

Understanding Customs-Bonded Warehouses and Foreign-Trade Zones



Introduction

When President Donald Trump announced in January 2018 that tariffs would be increased on [washing machines and solar panels](#), few realized the action was the first volley in what would become a full-blown exchange of retaliatory tariffs between the United States and China. By late 2019, the [scope of tariffs](#) had grown to include an [estimated \\$500 billion](#) in industrial and consumer goods, including cell phones, sports equipment, and footwear.

Faced with the fallout from these tariffs — some as high as [30 percent](#) — many U.S. manufacturers and retailers began to look for ways to mitigate the impact on their businesses. An August 2019 report by [National Public Radio](#) featured one hiring specialist who said there had been a “noticeable spike” in companies looking to hire tariff specialists and supply chain experts. “Any time that the economic situation is becoming more complicated or more volatile, companies who figure out how to take advantage are going to move ahead,” the expert, Martha Gimbel of the Indeed Hiring Lab, explained.

Indeed, many companies have attempted to avert fallout from the increased tariffs through various methods. Some have [shifted manufacturing operations](#) out of China, with [CNBC](#) reporting at least 50 U.S. multinationals including Apple, Hewlett-Packard, and Dell had already moved at least some production to Southeast Asian countries.

Uprooting production though, especially within a very short time frame, is costly and therefore not an option for most businesses. Instead, as [Bloomberg](#) reported, companies are increasingly turning to more creative options, including “tariff engineering,” which refers to instances where companies make minimal adjustments to products, but enough to qualify for an adjusted, more favorable classification rate. Bloomberg’s reporting cites a historical example in which an importer “colored sugar with molasses to avoid higher duties.” Such blatant attempts at avoiding higher tariffs though — a process referred to as “existing in a legal gray-zone” by [Customs and International Trade Law](#) — will often set off red flags among trained U.S. Customs and Border Protection (CBP) agents and may result in stiff penalties or a costly audit review.



Coca-Cola was among the companies cited by the [Cato Institute](#) as being adversely affected by recent tariff increases. According to Cato: “The soft drink maker raised prices for soda and other beverages to offset tariff-induced price increases for freight shipments and metals used in its bottling system.”

A better option might be to take advantage of long-established — and highly reputable — customs bonded warehouses or foreign-trade zones (FTZs). Both are authorized by the federal government and allow businesses to manage tariff responsibilities. Customs bonded warehouses allow importers to store foreign goods for as long as five years, with no duty owed until the goods leave the facility. “The warehouse can be used either to manage cash flow by spreading the duties over time,” the [Financial Times](#) reported, “or to pay lower rates if tariffs are reduced at a later date.”

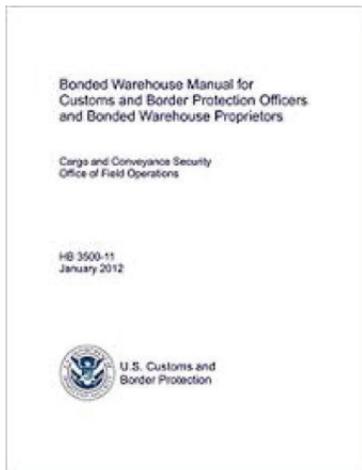
Foreign-trade zones (FTZs) are defined by [CBP](#) as “secure areas located in or near U.S. ports of entry. Legally, FTZs are considered to be outside the customs territory of the U.S. for duty assessment and entry purposes.” Importers may store foreign or domestic goods within an FTZ and avoid customs filings and duties so long as the goods remain within the zone.

Bonded warehouses and FTZs provide significant benefits, including delayed customs payments and the ability to re-export goods without penalties. However, a business considering taking advantage of either must have an understanding of the differences between the two and potential implications for its operations. Use of these facilities does not make sense for every business but can be extremely beneficial, for example, for a business that relies heavily on imported goods.

Following is an overview of foreign-trade zone and bonded warehouse “basics” that can help a business determine if either approach might be a viable strategy worth pursuing.

What Is a Customs-Bonded Warehouse?

The U.S. Customs and Border Protection (CBP) agency defines a bonded warehouse as “a building or other secured area in which imported dutiable merchandise may be stored, manipulated, or undergo manufacturing operations without payment of duty for up to five years from the date of importation.”



U.S. Customs and Border Protection enforces movement of goods into and out of bonded warehouses.

Further, CBP notes, “upon entry of goods into the warehouse, the warehouse proprietor incurs a liability for the merchandise under a warehouse bond.” This liability is generally cancelled when the merchandise is:

- ▶ Exported
- ▶ Withdrawn for supplies to a vessel or aircraft
- ▶ Destroyed under CBP supervision, or
- ▶ Withdrawn for consumption within the United States after payment of duty.

Bonded warehouses are under CBP’s supervision, and merchandise entering a facility must be accounted for via strict record-keeping and documentation requirements. Merchandise in a bonded warehouse is considered to have not made entry into U.S. commerce and is secured by the bond on the warehouse.

11 “Classes” of Bonded Warehouses

Currently, CBP maintains 11 different “classes” of bonded warehouses:

- ▶ **Class 1:** Premises owned or leased by the government, used for the storage of seized

merchandise undergoing examination by CBP, pending final disposition.

- ▶ **Class 2:** Importer’s private warehouse used exclusively for the storage of merchandise belonging to, or consigned to, the proprietor.
- ▶ **Class 3:** Public bonded warehouse used exclusively for the storage of merchandise imported or subject to IRS tax. This bonded warehouse is generally available to any importer at the discretion of the proprietor. A proprietor may impose restrictions on the use of the bonded warehouse by importers, including allowing the exclusive use of the bonded warehouse by one importer.
- ▶ **Class 4:** Bonded yards or sheds for the storage of heavy and bulky imported merchandise; stables, feeding pens, corrals, other similar buildings or limited enclosures for the storage of imported animals; and tanks for storage of imported liquid merchandise in bulk.
- ▶ **Class 5:** Bonded bins or parts of buildings or elevators to be used for the storage of grain.
- ▶ **Class 6:** Bonded warehouses established for the manufacture in bond, solely for exportation, of articles made in whole or in part of imported materials or of materials

subject to IRS tax; and for the manufacture for domestic consumption or exportation of cigars made in whole of tobacco imported from one country. (Although, CBP notes, there are currently no Class 6 warehouses for the manufacture of cigars in the United States.)

- ▶ **Class 7:** Bonded warehouses established for smelting and refining imported metal-bearing materials for exportation or domestic consumption.
- ▶ **Class 8:** Bonded warehouses established for the cleaning, sorting, repacking, or otherwise changing the condition of, but not the manufacturing of, imported merchandise, under CBP supervision, and at the expense of the proprietor.
- ▶ **Class 9:** Bonded warehouses, known as “duty-free stores,” used for selling conditionally duty-free merchandise for use outside the customs territory. Merchandise in this class must be owned or sold by the proprietor and delivered from the warehouse to an airport or other exit point for exportation by, or on behalf of, individuals departing from the Customs territory or foreign destinations. These stores may also sell items other than duty-free merchandise.

A direct-ship vendor solution, in which a retailer owns some of its inventory, is essentially a hybrid of a traditional “drop ship” model, in which the retailer holds no inventory. In a DSV solution, a retailer only off-loads fulfillment for certain products and vendors.



Duty-free stores, common sights in airport terminals, are a type of customs bonded warehouse.

- ▶ **Class 10:** Bonded warehouses for international travel merchandise, goods sold conditionally duty-free aboard aircraft and not at a duty-free store.

- ▶ **Class 11:** Bonded warehouses established for the storage of General Order (GO) merchandise. According to [Investopedia](#), GO merchandise refers to imported goods that are missing proper documentation or cannot be quickly cleared through customs. Goods are held under General Order if they remain uncleared for more than 15 days. After 15 days, GO merchandise is moved to a Class 11 bonded warehouse, and after six months, will be confiscated by the government or put up for an auction run by CBP.

A bonded warehouse may be designated as more than one class, according to CBP, provided that it meets all the requirements of each of those classes.

Where are Bonded Warehouses Located?

Bonded warehouses are located throughout the United States and generally accessible to interested businesses. Many logistics companies, for example, maintain bonded warehouses and advertise their services to potential customers.

In some instances, a private company may decide to have a portion of an existing facility designated as a bonded warehouse. However, analysis by [Neville Peterson LLP](#) notes, care must be taken to ensure “the bonded and non-bonded areas are sufficiently separated by substantial materials that render it impossible for unauthorized personnel to enter the bonded area.” To keep the bonded and non-bonded areas separate, a proprietor must erect partitions that meet precise CBP standards.

Activities Permitted in a Bonded Warehouse

Certain activities — referred to as “manipulations” — may be performed on products held in a bonded warehouse, provided the condition of the goods is not fundamentally altered. This is a critical distinction, since manufacturing activities are not allowed (unless goods are intended for [export](#)). An importer must take care to ensure any actions fall within the scope of allowable “manipulations” and do not constitute a manufacturing activity. This can be somewhat complicated, since CBP acknowledges there is “no precise definition of manipulation.”

With narrow exceptions, manufacturing is not allowed in customs bonded warehouses.

According to [CBP](#), allowable activities include:

- ▶ Cleaning, sorting, or repackaging
- ▶ Simple packing or unpacking
- ▶ Dismantling or disassembly
- ▶ Opening containers for viewing, exhibition, or sampling
- ▶ Labeling, tagging, or insertion of instructional or sales brochures
- ▶ Sorting, grading, or separation of damaged-from-good-order merchandise

When there is any doubt as to whether a certain process constitutes a “manipulation” versus “manufacturing,” an importer should request an opinion or binding ruling from CBP before allowing the procedure in question to take place.

Advantages of Using a Bonded Warehouse

CBP cites several benefits of using a bonded warehouse, including:

- ▶ **Duty deferral.** Duty is not collected [until merchandise is withdrawn](#) from the warehouse. This allows an importer greater flexibility in managing cash flow.
- ▶ **Long-term storage solution.** Imported goods can be stored in a bonded warehouse for up to five years. Depending on a business’s specific needs, this can provide a viable solution for short-and-long-term inventory management.
- ▶ **Ability to export unsold goods.** If no domestic buyer is found for the imported goods, the importer can export the goods, thereby eliminating any obligation to pay duty. This duty-free status also applies to goods intended for re-exportation.
- ▶ **Potential for reduced tariff obligations.** If the rate of tariff for a particular product is reduced while the item is stored in the warehouse, the reduced rate will apply when the product leaves the warehouse.

- ▶ **Duty on manipulated goods.** Duties owed on [articles that have been manipulated](#) while in the warehouse are determined at the time the products are withdrawn from the warehouse.
- ▶ **Ability to store “restricted” items.** Many items [subject to quota or other restrictions](#) may be stored in a bonded warehouse. A business should consult with a CBP office to ensure the eligibility of such merchandise prior to placing it in the warehouse.

What Is a Foreign-Trade Zone?

According to [U.S. Customs and Border Protection](#) (CBP), foreign-trade zones (FTZs) are secure areas that are generally considered to be outside U.S. customs territory for duty assessments and other customs entry procedures. Specifically, zones are physical areas into which foreign and domestic merchandise may be moved for lawful operations, including storage, exhibition, assembly, manufacture, or processing. FTZs are licensed by the Foreign-Trade Zone Board (FTZ Board) and operated under the supervision of CBP.

Foreign-trade zones offer a range of financial benefits to companies by allowing them to reduce, eliminate, or defer duty payments on goods manufactured or stored in FTZs before they enter U.S. commerce or are exported. Located in or near CBP ports of entry, foreign-trade zones are the United States' version of what are known internationally as free-trade zones.



The Foreign-Trade Zones Act of 1934 authorized a Foreign-Trade Zones Board “to review and approve applications to establish, operate and maintain foreign-trade zones.”

As noted by the [FTZ Board](#): “Zones have as their public policy objective the creation and maintenance of employment through the encouragement of operations in the United States, which, for customs reasons, might otherwise have been carried on abroad.”

Foreign-trade zones were authorized by the U.S. Congress under the Foreign-Trade Zones Act of 1934 as a way to expedite and encourage international commerce. Although U.S.

businesses failed initially to embrace FTZs, the concept has taken hold, especially over the last 30 years. According to the [Foreign-Trade Zone Corporation](#), in 1970 there were eight U.S. FTZ projects, whereas today the [Foreign-Trade Zones Board](#) lists more than 250 authorized FTZs, with at least one in each state and in Puerto Rico. In addition, there are almost 500 “subzones,” which are individual businesses or manufacturing facilities.

Although FTZs have broad appeal across many sectors, [CBP cites](#) the petroleum refining industry as the largest zone user, along with the automotive, electronic, pharmaceutical, and machinery/equipment industries. The 2018 NAFTAZ Annual Report notes that during 2017, roughly 3,200 businesses were actively using FTZs.

Types of Foreign-Trade Zones

A business considering the merits of the FTZ program will need to be familiar with the different types and subcategories of foreign-trade zones. [CBP](#) designates two main categories of FTZs:

- ▶ **General Purpose Zones:** Usually located in an industrial park or port complex, with facilities available for use by the general public.
- ▶ **Subzones:** Sites that are sponsored by a general-purpose zone that are normally for a single-purpose, which cannot be moved or accommodated in a general-purpose zone. An individual company's qualified warehouse is a common example of an FTZ subzone.

Allowable Activities within an FTZ

According to the [International Trade Administration](#), when a company receives authority from the FTZ Board, it must closely adhere to the precise scope of activities included in the application and must only allow entry to the listed finished products and foreign-status components.



FTZs can be used for a variety of purposes including storage, manufacturing, assembly, and preparation.

Source: Foreign-Trade Zone #79 — Tampa

Production in a zone may include traditional manufacturing activities as well as kitting or assembly applications. However, if activity within a zone results in a change in a product's tariff classification code, or a "substantial transformation," specific approval will be required from the FTZ Board.

Foreign-Trade Zone Benefits

Businesses that take advantage of FTZs can avail themselves of a multitude of benefits that can help drive down — in some cases eliminate — duty payments and improve supply chain operations. The National Association of Free Trade Zones provides an overview of common FTZ benefits and opportunities that [include the following](#):

- ▶ **Duty deferral benefits.** Instead of paying U.S. duty when a shipment arrives in the U.S., duty payment is deferred until the goods are actually transferred from the zone into the U.S. market, providing valuable cash-flow benefits. Goods may be stored indefinitely in an FTZ.
- ▶ **Duty reduction (inverted tariff).** Businesses utilizing a particular FTZ can petition the board to use a certain "zone status" on merchandise admitted to the zone. This zone status determines the duty rate that will be applied to foreign merchandise should it eventually enter the U.S. market from the FTZ. Through this process, a business can elect to pay either the duty rate applied to foreign components

placed in the zone or the duty rate applicable to the finished product transferred from the zone — whichever is lower.

- ▶ **Elimination of duties.** Since no duty is paid on merchandise exported from an FTZ, duty is effectively eliminated on foreign merchandise admitted to a zone that is eventually exported from an FTZ. Duties are also eliminated on merchandise that is scrapped, wasted, destroyed, or consumed in a zone.
- ▶ **Reduced customs fees.** A [Merchandise Processing Fee \(MPF\)](#) is assessed by CBP on every shipment valued at \$2,500 or more entering an FTZ. The MPF is an ad valorem fee assessed at a rate of 0.3464 percent of the value of the merchandise being imported. MPF “rules” provide that fees range from a minimum of \$25 to a maximum of \$485.

However, FTZ users are now able to file a single entry for all goods shipped from a zone in a consecutive seven-day period. This is a significant change from previous rules that required each shipment to have its own entry. Since the maximum MPF is \$485 per entry, a business can significantly reduce its fee obligations.

- ▶ **Labor and overhead costs.** Zone users are authorized to exclude costs associated with processing or fabrication, general expenses, and profit. Therefore, duties are not owed on labor, overhead, and profit attributed to merchandise produced in an FTZ.
- ▶ **Cash-flow savings.** 2019 analysis by [The Trade Partnership](#) cited the potential for a company to realize significant cash-flow efficiency through use of an FTZ. “Customs duties are paid only when and if the goods exit the zone for entry into the U.S. customs territory for consumption,” the report noted. “While the goods are in storage (there is no time limit for how long imported merchandise can remain in the FTZ) companies can, for example, inspect them and only later enter those that pass inspection. This benefit is of particular value to retailers, to companies with higher capital costs, and to those who import goods subject to quotas.”
- ▶ **Streamlined logistics.** FTZ users can take advantage of direct delivery whereby imported goods move directly from the port of unloading to the distribution center, thereby eliminating certain customs-related delays. For companies moving products from the West Coast to East Coast, direct delivery can save days.

Foreign-Trade Zones vs. Customs-Bonded Warehouses — Key Differences

While FTZs and bonded warehouses have many similarities — namely the ability to defer duty payments — each has distinguishing characteristics that may affect viability for a particular business. The [National Customs Brokers & Forwarders Association of America](#) (NCBFAA) summarizes the two entities as follows:

- ▶ Foreign-trade zones are frequently used for storage, testing, cleaning, processing, assembling, manufacturing, relabeling, repackaging, displaying, exhibition, and repairing of merchandise.
- ▶ Bonded warehouses are generally used for the storage of imported merchandise entered for warehousing, placed in General Order, or for the manipulation of merchandise in-bound.

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Within these two categories, specific differences include:

- ▶ **Time limits.** Goods may only be held in a bonded warehouse for five years, whereas they can be held indefinitely in an FTZ.
- ▶ **CBP authority.** Bonded warehouses are under the direct control and supervision of CBP, while FTZs are not. This means CBP maintains authority with regard to movement of goods held in a customs warehouse.
- ▶ **Foreign vs. domestic goods.** Only foreign goods are allowed to be stored in bonded warehouses. An FTZ may include both domestic and foreign merchandise.
- ▶ **Entry payment.** Entry must be paid at the time goods enter a bonded warehouse. Entry payment is only paid when goods held in an FTZ enter U.S. commerce.
- ▶ **Duty payment.** Duties are paid when goods exit the FTZ and enter U.S. commerce. Similarly, duties are not paid until withdrawal from a bonded warehouse.

- ▶ **Allowable activities.** Manufacturing processes are permitted in an FTZ, but not in a bonded warehouse.
- ▶ **Ease of withdrawal or removal.** Because merchandise stored in a bonded warehouse is under CBP authority, the agency must authorize the removal of any goods. This requires compliance with required documentation. In addition, shipments stored in a customs warehouse must be withdrawn in their entirety, rather than as a series of partial “as-needed” removals. A business seeking to withdraw a partial quantity must obtain CBP permission. Goods stored in FTZs, on the other hand, can be withdrawn with few limitations.

Given the nuances between FTZs and bonded warehouses, a business will need to consider its unique circumstances and goals in determining which option would be most beneficial. “Bonded warehouses are available for repositioning, consolidation and deconsolidation, and light manipulation, although they are not appropriate for most manufacturing activities,” noted analysis by [Benesch Friedlander Coplan & Aronoff LLP](#). “FTZs are available to satisfy manufacturing needs in addition to the many benefits offered by bonded warehouses and offer ease of withdrawal, although they are subject to greater regulation.”

Conclusion

Although the current trade war has heightened attention on the role of tariffs in international trade, seasoned businesses have long understood the importance of managing — indeed mitigating — the impact tariffs can have on business costs.

For tens of thousands of businesses, this has meant incorporating FTZs or bonded warehouses into their trade strategies as a way to defer and manage duty payments. The U.S. Congress authorized these entities — FTZs in 1934, and bonded warehouses in [1930](#) — specifically to expedite and encourage international commerce.

Since then, companies have reaped significant benefits. A 2019 [analysis](#) by the National Association of Foreign-Trade Zones, for example, found employment, wage, and value-added increases among communities with established FTZs. BMW noted that its FTZ operations directly and indirectly add \$6.3 billion annually to the state of South Carolina, and they have led to the employment of more than 36,000 people in the state. Nationwide, BMW says it has added almost \$16 billion in value and helped create 120,000 jobs.

As FTZs and bonded warehouses receive a fresh look, businesses may realize the benefits afforded through these options may provide a new path forward in managing their trade strategies.

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