RENEWED ARAB BOYCOTT THREAT RAISES COMPLIANCE ISSUES UNDER U.S. LAW

Last year, the Arab Office of the Boycott of Israel, a subgroup of the Arab League, announced that it was reactivating the boycott of Israel. Last August, Saudi newspapers reported that 190 Arab and Western companies had been "blacklisted" by the Council of Saudi Chambers of Commerce and Industry, which also recently asked its members not to import any goods suspected of Israeli origin. This renewed threat of boycott enforcement raises serious questions for companies doing business in both Arab states and Israel, since United States law, implemented by U.S. Department of Commerce and Internal Revenue Service regulations, in general prohibits "U.S. persons" from complying with the boycott. This memorandum briefly describes what U.S. law and regulations prohibit and permit regarding the boycott, and the responsibilities of affected businesses.

Summary

U.S. law generally prohibits a U.S. company and, in some circumstances, its foreign subsidiaries from participating, or agreeing to participate, in foreign boycotts that are not sanctioned by the U.S. government. This includes the Arab League's boycott of Israel. The anti-boycott laws are implemented through the U.S. Department of Commerce ("DOC") and the Internal Revenue Service ("IRS"). The DOC regulations, promulgated under the authority of the Export Administration Act, provide both criminal and civil penalties for violations of the anti boycott prohibitions, which include failure to report requests for compliance, and compliance with boycott-related activities. These penalties include fines, imprisonment, and revocation and denial of export licenses and privileges.

The IRS Guidelines, which implement Section 999 of the Internal Revenue Code, require that any U.S. taxpayer (and its related companies) with operations in, with, or related to boycotting countries, report such operations, the receipt of boycott requests, and boycott agreements made. The boycotting countries currently listed by the Department of the Treasury are Bahrain, Iraq, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, and the Republic of Yemen, or any other country which a reporting entity knows or has reason to know imposes boycott-related requirements. As a consequence of cooperation with or participation in an international boycott, a taxpayer risks the loss of certain tax benefits.

The Arab Boycott of Israel

The Arab Boycott was formally declared by the newly formed Arab League Council on December 2, 1945, and states that " 'Jewish' products and manufactured goods shall be considered undesirable to the Arab countries." Subsequently all "Arab institutions, organizations, merchants, commission agents and individuals [are obliged] to refuse to deal in, distribute, or consume 'Zionist' products or manufactured goods." The object of the boycott is

to isolate Israel from its neighbors and the international community, as well as to deny Israel trade that might be used to augment its military and economic strength.

The boycott is divided into three components. The primary boycott prohibits direct trade between Israel and the Arab nations. The secondary boycott is directed at companies that do business with Israel. The tertiary boycott involves the blacklisting of firms that trade with other companies that do business with Israel. While the primary aspect of the boycott prohibits the importation of Israeli-origin goods and services into boycotting countries, the secondary and tertiary aspects of the boycott discriminate against U.S. and other foreign firms that do business with both Israel and the boycotting countries. Where enforced, the boycott results in significant economic harm to U.S. firms in terms of lost sales, foregone opportunities, and distortion of investment decisions.

U.S. Anti Boycott Regulations

The DOC Regulations apply to all "U.S. persons" and cover U.S. exports and imports, financing, forwarding and shipping, and certain other transactions that may take place wholly offshore. The DOC defines a U.S. person to include both the U.S. subsidiary of a foreign company and "any domestic concern's foreign subsidiary, partnership, affiliate, branch, office or other permanent foreign establishment which is controlled in fact by such domestic concern." The term "domestic concern" does not include individual U.S. citizens or residents. The DOC regulations include complex rules of interpretation for when a foreign concern will be considered to be "controlled in fact" by a domestic concern. Since in many cases boycotting countries ask foreign entities affiliated with U.S. businesses, rather than the U.S. entities themselves, to comply with the boycott, it is important for a business receiving such requests to determine whether its corporate structure and management fit within the definitions of what the DOC considers "controlled in fact."

The DOC requires U.S. persons to report quarterly any requests they have received to take any action to comply with, further, or support an unsanctioned foreign boycott. Such actions include:

- Agreements to refuse or actual refusals to do business with or in Israel or with blacklisted companies.
- Agreements to discriminate or actual discrimination against other persons based on race, religion, sex, national origin or nationality.
- Agreements to furnish or actually furnishing information about business relationships with or in Israel or with blacklisted companies.
- Agreements to furnish or actually furnishing information about the race, religion, sex or national origin or another person.
- Furnishing information about business relationships with Israel or with blacklisted persons.

- Implementing letters of credit containing prohibited boycott terms or conditions.

The IRS Guidelines impose certain reporting requirements on all U.S. taxpayers (and their related companies) regarding taxpayers' operations in, with, or related to boycotting countries or their nationals. The requirements and penalties apply to those taxpayers with foreign tax credit benefits.

The IRS requires taxpayers to report "operations" in, with, or related to a boycotting country or its nationals and requests received to participate in or cooperate with an international boycott. IRS regulations do not prohibit conduct; rather they deny tax benefits for certain types of boycott-related agreements. The IRS considers the following to be prohibited conduct:

- Refraining from doing business with or in a country that is the object of the boycott or with the government, companies, or nationals of that country.

- Refraining from doing business with any U.S. person engaged in trade in a country that is the object of the boycott or with the government, companies, or nationals of that country.

- Refraining from doing business with any company whose ownership or management consists, in whole or in part, of individuals of a particular nationality, race, or religion, or removing (or refraining from selecting) corporate directors who are individuals of a particular nationality, race, or religion.

- Refraining from employing individuals of a particular nationality, race, or religion.

- As a condition of the sale of a product to the government, a company, or a national of a country, refraining from shipping or insuring products on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott.

Both the DOC regulations and the IRS Guidelines provide narrow exemptions from the prohibitions and reporting requirements. U.S. persons, in shipping goods to a boycotting country, may comply with shipping document requirements as to the country of origin of the goods, the name of the carrier, the route of the shipment, and the name of the supplier of the shipment, so long as they are not stated in the negative ("will not ship," "is not of origin"). Contract certifications that goods will not be shipped on certain carriers or that restrict the route of shipments are also permitted.

Given the current climate of enhanced tension and the scrutiny surrounding all dealings in the Middle East region, renewed enforcement of the Arab boycott will almost certainly result in heightened U.S. attention to violations of the anti boycott laws and regulations. The DOC regulations and the IRS Guidelines are very complicated and companies doing business in Arab nations need to be aware of who is covered and what is and is not permitted to avoid possible

enforcement, and to be prepared to adjust their operations to assure that they are not vulnerable to such enforcement.

If you wish to obtain additional information regarding the Arab boycott and how it might affect your operations, please contact Russell Smith at (202) 303-1116, rsmith@willkie.com in our Washington, D.C. office.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, New York 10019. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111.

January 7, 2003

Copyright © 2002 by Willkie Farr & Gallagher.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information.