

## Customs Arrangements within Commerce Agreements between Israel and the Palestinian entity

### Forward

This document is a completion of, and an addition to, the document prepared by David Brodet and Arie Bar titled "*Alternative Commercial Arrangements between Israel and the Palestinians Entity*" (hereinafter: "the Commerce Arrangements Document"), and it aims to shed light and add practical aspects to customs issues, to be defined below, and to enable the implementation of the alternative that would be selected, in the best possible way.

Since 1994 there has been an Israeli-Palestinian customs envelope which functions according to the rules agreed upon within the Paris Protocol of April 1994. It appears that if the sides decide to continue to implement the customs envelope, there would be no need for different customs arrangements than those currently in place. Therefore, this document will detail with the customs arrangements expected if one of the *other* alternatives suggested in the Commerce Agreements Document would be chosen. At the same time, if the unified envelope arrangements continue to exist for the time being, and since closures resulting from violent operations prevent ongoing commerce between the sides, I believe it would be possible to cut segments of the arrangements detailed below, and to implement them as separate elements.

The customs authorities in all countries are a central element in global trade, as their main function is to guard the entrance and exit of goods into- and out of- the country where they operate. Such customs authorities have always been perceived as bodies that can encumber global trade activities. However, in recent years a change has occurred, and customs authorities have realized that they need to enhance their efficiency in order to enable the correct balance between the need to ensure the legality of imports and the collection of import taxes on the one hand, and the need to enable the proper, rapid and low-cost flow of goods on the other hand. The arrangements detailed in this document will be based on the need to enable ongoing, rapid and efficient commerce both between the various regions of the two sides and between the areas of the Palestinian entity to the rest of the world, via Israel's land, sea and airports.

In fact, if it were a discussion of commerce arrangements between two neighboring states, each of which has the necessary infrastructure to enable independent international commerce, and between which there are regular peace and commercial relations, no special customs arrangements would have been necessary. However, in the existing circumstances the Palestinian entity still has no independent infrastructures, and many years are likely to pass before such infrastructures will be fully established. Moreover, the peaceful relations between the sides are being constructed gradually with many ups and downs, and which have still not reached a conclusion. Therefore, in any future

commerce agreement – both in the short-term and in the medium-term – special customs arrangements would be needed in order to enable the Palestinian entity to implement ongoing, efficient and continuous commerce activities with the other countries of the world, including Israel, and in parallel in order to enable Israel to properly control its borders against unwanted smuggling of goods, both from the economic perspective and from the security aspect.

The main customs arrangements that would be needed for a commerce agreement between Israel and the Palestinian entity to be established, and to which this document relates, will include the following elements:

1. Bonded warehouses;
2. Goods in transit;
3. The reimbursement of import taxes.

As far as customs arrangements are concerned, in addition to considerations of efficiency aimed at supporting as rapid, low-cost and continuous import and export processes as possible for the benefit of importers and exporters from both sides, the document will also relate to economic and security concerns, aimed at preventing security related and commercial smuggling.

### **Bonded Warehouses**

Bonded warehouses are warehouses under the supervision of the customs authorities in which imported taxable goods are usually placed for temporary storage, until the import taxes have been paid and the goods can be released from supervision. In Israel there are a few types of bonded warehouses that can be divided into two main categories as follows:

1. General bonded warehouses - where every person can place goods in return for payment. These warehouses are privately owned, are located in the vicinity of customs houses and usually hold goods that are taxable or owe purchase taxes. The advantage of temporarily storing such goods lies in the fact that goods can be released from these warehouses little by little, contrary to only whole shipment release from the import port that enables only the release of the entire shipment at once. In this way, the payment of taxes is delayed and broken down according to the dates of the releases. Any commercial entrepreneur can establish such warehouses after receiving the needed license from the customs director, if he or she fulfill the bonded requirements that include, among other things, sufficient storage facilities, proximity to the customs house (for the purpose of supervision by the customs authorities), the payment of fees, a character reference to the owners of the warehouse etc. This type of bonded warehouses is the one most common in Israel.

2. Private bonded warehouses in which a person can store only his or her own goods. There are only a few such warehouses in Israel, mostly in the field of car imports where large storage space is required.

In fact, it is possible to say that from Israel's point of view, the existing general warehouses can suffice also for answering the needs of Palestinian importers and there is no need to add a third type of warehouses. However, after a more in-depth examination of the issue, as will be detailed below, I have come to the conclusion that both sides should be interested in constructing one or two bonded warehouses that would be specifically designated for interim storage of goods imported via Israel's land, sea and airports, destined to reach the Palestinian entity's territories. Following are the reasons behind this conclusion:

- a) The phenomenon of violence that is characterized by many ups and downs, has led to the State of Israel having to implement security closures for prolonged periods of time throughout the past years, and it is impossible to guarantee that such a need won't arise again in the future. These closures lead to a situation in which the Palestinian importers and exporters are faced with specific periods, at times prolonged periods, during which they are unable to export goods to the outside world nor to release import goods from Israel's ports that have arrived and were destined for the Palestinian entity's territories. This inability to export and import obviously caused severe economic damages to these exporters and importers, to the Palestinian entity's economy and, to a certain extent, also to Israeli merchants.
- b) If it would have been theoretically possible to guarantee that the phenomenon of violence would cease altogether and that therefore there would be no need for future closures, in such a case import into- and export out of the Palestinian entity could have been implemented directly, without the need for special interim storage bonded warehouses. However, since it isn't possible to guarantee the complete cessation of violence, it is both sides' duty to minimize as much as possible the consequent damages. One of the most operative options for minimizing these damages is via the construction of one or two bonded warehouses, which would be designated for Palestinian importers and exporters for temporary storage of import or export goods.
- c) In order for such a designated warehouse to answer the need of ensuring a continuous flow of goods, it needs to be located near the land crossings between Israel and the Palestinian entity's territories. And, since the territories of the Palestinian entity are characterized as being two separate regions that are rather distant from each other, the construction of two warehouses should be examined – one near one of the crossings of the Gaza Strip and

the other near one of the major crossings to the West Bank. The construction of these two warehouses as described here should give an appropriate response both to the needs of the Palestinian importers and exporters, and to the economic and security needs of Israel.

- d) It is no secret that in the current reality, in which there is a direct flow of goods from Israel's ports to the Palestinian entity, Israeli customs employees have a hard time implementing appropriate monitoring measures to ensure that all these goods actually reach their destination. Thus, there are many cases in which such goods remain in Israel without import taxes having been paid to Israel and without the required tests having been implemented regarding, for example, sanitary bonded, standardization tests, etc. The establishment of the interim storage warehouses described here and the channeling of all import and export of goods destined for the Palestinian entity's territories through these bonded warehouses, would make it possible to significantly lessen the quantity of goods that "leak" into Israel proper and therefore, in parallel to the Palestinian interest, Israel also has an interest in their construction.

Given the significant interest that both sides have in the establishment of such bonded warehouses, and if the two sides manage to reach an agreement regarding their construction, there is room to examine whether storing goods in them would be optional, or whether it should be obligatory. Each one of these options has its advantages as well as disadvantages, which will be examined below:

- a) The flow of goods from Israel's ports to the warehouses or from the warehouses to the ports can continue to take place even during days in which Israel wishes to implement a security closure. In parallel, due to the vicinity of these warehouses to the crossing points between Israel and the Palestinian territories, the flow of goods into and out of these territories would also be possible, while taking the appropriate measures, regardless of the security closures. This point tilts the scale towards the stand of an "obligatory passage" of goods through such warehouses as this would prevent a situation in which goods are stuck in the port and cannot be released due to a security closure.
- b) An obligatory passage of goods via these warehouses would significantly enhance the ability to monitor them and ensure that goods destined for the Palestinian entity's territories actually reach them and don't enter the Israeli market. This kind of monitoring exists today whenever goods are transferred from Israel's ports to bonded warehouses within Israel, with the owner of the warehouse is under obligation to report to a computerized system that the goods have

reached the warehouses and have been registered inside. In contrast, allowing an optional passage of goods through the warehouses would maintain, and might even enhance, the leakage of goods into Israel proper.

- c) An obligatory passage through the bonded warehouses would also enable the decision makers within the Palestinian entity to decide if they wish to independently collect import taxes. The law in Israel states that goods can be released directly from the ports when the import taxes are paid, or otherwise the goods can be transferred to bonded warehouses and the import taxes would then be paid upon released from the warehouse. In the current situation, Israel collects the import taxes for the Palestinian entity, and passes the money to the Palestinians once a month. When the authorized bodies in the Palestinian entity decide that the time has come to independently act regarding the collection of import and export taxes, it would be possible to transfer these goods to the designated bonded warehouses without collecting the taxes, and then the goods would be released directly into the territories of the Palestinian entity with the taxes being collected by the Palestinian customs employees upon passage. In such a case, the Israeli customs authority would only need to implement security inspections.
- d) In addition to all the advantages listed above for the obligatory passage of goods via the bonded warehouses, an additional point to consider is in relation to the economic element for the importer or exporter:

In the case where goods are released directly from the port by the Palestinian importer, the importer must pay as follows: (1) the payment of dock fees and transport fees to the Israeli port authorities; (2) if goods are released within four days of their arrival to the port there are no extra charges, but if goods are left in the port for over four days, there is an additional payment of storage for each additional day; (3) payment for the security and customs inspections; (4) payment for transport from the port to the border crossing; (5) payment for inspection and transport at the crossing.

On the other hand, if goods are transferred to the designated bonded warehouses, I believe costs can be lowered as follows: (1) dock payment remains the same; (2) transport payment to the port authorities would be lower since there will be no need to pay for transporting the goods to the inspection area; (3) the possibility to transfer the goods to the designated warehouse would prevent the need to leave the goods longer in the port (more than four days) and thus the storage payment in the port would be unnecessary; (4) since the security and customs inspections would be carried out in the warehouse, their cost would remain the same; (5) the payment for transferring the goods from the port to the warehouse would be equal to the transfer costs from the port to the border crossing; (6) the cost of inspections and transport in the border crossing would be saved because the inspections would be implemented only once in the

warehouses, and thus no additional inspections or transfer would be necessary.

I believe that when calculating all the various costs listed above, and especially due to the fact that storage costs in the port for more than four days reach incredible sums, would lead to a situation in which there would be an economic benefit for the importer. If we add to this the fact that this way the goods would be continuously available for import and export activities, then the economic benefit due to lower costs would have a manifold increase.

For all the reasons listed above I believe there is a need to act decisively for the establishment of the designated bonded warehouses. If the sides in fact decide to move to this new system, this will entail the legislating of new designated regulations, as well as a new cooperation agreement between the two customs authorities that would include, among other things, also technical arrangements, computerization and reporting regulations, security checking procedures, joint monitoring procedures etc.

An additional and important point to be mentioned is regarding the security aspect. There is no doubt that the transfer of goods from third countries to the Palestinian entity's territories would not be possible without security checks by Israel. Therefore, when we are discussing the establishment of these designated warehouses for storage, they should be planned in a way that would include sophisticated security checking devices which would enable the implementation of these security checks in an efficient and rapid way.

### **The passage of goods in transit**

The system of "passage of goods in transit" is an accepted system in the world, in which goods pass between two states on their way to a third state, without requiring the paying of import taxes. In fact, the transit state allows the passage of goods through its territory with customs monitoring, without this being considered as import or export through this state. In this way, for example, it was decided in the Israel-Jordan Peace Agreement that the Haifa Seaport would act as a gate for the export of Jordanian goods to third countries. The passage of these goods from Jordan via Israel is done through a "goods in transit" arrangement, according to the rules both sides agreed to.

In a similar fashion it would be possible to reach understandings that would allow the passage of goods from third countries via Israel to the territories of the Palestinian entity and vice versa (hereinafter; "**transit**").

One thing should be made clear at this point: the implementation of the storage arrangements in designated warehouses that was outlined above is, in fact, a transit arrangement. The entire difference between a "pure" transit arrangement to the bonded warehouses arrangement outlined above is that in a direct transit arrangement there is no interim storage point and goods pass directly from the

import port to the border crossing and vice versa, while in a transit arrangement that includes also interim storage in bonded warehouses, there is no direct passage of goods.

There is no doubt that a direct transit arrangement is quicker and of lower cost, which is why such an arrangement is advantageous. At the same time, considering the special situation between Israel and the Palestinian entity in which Israel must act decisively and unambiguously to ensure its safety, I believe it would not be possible in the near future to move to the pure transit arrangement, and therefore the implementation of a combined system that includes both pure transit and interim designated warehouses should be considered.

For example, an agreement could be reached according to which on days without a security warning, exports from the Palestinian entity's territories to third countries would be executed via a pure transit arrangement, while imports into the Palestinian areas via Israel would be implemented in a transit system that also includes interim passage through bonded warehouses (hereinafter: "**combined transit**"). Such an arrangement could provide the sides with operational flexibility according to a scenario in which the export from the territories of the Palestinian entity is in question, Palestinian exporters could rapidly export goods on days without a security warning in an optimal way via Israeli ports, while when imports into the territories of the Palestinian entity is in question, it would be possible to allow the Palestinian entity to execute its own independent customs system and to collect the import taxes by itself.

Why should a direct transit arrangement be used regarding export while a combined transit arrangement would be used in case of import? First of all because Israel still has the vital and existential need to implement security checks in order to prevent the import of arms into the areas of the Palestinian entity, and secondly since the existence of a customs envelope provides Israel with the possibility to monitor the legality of goods imported (such as sanitary or environmental requirements, protection of copyrights, standardization requirements etc.)

### **Reimbursing import taxes**

Reimbursing import taxes is a procedure in which the state collects import taxes (customs, purchase tax, excise and levies, though excluding VAT) according to the customs' rate when the goods are released from the port of embarkation, and later when the importer proves that these goods were then used to produce goods for export, the import taxes are then returned to the importer/exporter. The general idea is that import taxes are taxes collected for consumption or use of the goods in the importing country, and when goods were imported for a period of time but were then exported again, no consumption actually took place in the importing country and therefore the import taxes collected need to be reimbursed.

According to Israeli law there are two reimbursement systems: the first is the collection of import taxes when the goods are imported, and their reimbursement after the exporting has already taken place, according to import-export reports that prove that the export included the imported goods on which import taxes have been paid. The second system is the deferred tax system, according to which the export rate is estimated and import taxes are paid only on the quantity of goods that are expected to remain in Israel. Then, at the end of the year, a report is presented in which the actual import and export rates are reported and according to which the calculations are implemented – whether customs should be repaid in case the actual export rate was lower than the one estimated, or whether the exporter should be paid if the actual export rate was higher than the one estimated.

In the Paris Protocol no instructions were included regarding tax reimbursement, and therefore Palestinian importers are somewhat discriminated against compared with Israeli importers. I will now explain why this is only "somewhat".

As a matter of fact, there is no theoretical problem with the Palestinian exporters receiving import tax reimbursement directly from the Palestinian customs authority for their exported goods, since Israel transfers the income taxes it collects from Palestinian merchants to the Palestinian Authority. However, receiving the reimbursement of import taxes only after the export of goods has already taken place carries with it very high financing costs, which can be extremely high in cases of exporters who export large quantities of goods that are highly taxed. The Israeli solution for lowering the burden of these financing costs is by utilizing the deferred tax system, but according to the existing agreements this system doesn't apply to the Palestinian importers.

I believe that in the framework of a renewed dialogue it would be possible to implement the deferred tax system also in regards to the big importers and exporters of the Palestinian entity in the following way:

- a) A minimal export value should be set for exporters wishing to join the arrangement, so that this arrangement, which isn't easily monitored, would be narrowed to include only the largest exporters who are also currently those most hardly hit.
- b) The proper bodies within the Palestinian Authority would authorize *a-priori* the importers/exporters that can participate in the arrangement, and this only after the quantity of export of these merchants for the past year can be confirmed.
- c) Since the customs envelope continues to exist, and in order to prevent a situation in which a Palestinian importer/exporter would enjoy lower taxation as a result of this arrangement while in fact his or her goods aren't exported, there will be an arrangement according to which the Palestinian customs people will present to the Israeli customs people the yearly reimbursement reports presented to them by the Palestinian exporters, together with the documents authenticating the actual

implementation of export. Failing to present these reimbursement reports to the Israeli customs authorities on the date determined would automatically annul this arrangement for the delaying exporter.

Needless to say that this reimbursement arrangement is good only so long as the customs envelope continues to exist, and when an agreement will be reached to cease the customs envelope arrangement, there will also be no more need for the reimbursement arrangement.

One last comment on this issue: attention should be paid to the question whether free trade agreements could prevent the implementation of the reimbursement arrangement. For example: in the free trade agreement between Israel and the European Union it is clearly stated that export from Israel to one of the EU states and vice versa would not be alleageable for reimbursement. This clause does not exist in other free trade agreements Israel is a party to. Thus, a situation of discrimination should not be created in which export from the Palestinian Authority would enjoy reimbursement, while export from Israel itself wouldn't enjoy such an arrangement.

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