The Dos and Don'ts of a Foreign Trade Zone

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Imagine a corporation in the business of building and leasing warehouses to manufacturers, in particular, manufacturers that import raw materials to be manufactured here in Arizona. The hypothetical corporation owns a large plot of undeveloped land in Maricopa County upon which it would like to construct a warehouse. But, in order to build the warehouse, it needs construction financing and tenants who are willing to pre-lease space in the warehouse. The corporation needs to make its property as attractive as possible to would-be manufacturing tenants. But how?

Now imagine a manufacturer in the business of assembling goods. While it produces final goods in the United States, most of its raw materials are imported from outside the country and are subject to tariffs. Moreover, the tariffs on the imported raw materials are higher than the tariffs on the final product. The manufacturer needs to find cost-saving measures that will help it compete in a globalized market. What can it do?

In either case, a "foreign trade zone" (FTZ) could be the answer. FTZs are physical zones in the United States that are considered to be outside the country for the purpose of assessing duties and tariffs against businesses within the zone. Thus, manufacturers that import raw materials from outside the country stand to benefit from duty eliminations, duty deferrals, duty reductions and other logistical benefits that come with operating within an FTZ. There are also state property tax benefits conferred by Arizona upon FTZ users. The process of granting FTZ status is overseen by the FTZ Board in Washington, D.C. The board grants authority to establish FTZs to local authorities that deal directly with FTZ applicants. In Arizona, the city of Phoenix is one of the local authorities, or "grantees," with the power to sponsor local applications for FTZ status. Accordingly, applicants apply for FTZ status to the FTZ Board through the city of Phoenix.

But the process of obtaining FTZ status can be fraught with roadblocks and red tape for the unprepared developer. While every corporation's path to FTZ status will present unique challenges, the following are some common "dos" and "don'ts" to keep in mind when pursuing FTZ status.

Do decide whether to pursue a "magnet site" or a "usage driven site."

A corporation could apply to become one of two different types of FTZs: a magnet site or a usage-driven site. A magnet site is a site designed to cover multiple users who will all independently operate on one FTZ site. A usage-driven site covers only one user, regardless of whether that user operates on a site with other businesses.

The current trends in Arizona favor usage-driven sites over magnet sites for a number of reasons. First, the FTZ Board, as well as many local grantees, including the city of Phoenix, have implemented a streamlined application procedure called the "Alternative Site Framework" (ASF). The ASF was designed to make it easier and faster for applicants to achieve FTZ status. The FTZ Board's goal was to minimize speculative application filings by developers who wanted to get preapproved FTZ sites, even though there were no actual users to occupy the site.

Second, it will likely be harder for a Phoenix applicant to get magnet site approval. The city of Phoenix limits the number of magnet sites to six. Five have already been granted and one is pending. Phoenix will consider additional applications for magnet sites, but because the magnet sites are currently at or near the limit, the city will more carefully scrutinize whether the current magnet sites are being used to their capacity before granting additional magnet sites. Usage driven sites, however, are unlimited.

Third, unless a magnet site applicant has a specific user on board to begin operations in the FTZ, there is a risk that the magnet site's FTZ status will lapse before the applicant can bring in any users. An approved magnet site's FTZ status will lapse after five years unless a user activates its operations within the FTZ.

Finally, a magnet site applicant must have an "operator" ready to oversee the recordkeeping and daily operations of the site. This may be the applicant itself or a third party, but it may be difficult to find an operator willing to oversee an entire magnet site's operations. While a usage driven site also must have an operator, usually the individual user becomes their own operator.

Don't confuse an FTZ's tariff benefits with Arizona's property tax benefits.

Businesses in an FTZ receive both tariff and state property tax benefits, but the benefits come from different places. Tariff benefits come from federal law and are regulated at the federal level. These benefits include increased cash flows from duty deferrals, duty elimination for re-exported goods, inverse tariffs on final goods manufactured in an FTZ and other logistical benefits coordinated by U.S. Customs and Border Protection. State property tax benefits, on the other hand, are a product of state law and operate independent of federal tariff benefits. Arizona incentivizes FTZs by reducing the property tax applicable to businesses inside the zones by 75 percent. But be careful, an FTZ must be "activated" by CBP before a user can realize these tax benefits.

Do get permission from the local tax authorities.
FTZ applicants need more than the city of Phoenix's permission to operate an FTZ; other local tax authorities (e.g., school districts, water districts, fire districts, etc.) must also give their blessings. This process can be time-consuming, especially if there are many local tax bodies covering the same site.

Don't plan on using FTZ status to avoid paying your current property taxes.
While Arizona law provides a property tax incentive to FTZ users, FTZs are not intended simply to be a means to lower a business's property taxes. For example, the city of Phoenix will not provide any support for a business attempting to take advantage of Arizona's tax benefits for pre-exiting real property. It is far easier for FTZ applicants to get approved for Arizona's property tax benefits covering soon-to-be constructed real property.

Do get a user on board early.
An applicant's FTZ status must be both "approved" and "activated" before the applicant can receive preferential state tax treatment. Activation is achieved through a separate application to CBP. An approved magnet site can remain inactivated for up to five years before the approval lapses. A usage-driven site can remain inactivated for three years.

Do have a "tariff rationale" ready.
It is critical that any FTZ applicant have a tariff rationale — an economic justification for why the applicant should be granted FTZ status. Good tariff rationales are those that demonstrate how an FTZ status will help the applicant better compete in a global marketplace or increase its hiring capacity for domestic labor.

Applicants should pay particular attention to leveraging an FTZ's inverse tariff benefits. An inverse tariff allows a manufacturer operating inside an FTZ to pay the tariff rate applicable to its final product, rather than that applicable to its raw materials. This is useful to manufacturers whose imported raw materials carry a higher duty rate than the final products that are manufactured in the FTZ.

Do prepare for lots of paperwork.
An FTZ applicant must complete a number of detailed applications. The process can take more than 15 months to complete.

Do make sure the benefits of FTZ status will outweigh the costs.
A potential FTZ applicant might be blinded by the promise of lower duties, tariffs and property taxes that come with operating in an FTZ. But there are costs associated with an FTZ status, too. These costs include the cost of complying with CBP regulations and maintaining the necessary records required of FTZ manufacturers. There can also be additional security, software, administrative, legal and customs costs depending on the type of FTZ user. Potential FTZ applicants should prepare a detailed cost-benefit analysis of obtaining FTZ status before deciding to apply.

Conclusion
FTZ status has the potential to confer a number of benefits on businesses that regularly deal with imports, duties and tariffs. But the process of applying for and obtaining an FTZ status can be complicated and time-consuming. It is important that any business, whether a land developer or a manufacturer, fully understands the application process and how it will affect their operations.

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