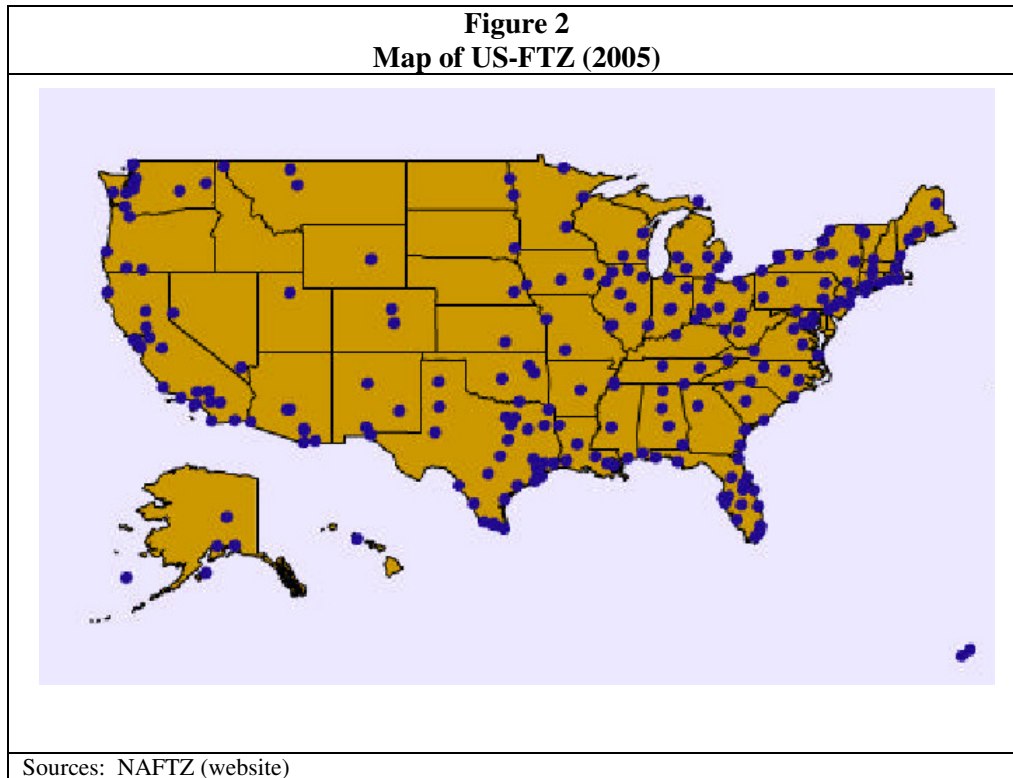
<sup>47</sup> Otsubo (2005) p.30. 'Active' means there was at least one firm in operation under zone procedures.

<sup>48</sup> Otsubo (2005) p.30.

<sup>49</sup> Otsubo (2005) pp.11-12

<sup>50</sup> Otsubo (2005) p.12

<sup>51</sup> Otsubo (2005) p.14



### 6.1.5 Basic Mechanics of FTZ Activity<sup>52</sup>

Domestic goods are shipped into an FTZ generally without any US-Customs paperwork or special FTZ-procedures.

Imported goods are ‘admitted’ into an FTZ (requiring the operator to submit a request and documentation to the US-Customs Port Director, who issues a Permit for Admission).

US-Customs Form (*CF214*) is used for admission of foreign good into an FTZ. The form is usually handled by a Customs Broker or Operator for the FTZ-user. Information included on a *CF214* is the same as the information on a US-Customs entry form, except that it may also be used as a delivery ticket. The goods are designated in one of four categories, as either:

1. *Domestic Status*: goods originating from within the US Customs Territory, either as domestically produced goods, or foreign goods on which duty has already been paid; or
2. *Zone Restricted (ZR) Status*: for the sole purpose of exportation of the imported goods<sup>53</sup>. ZR-status goods cannot be processed/changed or brought into the US-Customs territory without the specific permission of the FTZ-Board on a case-by-case review; or

<sup>52</sup> Most of this material comes from Carver (2005)

<sup>53</sup> In addition, goods for destruction or storage are ZR-status.

3. *Privileged Foreign (PF) Status*: for goods previously cleared by US-Customs<sup>54</sup>, whose condition is already classified and appraised with duties and taxes determined. PF-status cannot be changed; or
4. *Non-Privileged Foreign (NPF) Status*: for goods not previously cleared by US-Customs, whose condition is appraised when the goods leave the FTZ and enter US-Customs territory. NPF-status may be changed upon approval from US-Customs, provided the goods are still in the same condition as when admitted to the FTZ. NPF-status goods can be processed/manufactured into another good with a different tariff classification. NPF-status allows FTZ-users to pay duty at the rate of the finished product produced in the zone.

US-Customs Form (*CF214*) and the Operator's internal 'Receiving Report' make up the initiation of the inventory control and record keeping system, which must meet US-Customs requirements. Imported goods that will receive 'inverted tariff' benefits are entered as NPF-status (i.e. their tariff classification is not appraised at the time of admission into the FTZ) so that they can be subsequently appraised to the tariff classification of the finished good (i.e. their tariff classification is appraised at the time of removal from the FTZ and entry to the US-Customs territory)<sup>55</sup>.

US-Customs Form (*CF216*) is an application for FTZ-activity to be performed on or with the goods. A blanket *CF216* may be filed for a period of up to one year covering all types of activity anticipated. The Operator must maintain records, and document approved activities to provide an accounting and audit trail of the merchandise through the approved operation.

US-Customs Form (*CF3461*) is required to remove goods from an FTZ for 'entry' into US-Customs territory. FTZ-users may obtain US-Customs permission for unrestricted shipments out of the zone, based on a weekly estimate approved prior to the start of the week<sup>56</sup>. For 'entry' purposes, the finished goods leaving a US-FTZ must be declared to have a non-US 'country of origin'. The declared 'country of origin' is the foreign country with the highest value of imported components in the finished good<sup>57</sup>. However, under NAFTA the finished good exported from a US-FTZ to Canada may be treated as having US-country of origin if it meets NAFTA content requirements<sup>58</sup>.

US-Customs Form (*CF7512*) is required to remove goods from an FTZ for export or transfer to another FTZ.

---

<sup>54</sup> In addition, goods subject to Special Import Measures (e.g. anti-dumping or countervail) are PF-status.

<sup>55</sup> S. Grant (2009) teleconference. Electronic filing of the *CF214* admissions document is possible under the *E214* program.

<sup>56</sup> McGee (2006) p.7

<sup>57</sup> The proposed *Trade Agreement Parity Bill (TAP)* (see below) seeks to change this FTZ-requirement to allow FTZ finished goods to be eligible to meet 'rules of origin' under various US-FTA that might have a more favourable US tariff rate on the finished good.

<sup>58</sup> Bailey Barnes-Whiteman (2008) p.239. This can give rise to the 'trade fiction' that two exactly similar BMW automobiles manufactured at the Spartansburg (SC) FTZ are: 1) Germany-country of origin for import into the US-domestic market; and 2) US-country of origin for export into Canada.

The FTZ-operator or FTZ-user *Inventory Tracking System* (ITS) must track and account for all goods in an FTZ and provide sufficient information for goods to be removed from the zone. ITS records must indicate:

- 1) location of merchandise;
- 2) zone status;
- 3) beginning balance, receipts, removals and current balance;
- 4) any destruction, scrap, waste, and by-products; and
- 5) cost or value (i.e. unless the FTZ-operator financial records maintain cost or value and are made available for US-Customs review).

US-Customs requires a physical inventory at least once per year or a cycle-count procedure, and an annual reconciliation report. The annual reconciliation report must be available for US-Customs to review and a letter stating that the report has been prepared must be sent to the local US-Customs Port Director.

US-Customs accepts First-In-First-Out, Foreign-In-First-Out, unique-identifier-number, lot-specific, part-number, bill-of-materials, liquid-bulk, serial-number-specific, and almost any other inventory control system that 'protects the revenue of the US'. If an FTZ-operator can demonstrate raw material balance, inputs to production, finished product balance and some form or correlation between the three, this is satisfactory for US-Customs. Inventory discrepancies must be recorded in ITS and financial systems and reports to US-Customs if over 1% of quantity *and* over US\$100 in duty owed.

Many products subject to an Internal Revenue tax may not be manufactured in an FTZ, including: alcoholic beverages, products containing alcoholic beverages (except domestic denatured distilled spirits), perfumes containing alcohol, tobacco products, firearms, and sugar. In addition, the manufacture of clock and watch movements is not permitted in an FTZ. No retail trade of foreign merchandise may be conducted in a FTZ. However, foreign and domestic merchandise may be stored, examined, sampled, and exhibited in an FTZ.

#### 6.1.6 US-FTZ Benefits

Due to its privileged status in how US customs duties are administered and imposed, the FTZ program generally can provide users with a wide range of benefits. Spencer (2008) claims that a US-distributor should be able to achieve savings from FTZ-operation if they<sup>59</sup>:

- import more than US\$100M per year;
- file more than 1,000 US-Customs entries per year; or

---

<sup>59</sup> Spencer (2008) p.50. Also, benefits from FTZ-operations are 3-10 times the cost of operating within an FTZ.

- operate a distribution centre larger than 300,000 ft<sup>2</sup>.

Generally, the ‘inverted tariff’ savings (described below) have been the principal driver of FTZ-benefits over the past 35 years<sup>60</sup>. However, it should be noted that ‘inverted tariff’ benefits are only available on a ‘case-by-case’ basis and must be authorized by the US-FTZ Board for a specific location and activity that meets a ‘public interest’ test<sup>61</sup>.

FTZ-benefits include<sup>62</sup>:

1. *Duty Exemption*: on imported goods to an FTZ that are subsequently exported, no customs duty is paid<sup>63</sup>. Generally, duties are eliminated on US-imports of foreign goods admitted into an FTZ (i.e. stored or used in a manufacturing process) which are subsequently US-exports to a foreign country. Normally (and outside FTZ-procedures)<sup>64</sup>, the US-based company would have to pay the customs duties at the time of import and seek a duty drawback (i.e. repayment) upon subsequent export, so the FTZ-benefit is in terms of cash-flow interim financing (i.e. time value of funds between duty payment and duty drawback);
2. *Duty Deferral*: on imported goods to an FTZ that are subsequently entered into the US-domestic market (perhaps in processing form), customs duty are payable when goods leave the FTZ and enter US-Customs territory. Normally, the US-based company would have to pay the customs duties at the time of import, so the FTZ-benefit is in terms of cash-flow interim financing (i.e. time value of funds between goods *admission*<sup>65</sup> into the FTZ and goods *entry*<sup>66</sup> into the US-Customs territory);
3. *Duty Reduction*: on imported goods (i.e. components, raw materials) to an FTZ that are subsequently processed or manufactured into finished goods and entered into the US-domestic market, on which a lower (possibly zero) duty rate applies compared to the duty rate for the imported goods (i.e. *Inverted Tariff*<sup>67</sup> benefit). Manufacturers pay less (or no) customs duty on the entry of finished goods into the US-Customs territory, because the

<sup>60</sup> Spencer (2008) p.50.

<sup>61</sup> The US-FTZ Board ‘*public interest*’ test involves ensuring that FTZ-activity is consistent with US-trade policy and results in a net positive economic effect to the US-economy as a whole, taking into account potential impacts on US-suppliers and plants that are not located in FTZ.

<sup>62</sup> Otsubo (2005) pp.18-20; Deloitte (2008) p.9, citing Lamb & Lerch (2002) p.6 *Is a Foreign Trade Zone for You?*; Spencer (2008) p.50; Miller-Pavilack (1997); and Puccinelli (2003).

<sup>63</sup> There are exceptions to this rule on duty relief for US-exports. For example, under NAFTA Article 303 (‘lesser of’ rule), a US-exporter (for goods shipped to Canada or Mexico – involving imported components from a non-NAFTA country) cannot claim (in duty drawback or remission) more than the ‘lesser of’: (1) the total duties paid or owed on goods imported into the US; or (2) the total amount of duties paid on the exported good upon subsequent importation into Canada/Mexico (i.e. which in many cases is zero under NAFTA). (GPOAccess NAFTA Part 181)

<sup>64</sup> Similar benefits would be available under a Customs Bonded Warehouse for goods undergoing minimal processing.

<sup>65</sup> ‘Admission’ refers to the physical arrival of goods into an FTZ with the appropriate approvals of the grantee and US-Customs. The word ‘admission’ is used instead of ‘entry’ to avoid confusion with administrative processes for goods entering into the US-Customs territory.

<sup>66</sup> ‘Entry’ refers to notification of US-Customs of the arrival of imported goods in the US-Customs territory i.e. goods withdrawn from an FTZ for consumption in the US-domestic market.

<sup>67</sup> ‘Inverted Tariff’ refers to where the customs duty structure encouraged imports of finished goods rather than component goods. The ‘normal’ economic rationale is for ‘Escalating Tariff’, whereby the customs duty structure encouraged imports of component goods and domestic processing of finished goods (i.e. duty rates are higher on finished goods than on components or raw materials).

duty is calculated at the lower rate of the finished goods, compared to the higher rate of the component good or raw material. The ‘inverted-tariff’ benefit is not automatic and must be approved by the US-FTZ Board on a ‘case-by-case’ basis<sup>68</sup>. Generally, the US-FTZ Board approves the use of the MFN rate in the US-Customs tariff schedule for ‘inverted tariff’ benefits. In many cases (especially NAFTA), the tariff rate on the finished good may be zero;

4. *Volume Reduction*: on imported goods to an FTZ that are subsequently entered into the US-domestic market (perhaps in processing form), for which customs duty is payable on the volume of goods that leave the FTZ and enter US-Customs territory, rather than on the volume of goods that were imported and admitted to the FTZ. The FTZ-benefit is that no customs duty is payable on the volume of goods that are eliminated due to defect, damage, obsolescence, waste, or scrap within the FTZ-operation. There are strict requirements on this provision, so that no economic value can relate to the discarded goods (i.e. excludes resale of product ‘seconds’) and the eliminated goods must be destroyed<sup>69</sup>;
5. *Exemption of US-Value-Added (e.g. Labour, Overhead, Profit and US-Materials)*: on US-domestic value-added within the FTZ-operation, for which no customs duty is payable on goods that leave the FTZ and enter US-Customs territory. This is an advantage relative to non-US foreign (e.g. overseas) production, and obviously applies to US-operations both within, and outside of FTZ;
6. *US-Quota Application*: Goods may be stored at an FTZ even if they are subject to a US-quota restriction. The goods may be entered into the US-Customs territory when future quota room is available;
7. *Indefinite Storage*: Goods may remain in an FTZ indefinitely, whether or not they are subject to duty. By contrast, other US-Customs procedures (e.g. Customs Bonded Warehouse (CBW) and Temporary In-Bond (TIB) movements) are subject to time limits;
8. *Exemption from State Inventory Taxes*: Under the *FTZ Act*, imported goods held in inventory and goods produced within FTZ which are intended for export are exempt from

---

<sup>68</sup> Authority to receive ‘inverted tariff’ benefits is not automatic for US-FTZ, and must be approved on a case-by-case basis by the US-FTZ Board based on a ‘public interest’ which looks at benefits to the US-economy as a whole (e.g. jobs gained or protected relative to foreign location advantages or competition), rather than state-by-state or company-level benefits. ‘Inverted tariff’ benefits are approved for specific manufacturing operations, and significant changes to such operations require further US-FTZB approval. The US-FTZ Board is not inclined to accord ‘inverted tariff’ benefits in cases of shifting jobs from one state to another, or to benefit a company at the expense of other US-companies.

In 2004, an additional method for achieving ‘inverted tariff’ benefits was introduced to expedite and reduce the cost of access to such benefits for small and medium sized enterprises (SME). The Temporary/Interim Manufacturing (T/IM) authority allows for inverted tariff benefits of up to 2 years under a 75-day process, provided that the activity is ‘non-controversial’ and similar to recent US-FTZ Board approvals. It can apply to up to 60 imported inputs and 10 finished products (at the 6-digit Harmonized Tariff Schedule (HTS) level of classification detail. (Bailey Barnes-Whiteman (2008) p.90)

<sup>69</sup> Goods sold as ‘scrap’ are not considered ‘destroyed’ and are entered into the US-Customs territory under scrap provisions at a zero duty rate. For example: a chemical plant manufacturing a product (with a 15% duty rate) uses the raw material (with the same 15% duty rate). In production, which involves bringing the raw material to extreme temperatures, about 30% of the raw material is lost as heat. No customs duty is paid on the 30% of the imported volume lost in the processing.

certain US-States<sup>70</sup> and local *ad valorem* taxes on ‘tangible personal property’. Generally, this exemption applies to all goods (i.e. domestic and imported) held in inventory within an FTZ. This exemption would be of considerable benefit to US oil refineries in Texas and Louisiana;

9. *Zone-to-Zone Transfers*: Goods can be transferred in-bond from one FTZ to another FTZ within being considered to have entered into US-Customs territory. This effectively extends the period of duty deferral through the supply chain until the finished good is either entered into the US-Customs territory for US-domestic consumption (i.e. duty deferral), or exported from the US (i.e. duty relief); and

10. *Streamlining of US-Customs Procedures*: can result in direct savings for various US-Customs fees and cash-flow savings from improved logistics management within the FTZ. These streamlined and simplified US-Customs procedures reduce the time required for customs clearance and support Just-In-Time (JIT) logistics and broader supply-chain management issues. These include:

- Direct Delivery Procedure (DDP) enables imported goods (i.e. ‘low-risk’ repetitive shipments under the control of the FTZ-user i.e. owned or purchased) to be transported directly to FTZ-user facilities without reporting to the local US-Customs office, thereby permitting ‘24/7’ JIT operations<sup>71</sup>;
- Weekly Entry Procedure (WEP) streamlines shipments and customs paperwork by requiring a single advance filing of US-Customs admission/entry documentation per week for an expected volume of goods (i.e. as opposed to one US-Customs admission/entry filing per shipment). There is an administrative Merchandise Processing Fee (MPF) of US\$485<sup>72</sup> per US-Customs filing, so the WEP can have significant savings if an FTZ-user has hundreds or thousands of weekly shipments<sup>73</sup>. Furthermore, payment of MPF is deferred until goods leave the FTZ;
- Harbour Maintenance Fees (HMF)<sup>74</sup> are paid quarterly on goods received within FTZ;
- E214 (electronic filing of CF214), Automated Broker Interface (ABI) for electronic filing of US-Customs administrative forms, and Automated Commercial Environment (ACE) secure data portal accounts with US-Customs<sup>75</sup>; and

<sup>70</sup> Several US-States have eliminated their ‘inventory tax’ over the past decade, so that in 2009, perhaps this tax only remained in effect in 8 States (i.e. Georgia, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Texas, West Virginia) (website: <http://www.justanswer.com/questions/wsr4-inventory-tax-rates-us-state>)

<sup>71</sup> Delivery can be received prior to the issuance of the admission documentation (CF214), as opposed to the requirement to submit the admission documentation prior to accepting delivery.

<sup>72</sup> W. Berry (NAFTZ) discussion (17 February 2009). Assuming an FTZ-user has 100 shipments per week, the savings from WEP are about US\$48,000/week, or US\$2.5M/year. Allocca (2007) refers to MEP being on an *ad valorem* basis of 0.21% for non-NAFTA imports arriving by ship, plane or truck. US\$485 is the maximum MPF per shipment – with US\$25 as the minimum MPF per shipment.

<sup>73</sup> In addition to the MPF savings per shipment documentation, there is often an associated customs broker fee (perhaps US\$90/shipment) which would be saved from the less frequent weekly filing requirement of WEP.

<sup>74</sup> Allocca (2007) refers to HMF being on an *ad valorem* basis of 0.125% for non-Canadian imports arriving by ship.

<sup>75</sup> US-GAO has frequently been critical of US-Customs administration of duty collection and automated systems, and oversight of the FTZ and Bonded Warehouse programs. See US-GAO (1994) p.5

- C-TPAT<sup>76</sup>-Tier 3 status with US-Customs, which represents the highest level of benefits afforded to importers, requiring certification of exceeding minimum standards, receiving low risk assessment score reductions and adopting C-TPAT best practices<sup>77</sup>. Tier 3 importers are subject to only infrequent random inspections. FTZ 'best practice' includes physical and procedural security manuals and systems, and a security survey (e.g. facilities, personnel, training)<sup>78</sup>.

In addition to the benefits derived from the FTZ program administered at the federal level, there are additional US-State and local business/industrial incentives that may be available to an FTZ-user (i.e. and theoretically available to non-FTZ businesses as well). These may be provided by US-States and Local Governments (e.g. counties, cities, business development agencies) but are not considered (by US-FTZ Board) to have any direct relationship with FTZ-status. They may be available for activities outside and within FTZ and are not associated with the approval process for granting of FTZ-authorization<sup>79</sup>.

It should be noted that duty exemption contributes solely to export promotion, while all other benefits can encourage imports as well as exports<sup>80</sup>. The growing import intensity may imply that the program has shifted its emphasis from duty exemption to other import supportive benefits.

#### *6.1.7 US-State & Local Incentives*

Companies operating within an FTZ may also be eligible for various US-State and local (i.e. county, municipal) government incentives for business and/or industrial development. One study in the late-1990s claimed that 16 US-States and Puerto Rico offer tax savings opportunities for firms utilizing FTZ<sup>81</sup>.

The US-GAO study of US-FTZ noted that various US-State and local governments have engaged in intense competitions for proposed automobile transplant factories and domestic company plants. These sub-national governments have offered companies incentive packages worth US\$10Ms to US\$100Ms. The State of Kentucky reportedly offered Toyota an incentive package worth an estimated US\$323M over 20 years (about half of this in up-front costs) in the mid-1980s<sup>82</sup>.

---

<sup>76</sup> C-TPAT is the US-Customs Trade Partnership Against Terrorism

<sup>77</sup> Spero (2006)

<sup>78</sup> Spencer (nd) p.4

<sup>79</sup> E. Whiteman (2009) teleconference. It is important to note that whereas certain US-federal business incentives (e.g. grants, subsidies) targeted for export assistance are prohibited under NAFTA and WTO rules, these commitments do no apply to sub-national governments (e.g. States and local).

<sup>80</sup> Otsubo (2005) p.20

<sup>81</sup> Miller-Pavilack (1997)

<sup>82</sup> US-GAO (1989) p.40

The Ohio Department of Development (OH) offers various business incentives including assistance (i.e. grants, low-interest loans, expedited approvals) for<sup>83</sup>:

- *site development*: (e.g. expedited permits; grant funds for public roadway improvements; grant and loan funds for public or private rail improvements; low-interest loan funds for public water/sewer improvements (i.e. made to local authorities); federal grant funds for infrastructure);
- *facility/equipment*: (e.g. grants for on-site or off-site infrastructure improvements; low-interest (i.e. 3%) loans for facility construction/expansion; tax-exempt bond (i.e. low-interest) loans for long-term capital assets (Ohio Enterprise Bonds); low-interest R&D investment loans;
- *workforce development*: (e.g. skills testing, employee recruitment; grants for industrial training; discount on workers' compensation premiums);
- *state tax incentives*: (e.g. refundable tax credit for (>25 full-time) employment creation; non-refundable tax credit for job retention (>1,000 full-time); training tax credit; non-refundable tax credit for R&D investments; sales tax exemption for R&D equipment; non-refundable tax credit for manufacturing machinery/equipment investments; sales tax exemption for manufacturing machinery/equipment; exemption from state inventory tax; technology investment tax credit (for individual taxpayers)); and
- *local tax incentives*: (e.g. reduction (i.e. abatement) on local property taxes (up to 75% for 15-years); exemption from local inventory tax).

Most of these incentives are State-wide for location anywhere in Ohio (obviously local tax incentives are location-specific). Some tax incentives are specific to OH-enterprise zones, which require state certification based on an application by a local government<sup>84</sup>. None are specific to US-FTZ, although these may well be sponsored as an enterprise zone. The Northeast OH-FTZ (#181) provides links to the OH-State website for industrial incentives as part of its webpage marketing<sup>85</sup>.

The Brooklyn Navy Yard (NY) (FTZ-#001) offers various incentives such as<sup>86</sup>:

- exemption from real estate and occupancy tax;
- US\$4,000/employee credits for relocation (up to 12 years);
- low-interest, tax exempt (i.e. Industrial Development Agency) bond financing;
- subsidized energy costs (-30% savings);

<sup>83</sup> OH-DOD (nd) pp.1-2, OH-DOD (website)

<sup>84</sup> OH-DOD (website)

<sup>85</sup> NEOTEC (website)

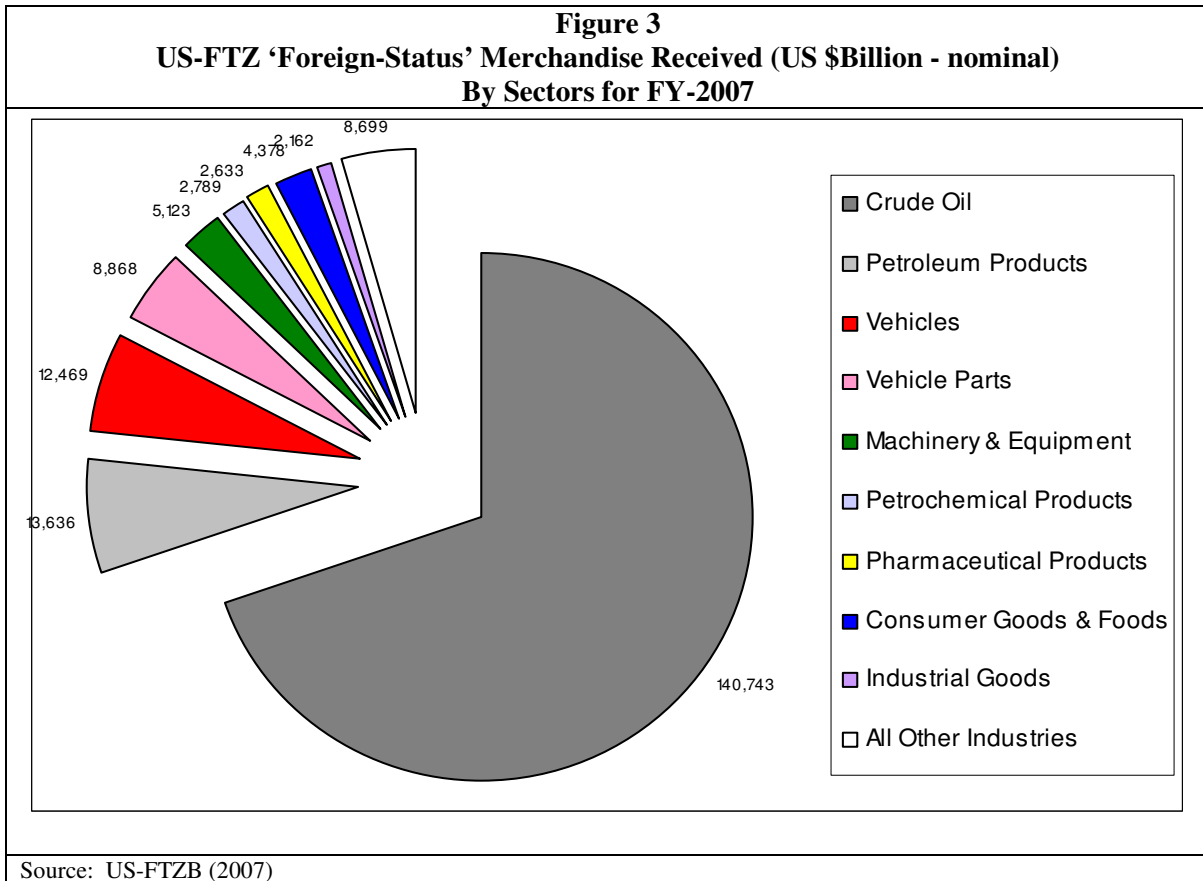
<sup>86</sup> Kayman (2008) pp.6-7

- sales tax exemption (up to US\$100,000/year);
- NY-State and local tax breaks for film/TV production; and
- Empire Zone credits and tax exemption.

6.1.8 Major Users of US-FTZ Benefits

The main US-states with FTZ are Texas (oil-refining), Illinois, Kentucky, Ohio and Pennsylvania<sup>87</sup>.

Figure 3. shows that the majority of imported ‘foreign status’ goods admitted into US-FTZ are related to oil refining and automobile manufacturing and import.



<sup>87</sup> McKenna (2008) p.37, citing NAFTA data.

### US Oil Refineries:

In the 1980s and 1990s, the US-tariff rates on certain refined petroleum products (e.g. petrochemical feedstock) were considerably lower than that on crude oil<sup>88</sup>. Prior to 1995, oil refinery FTZ-subzones were only approved under conditions that prohibited inverted tariff savings<sup>89</sup>. This changed in 1995, which encouraged many US oil refiners to apply for FTZ-subzone licenses. One US oil refiner testified that FTZ-status permitted a 28% customs duty savings (2002) on crude oil imports to its US-refineries<sup>90</sup>. In 2002, there were 60 oil refinery FTZ-subzones accounting for about 50% of US-imports of crude oil<sup>91</sup>.

About 80% of US oil refinery capacity operates under FTZ-procedures<sup>92</sup>. Crude oil imports have US-duty (depending on the crude oil specific gravity<sup>93</sup>) of US\$0.0525/barrel or US\$0.1050/barrel. Data from the US-Energy Information Administration (US-EIA) indicates that about 9% of US oil refinery output is exported (with no duty payable), while another 13% results in refined petroleum products on which no duty is payable (under the inverted tariff arrangement).

- The value of the ‘inverted tariff’ benefits to the US oil refinery sector is estimated to be about US\$40M per annum<sup>94</sup>; and
- The value of the ‘duty deferral’ benefits to the US oil refinery sector is estimated to be about US\$3-4M per annum<sup>95</sup>.

The US oil refinery example shows how ‘inverted tariff’ benefits can be more than 10 times the value of inventory carrying cost associated with duty deferral. It is highly unlikely that the US oil refinery sector would have established FTZ-operations if the only benefit achieved was duty deferral.

---

<sup>88</sup> Otsubo (2005) p.28

<sup>89</sup> Otsubo (2005) p.29

<sup>90</sup> Otsubo (2005) p.29

<sup>91</sup> Otsubo (2005) p.28

<sup>92</sup> Bailey Barnes-Whiteman (2008) p.8.

<sup>93</sup> Depending on API measure of specific gravity. If under 25 degrees API (i.e. ‘heavy’ oil) the duty is US\$0.0525/barrel. If 25 degrees API or more (i.e. ‘medium’ or ‘light’ oil), the duty is US\$0.1050/barrel. According to recent US-EIA data, US-Imports are split about 50%:50% between these categories.

<sup>94</sup> Based on 2008 data (January-November) of 3.3B barrels of crude oil imports at US\$0.0787/barrel import duty (i.e. an average of the US\$0.0525/barrel or US\$0.1050/barrel duty rates, assuming 50%/50% split based on API specific gravity of imports) times 13% refinery output for which ‘inverted tariff’ results in nil duty payable); plus 0.5B barrels of other liquid petroleum imports at US\$0.1050/barrel import duty, times 13% refinery output.

<sup>95</sup> Based on oil refinery throughput of 5.7B barrels, of which 50% is imported crude oil (subject to US\$0.0787/barrel import duty) and 8% is imported liquids (subject to US\$0.1050/barrel import duty), on which 87% involves duty payable – which results in import duties payable (without duty deferral) of US\$240M – which at a cost of capital of 15% and an assumed average time of 35 days between crude oil delivery and refinery output would involve an annual inventory carrying cost of US\$3.4M on the duty payable.

### US (Foreign) Automobile Manufacturers:

In the late-1980s, the US-tariff rate on finished automobiles was 2.5%, considerably lower than that charged on automotive parts (4% average), giving rise to an ‘inverted tariff’ situation which resulted in the establishment of many US-based FTZ manufacturing plants of foreign automakers<sup>96</sup>. By 1987, about 80% of US-auto plants were in FTZ-subzones<sup>97</sup>. At that time, auto-plant manufacturing accounted for 85% of FTZ-activity, and benefited from about US\$30-35M in annual duty relief<sup>98</sup>. However, with the lowering of North American and world duty rates in the 1990s, most of US Big-3 auto-plant production no longer operated under FTZ-procedures<sup>99</sup>.

Foreign automakers benefited from a duty reduction in the establishment of US-plants (in US-FTZ) that manufactured automobiles from foreign components, which would enter the US-Customs territory (after manufacture) at the lower ‘finished’ tariff rate (i.e. 2.5%). During the late 1980s, Toyota, Honda, Nissan, Mazda and Mitsubishi all established US-plants, using FTZ-subzones to reduce duties on imported components<sup>100</sup>. It is thought that almost every auto-plant in the US (except the Big 3) is under FTZ-status<sup>101</sup>.

One prominent example is BMW, which uses FTZ-#038A in Spartanburg (SC) as its US/North American manufacturing/distribution centre. BMW invested US\$500M in 1992 to establish its Greer (SC) facility, and worked with the state of South Carolina to establish an auto-parts cluster of 50 suppliers to support its operations<sup>102</sup>. In 2008, BMW announced plans to invest a further US\$750M in its plant, bringing total US-investments to US\$4.2B<sup>103</sup>. BMW employs 6,000 workers at 3 sites in FTZ-38A (i.e. main plant, tire/wheel assembly, warehouse)<sup>104</sup>.

BMW achieves the 62.5% ‘regional value’ content requirement under NAFTA<sup>105</sup>, and is looking to achieve US-customs savings on imported auto-parts under the proposed (extended) *Trade Agreement Parity* process within its FTZ-operations<sup>106</sup>. In the first half of 2008, 70% of BMW US-production was exported at a value of US\$3B, with about 66% of the export value being US-value-added<sup>107</sup>. BMW has auto-parts suppliers in over 200 locations within NAFTA-territory, including 180 in the US<sup>108</sup>.

---

<sup>96</sup> Otsubo (2005) p.27

<sup>97</sup> US-GAO (1989) p.3

<sup>98</sup> US-GAO (1989) p.40

<sup>99</sup> For example, 14 of 18 approved General Motors FTZ sites were deactivated as of 2008. US-ITA (website)

<sup>100</sup> Otsubo (2005) p.27

<sup>101</sup> McKenna (2008) p.37, citing W. Berry (President-NAFTZ).

<sup>102</sup> Froneberger (2008) p.8

<sup>103</sup> Froneberger (2008) p.9

<sup>104</sup> Miller & Associates (website) p.3

<sup>105</sup> Bailey Barnes (2008) p.54.

<sup>106</sup> Bailey Barnes (2008) p.56, calls TAP a ‘free-trade agreement with US-manufacturers’. See section 6.1.7 below for more detail on the *Trade Agreement Parity Bill* (TAP).

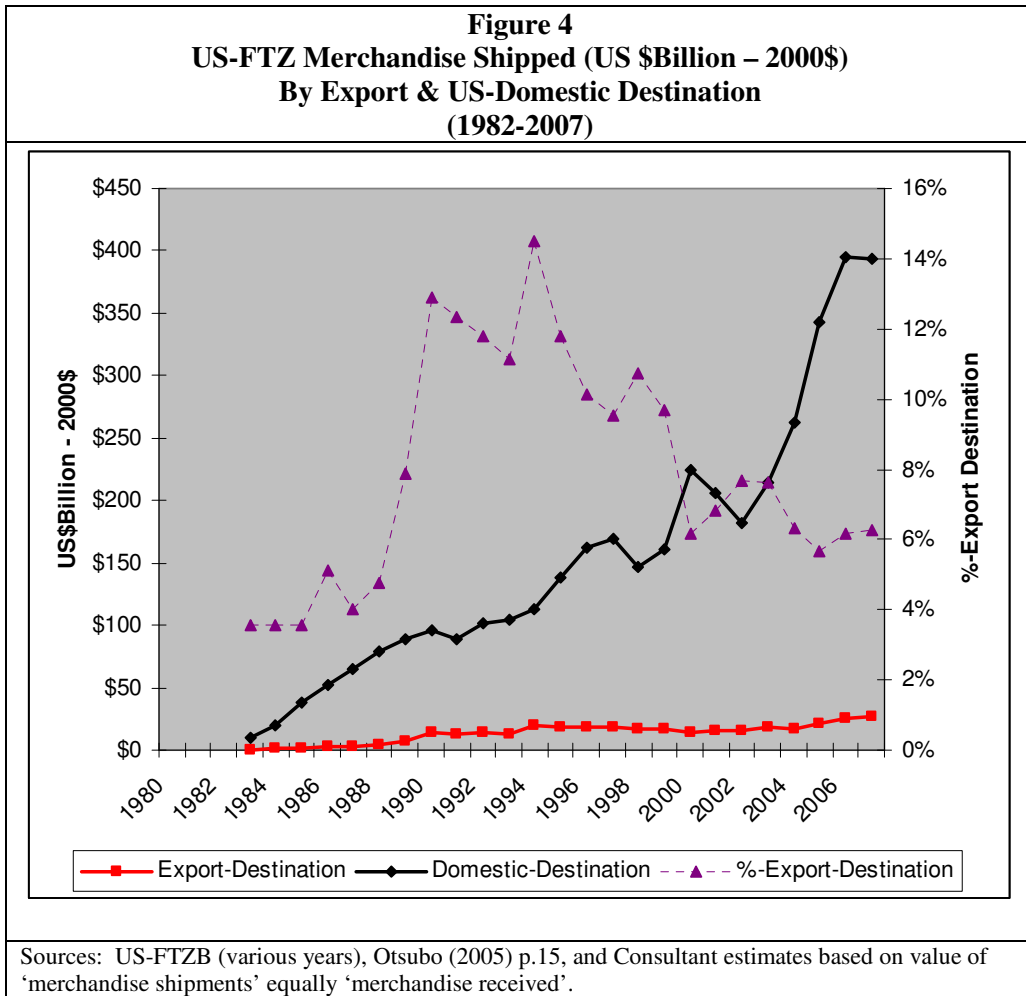
<sup>107</sup> Leibowitz (2008) p.44.

<sup>108</sup> Bailey Barnes (2008) p.54.

The BMW FTZ-site also serves as a North American distribution centre for imported finished automobiles. About 85% of US-duty paid is related to auto-imports to the US, compared to 15% on duty attributable to the US-manufacturing operation.

**FTZ-Shipments – Exports and US-Domestic:**

Figure 4 shows that the vast majority of merchandise removed from US-FTZ enters the US-domestic market (94%), and only a small minority (6%) is for export.



### 6.1.9 NAFTA Article 303 & FTZ

The *United States-Canada Free-Trade Agreement Implementation Act* amended the *Foreign Zones Act* to provide that, with the exception of “drawback eligible goods,” goods withdrawn from a foreign trade zone will be treated as if they are withdrawn for consumption in the United States, thus subject to applicable customs duties.

### 6.1.10 Possible Extension of FTZ Benefits (Trade Agreement Parity)

There is a US legislative proposal, actively sought for the National Association of Foreign Trade Zones (NAFTZ), called the *Trade Agreement Parity Bill* (TAP), which would effectively extend the ‘inverted tariff’ benefit of US-manufacturers by exploiting reduced US-tariff rates available on finished goods available for foreign-manufacturers under the terms of various US ‘free trade agreements’ (FTA). Currently, the US-FTZ Board authorization of ‘inverted tariff’ benefits is limited to the Most Favoured Nation (MFN) duty rate (i.e. Column 1 of the US-Harmonized Tariff Schedule, HTS), even though NAFTA (and other US-FTA) duty rates on the finished product may be lower (i.e. zero).

The US has FTA with 21 countries, including ‘rules of origin’ provisions to qualify for reduced US-tariff rates (or exemption)<sup>109</sup>. It is claimed that US-duties for the import of foreign goods from FTA-countries are higher for US-based companies than they are for FTA-based companies (i.e. this appears to be an extension of the ‘inverted tariff’ situation). With reduced duty rates on finished goods under various FTA, and continued ‘higher’ duty rates on imported components/raw materials, there is an incremental advantage (i.e. due to the FTA) for foreign manufacturers.

Under the proposed TAP, companies operating in FTZ could import foreign goods at reduced FTA tariff rates if their operations met the ‘rules of origin’ of an applicable FTA, and if the reduced duty was ‘not inconsistent with the public interest’ as defined in the *FTZ Act*<sup>110</sup>.

The spirit of TAP is ‘protectionist’ (i.e. defensive) to provide additional advantages for US-domestic manufacturers relative to foreign companies able to benefit from reduced US-tariff rates under an FTA with the US<sup>111</sup>.

A study for the NAFTZ indicated that TAP could create an additional 95,000 jobs and additional capital investment of US\$24B, at a ‘cost’ of reduced US-customs duties of about US\$190M per annum, which would represent about 40% of current FTZ customs duties paid<sup>112</sup>.

---

<sup>109</sup> Leibowitz (2008) p.40. In 2006, US-imports of duty-free goods from FTA-countries were US\$330B (including NAFTA).

<sup>110</sup> Leibowitz (2008) pp.40,42

<sup>111</sup> Leibowitz (2008) p.42.

<sup>112</sup> Leibowitz (2008) p.42, citing a study by Hufbauer-De Rosa for NAFTZ. W. Berry (2008) p.19

## 6.2. US – Other Customs Duty Deferral

Other US-Customs programs exist for activities outside of FTZ which provide duty deferral benefits for US importers and manufacturers.

### 6.2.1 US-Customs Bonded Warehouse

Customs Bonded Warehouses (CBW) are US-Customs regulated facilities that may be operated by independent warehousing firms or by importers. In 1992, there were 1,273 bonded warehouses with duties on merchandise withdrawn accounted for about 2% (US\$310M) of the US\$18.3B in duties collected by US-Customs during fiscal year 1992<sup>113</sup>.

No duty is paid upon a good's arrival to a CBW, however, the importer and warehouse proprietor incur a liability under a bond with US-Customs. This liability is generally cancelled when the goods are<sup>114</sup>:

- exported, or deemed to have been exported;
- withdrawn for domestic consumption within the US, after payment of duty;
- withdrawn as supplies to a vessel (i.e. ship's stores) or aircraft international traffic; or
- destroyed under Customs supervisions.

Accountability for merchandise entering a CBW must be maintained, and the warehouse proprietor's records may be audited on a regular basis. Bonded merchandise may not be co-mingled with domestic merchandise and must be kept separate from unbonded merchandise<sup>115</sup>. Merchandise in a Customs bonded warehouse may, with certain exceptions, be transferred from one CBW to another. Merchandise placed in a CBW may be stored, cleaned, sorted, repacked, or otherwise changed in condition, but not manufactured<sup>116</sup>.

### 6.2.2 US-Customs Temporary In-Bond (TIB) Shipments

*Temporary In-Bond* (TIB) shipments allow goods to transit the US without formally entering the US-domestic market. Imported goods intended for either the US-domestic or foreign markets may move from one US-port to another without being appraised of the cargo or assessed US-Customs duties or quotas and without officially entering US-commerce. The imported cargo is referred to as an *in-bond shipment*, and requires that a responsible party to be covered by a CBP-approved bond and agree to comply with applicable regulations.

---

<sup>113</sup> US-GAO (1994) p.12

<sup>114</sup> US-CBP (2001) p.1

<sup>115</sup> US-CBP (2001) p.3

<sup>116</sup> US-CBP (2001) p.3

The US-trade community believes the flexibilities provided by the in-bond system are needed to facilitate trade, particularly by allowing it to avoid congestion and delays at US-seaports whose infrastructure has not kept up with the dramatic growth in trade<sup>117</sup>.

In-bond goods must be transported by a carrier covered by a US-Customs approved bond that allows goods that have not yet entered US-commerce to move through the US. Such carriers can move goods by ship, truck, rail, plane, or any combination of these. The bond is a contract to ensure performance of obligations imposed by law or regulation and guarantees payment to US-Customs if these obligations are not performed.

The three parties involved in a CBP bond are:

1. the *principal*: which can be an importer, broker, carrier, or other business entity;
2. a *surety*: authorized by US-Treasury to write a US-Customs bond, normally an insurance company; and
3. *US-Customs*: as the beneficiary of the bond if US-Customs finds that the bonded party has violated laws or regulations in moving the in-bond goods and takes action to recover against the bond.

There three types of in-bond shipment movements that importers and shipping agents can use:

1. *Immediate Transportation*: allows merchandise arriving at a US-port to be transported to another US-port where it is entered into US-commerce, or admitted to a bonded warehouse or FTZ;
2. *Transportation and Exportation*: allows merchandise 'in transit' through the US from arrival at one US-port and exported from another US-port without the payment of duties; and
3. *Immediate Exportation*: allows merchandise to be unloaded at a US-port, and immediately exported from the same US-port without payment of duties.

US-trade community representatives indicate that larger importers use the in-bond system because they prefer to ship merchandise to central distribution warehouses to enter the shipments, rather than dealing with multiple ports of arrival<sup>118</sup>. Industries such as express consignment couriers (e.g. UPS, Fedex) also rely on the in-bond program for the expeditious movement of shipments as an integral part of the services they offer. The in-bond system also allows importers to delay payment of trade duties. Using the in-bond system, importers do not pay applicable import duties until the merchandise officially enters US-commerce, which can be delayed from 15 to 60 days after it arrives at the initial US-port and an additional 15 days at the destination US-port.

---

<sup>117</sup> US-GAO (2007) p.6

<sup>118</sup> US-GAO (2007) p.17

The in-bond system is also fundamental to FTZ-operations, where users depend on the in-bond system to import certain types of merchandise into zones without going through formal US-Customs entry procedures or paying import duties. Goods may either be exported directly from FTZ or may enter US-commerce at which point appropriate duties are assessed.

The US-GAO estimated that for a 6-month (October 2004 to March 2005) there were 6.5M in-bond transactions, divided between immediate transportation (69%), transportation and exportation (22%) and immediate exportation (9%)<sup>119</sup>. Couriers such as UPS and FedEx accounted for almost 50% of in-bond transactions.

Some US-Customs Port Directors estimate that in-bond shipments represent 30-60% of foreign goods received at their ports<sup>120</sup>. Over the past years, reports from the US-GAO and other audit agencies have noted various internal control weaknesses in the in-bond shipment system. These weaknesses have sometimes allowed goods to be improperly diverted and sold in US-markets, thus avoiding duties and quotas and possibly also posing security risks. For example, according to an Immigration and Customs Enforcement (ICE) report, more than 7,500 in-bond shipments of wearing apparel were diverted from Los Angeles to customers throughout the US during 1999-2002, with an estimated loss of revenue to the US of more than US\$100M.

A US-GAO audit of in-bond shipments found that US-Customs does not adequately monitor and track in-bond goods, and does not consistently reconcile the in-bond documents issued at the arrival port with documents at the destination port, to ensure that the cargo is either officially entered, with appropriate duties or quotas applied, or is in fact exported. For example, one of the US-seaports with the highest amount of in-bond traffic reported that up to 77% of their in-bond shipments remained un-reconciled i.e. 'open' with respect to US-Customs clearance for entry into the US-market<sup>121</sup>.

US-Customs regulations currently allow bonded carriers from 15 to 60 days, depending on the mode of shipment, to reach their final destination and allow them to change a shipment's final destination without notifying US-Customs. Administrative errors by shipping agents and US-Customs staff contribute to the high numbers of open in-bond records. US-Customs also inconsistently performs in-bond compliance exams, with some ports not performing these exams at all and other ports only recently beginning to perform them. Results from these compliance exams, when consistently performed, could aid port and US-Customs management in identifying system weaknesses.

### *6.2.3 US-Customs Duty Drawback*

US-Customs also refunds duties and taxes paid on imported merchandise that is subsequently exported or destroyed (i.e. duty drawbacks). Some drawbacks are made on an accelerated basis, before US-Customs has verified that such refunds are warranted. In these cases, US-Customs requires the importer to have a surety bond which is sufficient to ensure that it can

---

<sup>119</sup> US-GAO (2007) p.18

<sup>120</sup> US-GAO (2007) p.5

<sup>121</sup> US-GAO (2007) p.7

recover the drawback if the related documentation does not support it and the claimant cannot repay the amount due. In fiscal year 1992, US-Customs paid approximately US\$500M on 53,000 duty/tax drawback claims<sup>122</sup>.

In 1992, the US-GAO audited a sample of 65 liquidated duty drawback claims and found that US-Customs did not adequately verify the accuracy and validity of 14 (22%), and were unable to determine if 20 others (31%) had been adequately reviewed<sup>123</sup>. A further sample of 134 drawbacks showed that 113 (84%) had multiple entries associated with each claim (ranging from 2 to 957 entries), and 52 (47%) lacked written approval or documentation authorizing payment<sup>124</sup>. About 80% of drawbacks were paid before US-Customs had even reviewed the basis for the claim (i.e. accelerated drawback claims)<sup>125</sup>. Bonds posted to cover accelerated duty drawback payments were insufficient as 'insurance' against fraud or error<sup>126</sup>.

---

<sup>122</sup> US-GAO (1994) p.12

<sup>123</sup> US-GAO (1994) p.34

<sup>124</sup> US-GAO (1994) pp.36, 38

<sup>125</sup> US-GAO (1994) p.37

<sup>126</sup> US-GAO (1994) p.39

## 7. CA-Customs Duty Deferral & GST Relief Programs

### 7.1. CA – Customs Duty Deferral

Finance Canada (FIN) is responsible for tariff policy, including customs duties and other charges under the *Customs Tariff (Act)*. FIN is responsible for legislative changes to the Canadian *Customs Tariff* which can be introduced to eliminate the duties on inputs, machinery and equipment, as well as to deal with ‘inverted tariff’ (i.e. tariff anomalies) or tariff inequities.

The Canada Border Services Agency (CBSA) authorizes persons to use various duty deferral programs and ‘promotes’ the programs through its website and issuance of rulings/interpretations.

There are several Duty Deferral Programs administered by the CBSA:

- *Duties Relief Program (DRP)*;
- *Duty Drawback Program*; and
- *Customs Bonded Warehouse (CBW)*.

#### **Importer of Record:**

Unlike some other countries, the filing of Customs import documentation (i.e. Canada Customs Coding Form B3-3) must be done by the ‘importer of record’ (i.e. often through a customs broker) and not by a Customs Bonded Warehouse or other facility operator. In this respect, Canada is different from the US-FTZ where the ‘operator’ files documentation on behalf of the actual importer or user of the goods with US-Customs<sup>127</sup>.

Licensed Customs Brokers and public Customs Bonded Warehouse operators (which may be involved in the import transaction and movement of goods) have ‘security bonds’, whereby they assume liability for payment of any duties owed. As a result, these ‘agents’ exert considerable oversight over the filing of Customs documentation by the ‘importer of record’.

#### **Compliance/Penalties:**

CBSA engages in risk-analysis of duty deferral clients and can apply monetary penalties (AMPS) for violations. These are minimal in number as clients are aware they receive benefits under CBSA supervision, and they appear to operate in conformity of requirements to maintain access to those benefits.

---

<sup>127</sup> The US-Customs service, for FTZ-procedures, deals with the customs broker/FTZ-operator rather than the ‘importer of record’.

Self-adjustment is required to correct any inaccuracy in import documentation relating to goods' origin, value, tariff classification or diversion; and must be submitted (Form B2) within 90 days to CBSA<sup>128</sup>.

All records pertaining to imported goods (electronic or paper format) must be retained for 6 years after the year of importation, including information relating to: quantities received; price paid; country of origin; vendor information; product information; and all other related information<sup>129</sup>.

All commercial imported goods may be audited by CBSA and adjusted for origin, value for duty, or tariff classification up to four (4) years after importation. If CBSA adjusts duties owed, it issues a Detailed Adjustment Statement that outlines the adjustment. Importers have 30 days to pay any duties and taxes owing<sup>130</sup>.

### *7.1.1 Duties Relief Program*

An application for the Duties Relief Program (Form K90) involves<sup>131</sup>:

- filing an application at a local CBSA office; and
- a site visit by CBSA staff to complete a checklist (e.g. estimated volume and type of goods to be imported on a monthly basis etc.).

There is no security bond requirement for Duties Relief Program participants, and no physical security requirement. The compliance emphasis for DRP is on record-keeping processes and tracking of goods at the company-location. Unlike the US, there are no Customs fees.

The DRP is intended for export purposes, but applies equally to both exports and imports into the domestic market. There is no formal limitation (in terms of percentage of exports) for eligibility to participate in DRP, and there appears to be considerable local-CBSA latitude in practice as to a 'threshold' degree of export orientation to justify the issuance of a license for the DRP.

Generally, a company importing goods into Canada for which 70% is destined for eventual export (versus 30% for import into the domestic market) would be considered eligible for the DRP; whereas a company importing goods into Canada for which 30% is destined for eventual export (versus 70% for import into the domestic market) would be considered ineligible for the DRP, but would be able to claim duty drawback on the duty paid on imports which were subsequently exported.

The advantage of the DRP (relative to the Duty Drawback Program) is that there is no duty paid at the time the imported goods are received into Canada (at the location licensed under

---

<sup>128</sup> CBSA (2008a) p.8

<sup>129</sup> CBSA (2008a) p.8

<sup>130</sup> CBSA (2008a) p.8

<sup>131</sup> Meeting with CBSA Officials

the DRP), which applies to both goods imported for subsequent export as well as goods subsequently released into the domestic market.

No duties are paid or payable by the DRP participant for goods that are subsequently exported (either in the same condition or after being used or consumed in the processing of other goods). There are certain circumstances, involving import of non-NAFTA goods or supplies which are subsequently exported to a NAFTA country, in which a limit for duty relief applies under NAFTA Article 303.

With respect to the payment of duties, the DRP is more flexible (in terms of location; types of permitted activities; requirements to track goods by lot etc; physical security requirement; posting of a security bond) than the US-FTZ program. For example, there is no limitation on the type of manufacturing activity undertaken under the DRP. There is no requirement to separate or track export items from domestic items. Imported and domestic components, supply goods and raw materials can be used interchangeably<sup>132</sup>.

Duties are payable and paid (i.e. on duty deferral basis) for those imported goods that are released into the domestic market (either in the same condition or after being used/consumed in the processing of other goods). Duties must be paid within 90 days of the date the goods no longer qualify for duty relief, which involves either the sale in Canada to a company which is not a participant in the DRP, or that the goods are no longer intended for export<sup>133</sup>.

Duties Relief is available for goods imported for delivery or consumption in Canada under certain circumstances involving<sup>134</sup>:

- delivery for export to the Canadian Commercial Corporation or the Canadian International Development Agency; and
- delivery for a joint Canada/NAFTA government project.

Goods delivered in Canada for these purposes are deemed to have been exported from Canada.

In 2008, there were about 300 company-locations licensed under the DRP.

### **NAFTA Article 303:**

Under NAFTA, there are limitations to the amount of duties that can be relieved under the DRP, CBW and Duty Drawback Programs. These limitations apply to imported goods from non-NAFTA countries which end up in exports to NAFTA countries<sup>135</sup>. These limitations do

---

<sup>132</sup> CBSA (2003a) p.2

<sup>133</sup> CBSA (2007) Memorandum D7-4-1 p.5

<sup>134</sup> CBSA (2004b) p.1

<sup>135</sup> The 'quid pro quo' justification for NAFTA Article 303 and the 'lesser of two' concept is that one benefit (i.e. lower duty rate on exports under NAFTA to the US) is being traded-off against another benefit (i.e. the ability to claim duty deferral or duty drawback on non-NAFTA imports that result in exports to NAFTA countries).

not apply to goods exported in the same condition (i.e. little or no value-added)<sup>136</sup>. The amount of duties deferred or refunded on drawback cannot exceed the ‘lesser of two duties’, being<sup>137</sup>:

- the total amount of duties paid or owed on the goods imported into Canada; and
- the total amount of duties paid on the exported goods in the NAFTA country where the goods are imported.

Where goods imported under DDP are affected by the ‘lesser of two duties’ concept, the importer is allowed 60 days from the date of export of the goods to obtain ‘satisfactory evidence’ (i.e. of duties paid) and pay any duties owed<sup>138</sup>.

NAFTA Article 303 was designed to induce manufacturing operations to return to North America through the use of NAFTA-made parts and components in finished goods, which would be NAFTA-eligible (under ‘rules of origin’) and have duty-free status. The US insisted on NAFTA Article 303 out of concern that unless actual (high value-added) manufacturing took place, non-NAFTA suppliers would use Mexico or Canada as a platform for gaining duty-free access to the U.S. market through (low value-added) ‘assembly’ operation<sup>139</sup>.

#### *7.1.2 Duty Drawback Program*

The Duty Drawback Program is the refund of duties paid on imported goods and supplies which are incorporated into goods subsequently exported from Canada. Duties are payable on the date of import and must be paid within 5-to-30 days. Upon export of goods in the same condition as at import (i.e. no ‘substantial alteration’ to the goods), or after manufacturing or processing into a finished good, or after use of an imported good in a limited manner to produce other goods for export; the importer, exporter, processor, owner or producer of the goods may apply for a refund (Form K32 or K32-1) of the duties paid at anytime within 4 years of the date of release<sup>140</sup>.

Where more than one party is eligible to file a drawback claim, CBSA requires waivers from the other eligible claimants before it can process the claim.

The Duty Drawback Program also applies to circumstances where imported goods (on which duties were paid) which are destroyed as obsolete or surplus to requirements, or that were manufactured into final products that are destroyed as obsolete or surplus to requirements<sup>141</sup>. In this case, the drawback claim must be made within 5 years of the date of import, and after the imported goods (or finished products) are destroyed.

---

<sup>136</sup> CBSA (1996c) p.4. Minor value-added processing allowed includes: dilution with water; cleaning; application of preservative or paint; trimming or cutting; repackaging; and testing, marking, labelling, sorting.

<sup>137</sup> CBSA (1996c) p.3

<sup>138</sup> CBSA (1996c) p.9

<sup>139</sup> SK Ross (website <http://www.skralaw.com/Articles/nafta.htm>)

<sup>140</sup> CBSA (2004c) p.1

<sup>141</sup> CBSA (2004d) p.1

Imported goods, other than fuel or plant capital equipment, consumed in the direct manufacture of other goods which are subsequently exported from Canada, are eligible for duty drawback<sup>142</sup>.

CBSA makes accelerated full (or partial) refund payments on properly prepared and supported claims as soon as they are filed (i.e. prior to verification). When CBSA makes partial refund payments, it pays the balance owed upon claim verification, and pays interest after 90 days of the date of claim receipt on any outstanding balance<sup>143</sup>. Overpayment of duty drawback is subject to repayment within 90 days of notification of overpayment (i.e. or 'diversion')<sup>144</sup>. Penalties may be imposed for failure to report overpayment/diversion.

### 7.1.3 Customs Bonded Warehouse Program

The Customs Bonded Warehouse (CBW) program was established in 1952 and results in the deferred payment of taxes and duties until goods enter the Canadian economy or are exported. When goods are exported from a CBW, no taxes or duties are payable (i.e. exemption for duty and tax). When goods are released from a CBW into the Canadian market, taxes and/or duties are payable (i.e. duties and taxes are deferred while stored in a CBW)<sup>145</sup>.

A CBW may consist of<sup>146</sup>:

- *private warehouses*: operated by individuals or companies for the storage of their own in bond goods; or
- *public warehouses*: operated by entrepreneurs for the storage of goods imported by various importers.

A CBW facility may be<sup>147</sup>:

- an industrial-type structure;
- a conference room in a hotel or convention centre (e.g. to facilitate the temporary import of products to be exhibited at a trade show under a short-term 90-day CBW license);
- part of an existing office building; or
- part of a complex of buildings;
- owned or leased by the applicant or on a site licensed to a third party.

---

<sup>142</sup> CBSA (1996b) p.4

<sup>143</sup> CBSA (2004c) p.1

<sup>144</sup> CBSA (1996b) p.6

<sup>145</sup> FIN (2000d) p.6

<sup>146</sup> CBSA (2002a) p.3

<sup>147</sup> CBSA (2003a) p.1

A CBW can support Just-In-Time logistics management so that goods purchased in bulk are deferred of duties payable until the goods are removed as needed in production.

The CBW program allows for a wide range of 'basic service' activities to be carried on in a CBW; however this excludes activities that manipulate, alter or combine goods with other goods except in limited circumstances such as inspecting, labelling, storing, packaging or testing<sup>148</sup>. An example of activity undertaken within a CBW is the cutting and marking of imported fabric for export, on which no duties and taxes are payable in Canada<sup>149</sup>.

Application for a licence to operate a Customs Bonded Warehouse (Form E401) by a resident or non-resident of Canada involves<sup>150</sup>:

- filing an application at a local CBSA office with a site plan;
- a site visit by CBSA staff to complete a checklist (e.g. physical security, posted signs, authorized staff access, estimated volume and type of goods to be imported over a 12-month period etc.);
- calculation of a 'security bond' in the value of 60% of the product of the value of imported goods and the applicable duty rates, excise taxes, GST and any other trade duties (e.g. Special Import Measure Adjustments) for the expected types of products imported. The value of the bond is adjusted to reflect the annual value of goods and duty payable on actual shipments in the previous year; and
- licence issuance by CBSA to either a private operator (i.e. for own-use) or a public operator (i.e. for public use) at a specific company-location, which allows for the deferral of duties on imports to Canada until they are removed from the CBW for use, at which time duties are payable.

Shipment documents are filed with CBSA on incoming shipments into the CBW. No duties are paid or payable if these goods are subsequently exported (i.e. possibly with some limited value-added processing on these goods). Duties are payable on goods subsequently released into the domestic market, and must be paid within 90 days of their release from the CBW. Goods can be stored for up to 4 years under the CBW Program with duty and tax deferral.

The CBW operator must have a record-keeping system that tracks the movement of goods under CBSA control in the customs bonded warehouse including<sup>151</sup>:

- movement into the warehouse;
- movement within the warehouse;

---

<sup>148</sup> FIN (2000d) p.6. A complete list of acceptable activities can be found in the Customs Bonded Warehouses Regulations (Section 3 of Part I).

<sup>149</sup> CBSA (2003a) p.1

<sup>150</sup> Meeting with CBSA Officials, CBSA (2004a).

<sup>151</sup> CBSA (1996a) pp7-8.

- transfers to and from other licensed warehouses;
- movements out of the warehouse; and
- records of manipulation, unpacking, packing, alteration or combination with other goods in warehouse.

Goods moved into a CBW prior to export from Canada are ‘deemed’ to have been exported for the purposes of the Duties Relief and Duty Drawback Programs, and can result in the filing of a duty drawback claim for duties paid related to imported goods that make up, or consist of, the exported goods<sup>152</sup>.

In 2008, there were about 400 customs bonded warehouses licensed by CBSA. Many Canadian customs bonded warehouses are associated with manufacturing JIT-inventory systems, whereby duties are paid as imported material is used in the production process. CBW are also used to store imported tobacco and alcohol products on which federal excise taxes are deferred until such time as they formally enter the domestic market.

### **Sufferance Warehouse:**

Sufferance warehouses are privately owned and operated facilities licensed by CBSA for the control, short-term storage, transfer, delivery and examination of in-bond goods until the goods are released by the CBSA (e.g. moved into a CBW) or exported from Canada<sup>153</sup>.

There are 5 types of Sufferance Warehouse<sup>154</sup>:

- *General Merchandise*: used for storing imported goods carried in a company’s system; operated by a cargo handler acting under contract as an exclusive agent of an airline, marine, or railway company; or operated by a harbour commission, stevedoring company, or other person who provides equipment, personnel, and other services for unloading and storing imported goods arriving by vessel;
- *Air Sufferance*: used for receiving general merchandise arriving by air if the facility is located on airport property and if the CBSA provides service for receiving commercial shipments at the airport;
- *Cargo Handling*: where specific carriers may contract the services of a cargo handler to handle their imported freight. Cargo handlers may not operate as a consolidator, de-consolidator, or freight forwarder; but may provide cargo handling service on behalf of such service providers;
- *Rail Sufferance*: used for receiving general merchandise arriving by rail at a railway yard in the area of a CBSA office where vehicles containing imported goods are held

---

<sup>152</sup> CBSA (2002a) p.9

<sup>153</sup> CBSA (2008b) p.5

<sup>154</sup> CBSA (2008b) pp.11-12

until the CBSA releases the goods. Specific tracks within the yard may be designated for this purpose; and

- *Highway Sufferance*: used for receiving general merchandise arriving by road in the area of a CBSA office (i.e. a limit of one per CBSA office, unless volume or other circumstances warrant additional sufferance facilities) where vehicles containing imported goods are held until the CBSA releases the goods.

There are time limit requirements for the removal of goods from a Sufferance Warehouse into a Customs Bonded Warehouse: 40 days for general goods; and 4 days for perishable goods.

### **Differences with EDCP:**

The CBW Program can be used for certain export distribution centre type activities. A business operating in a CBW can carry on only clearly defined and limited processing activities with respect to goods. By contrast, a business authorized to use the EDCP can perform a wider variety of activities to customize goods for particular markets or purchaser requirements<sup>155</sup>. The CBW Program allows goods to be released for export or for entry into the domestic Canadian economy without restriction. By contrast, a minimum of 90% of revenues under EDCP must be from export sales. Only imported goods receive deferral of, or are relieved of the GST, under the CBW program; whereas the EDCP may relieve imported goods and domestic purchases of goods from the GST.

#### *7.1.4 Freight Forwarders & Consolidators*

In a similar manner to the US temporary in-bond shipments, CBSA allows bonded freight forwarders to move or transport in-bond goods from one point in Canada to another point(s) in Canada, or from an arrival warehouse to a CBW or other duty relief facility (e.g. DRP licensed)<sup>156</sup>.

No international movement or transportation of goods is allowed by a bonded freight forwarder carrier. The primary international carrier must show the freight forwarder as the consignee on arrival at a sufferance warehouse. The bonded freight forwarder must provide CBSA with a detailed breakdown of the grouping or consolidation into separate shipments prior to their release. In all cases, the bonded freight forwarder's secondary cargo control document acquits the primary carrier's cargo control document in the CBSA system i.e. the bonded freight forwarder becomes responsible for dealing with shortages, reporting overages, and for all such matters as would normally relate to the carrier<sup>157</sup>.

Where any shipments move forward to another point 'in-bond', they move under the bonded freight forwarder's security and documentation, provided that the bonded freight forwarder has an agent handling the load on their behalf or operates a sufferance warehouse at destination. In this case, the bonded freight forwarder is responsible to CBSA, and it is in their

---

<sup>155</sup> FIN (2000d) p.6

<sup>156</sup> CBSA (2008c) p.2

<sup>157</sup> CBSA (2008c) p.3

best interest to ensure that the transporting carrier is fully aware that the shipment is in-bond, that it is already covered by the bonded freight forwarder's cargo control document in the CBSA system, and that the shipment must be delivered into a sufferance warehouse that has been approved to receive such freight<sup>158</sup>.

Otherwise, the shipment will move under the actual transporting carrier's security and documentation, and will be turned over to the carrier as a domestic shipment with the domestic bill of lading annotated as 'Cargo Covered by the Freight Forwarder's Cargo Control Document. Do Not Manifest'<sup>159</sup>. The transporting carrier must not present the domestic bill of lading to the CBSA as this creates duplicate cargo reports within the CBSA inventory system.

#### *7.1.5 Tariff Relief Through Finance Canada*

Finance Canada (FIN) administers a number of processes that are available for Canadian-based businesses to seek various forms of tariff relief outside of the Duty Deferral programs administered by CBSA.

Generally, the structure of Canada's tariff schedule is based on 'tariff escalation' as you move upward in the value-chain, so that a higher degree of protection (i.e. duty rate) applies to higher value-added goods compared to lower value-added components. Accordingly, there are few instances of 'inverted tariffs' in the Canadian *Customs Tariff*.

#### **Means to Reduce or Eliminate Duties:**

There are three ways in which duty reduction or elimination for inputs, machinery and equipment (including 'inverted tariff' anomalies) can be addressed through changes to the tariff schedule or temporary exception (i.e. tariff relief), either initiated by the Government or in response to an application by a Canadian-based business<sup>160</sup>:

- *Legislative Amendment*: by changing the *Customs Tariff (Act)* through Parliamentary legislation. Periodically, such changes are made as part of the Budget 'ways and means' legislation. Generally this process is not used to address 'inverted tariff' anomalies;
- *Order in Council*: under s.82 of the *Act*, elimination or reduction of tariff rates may be made by the Governor in Council on the recommendation of the Minister of Finance. This 'regulatory' provision to amend the legislation is often done 3-4 times a year, during which about 20-30 tariff classification rates may be changed. This is generally the means by which tariff rates are eliminated or reduced for inputs, machinery and equipment, including cases of 'inverted tariff' anomalies.
- *Temporary Remission*: under s.115 of the *Act*, the Governor in Council, on the recommendation of the Ministers of Finance or Public Safety and Emergency Preparedness (i.e. of CBSA), may remit duties payable (in whole or on part). This is

---

<sup>158</sup> CBSA (2008c) p.4

<sup>159</sup> CBSA (2008c) p.4

<sup>160</sup> Teleconference with P. Halley (FIN).

an exception used in relatively ‘one-off’ situations, on a prospective or retroactive basis, where the application of the tariff is undesirable (e.g. certain imports associated with the Vancouver Olympics, certain vessel/oil-rig importations). It is not generally used to deal with ‘inverted tariff’ anomalies.

### **Application for Prospective Change to the Customs Tariff:**

A Canadian-based party can apply for a prospective tariff change (i.e. at least 6 months prior to importation of goods) by communication with Finance Canada. A questionnaire is used to assess the application, which includes information on:

- the value of imports (excluding customs duty) for the previous three years;
- country of origin of the imported goods;
- value of duties paid for the previous three years;
- CBSA determination regarding the actual tariff classification of the goods in question;
- efforts made to obtain the good (or substitutes) from Canadian producers;
- description of the manufacturing process;
- value of finished goods manufactured for the previous three years;
- size of the Canadian market for the finished good;
- proportion of goods exported (including to NAFTA countries);
- value of expected benefits derived from the proposed tariff relief; and
- how the tariff rate elimination or reduction, including any ‘inverted tariff relief’ would improve company competitiveness.

### **Consultation Requirement and Process:**

Finance Canada has an informal process of consultation with affected parties (e.g. relevant industry associations, companies, customs brokers, Industry Canada and other relevant departments) to obtain comment on the proposed tariff change, and to determine whether there are Canadian companies that would be negatively impacted by the proposed change (i.e. would a Canadian producer of a component be affected by a tariff change involving an imported component used for further processing)<sup>161</sup>. The tariff changes take effect on the date of passage of the Order in Council (i.e. are not retroactive).

---

<sup>161</sup> This process appears similar to the ‘public interest’ test used by the US-FTZB in determining whether the benefits of relief of ‘inverted tariffs’ would be granted under FTZ-procedures. The main difference is that the *tariff relief* being sought in the

Therefore, there is (generally) no need for a US-FTZ type system of exceptions that are granted on a 'case-by-case' basis for specific activities within a geographically defined FTZ location. However, there is the flexibility within the *Customs Tariff* for the introduction of duty reduction or elimination on a case-by-case basis (involving Finance Canada).

## 7.2. CA – GST/HST Relief Programs

Finance Canada (FIN) is responsible for tax policy, including that related to the Goods & Services Tax (GST)<sup>162</sup>.

The Canada Revenue Agency (CRA) authorizes persons to use the EDCP/EOPS/ETH programs and promotes the programs through publications available on its website and the issuance of GST rulings/interpretations<sup>163</sup>.

There are several GST/HST relief programs:

- *Export Distribution Centre (EDCP)*;
- *Exporters of Processing Services (EOPS)*;
- *Export Trading House (ETH)*;

### 7.2.1 Primer on the Goods and Services Tax (GST)

The GST was implemented in 1991 as a tax on the final consumption of goods and services in Canada. Thus, a key objective of the tax is to fully relieve exported goods and services from the tax. No GST/HST applies to exported goods and services, and tax paid on domestic and imported inputs by exporters is fully refundable through the input tax credit mechanism. The GST is integrated with provincial sales taxes for three provinces as a Harmonized Sales Tax (HST).

---

US is specific to a company operating in a US-FTZ and does not remedy the underlying US inverted tariff situation; whereas the Finance Canada *tariff relief* actually changes the underlying Canadian tariff structure.

<sup>162</sup> The focus in this paper is on the GST. The GST is harmonized with certain provincial retail tax systems (participating provinces of New Brunswick, Nova Scotia, and Newfoundland and Labrador) to form the Harmonized Sales Tax (HST).

<sup>163</sup> CRA (2008a)

**GST Neutrality:**

The GST is 'neutral' with respect to imports and domestic goods, relative to the previous 'Manufacturers' Sales Tax' (of 13.5%) which only applied to goods of domestic manufacture, which had the effect of favoring imported goods.

**GST Broad Base:**

The GST applies on the majority of goods and services supplied in Canada. Exported goods and services are generally zero-rated (taxed at 0%) for GST/HST purposes. Certain domestic supplies of goods and services are specifically relieved of GST/HST as zero-rated supplies (i.e., basic groceries, medical devices, prescription drugs).

A Canadian business pays GST (5%) or HST (13%) on taxable goods (excluding zero-rated goods) that they purchase in Canada or import into Canada; the GST registered business must collect GST/HST on any taxable supplies (other than zero-rated) that they make in Canada. In order to eliminate the potential for cascading of tax, the GST/HST is designed as a multi-stage tax. Businesses throughout the production and distribution value-chain charge tax on their domestic supplies and may claim a refundable credit, called an 'input tax credit', for any tax paid on purchases and imported goods that are used in the course of their commercial activities<sup>164</sup>.

For Canadian businesses selling goods or providing services in the domestic market this process means a constant stream of costs and revenues associated with payment and collection of GST/HST. Periodically (monthly, quarterly, or annually), the business is required to file a GST/HST return with the CRA where it will report the GST it collects on its GST taxable supplies and the GST that it has paid on its GST taxable imports or purchases. The *net amount* (GST collected less GST paid) is remitted to CRA. In this manner, the effect of the multi-stage tax is that Canadian business only effectively pays GST/HST on their value-added contribution (i.e., sales less cost of goods sold) to the value of the goods sold into the domestic market. Generally, for most domestic businesses, GST/HST produces a '*positive*' cash flow and results in payment owing.

However, for Canadian business primarily engaged in export sales of goods and services, the normal process of GST/HST operation results in a '*negative*' cash flow, as GST/HST is paid on domestic and imported inputs but no GST/HST is collected on export sales. The GST/HST paid on inputs is subsequently recovered (generally within 3 weeks of receiving the periodic GST/HST return, which may be 3-4 weeks after the initial purchase or importation of the inputs) as a refundable input tax credit. It is the 'time delay' between paying GST/HST on the purchases or imports and the recovery of the tax that is paid that gives rise to the '*cash flow cost*' that programs such as EDCP or EOPS are aimed to address.

---

<sup>164</sup> FIN (2000d) p.1

### **Export-Oriented GST/VAT Exemption/Deferral**

The multi-stage structure of Canada's GST system, coupled with neutrality between imports and domestic goods, broad-base of application, and system of refundable input tax credits ensures that the GST is not biased in favour of imports. Furthermore, the zero-rating (i.e. exemption) for export sales means that the GST does not place Canadian producers/exporters at a disadvantage relative to foreign producers/exporters for sales into the Canadian marketplace or into the global marketplaces.

However, having made this statement, there are specific cash-flow and other perceptual disadvantages related to the input tax credit and GST refund system for certain types of export-oriented businesses, and relative to the tax treatment of foreign producers/exporters.

There are at least 18 countries (other than Canada) that have one form or another of special treatment (either GST/VAT deferral or exemption) for trade-related imports or export movement (see Annex 3 for details)<sup>165</sup>. Perhaps most notable, is the experience of Germany, an advanced developed country similar to Canada in many respects, where special VAT treatment applies to historical special 'free ports' which have existed for more than 120 years. Furthermore, the special treatment (including exemption on inputs and capital acquisitions) available for Mexican Maquiladora for export purposes is significant given their competition with Canadian exporters for access into the US-market.

#### *7.2.2 Export Distribution Centre Program (EDCP)*

The Export Distribution Centre Program (EDCP) was introduced in 2001 to provide cash-flow relief to eligible non-manufacturing, non-producing export-oriented businesses that add only limited value to goods by allowing them to import and purchase on a tax-free basis most goods in the course of processing or selling goods for export<sup>166</sup>.

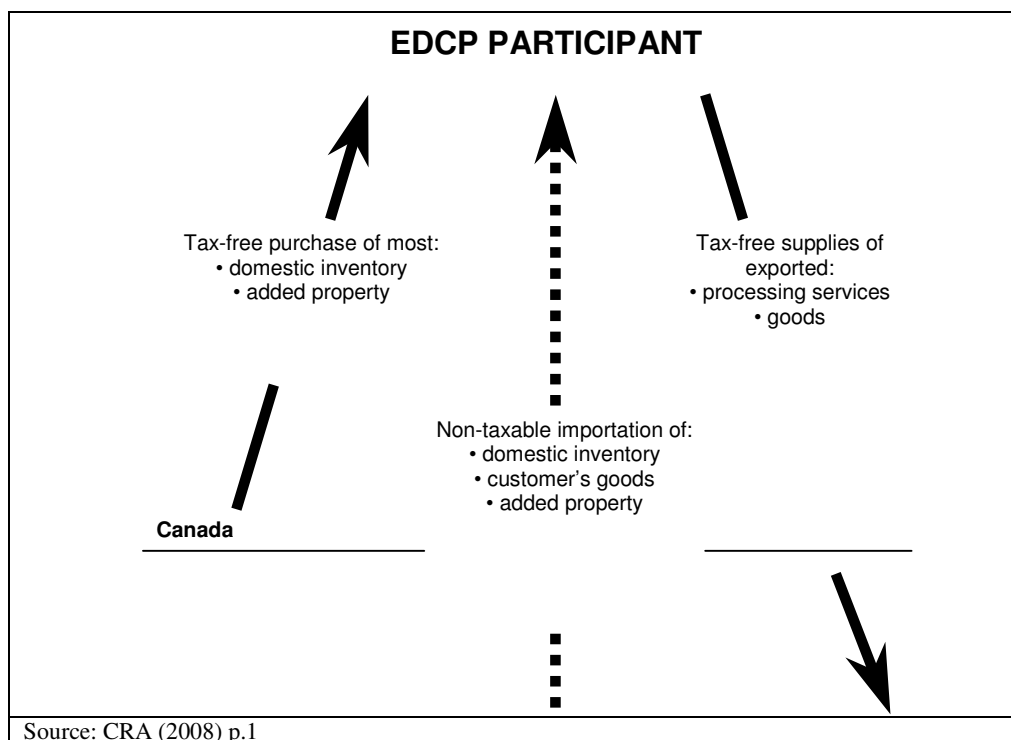
Under normal rules, a Canadian export distributor would pay GST/HST on supplies of goods imported or domestically acquired, and not charge GST/HST on export sales. It would submit a periodic GST/HST return claiming its GST/HST payments as an input tax credit and receive a refund for the net amount of GST/HST paid less any GST/HST collected on domestic sales.

Under the EDCP, authorized EDCP participants are relieved of the obligation to pay GST on most of their purchases (\$1,000 or more) and importations.

**Figure 5**  
**Export Distribution Centre (EDCP) Program**

<sup>165</sup> This section comes from material in Ernst & Young (2008) and PriceWaterhouseCoopers (2005).

<sup>166</sup> CRA (2001) p.3



A company or person (i.e. legal entity with GST/HST registration) can apply for certification to operate under EDCP (Form GST 528). The determination process is administered by CRA, and involves a review of information submitted to ensure that it meets the eligibility criteria, and contact with the applicant as required. Authorization is for an initial period of three years, with activation and expiry dates, and an applicant must renew its authorization before the three (3) year period expires to continue operations. The EDCP certificate includes an EDCP number, which must be provided to vendors to gain GST/HST exemption on purchased supplies<sup>167</sup>. EDCP authorization is valid for a three (3) year period, and can be extended through application.

The justification for the EDCP was that existing GST ‘cash flow relief’ measures (e.g. Export Trading House and Customs Bonded Warehouse programs) were targeted to particular types of activity, but in some cases did not extend to distribution activities with limited value-added in relation to the value of the goods<sup>168</sup>. The benefits of EDCP convey the same cash-flow advantage for goods owned by the GST/HST registrant, or owned by another registered owner, that would accrue to businesses that import goods of unregistered (for GST/HST) non-residents for the purpose of providing a service in respect of those goods<sup>169</sup>. An increasing number of firms are engaged in this type of activity, such as the installation of software or customization of products to reflect purchaser specific needs<sup>170</sup>.

<sup>167</sup> CRA (2008) p.5

<sup>168</sup> FIN (2000b) p.1

<sup>169</sup> FIN (2001) p.39

<sup>170</sup> FIN (2000d) p.1

The EDCP was intended to ensure that Canada was competitive as a location for North American distribution centres, without jeopardizing the integrity and effectiveness of the multi-stage GST/HST system<sup>171</sup>.

EDCP applies to *both* imported goods and domestic Canadian goods (i.e. ‘imported taxable supply’) acquired for distribution, primarily for export. The provision of an EDCP certificate relieves the seller of the goods of the obligation to collect GST/HST on the sale<sup>172</sup>.

EDCP excludes all purchases of capital property (i.e. investment in machinery and equipment for processing). EDCP excludes ‘soft costs’ associated with operations, such as rent, utilities, domestic transportation and professional services. Transaction involving purchases under \$1,000 are also excluded to reduce the compliance burden on vendors<sup>173</sup>.

### **Export Threshold:**

To qualify initially for an authorization to use an EDCP certificate, the person’s export revenue percentage for the year must reasonably be expected to be at least 90%. The export revenue percentage of a person for a year is calculated by dividing the person’s export revenue (defined in Appendix A) for the year by the person’s specified total revenue (defined in Appendix A) for the year. The person’s total export revenue for the year is generally arrived at by aggregating:

- its zero-rated export sales, and sales made outside Canada, of domestic inventory;
- its sales of added property acquired for use or supply in processing goods in Canada for export; and
- its sales of processing, storage and distribution services in respect of goods that are exported after the processing is complete.

To calculate the export revenue percentage for the year, a person takes into account only those inventory items, added property and customers’ goods that have been acquired in Canada, imported into Canada or transferred to the business in Canada. The calculation of the export revenue percentage is not affected by the operations of a foreign branch that does not deal in goods that have been processed or acquired in Canada. The export revenue percentage is based entirely on the person’s domestic business operations.

### **Value-Added Threshold:**

---

<sup>171</sup> FIN (2000b) p.1

<sup>172</sup> FIN (2001) p.13

<sup>173</sup> FIN (2000d) p.3 GST/HST paid on ‘soft costs’ would be refundable as input tax credits.

A person's eligibility for EDCP depends on the extent and nature of the person's processing activities in respect of customers' goods. Along with the other criteria in the program, the expected value-added to customers' goods for the year from the provision of non-basic services must be 10% or less, or its total value-added to customers' goods must be 20% or less. In all cases, potential EDCP participants must not engage in manufacturing or production of goods.

**Basic service** means a type of service that may be performed in a customs bonded warehouse. You do not have to actually perform the service in a customs bonded warehouse, but you should be able to perform it on the goods in their present stage of processing, and in a customs bonded warehouse. Basic services in respect of goods include the following:

- disassembling or reassembling the goods if they have been assembled or disassembled for packing, handling, or transporting;
- displaying, inspecting, labelling, packing, storing, or testing the goods;
- removing a small sample of the goods for the sole purpose of soliciting orders for goods or services; and
- cleaning, diluting, normal maintenance and servicing, preserving, separating defective goods from prime quality goods, sorting or grading, trimming, filing, slitting, cutting, and complying with any applicable law of Canada or a province, as long as the characteristics of the goods are not materially altered.

### **Non-Basic Services:**

'*Non-basic service*' means any other service other than a basic service, which does not constitute manufacturing or producing activity<sup>174</sup>.

### **Application of Thresholds & Adjustments to Net Tax:**

The business must meet the two tests to establish eligibility to be certified under EDCP on the basis of past levels of activity (if available) or on expected levels of activity (if prospective).

The export-revenue and value-added thresholds are reviewed annually at the end of each fiscal year. Where these tests are not satisfied, or there has been improper use of the certificate, the export distribution centre will be required to make adjustments to its net tax to ensure that no cash-flow benefits are realized beyond those anticipated under the EDCP<sup>175</sup>.

---

<sup>174</sup> 'Manufacturing' and 'producing' activities are not defined by legislation or regulation but by case law in Canada.

<sup>175</sup> FIN (2000b) p.2 This includes payment of the GST/HST owed plus interest at 4% per annum (compounded daily) calculated from the earliest date on which the tax would have been payable until the due date for the return for the reporting period that includes that day.

An EDCP certificate can be revoked if an export distribution centre falls below 80% for export-revenue, or fails to meet the value-added threshold, or engages in manufacturing or processing that is not permitted under the program<sup>176</sup>.

*Example:*

A Canadian distributor purchases plain shirts and processes them for foreign retailers by dyeing them, sewing on customer logos or emblems, ticketing and packaging the shirts in coverings that are sold to consumers by the foreign retailers. In this case, the ticketing and packaging activities constitute 'basic services' while the dyeing and sewing activities constitute 'non-basic services'.

Assume that the direct material cost was \$27.00 per shirt. Labour costs are \$4.20 per shirt for non-basic services and \$1.60 per shirt for basic services. There is an additional \$0.70 per shirt cost for non-labour value-added. The total product cost per shirt is \$33.50, of which 12.5% is non-basic service value-added and 4.8% is basic service value-added. As the total value-added percentage (for labour) is 17.3% (i.e. less than the 20% threshold, and the activities do not constitute 'substantial alteration of property' this activity is considered to be eligible for the EDCP, even though it exceeds the 10% value-added limit for non-basic services.<sup>177</sup>

### *7.2.3 Exporters of Processing Services (EOPS) Program*

The Exporters of Processing Services Program (EOPS) was introduced in 1992 to provide cash-flow relief to eligible export-oriented suppliers of processing services by allowing them to import on a tax-free basis goods belonging to unrelated non-residents for processing and export<sup>178</sup>.

An example of an EOPS-eligible activity may be a Canadian contract manufacturer who performs manufacturing activity on imported goods owned by a non-resident (e.g. electronic components) in order to produce finished goods (e.g. electronic products) which are exported to the original non-resident or another non-resident who has acquired ownership of the goods (i.e. at arms length from the Canadian exporter).

The eligibility criteria for authorization to use the EOPS program are not as strict as the eligibility criteria to use EDCP that are based on a participant's global operations. For example, under the EOPS, there are no annual export revenue or value-added conditions that must be met, and participants can manufacture or produce goods. However, the following specific conditions must be met with respect to each importation of goods made by the participant under the EOPS program:

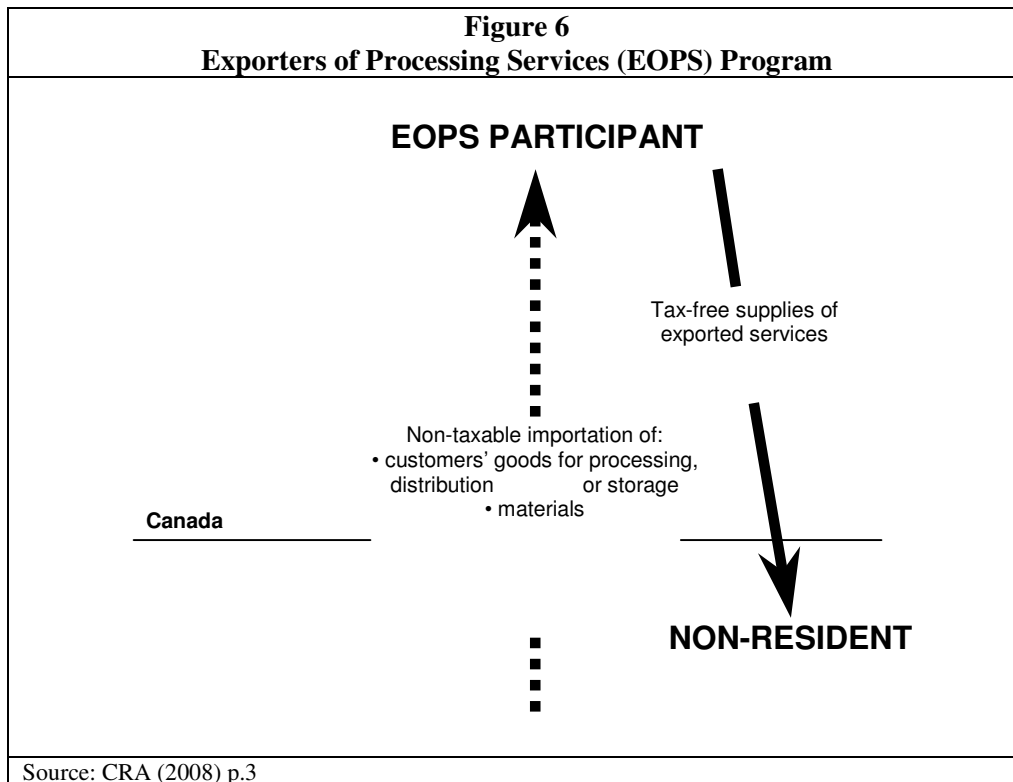
---

<sup>176</sup> FIN (2000b) p.2

<sup>177</sup> FIN (2001) p.52

<sup>178</sup> FIN (2000b) p.3

- the goods are imported for the sole purpose of having the participant supply processing, distribution, or storage services in respect of the goods to a non-resident customer;
- the goods are not owned by the participant and belong to a non-resident person while they are in Canada;
- the participant is not closely related to its non-resident customer or non-resident owner of the goods;
- the participant does not transfer physical possession of the goods to another person in Canada, except for their storage or transportation;
- the goods are exported within four years after they are accounted for;
- the goods must not be consumed or used in Canada, except to the extent reasonably necessary or incidental to their transportation; and
- the participant provides any security that is required in respect of the goods.



The applicant must prepare a letter requesting authorization to take part in the EOPS program and, if the applicant also wants to apply for the duty Deferral program, the applicant must also

complete CBSA form K-90 *Duties Relief Application* (available on the CBSA website at: <http://www.cbsa-asfc.gc.ca/E/pbg/cf/k90/README.html>)

If only applying for the EOPS program, the applicant must send the written request to its local CRA Tax Services Office (the list of offices is available at: <http://www.cra-arc.gc.ca/cntct/tso-bsf-eng.html>). If applying for both EOPS and Duty Deferral, the applicant must send the completed K-90 and letter to its local CBSA office (the list of CBSA offices is available at: <http://www.cbsa-asfc.gc.ca/contact/listing/indexpages/index-e.html>). The CBSA will review the K-90 and forward the written request to use EOPS to the applicant's local CRA Tax Services office for review.

The CRA will review the written request and contact the applicant in the course of its review.

Once the CRA completes its review, it will notify the applicant in writing whether the applicant is authorized to use the program. If the applicant is authorized to use the program, the CRA will issue an EOPS authorization number to the applicant that is to be disclosed when accounting for the non-taxable importation of goods under the program.

#### *7.2.4 Export Trading House (ETH) Program*

The ETH has been in place since January 1, 1990 to provide cash-flow relief (and interest carrying cost savings) for the GST/HST tax-free purchase of domestic goods which are primarily destined for export<sup>179</sup>.

There are two thresholds for ETH<sup>180</sup>:

- >90% of domestic inventory purchases must be exported with 0% value-added processing of goods in Canada; and
- >90% of sales revenue from inventory must be exported with 0% value-added processing of goods in Canada.

In 2001, ETH rules were amended to align them with EDCP<sup>181</sup>:

- to request that the authorization to use an ETH-certificate be revoked (i.e. to allow it to operate under EDCP with up to 20% value-added processing); and

---

<sup>179</sup> FIN (2000b) p.3

<sup>180</sup> FIN (2000b) p.3

<sup>181</sup> FIN (2000b) p.3

- to require an ETH (where there has been improper use of the certificate) to make adjustments to its net tax to ensure that no cash-flow benefits are realized beyond those anticipated under the ETH.

## 8. Comparison of Canada/US 'FTZ-Related' Programs

A comparison of Canadian and US policies and programs related to 'foreign trade' (i.e. FTZ-type) will consider the following factors:

- *Support for Infrastructure;*
- *Special Designation;*
- *Flexible Customs Regulations;*
- *Export Orientation;*
- *Incentives:* including:
  - exemption and/or deferral and/or drawback of customs duties;
  - exemption and/or deferral of sales taxes; and
  - grants for developing and employing human resources;
  - other grants for business capital, R&D or other investments;
  - other tax incentives (e.g. lower corporate income tax).

Table 1 provides a summary of the Canadian and US policies, including (where known) examples of relevant regional and local government programs.

**Table 1 – Comparison of Canadian & US ‘FTZ-Type’ Programs**

| Factor                                 | Canadian Policy/Program   | US Policy/Program  |
|--|---|--|
| <b>1. Support for Infrastructure</b>   | <p><u>Federal</u>: <i>Building Canada</i> CA\$9B per annum funding available, primarily in support of public infrastructure, including transportation and border services.</p> <p>Dedicated funding for the Asia-Pacific Gateway &amp; Corridor Initiative (CA\$1.0) and Gateways &amp; Border Crossings Fund (CA\$2.1B).</p> <p><u>Provincial</u>: Matching funding to federal program, plus additional funding for highways and other provincial infrastructure.</p> <p><u>Local</u>: Matching funding for federal program, plus additional funding for roads and other local infrastructure.</p> <p>No specific infrastructure funds dedicated to FTZ-type activities, except on a case-by-case basis.</p> | <p><u>Federal</u>: <i>American Recovery and Reinvestment Act</i> US\$27B for transportation investment, in addition to about US\$38B in transportation infrastructure funding from <i>SAFETEA-LU</i></p> <p><u>State</u>: Matching funding to federal program, plus additional funding for highways and other state infrastructure.</p> <p><u>Local</u>: Matching funding for federal program, plus additional funding for roads and other local infrastructure.</p> <p>No specific infrastructure funds dedicated to FTZ, except on a case-by-case basis.</p> |
| <b>2. Special Designation</b>          | <p>Duties Relief Program (DRP) licence issued by CBSA.</p> <p>DRP licence for specific company and site.</p> <p>No specific security procedures for DRP.</p> <p>Change to location (but not activity) requires CBSA approval.</p>   | <p>FTZ grantee of GPZ by approval of FTZ-Board. SZ status sponsored by grantee and approved by FTZ Board.</p> <p>FTZ-procedures apply to designated location and permit specific activities.</p> <p>Special security procedures apply in FTZ.</p> <p>Changes to location or activities likely require FTZ-Board approval of amendments.</p>  |
| <b>4. Flexible Customs Regulations</b> | <p>Flexible customs procedures (e.g. pre-approved Customs Self Assessment) apply generally for low-risk goods. There are no Customs fees of any kind.</p> <p>Electronic filing of customs documentation. Customs compliance primarily on paperwork.</p> <p>Importer of Record (i.e. end-user) deals with CBSA, with bonded operator as facilitator.</p>   | <p>FTZ benefit from specific, flexible procedures for Customs reporting and compliance which are less costly (in terms of fees), provide 24/7 ‘direct delivery’ operation, and allow for advance weekly filing of documentation (rather than per shipment).</p> <p>Electronic filing of customs documentation. Customs compliance primarily on paperwork.</p> <p>Bonded operator deals with Customs, rather than end-user (for GPZ).</p>   |

|  |  |   |
|--|--|---|
| <p><b>4. Export Orientation</b></p>      | <p>EDCP allows up to 10% domestic shipments to benefit from GST deferral.</p> <p>Duties Relief Licence requires (generally) exports to exceed 70% of revenues</p> <p>Duty deferral schemes apply to imported goods which may go into the domestic or export markets.</p> <p>Duty exemption applies only to export activities.</p>  | <p>FTZ direct only 6% of shipments to export markets, compared to 94% for domestic consumption.</p>   |
| <p><b>5. Incentives</b></p>              |  |   |
| <p><b>5.1 Duty Exemption</b></p>         | <p>DRP offers duty exemption on imported goods destined for export markets.</p> <p>DRP offers duty exemption on imported goods that are 'consumed' or 'expended' in processing final goods that are exported.</p>  | <p>FTZ offer duty exemption on imported goods destined for export markets.</p> <p>FTZ offer duty exemption on imported goods that are 'eliminated' and 'destroyed' in processing (i.e. scrap, wastage, defective, consumed).</p>  |
| <p><b>5.2 Duty Deferral</b></p>          | <p>DRP offers duty deferral on imported goods destined for domestic market.</p> <p>Duty is payable only on cost of materials, and not on CA value-added.</p> <p>4-year limit on the period of duty deferral under the DRP.</p> <p>Transfers between DRP sites remain duty deferred.</p> <p><i>Other Programs:</i></p> <ul style="list-style-type: none"> <li>- Customs Bonded Warehouse (with more limited allowable 'basic' value-added services); and</li> <li>- Sufferance Warehouses.</li> </ul> | <p>FTZ offer duty deferral on imported goods that are destined for the domestic market.</p> <p>Duty is payable only on cost of materials, and not on US value-added.</p> <p>No limit on the period of duty deferral within FTZ.</p> <p>Transfers between FTZ remain duty deferred</p> <p><i>Non-FTZ Programs:</i></p> <ul style="list-style-type: none"> <li>- Customs Bonded Warehouse;</li> <li>- Temporary In-Bond Shipments.</li> </ul> |
| <p><b>5.3 Inverted Tariff Relief</b></p> | <p>FIN process exists to make changes in Tariff Schedule to provide duty relief. This may be permanent, or temporary.</p> <p>The permanent process is not restricted to a particular company. The temporary process may be on a case-by-case basis.</p>  | <p>FTZ imports may pay duty (if approval granted) on lower rate applicable to finished goods.</p> <p>This is a major part of economic benefits arising from FTZ status on a case-by-case basis.</p>   |
| <p><b>5.4 Duty Drawback</b></p>          | <p>Not part of DRP.</p> <p>Customs duty drawback, including on 'accelerated' basis, for duty paid on imported goods which are subsequently exported or destroyed.</p>  | <p>Not part of FTZ.</p> <p>Customs drawback, including on 'accelerated' basis, for duty paid on imported goods which are subsequently exported or destroyed.</p>  |

|   |   |   |
|---|---|---|
| <p><b>5.5 Sales Tax Exemption</b></p>   | <p><u>Federal</u>: EDCP/ETH exemption of GST on all imported and domestic goods. Exports must be &gt;90% of corporate revenue.</p> <p>EOPS/Drop Shipment/NTI exemption of GST on imported goods not owned or controlled by Canadian importer/processor.</p> <p><u>Provincial</u>: not known*.</p> | <p><u>Federal</u>: Not applicable (i.e. no GST or sales tax).</p> <p><u>State</u>: Offered on state-by-state basis (e.g. NY up to US\$100,000/annum for FTZ operation; OH exemption on R&amp;D investments).</p>  |
| <p><b>5.6 Sales Tax Rebate</b></p>  | <p><u>Federal</u>: GST refund for imported and domestic good destined for export.</p> <p><u>Provincial</u>: not known*.</p>   | <p><u>Federal</u>: Not applicable (i.e. no GST or sales tax).</p> <p><u>State</u>: not known*.</p>  |
| <p><b>5.7 Grants for HR employment or development</b></p>                                     | <p><u>Federal</u>: not known*.</p> <p><u>Provincial</u>: not known*.</p>  | <p><u>Federal</u>: not known*.</p> <p><u>State</u>: Offered on state-by-state basis (e.g. NY up to US\$4,000/annum/employee as tax credit; OH grants, tax credits, both refundable and non-refundable)</p> <p>Are likely not specific to FTZ operation</p>  |
| <p><b>5.8 Grants for business capital investment</b></p>                                      | <p><u>Federal</u>: not known*.</p> <p><u>Provincial</u>: not known*.</p>  | <p><u>Federal</u>: not known.</p> <p><u>State</u>: Offered on state-by-state basis (e.g. NY up to US\$4,000/annum/employee as tax credit; OH grants, low-interest loans, tax credits, both refundable and non-refundable)</p> <p>May not be specific to FTZ operation</p>   |
| <p><b>5.9 Other tax incentives</b></p>  | <p><u>Federal</u>: not known*.</p> <p><u>Provincial</u>: not known*.</p> <p><u>Local</u>: not known*.</p>   | <p><u>Federal</u>: FTZ offer exemption from applicable state inventory taxes (<i>ad valorem</i> basis).</p> <p><u>State</u>: Offered on state-by-state basis (e.g. NY Empire Zone credits and tax exemption; tax incentives for film/TV production)</p> <p><u>Local</u>: Offered on local basis (e.g. abatement on property and real estate taxes).</p> |
| <p>* Time and resource constraints prevented investigation of these matters in the study.</p> |   |   |

## 8.1. Similarities Between Canada/US

The Canadian program most comparable to the US-FTZ is the *Duties Relief Program* (DRP) administered by the CBSA and directed at customs duty exemption (for exports) and duty deferral (for domestic market) on imports to Canada. It is unfortunate that media and industry focus has been directed to the Export Distribution Centre Program (EDCP) and other GST exemption and deferral programs, which are beneficial for certain exporters, but which are not directly comparable to the US-FTZ.

The DRP is comparable to the US-FTZ in terms of:

- duty exemption on imported goods that are subsequently exported (in essentially the same condition; or processed into finished goods);
- duty exemption on imported goods that are consumed or expended in processing of finished goods which are subsequently exported (although this may be more limited in scope in Canada to goods whose consumption can be traced to exported goods)<sup>182</sup>;
- duty deferral on imported goods that subsequently enter the domestic market (in essentially the same condition; or processed into finished goods), and on which duty is payable on the value of the imported goods *only* (i.e. not on the value-added in processing);
- requirement to be licensed for a specific company location;
- ability to electronically file Customs documentation;
- reliance on CBSA review of documentation in terms of compliance; and
- ability to transfer goods under duty exemption/deferral between sites covered by the program.

***Other Federal Programs:***

Although not limited to DRP license holders, Canada also has a process to provide duty reduction or elimination, including cases of ‘inverted tariff’, either on a permanent basis to all importers (i.e. not company and activity specific as with US-FTZ), or on a temporary basis. This process involves an application to Finance Canada and entails consultations with industry stakeholders and other government departments before a decision is made.

Canada also has comparable duty drawback, Customs Bonded Warehouse and Bonded Sufferance Warehouse (Freight Forwarders) programs to those available in the US (i.e. not part of US-FTZ program).

Canada provides roughly similar (to the US) federal-level infrastructure investment funding for (primarily) public forms of transportation and other trade-related infrastructure (e.g. border crossings, some private rail infrastructure). In neither country is this support targeted to, or prevents FTZ-like activities from benefiting from, such infrastructure investment.

Generally, in neither Canada nor the US is there any other additional, federal form of subsidy, grant or tax benefit that depends upon FTZ-like activity.

---

<sup>182</sup> Whereas in US-FTZ, this duty exemption applies to imported goods ‘destroyed’ in the processing of either goods for export *and* goods destined for the domestic market.

## 8.2. Differences Between Canada/US

The DRP differs from the US-FTZ in terms of:

- absence of specific physical security requirements;
- absence of special procedures which provide additional flexibility and/or lower costs of complying with Customs documentation and procedural requirements;
- requirement that the ‘importer of record’ (i.e. rather than a customs broker) have the primary relationship with Customs;
- absence of requirement for specific type of goods tracking system (e.g. lot-basis) – i.e. greater flexibility for corporate record-keeping system;
- primary focus on export activity (i.e. roughly >70% export threshold to receive a DRP license<sup>183</sup>); and
- limit on the period of duty deferral (or duty exemption) of four (4) years<sup>184</sup>.

### ***Other Federal Programs:***

The EDCP/EOPS/ETH and other GST exemption and deferral programs have no counterpart in US-FTZ. However, there are many other federal jurisdictions with multi-level GST/VAT programs that provide special treatment (i.e. exemption) for imports related to foreign trade zones or in support of specific export activities. This is notwithstanding general WTO/GATS/TRIMS obligations and limitations on export subsidies.

## 8.3. Overall Assessment

- In the most important respects, Canada offers comparable treatment and benefits in support of export processing through existing programs as are currently available in the US-FTZ program.
- Quite appropriately, Canadian programs attempt to restrict benefits to export activities, rather than processing for the Canadian domestic market (i.e. unlike the US-FTZ program). This is important, as it is undesirable to provide benefits that encourage imported components or specific Canadian processors (rather than domestic components or other Canadian processors) in supplying the Canadian domestic market.
- The CBSA *Duties Relief Program* (DRP) needs to be highlighted as the Canadian ‘FTZ’ program.

---

<sup>183</sup> Whereas in US-FTZ, there is no requirement related to exports, and duty deferral is available for all domestic shipments of imported goods.

<sup>184</sup> Whereas in US-FTZ, there is an unlimited time period on storage of goods.

- It is not appropriate that the focus be on the GST exemption/deferral programs (e.g. EDCP/EOPS/ETH).
- Consideration should be given to providing further CBSA procedural benefits under the DRP (as is available under US-FTZ).
- While the GST is refundable on exports, and is neutral with respect to imported or domestic inputs into finished goods, there are other federal jurisdictions with multi-level GST/VAT programs that provide special treatment (i.e. exemption) for imports related to foreign trade zones or in support of specific export activities.

In an effort to better market the existing Canadian 'FTZ-like' programs and policies, consideration should be given to better integrating the existing Canadian duty deferral and exemption programs (DRP and CBW) and GST deferral and exemption programs (EDCP and EOPS) to provide a more coherent and simpler set of program instruments.

## 9. References

### 9.1 GENERAL – FTZ Literature

Deloitte (2008) *Free Trade Zone Study* (for Western Economic Diversification Canada)

FIAS (2008) *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (World Bank Group)

R. Haywood (2001) *Economic Processing Zone Incentives and the WTO Agreement on Subsidies and Countervailing Measures* (WEPZA Conference)

D. Madani (1999) *A Review of the Role and Impact of Export Processing Zones* (WB #2238)

W. Milberg (2007) *Export Processing Zones, Industrial Upgrading and Economic Development: A Survey* (Paper for ILO)

wikipedia (website) *Special Economic Zones* ([http://en.wikipedia.org/wiki/Special\\_Economic\\_Zone](http://en.wikipedia.org/wiki/Special_Economic_Zone))

World Bank-Independent Evaluation Group (WB-IEG) (2006) *Assessing World Bank Support for Trade, 1987-2004*

### 9.2 UNITED STATES Program - Literature

J. Alavi, H. Thompson (1988) *Towards a Theory of Foreign Trade Zones* (International Trade Journal Vol. II, No. 2 pp203-216)

M. Allocca (2007) *APICS Import Compliance* (Presentation)

D. Bailey Barnes, E. Whiteman (2008) *FTZ Fundamentals* (Presentation)

W. Berry (2008) *Trade Agreement Parity: Keeping Manufacturing and Jobs in America* (Presentation)

R. Froneberger (2008) *How Business Clusters are Used in the U.S. and Europe to Enhance Regional Economic Development – Lessons for Zones* (Presentation)

J. Carver (2005) *Understanding Foreign Trade Zones* (Colliers International)

Foreign-Trade Zone Resource Centre (FTZ-RC) *A Brief History of the US Foreign-Trade Zones Program* (website: <http://www.foreign-trade-zone.com/history.htm>)

FTZ-RC *Foreign-Trade Zones Grantee Responsibilities*  
(website: [http://www.foreign-trade-zone.com/grantee\\_respon.htm](http://www.foreign-trade-zone.com/grantee_respon.htm))

GPOAccess *NAFTA Part 181* (Electronic Code of US-Federal Regulations)  
(website: <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=2e169e>)

Journal of Commerce (2008) *Foreign Trade Zones* (15 September, Advertising Feature)

D. Bailey Barnes (2008) *Automakers TAP US for More Jobs* (JofCommerce Advertising Feature)

B. Hanback (2008) *FTZs Help US Companies Expand Exports* (JofCommerce Advertising Feature)

L. Leibowitz (2008) *Trade Agreement Parity Proposal 'Essential' for Increased Manufacturing and Jobs* (JofCommerce Advertising Feature)

E. McKenna (2008) *NAFTZ Rides Momentum to Increase US Job Opportunities* (JofCommerce Advertising Feature)

C. Spencer (2008) *Recessions and the Foreign-Trade Zone Program* (JofCommerce Advertising Feature)

A. Kayman (2008) *New York Case Study on Incentives* (Presentation)

M McGee (2006) *Current Trade Practices and When to Utilize an FTZ* (Presentation)

A. McGilvray (2004) *Enhancing the Foreign-Trade Zones Program for Small and Medium-Sized Manufacturers* (US-FTZ Board Staff Report)

Miller & Associates *Zone No. 38*

(website: <http://www.millercoco.com/referenceguide/tableofcontents/main.htm>)

M. Miller, D. Pavilack (1997) *Trade Advantages Afforded Under the US Foreign-Trade Zones Program* (US Custom House Guide)

Northeast Ohio Trade and Economic Consortium (NEOTEC)

(website: <http://www.neotec.org/foreigntradezone181.htm>)

OH-Department of Development (DOD) (nd) *Business Incentives to Help You Locate Your Next Expansion in Ohio*

OH-DOD *Business Incentive Tax Credits*

(website: [http://www.development.ohio.gov/EDD/Tax\\_Credit.htm](http://www.development.ohio.gov/EDD/Tax_Credit.htm))

H. Otsubo (2005) *Regional Economic Function Analysis of US Foreign-Trade Zones* (MIT MA-Thesis)

D. Puccinelli (2003) *Foreign Trade Zones – US-Customs Procedures and Requirements* (Export America, February)

C. Spencer (2007) *FTZs for Brokers* (Presentation)

C. Spencer (nd) *FTZ Security as Model for Importers* (Presentation)

D. Spero (2006) *Remarks of Acting Commissioner* (website:  
[http://www.cbp.gov/xp/cgov/newsroom/commissioner/speeches\\_statements/03012006\\_ctpat\\_conf.xml](http://www.cbp.gov/xp/cgov/newsroom/commissioner/speeches_statements/03012006_ctpat_conf.xml))

US-Customs and Border Protection (CBP) (2008) *FTZ Manual*

US-CBP (2001) *US Customs Bonded Warehouse*

US-Government Accounting Office (GAO) (2007) *Persistent Weaknesses in the In-Bond Cargo System Impede Customs and Border Protection's Ability to Address Revenue, Trade, and Security Concerns* (#07-561)

US-GAO (1994) *Control Weaknesses Limited Customs' Ability to Ensure that Duties Were Properly Assessed* (#94-38)

US-GAO (1989) *Foreign Trade Zones Program Needs Clarified Criteria* (#89-85)

US-International Trade Administration (ITA) *List of FTZ Subzones*  
(website: <http://ia.ita.doc.gov/ftzpage/letters/szlist.html>)

US-International Trade Administration (ITA) (2005) *NAFTA Duty Deferral*

US-International Trade Commission (ITC) (2009) *Harmonized Tariff Schedule of the US*

### 9.3 CANADA Program - Literature

CBSA (2008a) *A Step-by-Step Guide to Importing*  
(website: <http://www.cbsa-asfc.gc.ca/sme-pme/i-guide-eng.html>)

CBSA (2008b) *Memorandum D4-1-4 (Customs Sufferance Warehouses)*

CBSA (2008c) *Memorandum D3-3-1 (Forwarded and Consolidated Cargo-Import Movements)*

CBSA (2004a) *Importing in a Bonded Warehouse*  
(website: <http://www.cbsa-asfc.gc.ca/import/ddr-red/tab9-eng.html>)

CBSA (2004b) *Relieving Duties on Supplies for Government Contracts*  
(website: <http://www.cbsa-asfc.gc.ca/import/ddr-red/tab5-eng.html>)

CBSA (2004c) *Claiming a Drawback on Exported Goods*  
(website: <http://www.cbsa-asfc.gc.ca/import/ddr-red/tab2-eng.html>)

CBSA (2004d) *Claiming a Drawback for Obsolete or Surplus Goods You Destroy*  
(website: <http://www.cbsa-asfc.gc.ca/import/ddr-red/tab3-eng.html>)

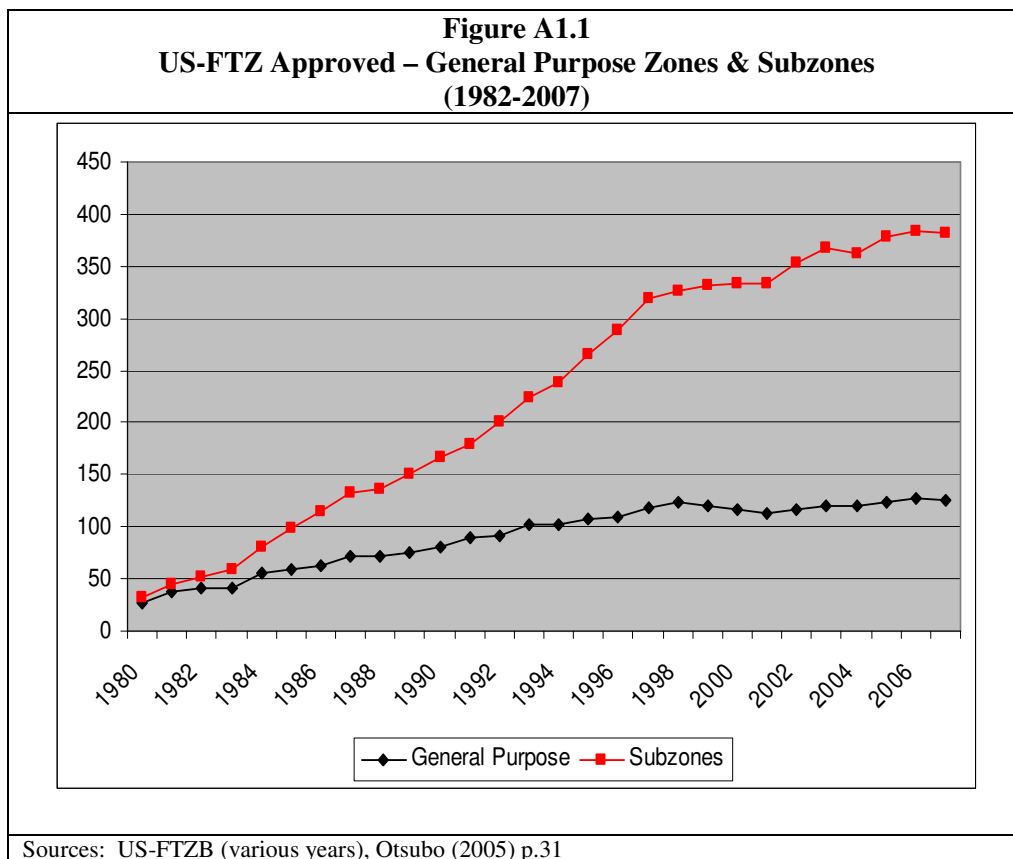
- CBSA (2003a) *The Duty Deferral Program – Access the World*  
(website: <http://www.cbsa-asfc.gc.ca/publications/pub/97-252-eng.html>)
- CBSA (2002a) *Memorandum D7-4-4 (Customs Bonded Warehouses)*
- CBSA (1996a) *Memorandum D7-4-1 (Duty Deferral Program)*
- CBSA (1996b) *Memorandum D7-4-2 (Duty Drawback Program)*
- CBSA (1996c) *Memorandum D7-4-3 (NAFTA Requirements for Drawback and Duty Deferral)*
- CRA (2008a) *GST/HST Relief Programs for Export-Oriented Businesses* (Presentation)
- CRA (2008b) *Export Distribution Centre Program & Exporters of Processing Services Program* (Presentation)
- CRA (2001) *Export Distribution Centre Program* (B-088)
- FIN (2001) *Amendments to the Excise Tax Act – Explanatory Notes*
- FIN (2000a) *GST/HST Treatment of Export Distribution* (in FIN (2000c) *Tax Expenditures and Evaluations*) (website: [http://www.fin.gc.ca/taxexp-depfisc/2000/taxexp00\\_5-eng.asp](http://www.fin.gc.ca/taxexp-depfisc/2000/taxexp00_5-eng.asp))
- FIN (2000b) *Goods and Services Tax/Harmonized Sales Tax Changes* (in FIN (2000a) *Budget Plan*) (website: <http://www.fin.gc.ca/budget00/bp/bpanc5-eng.asp>)
- 9.4 INTERNATIONAL Program - Literature
- M. Curiel, H. Reyes (2006) *Mexican Tax System & the Shelter Plan* (Presentation)
- M. Engman et al (2007) *Export Processing Zones : Past and Future Role in Trade and Development* (OECD TD/TC/WP(2006)39/FINAL)
- Ernst & Young (2008) *Worldwide VAT & GST Guide*
- J. Padierna-Peralta, G. Thompson (2001) *Maquiladoras and Mexico's Sectoral Programs 2001* (website: <http://www.usmcoc.org/usa/cha2a.html>)
- PriceWaterhouseCoopers (2005) *Quovatis*

## Annex 1 – US-FTZ Data

This annex contains data on US-FTZ data taken from two primary sources<sup>185</sup>.

### *1. Approved FTZ – General Purpose Zones & Subzones*

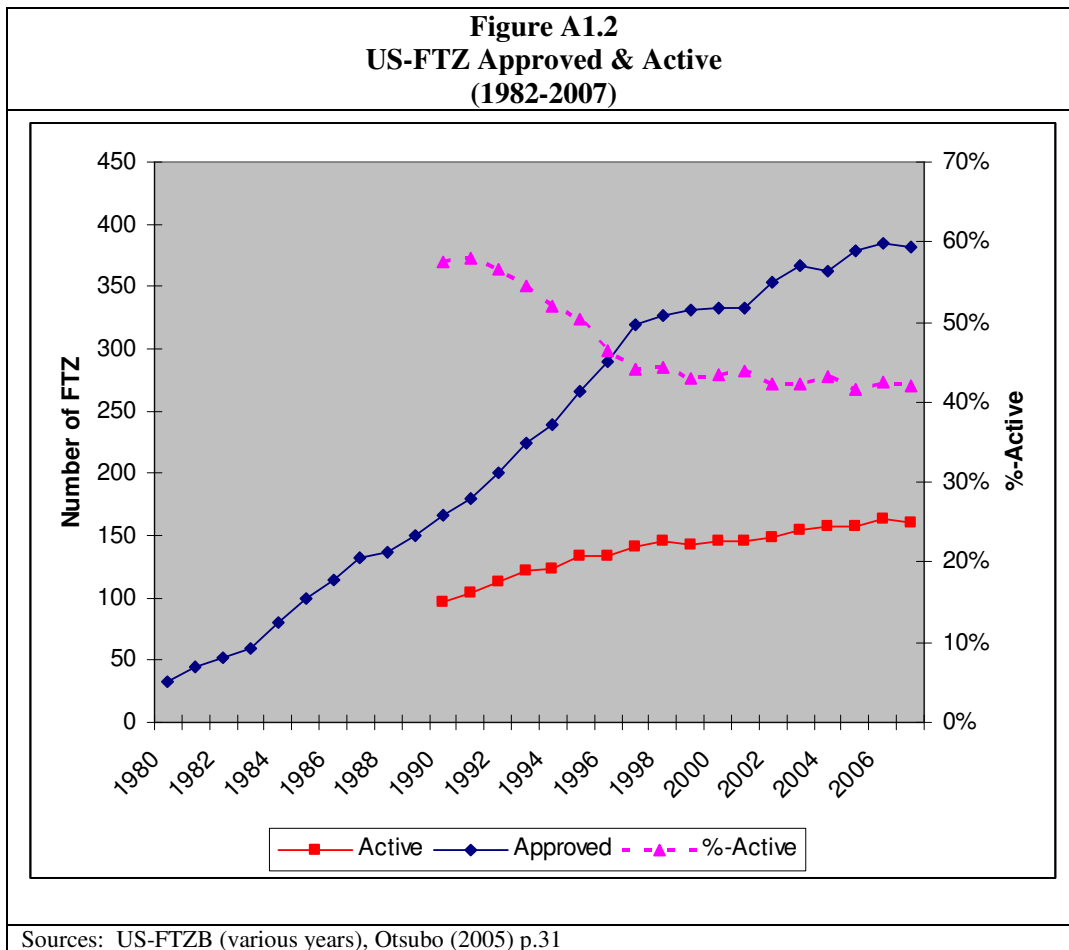
The number of US-FTZ has increased dramatically over the 1980s and 1990s, principally in terms of the number of subzones approved, which grew from 5 (1980) to 86 (1990) to 216 (2000) and is now at 256 (2007). By contrast, the number of General Purpose Zones has grown more slowly, from 27 (1980) to 81 (1990) to 117 (2000) and is now at 126 (2007). The increase in approved FTZ is shown in Figure A1.1.



<sup>185</sup> US-FTZB *Annual Reports of the Foreign Trade Zones Board* (various years), and Otsubo (2005) pp.13-15, 28, 31

## 2. Active FTZ

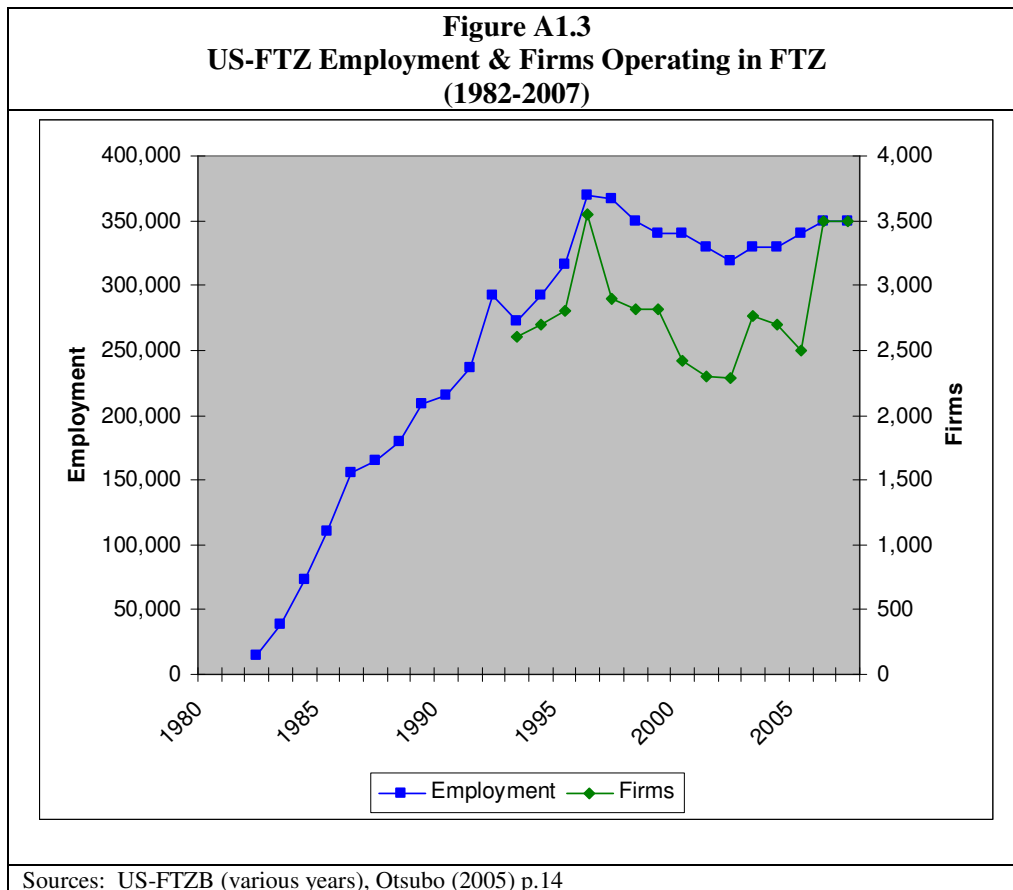
Once a subzone is approved, it generally remains in that status, even if the firm is no longer in business or actively engaged in business under FTZ-procedures. Similarly, there are General Purpose Zones that are approved but have never been in operation under FTZ-procedures. The number of ‘active’<sup>186</sup> FTZ has risen slowly from 96 (1990) to 145 (2000) and is now at 161 (2007). The proportion of ‘approved’ FTZ that are ‘active’ has fallen from 57% (1990) to 44% (2000) and is now at 42% (2007). This is shown in Figure A1.2.



<sup>186</sup> An ‘active’ FTZ has at least one firm operating under FTZ-procedures for customs clearance and reporting.

**3. Employment & Firms Operating in FTZ**

The FTZ-Board reports on employment in FTZ and the number of firms operating within FTZ. It is not clear how reliable this information is, as it is self-reported by companies and may not be specifically related to firm operations under FTZ-procedures. Employment has risen sharply from 14,000 (1982) to 215,000 (1990), to 340,000 (2000) and is now at 350,000 (2007). The number of firms operating in FTZ has fluctuation from 2,600 (1993) to 2,420 (2000) and is now at 3,500 (2007)<sup>187</sup>. This is shown in Figure A1.3.



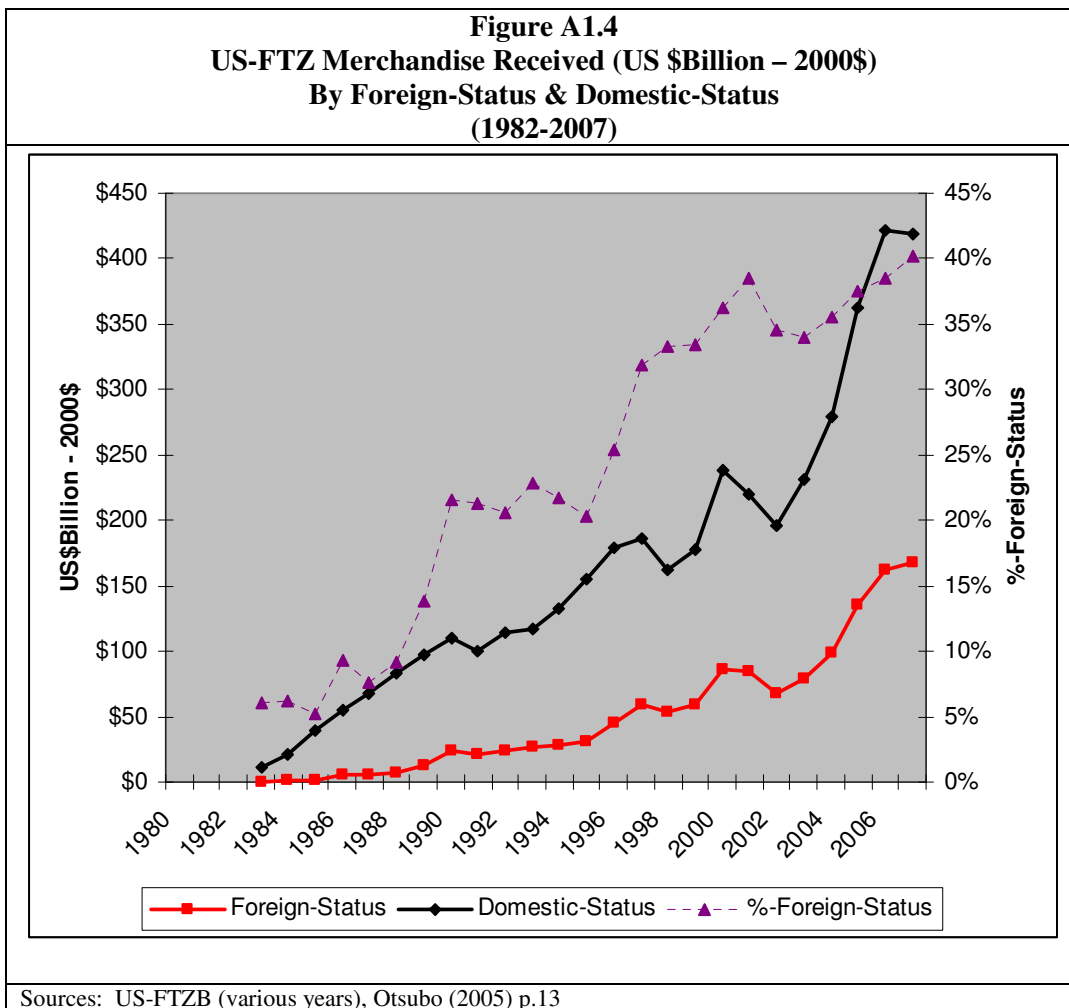
<sup>187</sup> The 2007 US-FTZB annual report shows 6,500 firms but this is implausible relative to the 2006 figure of 3,500.

#### 4. Merchandise Received into FTZ

The FTZ-Board reports on the value of merchandise received into FTZ and whether goods are ‘foreign-status’ or ‘domestic-status’ according to whether the goods have passed through US-Customs and paid duty. Nominal US-dollar value data has been converted into real US-dollar values (2000-\$) using US-GDP deflator values<sup>188</sup>.

The real value of merchandise received into FTZ has risen sharply from US\$11B (1983) to US\$100B (1990), to US\$238B (2000) and is now at US\$419B (2007). In nominal value, the US-FTZ merchandise received exceeds US\$500B in 2007.

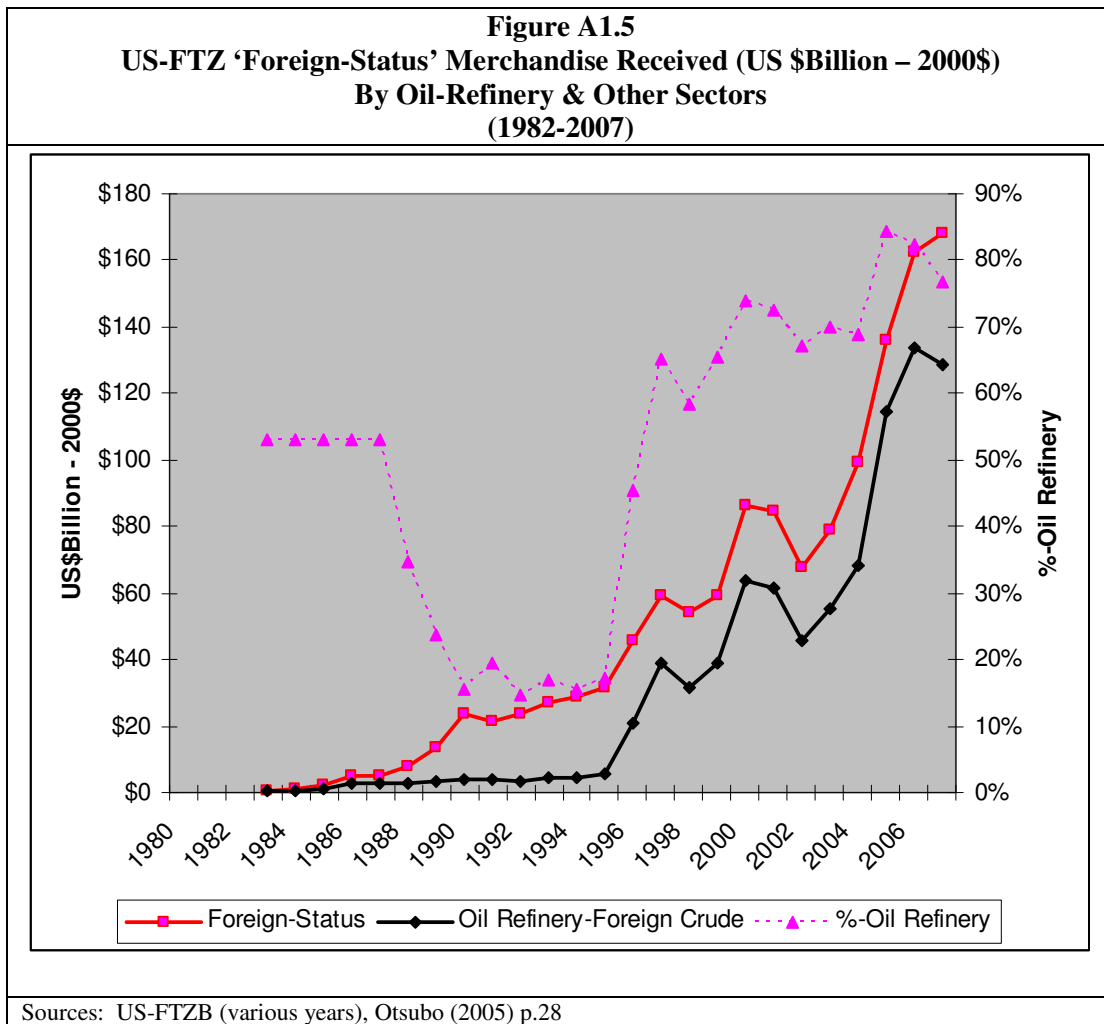
The rate of increase in ‘foreign status’ goods has risen more sharply than ‘domestic-status’ goods, so that the foreign-status percentage of merchandise received has increased from 6% (1983) to 22% (1990) to 36% (2000) and is now at 40% (2007). This is shown in Figure A1.4.



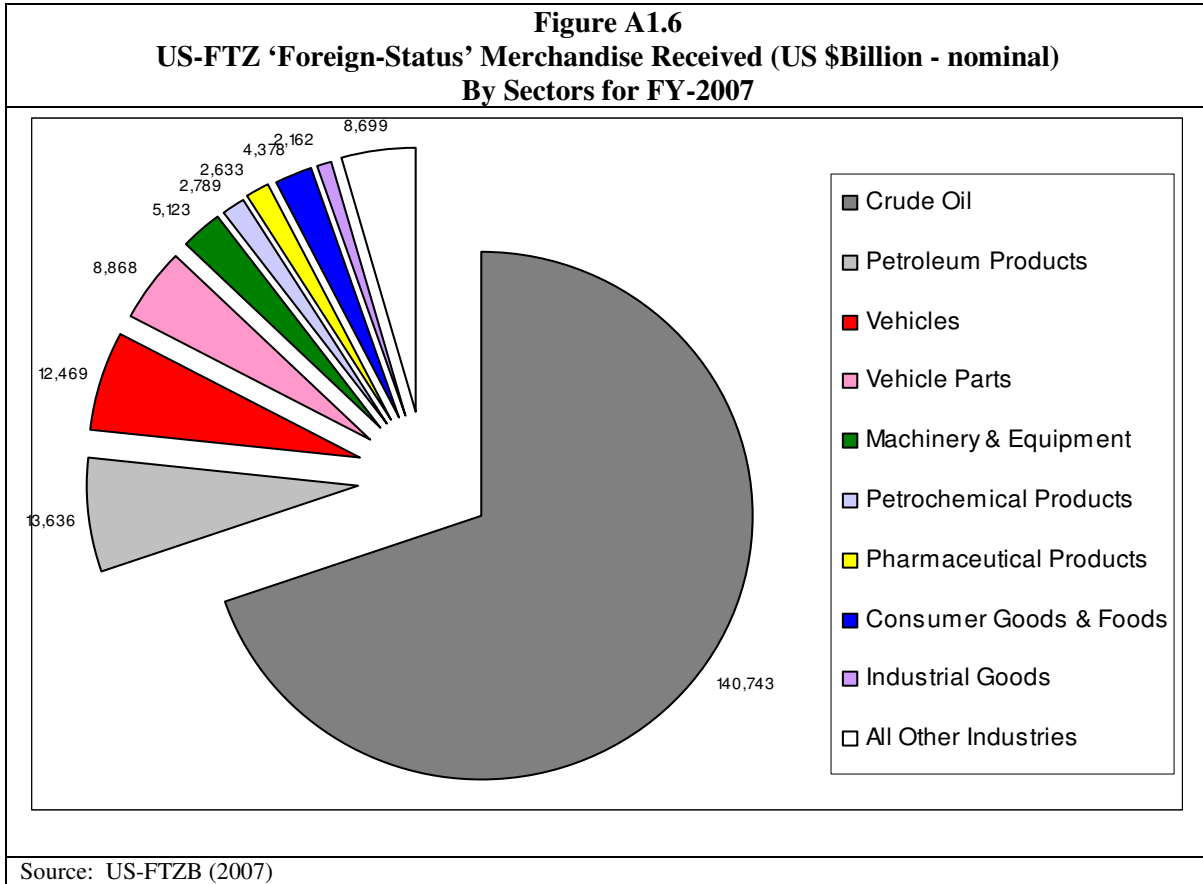
<sup>188</sup> The source for US-GDP deflator values was: US-Federal Reserve Bank of Dallas (website: <http://www.dallasfed.org/data/data/pgdpcw.tab.htm>)

**5. Foreign Merchandise Received into FTZ – by Oil-Refinery & Other Sectors**

The FTZ-Board reports on the main (i.e. top five for each FTZ General Purpose Zone and subzone) types of foreign merchandise received into FTZ. Since US oil-refineries became eligible for subzone status after 1995, this has become a major part of FTZ activity, especially the importation of foreign crude oil into the US for refining into petroleum products for export and US-domestic consumption. The percentage contribution of oil-refinery ‘foreign-status’ merchandise received (e.g. crude oil supplies and other petroleum products) has fluctuated wildly, depending on the world spot price of crude oil, from about 50% (early 1980s) to a low of 15% (1992-1995) to about 80-85% in recent years (2005-2007). This is shown in Figure A1.5.



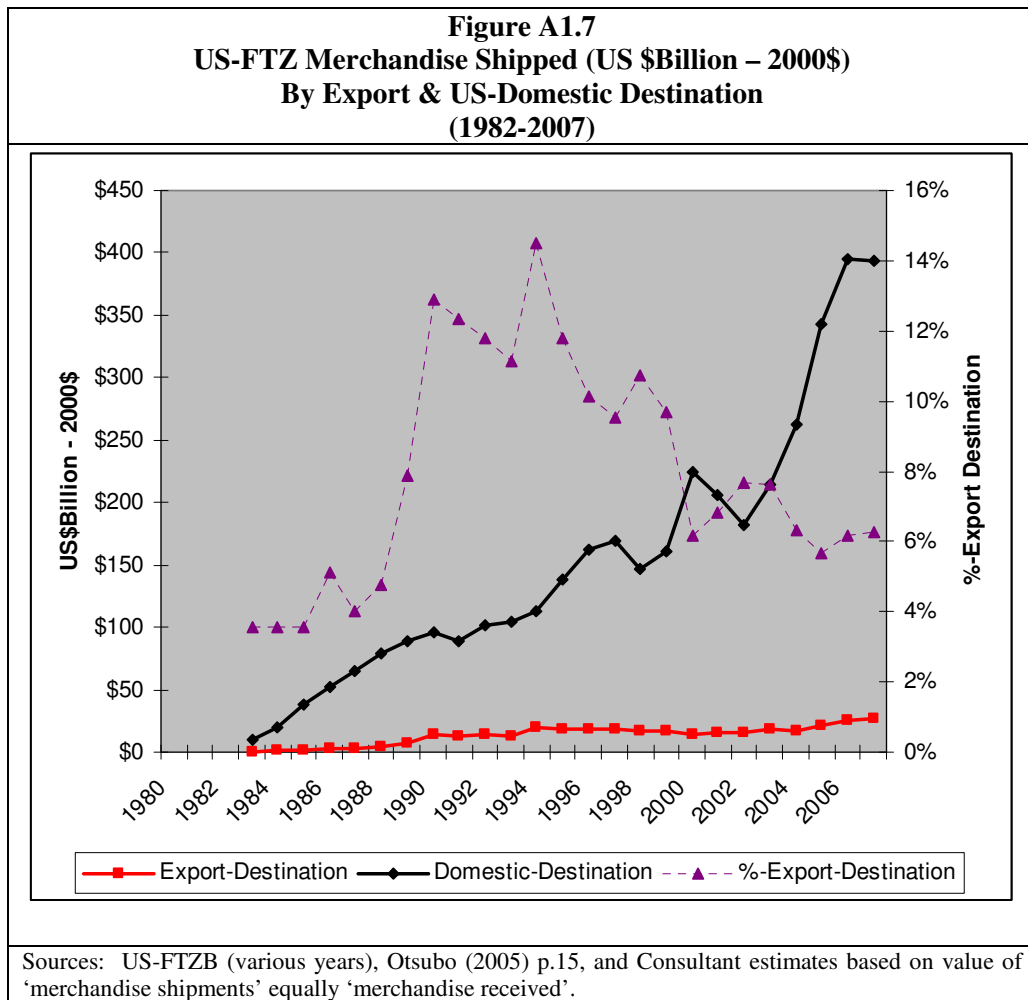
Some of the other sectors of importance in terms of foreign-status merchandise received into FTZ are: vehicles and vehicles parts; machinery & equipment; petrochemical products; pharmaceutical products; various consumer goods (e.g. electronics, food & beverages, tobacco products); and various industrial products (e.g. aerospace equipment, electrical equipment). This is shown in Figure A1.6.



**6. Merchandise Shipped from FTZ**

The FTZ-Board reports on the value of export merchandise shipped from FTZ and (in detailed data for specific FTZ) on whether goods are for ‘export’ or ‘US-domestic’ destination according to whether the goods have passed through US-Customs and paid duty. Generally, the FTZ-Board highlights the US-export value from FTZ and downplays the US-domestic merchandise shipment value. Based on analysis of detailed 2007 data by individual FTZ, it would appear that the value of ‘merchandise received’ is approximately equal to the value of ‘merchandise shipped’, so that we may compare FTZ merchandise shipped by ‘export’ or ‘US-domestic’ destination using this assumption for previous years.

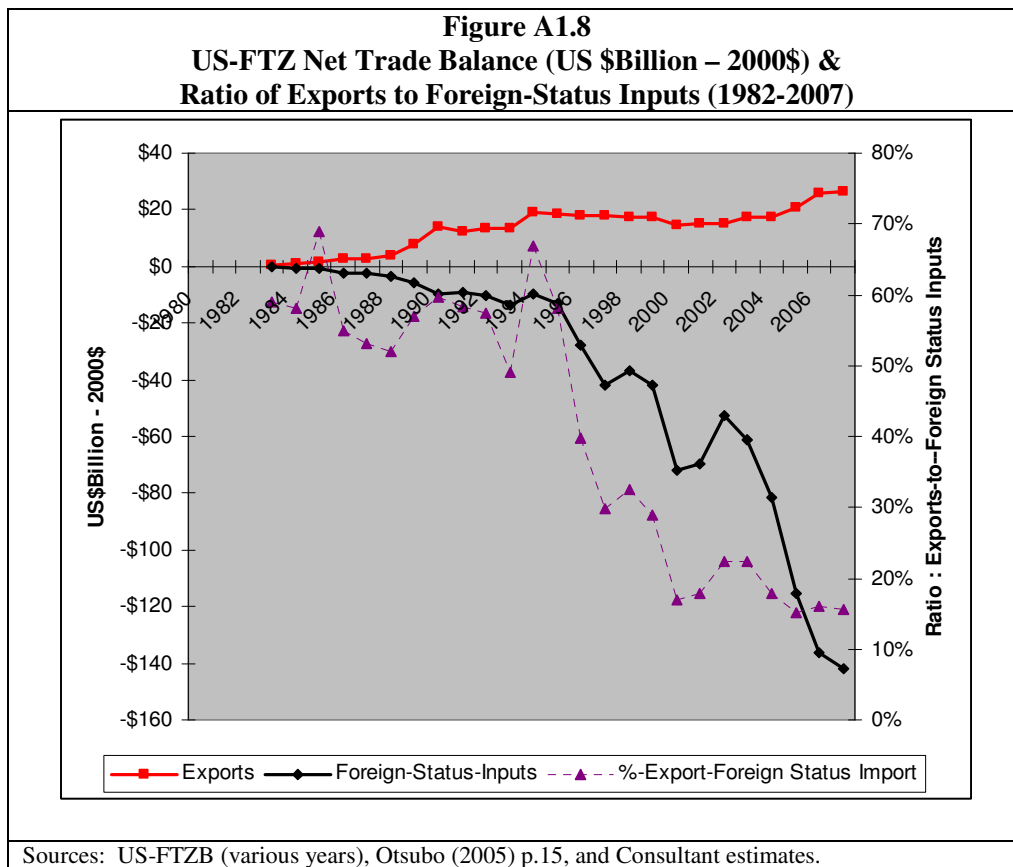
The real value of merchandise exports shipped from FTZ has risen slightly from US\$1B (1984) to US\$14B (1990), then after a rise and fall stayed at US\$14B (2000) and is now at US\$26B (2007). The rate of increase in ‘export’ destination shipments has been slower than for ‘US-domestic’ destination shipments since the mid-1990s, so that the export-destination percentage of merchandise shipped, after rising from 4% (1983) to 13% (1990) and 14% (1995), has since fallen to 6% (2000) where it now remains (2007). This is shown in Figure A1.7.



### 7. Net Trade Balance related to FTZ

The FTZ-Board reports on the ratio of ‘exports’ (in merchandise shipped) to ‘foreign-status inputs’ (in merchandise received). The US-FTZB has often highlighted improvements in this ratio (i.e. ‘exports’ rising faster than ‘foreign-status inputs’) as evidence of the beneficial impact of FTZ on the US-economy. We extend this analysis by using this information and our estimates for the real value of ‘exports’ and ‘foreign-status inputs’ to calculate the real value impact on US-trade balance (i.e. exports less imports)<sup>189</sup>.

The real value net US-trade balance related to FTZ activity has decreased dramatically from -US\$0.5B (1982-1984) to -US\$10B (1990), to -US\$72B (2000) and is now at -US\$142B (2007). The ratio of exports-to-foreign-status inputs, which hovered in a range around 50-65% from 1982-1995, has fallen dramatically to 17% (2000), near where it now remains (16%, 2007). This is shown in Figure A1.8.



<sup>189</sup> While ‘foreign-status inputs’ are clearly an ‘import’, it is also possible that some portion of ‘domestic-status inputs’ may also be ‘imports’, provided that US-Customs have already been paid on their importation. It is difficult to judge, within the overall supply-chain associated with goods moving into and out of US-FTZ, the extent of ‘imports’ within ‘domestic-status inputs’.

**Annex 2 – US-FTZ Case Study – Boston FTZ-#027**<sup>190</sup>

FTZ-027 is located around the Port of Boston (MA) in the vicinity of Logan International Airport. Plans for its establishment arose in 1974 during a period of regional economic stagnation. Initially, 32 local firms expressed ‘interest’, of which 11 firms submitted letters in support of the application to the US-FTZB for authorization.

FTZ-027 commenced operation in 1977, but experienced a long period of underutilization, even though the zone expanded geographically and established 13 subzones in and around Boston. It was only in the late 1990s that FTZ-027 experienced growth in merchandise shipments.

In 2003, FTZ-027 was ranked 58<sup>th</sup> (among US-FTZ) in volume of merchandise shipments, 35<sup>th</sup> in exports, 66<sup>th</sup> in imports and 54<sup>th</sup> in direct employment (1,640 full-time workers). The export-to-import ratio was 105% (i.e. balance of exports and imports for outward shipments), compared to the US-FTZ average ratio of 22%. However, more than 80% of the export value from FTZ-027 is from aviation fuel refined from imported crude oil at other FTZ-subzones and benefiting from duty exemption on the value of the crude oil import component<sup>191</sup>.

Boston (FTZ-027) zone users have included<sup>192</sup>:

- Lawrence Textiles (subzone 27C) (from 1984 to 2002): which processed fabric (in bond) in terms of examination (for defects), cleaning and warehouse/distribution, making use of duty exemption (for US-exports) and duty deferral (for US-imports) on imported fabrics (from China, India, Mexico) which it processed (outside of FTZ) into garments. The company went out of business in 2002 as a result of increased (mostly China) competition and falling tariffs on finished garments;
- Polaroid Corporation (subzones 27F, 27H, 27I) (from 1995 to present, partially): which operated a warehouse/transit location (27F) for imported film, cameras and accessories, a plant (27H) for film-production exports, and a storage/distribution centre (27I) for final packaging of imported film and camera accessories for both US-import and US-export (to Canada, Mexico). Subzone 27F was closed in 1999 as film shipment volume dropped. Subzone 27H received duty exemption, reduction and deferral for film products, until duty rates on imported materials (for film production) fell and FTZ benefits diminished, leading to its closure in 2003. Subzone 27I received duty exemption for US-exports, and was still in operation in 2003. Polaroid suffered from the growth in digital photography and emerged from bankruptcy in 2003;
- Bosfuel Corporation (Site 3) (from 1997-present): is a storage/distribution centre for aviation-fuel for a consortium of major US air carriers, and includes three storage tanks (and a pipeline) in East Boston. Aviation-fuel is ‘domestic-status’ (i.e. US-Customs duty paid) for domestic flights, and ‘foreign-status’ (i.e. US-Customs duty-

<sup>190</sup> Case-Study is based on Otsubo (2005) pp.35-50

<sup>191</sup> Otsubo (2005) p.49

<sup>192</sup> Otsubo (2005) pp.39-48. Note that ‘present’ means as of 2005 when the study was published.

free) for international flights. In 2002, foreign-status aviation fuel was valued at US\$74M, mostly received from US oil refineries operated from FTZ-subzones. The aviation-fuel US-exports accounted for 84% of the total FTZ-027 export value in 2002. For this ‘foreign-status’ aviation fuel, there would be supply-chain duty savings arising from crude oil imports (at the FTZ-subzone oil refinery), passed through (in terms of FTZ-to-FTZ transit) to FTZ-027, and then resulting in duty-free export as ‘foreign-status’ aviation fuel on international flights, with an estimated annual duty savings of US\$1M per annum<sup>193</sup>;

- Summit Logistics (Site 1-1) (from 1998 to 2000): was a 3<sup>rd</sup> party logistics management/warehouse/distribution centre which experienced labour difficulties and lost a major account and went out of business in 2000;
- Coastal Inc. (Site 4) (from 2002 to present): is a container distribution centre/warehouse engaged in footwear import (from China etc.) for Reebok International, which benefits from duty deferral while goods are in warehouse;
- Reebok International Ltd. (subzone 27M) (from 2003-present): is a global ‘offshore’ manufacturer of footwear (from China, Indonesia, Thailand, Vietnam) and sports apparel (from Caribbean Basin, East Asia), using three sites for warehouse/packaging/distribution for US-import. The subzone benefits from duty deferral, volume reduction (i.e. no duty paid on ‘discarded’ quality-controlled goods), and simplification of import procedures (i.e. on China quota, inspection/documentation requirements, variable tariff rates from 4.3-66.0% depending on footwear construction and components), with an estimated annual duty savings of US\$1.1M per annum<sup>194</sup>; and
- Inactive Sites (13 sites not yet utilized under zone procedures, including Site 2 ‘Boston Autoport’ which was used by VW until 2002)

Overall, the case-study notes that FTZ-027 has evolved from traditional manufacturing (which withdrew from zone operations due to falling tariff rates and international competitive pressures, e.g. Lawrence Textiles, Polaroid) towards import distribution (e.g. Reebok International) and distribution of fuel (e.g. Bosfuel)<sup>195</sup>. Only four of the 17 approved FTZ-027 sites were operational in 2003 under FTZ procedures<sup>196</sup>.

---

<sup>193</sup> Otsubo (2005) p.57 contains calculations, based on 1.79M barrels of aviation fuel and US-tariff rate of US\$0.525 per barrel. This savings is based on the value and tariff rate for the ‘finished product’ (i.e. aviation fuel) and may not fully reflect the duty savings on crude oil at the US-refinery based on the volume of crude oil imports to produce the aviation fuel, volume reduction (in the refining process), and the US-tariff rate on crude oil.

<sup>194</sup> Otsubo (2005) p.57 contains calculations, based on US\$118M import value, US-tariff rate of 37.5%, and cost of capital (10%) for 90 days inventory holding for duty deferral.

<sup>195</sup> Otsubo (2005) p.49

<sup>196</sup> Otsubo (2005) p.66

The study estimated regional economic benefits (from the US\$2M in annual duty exemption and deferral) of about 12 additional jobs, US\$1.6M in regional economic output, and US\$0.9M in personal income to the Greater Boston region<sup>197</sup>. These were considered to be negligible in the context of the Greater Boston economy.

FTZ employment in Boston had declined by 60% (since 1999) due to job losses at existing manufacturers, and the FTZ lacked supply-chain linkages that would initiate regional economic growth<sup>198</sup>. The case study found that the FTZ program was losing its economic significance for regional economies, due to falling tariff rates, and that the US-FTZ program required substantial modifications in policy and administration to improve its efficacy.

---

<sup>197</sup> Otsubo (2005) p.60

<sup>198</sup> Otsubo (2005) p.2

**Annex 3 – Other Federal Examples of FTZ-Related GST/VAT Treatment**

| <b>Other Federal Examples of FTZ-Related GST/VAT Treatment</b>                                   |  |  |
|--|--|--|
| <b>Country</b>   | <b>GST/VAT Trade-Related Provision</b>   | <b>Source</b>  |
| Australia  | GST-deferral for registered importers.<br>The deferral is limited to GST payable on imports until the importer's next monthly (if annual sales > AU\$20M) or quarterly (AU\$20M > AU\$2M) or annual (otherwise) report.  | E&Y pp.14, 17  |
| Brazil   | VAT exemption for input sales to a trading company or for plant expansions.  | E&Y p.48   |
| Columbia   | VAT exemption (i.e. zero-rating) for goods entering Free Trade Zones (i.e. these are considered as exports).   | E&Y p.92   |
| Czech Republic   | VAT exemption (i.e. zero-rating) for goods entering Free Zones.  | E&Y p.112  |
| Germany  | VAT exemption (if ultimately exported) or deferral (if ultimately entered into the domestic market) for shipment into Free Zones of control type I (i.e. free port - e.g. Hamburg, Bremen, Bremerhaven, Emden, Kiel, Cuxhaven, Deggendorf, Duisburg).<br>Hamburg offers unlimited storage with no import duties, sales tax or VAT within the free port until goods leave the free zone. The free port covers 16km <sup>2</sup> with container terminals, cargo handling facilities and specialist gear for general cargo, numerous warehouses and the worlds largest contiguous warehouse complex. | E&Y p.179<br><br><a href="http://www.otal.com/europe/germany.htm">http://www.otal.com/europe/germany.htm</a> |
| India  | VAT exemptions and deferrals for eligible industrial units.<br>VAT replaced sales taxes in 2005 (in 20 of 28 states).  | PWC p.27   |
| Indonesia  | VAT exemption for companies within Bonded Zone Areas, and VAT deferral on imported goods until they leave such areas.  | E&Y p.226  |
| Jordan   | Special GST treatment for goods entering Special Economic Zones (e.g. Aqaba).  | E&Y pp.274-276   |
| Kenya  | VAT exemption (i.e. zero-rating) for goods entering Export Processing Zones.   | E&Y p.279  |
| Lithuania  | VAT deferral on goods in Free Zones or in a Free Warehouse.  | E&Y p.307  |
| Malaysia   | Sales tax exemption for goods imported into, or exported from free zones.  | E&Y p.323  |
| Mexico   | Maquiladora exempt from VAT on exports, with expedited refund on VAT paid on inputs.<br><br>Maquiladora exempt from VAT on purchase of inputs, capital equipment and machinery used in manufacturing of goods for export.  | Curiel-Reyes p.31<br><br>Padierna-Peralta/Thompson p.1   |
| Netherlands  | VAT deferral for imported goods under a duty suspension regime, until such goods leave regime-status.  | E&Y p.353  |
| Panama   | VAT exemption for inputs to goods made within a Free Zone.   | E&Y p.384  |
| Philippines  | VAT exemption for PEZA (eco-zone) and SBMA (free port zone) companies who enjoy a preferential tax of 5% in lieu of all other taxes.   | E&Y p.397  |
| Poland   | VAT deferral on imports.   | PWC p.68   |
| Singapore  | GST deferral for goods in a Free Trade Zone.   | E&Y p.445  |
| South Africa   | VAT exemption for certain supplies of goods that are exclusive exported.   | E&Y p.471  |
| Sources: Ernst & Young (2008), PWC (2005), Curiel-Reyes (2006), Padierna-Peralta/Thompson (2001) |  |  |