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**VIA eRulemaking Portal: Docket No. ITA-2010-0012**

May 25, 2011

Andrew McGilvray, Executive Secretary  
Foreign-Trade Zones Board, International Trade Administration  
U.S. Department of Commerce  
1401 Constitution Avenue NW, Room 2111  
Washington, DC 20230

**Re: Comments in Response to Notice of Proposed Rulemaking Concerning Foreign-Trade Zones Board Regulations; Docket No. ITA-2010-0012 (RIN 0625-AA81)**

Dear Mr. McGilvray:

On behalf of KPMG LLP, we welcome the opportunity to submit comments in response to the Foreign-Trade Zones Board's (the "Board") notice of proposed rulemaking (the "Notice") concerning amendments to its regulations.<sup>1</sup> Although KPMG LLP represents numerous clients that would be affected by the proposed regulations, we are not submitting these comments on behalf of any particular client; and while we generally welcome the practical approach proposed by the Board in the proposed regulations, we will discuss several issues that we believe the Notice raises and which require clarification and/or modification.

**Background**

The Board is authorized to promulgate regulations to accomplish the goal of foreign-trade zones ("FTZs" or "zones") to "expedite and encourage foreign commerce." The Foreign-Trade Zones Act of 1934, as amended, (19 U.S.C. §§81a-81u or the "Act") sets forth the substantive rules establishing the FTZ program. According to the Board, the proposed amendments constitute "a major revision" to its existing regulations (15 C.F.R. Part 400), and are intended to

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<sup>1</sup> See 75 Fed. Reg. 82340-82362 (December 30, 2010).

“improve flexibility for U.S.-based operations, particularly for most circumstances involving exports; enhance clarity; and strengthen compliance and enforcement.”

Our specific comments are documented below. All references herein to regulatory “section(s)” refer to the proposed regulations contained in the Notice, under Title 15 of the United States Code of Federal Regulations unless specified otherwise.

## **Comments**

### **§400.14 Production.**

In this section, the Board proposes to limit the requirement for advance Board approval for production activity in a zone to only certain circumstances. The proposed rules also simplify procedures for requesting production authority. In order to provide more clarity around the proposed regulations and further facilitate the federal government’s initiative to foster manufacturing activity and exports, the following modifications are suggested to the Board’s proposed regulations.

Paragraph (d) outlines a procedure for the Board to allow for interim approval of some or all of the activity after the close of the period for public comment period while the Board is completing its review of the application. This provision also provides for written concurrence to the proposed activity from the CBP port director. It is suggested that the Board eliminate the requirement for CBP concurrence to the Board for the proposed interim activity. This modification is suggested because CBP will already need to work with the zone operator and Grantee to authorize the zone to activate in order to conduct the proposed interim activity under FTZ procedures. For this reason, it is an additional burden for CBP to be required to provide the Board with written concurrence to the request for interim approval of production activity.

Paragraph (e) (1) on “Production Changes”, provides that zone applicants may request authority to notify the Board on a quarterly retrospective basis of production changes involving new finished products or foreign components/inputs resulting in inverted tariff or scrap benefits.

This paragraph should be modified to provide clarification on the Board’s definition of “production changes”. For example, the Board should explain if this provision includes sourcing changes currently provided for in 15 C.F.R. §400.28 or only new finished products and components. Additionally, this paragraph should be modified to extend the notification period from quarterly to annually, for instance such production changes can be reported retroactively as part of the Annual Report to the FTZ Board.

Likewise, paragraph (e)(2) on “Capacity Increases” provides that the Board should be notified of production capacity increases no later than the end of the calendar quarter during which the capacity increase becomes effective. This paragraph should be reconsidered and potentially eliminated in order to make reporting requirements less burdensome for companies conducting manufacturing under FTZ procedures. Alternatively, if the Board cannot eliminate this requirement, it may be helpful to modify the proposed regulations to provide that any increases to approved capacity in excess of a specific threshold factor (*e.g.*, 10%) could be reported on an annual retrospective basis instead of on a quarterly basis.

#### **§400.15 Production equipment.**

This section of the proposed regulations applies to the availability of zone benefits for parts and merchandise admitted to a zone for use as production equipment as part of zone production activity, pursuant to 19 U.S.C. §81c(e).

This section should be expanded to allow for zone benefits on merchandise or parts admitted to a FTZ for use as equipment in warehousing / distribution and other types of processing activity, not just production activity. This modification is needed to provide uniform treatment to zone operators, regardless of the type of activity they conduct within the zone. Because the purchase and admission of parts for equipment typically involves a capital expenditure and necessitates the use of skilled employees to conduct equipment assembly, installation, testing, calibrating, etc., expanding the scope of this provision to also include equipment for any zone activity, including warehousing / distribution activity seems to be

consistent with the ideals of the FTZ program to support employment and investment in the United States.

**§400.16 Exemption from state and local ad valorem taxation of tangible personal property.**

In this section, the Board provided that “Foreign merchandise (tangible personal property) admitted to a zone and domestic merchandise held in a zone for exportation are exempt from state and local ad valorem taxation while such merchandise remains in the zone in zone status (19 U.S.C. §81o(e)). The exemption from such taxation is limited to tangible personal property imported from outside the United States and held in a zone for the purposes stated in 19 U.S.C. §81o(e), and tangible personal property produced in the United States and held in a zone for exportation, either in its original form or as altered by any of the processes stated in 19 U.S.C. §81o(e).”

The Act provides “Tangible personal property imported from outside the United States and held in a zone for the purpose of storage, sale, exhibition, repackaging, assembly, distribution, sorting, grading, cleaning, mixing, display, manufacturing, or processing, and tangible personal property produced in the United States and held in a zone for exportation, either in its original form or as altered by any of the above processes, shall be exempt from State and local ad valorem taxation.”

In this section, the Board limited the applicability of the state and local exemption to foreign merchandise (tangible personal property) *admitted* to a zone and domestic merchandise *produced in the United States* held in a zone for exportation in zone status. The Board’s proposed regulation seems to be more narrowly constructed than the statute it implements. The Board should consider editing this proposed regulation to be consistent with section 81o(e) of the Act as currently implemented in order to avoid any potential confusion by state and local tax authorities and zone users / operators.

#### **§400.35 Completion of case review.**

Paragraph (d) provides that the Board may opt to terminate review of an application with no further action if the applicant fails to provide in a timely manner information needed for evaluation of the application or if the Board is unable to reach a unanimous decision regarding the disposition of the application. This paragraph further provides that the Executive Secretary may terminate review of an application where the circumstances presented in the application are no longer applicable as a result of a material change, and will generally notify the applicant of the intent to terminate review and allow 30 days for a response prior to completion of any termination action.

As an alternative to the above provisions when the Board may terminate review of an application because the applicant (1) fails to provide information in a timely manner and / or (2) circumstances underwent a material change, the Board should consider the following alternatives: (1) including a provision for the zone applicant to request additional time to provide the information requested by the Board and (2) modify the proposed regulation to include language in which the zone applicant would be the party to notify the Board of a material change in the circumstances in the application in order to request termination of the review.

In both cases, the Board *should provide written notification* to the applicant of the intent to terminate the review.

In situations when the Board is unable to reach a unanimous decision regarding the disposition of the application, the Board should make available an administrative review process in the Grantee and / or zone applicant can have an opportunity to meet with the Board to discuss questions and / or issues before the Board provides written notification of their intent to terminate review of the application.

Finally, this proposed regulation should be updated to reinstate 15 C.F.R. §400.27(f)(2) which provide the decision as to concurrence within 20 days after being notified of the request or application includes a 20 day limitation for CBP to provide concurrence of application.

### **§400.38 Monitoring and reviews of zone operations and activity.**

Paragraph (b) provides that the Board may undertake “public interest” or compliance reviews in response to requests from parties directly affected by the activity in question showing good cause. While it may be implied that the party making a request for said review will be disclosed to the affected zone participant pursuant to §400.53 (Official record; public access), proposed §400.38(b) should explicitly state that all requests for such review, including the party requesting such review, will be disclosed to the affected zone participant prior to the initiation of the review. It should also state any review conducted pursuant to this paragraph is subject to the notice and hearing requirements of §400.52.

Paragraph (c) provides that prohibitions or restrictions on zone activity may be put in place after a preliminary review (*e.g.*, prior to potential steps such as public comment period). Due to the potentially disruptive nature of such a measure to the zone participant prior to the Board having had an opportunity to complete its review of all information, and prior to the zone participant’s opportunity for public notice and hearing, it is recommended that such premature measures should be removed from the proposed regulations.

Alternatively, the proposed regulations should provide that any preliminary measures would only be put in place upon the following showing (akin to what may be required for injunctive relief): (a) the party initiating or requesting the review has a substantial likelihood of success on the merits; (2) said party would suffer irreparable injury if the preliminary prohibition or restriction is not put in place; (3) the preliminary prohibition or restriction will not substantially injure the opposing party (*e.g.*, zone participant) or other third parties; and (4) the preliminary prohibition or restriction would further the public interest. The burden of proof should be on the party initiating or requesting the review.

The proposed regulations should also specify that if any such preliminary prohibition or restriction is put in place by the Board, and is subsequently upon the Board’s complete review determined to have been unnecessary (*e.g.*, if ultimately there is no adverse finding against the zone participant) then the affected zone participant may be entitled to a refund of any additional customs duties and related fees paid resulting from the preliminary denial of zone benefits (*e.g.*,

an agreement from CBP may also be required to suspend liquidation until the Board's review is complete in such cases in order to allow for timely Protest).

#### **§400.43 Uniform treatment.**

Paragraph (e) precludes certain conflicts of interests in *agent's* performance of specified zone-related grantee functions, including oversight of zone participants operations within the zone project or collecting/evaluating annual report data from zone participants.<sup>2</sup> The proposed regulations state that the specified zone-related grantee functions shall not be undertaken by, *inter alia*, a third party that currently engages in, or which has during the prior two years engaged in, offering/providing a zone-related product/service to or representing a zone participant in the grantee's zone project. The proposed regulation appears to create an inherent conflict of interest for zone operators.

The term "agent" is defined in proposed §400.2(b) to mean "a person (as defined in §400.2(h)) acting on behalf of or *under agreement with the zone grantee* in zone-related matters." A "zone operator" is defined in proposed §400.2(s) to mean "a person that operates within a zone or subzone *under the terms of an agreement with the zone grantee*, with the concurrence of the Port Director." Thus, a zone operator is, by definition, also an "agent."<sup>3</sup> As such, zone operators are precluded from providing oversight of zone participants operations within the zone project or collect/evaluate annual report data from zone participants if they are also providing "zone-related services" (undefined) to zone participants.

The potential problem arises because, in practice, zone operators provide zone-related services to zone participants in several ways. Arguably, zone operators *per se* provide "zone-related services" to zone participants because zone users benefit from many of the zone operator's essential zone responsibilities (*e.g.*, handling of merchandise, inventory management,

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<sup>2</sup> The specified zone-related functions include: reviewing, making recommendations regarding or concurring on proposals/requests by zone participants pertaining to FTZ authority or activation by CBP; any oversight of zone participants operations within the zone project; or collecting/evaluating annual report data from zone participants.

<sup>3</sup> This understanding is consistent with the Executive Secretary's public comments at the National Association of Foreign-Trade Zones 2011 Regulatory & Legislative Seminar (2/8/11), indicating that the term "agent," as defined by the proposed regulations, would include "zone operators."

reporting, *etc.*). In some instances, there is a contractual arrangement between the zone operator and the zone user. Accordingly, the proposed regulation may create an inherent conflict of interest for zone operators (*i.e.*, zone operators are by definition an “agent” of the grantee that provides “zone related services” to zone participants). While it is not believed that this is the kind of prohibition intended by the proposed regulations, it may be an unintended paradox absent additional modification and clarification of the proposed regulations by the Board.

In addition, a zone operator may sometimes hold itself out as a third party provider of zone related services or logistics services to zone users (*e.g.*, 3PL). In some cases, these services are provided to zone users through “zone-user agreements” which grant zone users the privilege to sub-operate and manage zone operations. If the proposed regulations restrict zone operators from performing such services, this may be potentially disruptive to zone users. Zone users would have to seek other non-operator 3PLs to perform services that may be most effectively performed by zone operators who are already familiar with the zone operations in general, and the zone user’s business in particular.

The perceived problem may be resolved if the Board clarifies that the reference to “third parties” in paragraph (e)(1) does not include the zone operator. In addition, the regulations may define the term “zone related services” in a manner that excludes those services generally provided by the zone operator to zone users in the ordinary course of the zone operator’s responsibilities or as a contracted 3PL.

#### **§400.48 Retail trade.**

Paragraph (a) provides that the Board’s “Executive Secretary” will determine whether an activity is prohibited “retail trade” in a zone. Under existing FTZ regulations (§400.45) such determinations are currently made by CBP’s “Port Director.” Accordingly, CBP has issued binding rulings and other decisions addressing what constitutes prohibited retail trade; and companies have relied on the principles set forth in those rulings, often cited as authority, to organize their zone transactions.

The Board should clarify whether this proposed change indicates that CBP will no longer issue binding rulings, or other decisions, concerning “retail trade” for zone purposes. If CBP will no longer make such determinations, then the Board should clarify that the Executive Secretary intends to follow the precedent established by existing CBP decisions, and that the principles contained in binding rulings will continue to be authoritative unless specifically modified or revoked pursuant to 19 C.F.R. §177.12 (*e.g.*, subject to notice requirements).

In addition, it is recommended the Executive Secretary should adopt a procedure to make its written decisions concerning “retail trade” available to the public, similar to CBP’s binding ruling process. This information is of interest to the public as technological developments continue to transform forms of commerce which may affect zone activity (*e.g.*, internet retail trade involving zone merchandise),

Finally, the fulfillment of orders in a FTZ should not be considered retail trade.

#### **§400.62 Fines, penalties and instructions to suspend activated status.**

As a general matter, the violations contained in the proposed regulations are strict liability offenses. It is our view, however, that proposed §400.62 should provide that fines may not be imposed on any party for any offense that is not the result of the offending party’s negligence. Other corrective or punitive measures may be appropriate on a strict liability basis to enforce compliance, but financial penalties should be reserved only for violations that arise to a level of culpability of at least negligence.<sup>4</sup> Otherwise, a violation resulting from clerical error may be fined at the same level as one resulting from gross negligence. This is seemingly inequitable.

For instance, paragraph (c) provides for fines each day during which the grantee fails to submit a complete and accurate annual report. However, the grantee’s failure may be result of the zone operator’s failure to timely submit to the zone grantee information required by the

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<sup>4</sup> This would be similar to 19 U.S.C. §1592 which imposes customs fines only for certain levels of culpability: negligence, gross negligence, or fraud.

grantee, despite the grantee's best efforts. Although the proposed regulations recognize that the zone operator's failure may constitute a "*separate offense* subject to a fine," and that the "responsible operator would be *the focus* of any fine-assessment," such language does not guarantee that the offending grantee *i.e.*, through no negligence of its own, would not also be subject to fines notwithstanding the operator's "separate offense."

By limiting financial fines and penalties to only those violations that rise to a level of at least negligence, this would ensure that only culpable parties are fined for any offense, whilst parties that actively exercise reasonable care are not. This would also avoid the inefficient use of private and public sector resources to pursue and defend against fines for non-egregious violations (*e.g.*, clerical errors). Given the interwoven relationship between grantees, zone operators and other zone participants in any zone program, the inclusion of such a requirement would be equitable, and provide a higher degree of fundamental fairness to the penalty process than the discretionary "mitigation guidelines" under proposed §400.62(f).

Under the proposed penalty framework, zone participants may also be subject to the overlapping penalty authority of both CBP and the Board. Pursuant to 19 C.F.R. §146.81, CBP may impose fines similar to those proposed by the Board under §400.62 "upon violation of the [FTZ Act], or any regulation issued under the [FTZ Act]."<sup>5</sup> Since the proposed Board regulations are issued under the FTZ Act, CBP may arguably impose fines for the same offense pursuant to 19 C.F.R. §146.81. Thus, it is requested that the proposed regulations explicitly prohibit the imposition of fines by both the Board and CBP on the same party resulting from the same offense.

### **§400.63 Prior disclosures.**

Similar to U.S. customs law, paragraph (a) allows persons to make a *written* "prior disclosure" of violations of the FTZ Act or the Board's regulations. However, unlike the

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<sup>5</sup> Like the proposed FTZ regulations, the customs regulations, 19 C.F.R. §146.81, imposes fines up to \$1,000 per violation, with each day during which a violations continues constituting a separate offense.

customs prior disclosure law (19 U.S.C. §1592(c)(4)) under which offenders may disclose violation until it has *knowledge* of the commencement of a formal investigation, proposed §400.63(a) states that a valid prior disclosure must be submitted “*prior to the commencement of an investigation by the Board of the violation.*” As proposed, the FTZ regulation may create situations whereby persons may unwittingly make an invalid prior disclosure to the Board unaware that an investigation has already commenced.

It would seem fundamentally unfair to establish a prior disclosure program whereby parties are encouraged to volunteer details of a violation without any potential benefit to the disclosing party. This uncertainty may discourage prior disclosures. Accordingly, it is requested that the Board amend the proposed regulation to mirror the customs law by providing that any person may submit a prior disclosure “*prior to, or without knowledge of, the commencement of an investigation by the Board of the violation.*”

The proposed regulations should also include an opportunity for an oral prior disclosure, as do the customs regulations. See 19 C.F.R. §162.74(a)(2) (*e.g.*, in the case of an oral disclosure, the disclosing party shall confirm the oral disclosure in writing within 10 days of the oral disclosure).

In addition, a prior disclosure made under the proposed FTZ regulation does not appear to provide the assurance of penalty mitigation. Instead, proposed §400.63(e) merely provides that “it shall be the *general policy* of the Board (except in cases involving fraud) to reduce to a maximum of 1,000 dollars the total sum of potential fines for a single violation or series of offenses stemming from a continuing violations.” It is requested that the proposed regulations be amended to provide a legal assurance of said penalty mitigation for valid prior disclosures, rather than as a discretionary matter of “*general policy.*” Paragraph (e) should provide that if a party submits a valid prior disclosure, “no fine or penalty shall be assessed.” Alternatively, paragraph (e) should specify that, upon submission of a valid prior disclosure, fines “shall not exceed” the specified amounts in paragraph (e).

Paragraph (f) also provides that prior disclosures made to the Board “shall not involve the loss of revenue and is only applicable to those fines imposed pursuant to this section.” It further

provides that “loss of revenue must be addressed through the [CBP] procedures established by 19 U.S.C. §1592(c)(4).” However, the proposed regulations do not specify which violations, nor provide guidance to evaluate which activities, directly or indirectly, may in the Board’s view “involve the loss of revenue.” Arguably, since duty is not imposed until goods are removed from the zone and entered for domestic consumption, there can be no loss of revenue for any violation occurring strictly within a zone if the goods have not yet been entered into the customs territory. Alternatively, would the mere *potential* for loss of revenue trigger the customs prior disclosure procedures instead of the FTZ procedures (*e.g.*, does a violation concerning inverted tariff production within a zone “involve” loss of revenue even though the finished good has not entered the customs territory, and may never enter if exported)?

In addition, paragraph (f) merely provides that “loss of revenue” must be addressed through CBP procedures (19 U.S.C. §1592(c)(4)). As written, the proposed regulation is unclear as to whether only the “loss of revenue” aspect of the prior disclosure should be handled pursuant to CBP procedures (*i.e.*, whether the prior disclosure should be made to the Board, but unpaid duties should be tendered to CBP), or whether it is intended that the prior disclosure itself should be made to CBP. If the latter is intended, it is recommended that the phrase “loss of revenue must be addressed through the [CBP] procedures established by 19 U.S.C. §1592(c)(4)” be replaced with “violations involving a loss of revenue must be disclosed to CBP through the procedures established by 19 U.S.C. §1592(c)(4).”

Thus, it is requested that the Board provide additional guidance and clarification surrounding these “prior disclosure” issues.

## **Conclusion**

As noted above, we generally welcome the practical approach embodied in the proposed regulations, intended to improve the flexibility of the FTZ program in the United States. However, it is our view that such objectives should be achieved only upon consideration and adoption of the practical recommendations made herein. KPMG would welcome the opportunity to further discuss our proposed amendments and comments to assist the Board, where necessary.

For the foregoing reasons, we respectfully submit that the proposed regulations should be clarified and/or modified as discussed throughout this submission.

Respectfully Submitted,



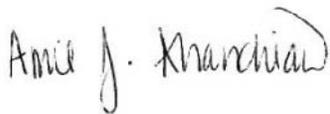
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