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Importer Appeals Houston COA Finding That Denied Importer's FTZ Exemption

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Key Points

The Texas Supreme Court has been asked to consider what constitutes an "activated" foreign trade zone (FTZ) and thus ad valorem tax exemption.

The case at hand involves a FTZ subzone that was implied and assumed to be activated via merger and consolidation with a previous operator and not explicitly conveyed by U.S. Customs and Border Protection.

To reach a decision, the Texas Supreme Court must determine whether "activation" and "operator" are formal designations from a defined process, or can be implied from a course of conduct by the zone grantee, turning to ambiguous definitions of the Foreign-Trade Zones Act of 1934.

The case at hand: establishing a foreign trade zone

On December 5, 2019, the Texas Supreme Court heard oral arguments in *PRSI Trading, LLC v. Harris County, Texas*, No. 18-0664. Before the Texas Supreme Court is the issue of whether a foreign trade zone (FTZ) subzone was still "activated" for the purposes of a company's claim for an ad valorem tax exemption when the company was operating the subzone without a formal "operator" designation from U.S. Customs and Border Protection (CBP).

In 2005, Pasadena Refining System Inc. (PRSI) entered into an agreement with the Port of Houston to operate a subzone of a FTZ for the manufacturing, blending and storage of petrochemicals and other related products at a refinery. The CBP approved PRS1 as the operator of the subzone. The approval provided the operator all of the rights and benefits of a FTZ, including

exemption from state and local ad valorem taxation on goods held in a FTZ for export out of the United States.

At issue: a transfer of operator designation through company merger

In 2006, PRS1 merged into its parent company, and the parent company subsequently merged into its parent company. The merged entity was also named Pasadena Refining System Inc. (PRS2). PRS2 applied to CBP for approval to be the new operator of the subzone previously operated by its subsidiary. In 2008, the CBP issued a letter instructing the PRS2 that the operator approval process, in part, depended on Harris County issuing a letter of non-objection. This CBP letter was issued despite the PRS2 amended argument that it was the same operator as the merged parent company of the previous operator. The CBP letter stated that CBP would not approve the FTZ activation for the subzone without county approval. PRS2 never obtained the required letter from Harris County. In May 2013, the FTZ was ultimately deactivated after PRS2 was declined as the new subzone operator.

In August 2013, Harris County filed a lawsuit challenging the Harris County Appraisal District's grant of FTZ taxation exemptions to PRS2 for 2006 to 2013 for the subzone. Harris County claimed that because PRS2 was never approved as an operator, the subzone was not activated for the purposes of FTZ exemption from state and local ad valorem taxation. The Trial Court granted summary judgment against Harris County, determining that the FTZ exemption was still in effect due to PRS2 continuing to operate the subzone (and thus, being "activated") despite not receiving the "operator" designation. Harris County appealed the issue to the First Court of Appeals, which reversed and rendered judgment for Harris County. The Court of Appeals based its finding, in part, on its determination that "without activation…pursuant to approval of a new operator," the inventory held by PRS2 "could not have been properly admitted into the subzone, and, thus, was not entitled to exemption from ad valorem taxation." *Harris Cnty. v. Harris Cnty. Appraisal Dist. and PRSI Trading, LLC*, 579 S.W.3d 77, 85 (Tex. App.—Houston [1st Dist.] 2017, pet. granted). PRS2 appealed the issue to the Texas Supreme Court.

Last Thursday, December 5, 2019, the Court held oral arguments. PRS2 argued that CBP's operator designation is separate and not dispositive of whether a (sub)zone is activated. PRS2 contended that CBP's continued temporary authorization for the former to operate the subzone, coupled with the formal request to deactivate in 2013, indicates that the zone was activated for 2006 to 2013 for the purpose of the FTZ ad valorem taxation exemption. Meanwhile, Harris County argued that a zone cannot be activated without a CBP-approved operator. To the extent that CBP allowed PRS2 to operate for the 2006 to 2013 period, Harris County claims that whether a party is an operator requires an official (and explicit) designation, and cannot be implied or inferred from a course of conduct.

What this means to you

Under the current holding, a FTZ or subzone can only be activated with an approved operator. Operator status cannot be implied or assumed from a merger or consolidation with a previous operator, and must explicitly be conveyed by CBP. If a merger or change of operator is desired, then seeking CBP approval prior to the merger or change is a best practice to avoid any issue with the FTZ or subzone activation (and more importantly, FTZ taxation exemption).

The Texas Supreme Court will have to evaluate two important terms under FTZ law before reaching a decision in this matter. Specifically, the Court must determine whether "activation" and "operator" are formal designations from a defined process, or can be implied from a course of conduct by the zone grantee. The Foreign-Trade Zones Act of 1934 states that "'activation' means approval by the grantee and port director for operations and for the admission and handling of merchandise in zone status." 19 C.F.R. § 146.1(b). "Operator" is "a corporation, partnership, or person that operates a zone or subzone under the terms of an agreement with the zone grantee." *Id*. Both definitions have ambiguity, which the Texas Supreme Court will ultimately have to address before deciding this matter.

Contact us

If you have questions about this update or how it might affect your business, contact Kate David, Robert Eckels, Sandy Hellums-Gomez, Arturo Michel, Mike Stafford, Anthony Franklyn or Ben Stephens.