BOYCOTT ALERT

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Many companies can do extensive transnational business without being touched in any way by the Arab League boycott. Companies that are heavily involved in transactions with or operations in the Middle East probably do not need a boycott alert. They know that mastering the complexity of U.S. antiboycott laws and maintaining strong compliance systems go with the territory. Such companies are likely to be aware of the fact that maximum penalty levels have been greatly increased.

This “alert” is intended primarily for those who will encounter the boycott for the first time – or who may not realize that they have encountered it, because of the ambiguous content of a boycott-related request or because the boycott has found its way into business being conducted outside of the Middle East. The objective here is to provide a “quick read” overview of the main features and scope of the Arab League boycott of Israel and of the antiboycott laws of the United States. I shall subordinate completeness to brevity, but I hope to leave readers with a sense of when it may be necessary to look more closely into the details of U.S. antiboycott laws.

The Boycott

In the mid-1940s, the Arab League declared a “primary” boycott of direct trade between League countries and the territory that was soon to become Israel. In 1950, “secondary” boycott elements were added. This development involved establishing a blacklist of firms that the Central Boycott Office in Damascus or a national boycott authority determined were making a significant contribution to the economic development or military capability of Israel. By denying Arab business to blacklisted firms, the boycott sought to induce the firms to drop or restrict their business with Israel. In some instances, boycott pressure has extended to a “tertiary” level, with firms being required to forego dealings with a blacklisted firm in order to obtain business in a boycotting country.

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Lacking other systematic means for gathering information on business dealings and relationships relevant to the boycott of Israel, the Arab League boycott proceeded to solicit such data from foreign firms. This was done both by means of a standardized questionnaire and by more limited ad hoc inquiries. Failure to respond is among the stated grounds for being added to the blacklist, but this consequence appears to have become rare. If a boycotting state wants a transaction with a foreign firm, it is common for boycott-related questions to be avoidable.

The administration of this boycott has been very uneven. Arab League members have national discretion in implementing the recommendations of the Central Boycott Office. Member states have generally observed the primary boycott, as have some Islamic states outside the Middle East. (Egypt and Jordan dropped the official boycott after they concluded peace treaties with Israel.) Application of the secondary and tertiary levels of the boycott has principally been by some Middle Eastern countries. Even these countries have varied their boycott practices in response to changes in the political climate or as a result of pragmatic assessment of their economic needs. The United States has sought to tie its negotiation of free trade agreements to the elimination of secondary and tertiary boycott practices.

The U.S. Antiboycott Laws

As the oil wealth of countries in the Middle East surged, more and more firms were seeking business there and were encountering increasingly aggressive implementation of the boycott. In the latter 1970s, the United States responded with two pieces of legislation.

The “Ribicoff Amendment” to the Tax Reform Act of 1976 added section 999 to the Internal Revenue Code. Basically, this section denies certain tax benefits related to foreign operations to a U.S. taxpayer if that person or a member of a “controlled group” agrees to “participate in or cooperate with an international boycott.” (“PCIB”).

The Export Administration Act was amended in 1977 to add new antiboycott provisions. These provisions are now found in section 8 of the Export Administration Act of 1979, and they are implemented in part 760 of the Export Administration Regulations of the Department of Commerce. (50 U.S.C. app. 2407; 15 C.F.R.760.1-760.5.) This law requires the reporting to Commerce of boycott requests and prohibits specified actions, including the furnishing of boycott related information and refusing or agreeing to refuse to do business on boycott grounds. These provisions apply only to a “United States person” with respect to that person’s activity “in the interstate or foreign commerce of the United States.”

As it is generally recognized that nations have a sovereign right to conduct primary boycott operations against other nations, both pieces of legislation were structured to permit compliance with the primary boycott. For example, they permit an American firm selling a
piece of equipment to a boycotting country to comply with the boycotting country’s prohibition of the importation of goods from Israel by substituting non-Israeli components for Israeli components.

**Treasury Provisions**

Which tax benefits can be affected by IRC section 999? The main ones are those relating to IC-DISC benefits, deferral of tax on foreign subsidiary earnings, and foreign tax credits or to the pre-2005 extraterritorial income exclusion and certain “Foreign Sales Corporation” benefits.

There also are reporting requirements, under which willful failure to report is subject to a fine up to $25,000 and imprisonment for not more than a year. The reports are to be filed annually with tax returns on IRS Form 5713. Reports are to cover operations in, with, or related to a country (or a company or a national of a country) listed by Treasury. Reporting is also required for an unlisted country if a person knows or has reason to know that it officially requires boycott participation. Note that such operations must be reported even by a taxpayer who claims none of the relevant tax benefits and even if the operations have involved no boycott related activity or request. The countries currently listed are Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Republic of Yemen. Note that the removal of Libya from the U.S. list of state sponsors of terrorism in 2006 was not accompanied by its removal from the boycott list.

In abbreviated form, PCIB is an agreement as a condition of doing business (1) to refrain from business in or with a boycotted country or its firms or nationals, (2) to refrain from business with a United States person trading with a boycotted country, or (3) to refrain from business with a company on the basis of the nationality, race or religion of its management or owners. Any request for PCIB must be included in the annual report to the IRS, and the report must state the nature of any operation in which PCIB has occurred or been requested.

It is the extremely broad scope of whose operations the taxpayer must report that can make compliance with reporting requirements enormously complex and the potential loss of tax benefits so daunting. Section 999 extends beyond the operations of the taxpayer to reach those of a “controlled group” that includes the taxpayer and of a foreign corporation of which the taxpayer is a “United States shareholder” or an affiliate. The usual IRC definition of “controlled group” is modified for purposes of section 999 to substitute a fifty percent for an eighty percent threshold. Section 951 (b) of the Code defines “United States shareholder” to mean a U.S. person who owns ten percent or more of the combined voting power of a foreign corporation.

Finally, there is the impact of what people at Treasury have called the “bubonic plague” effect. If there is any PCIB by the taxpayer or the controlled group during the tax year, all
operations of that person or group in any boycotting country shall be treated as PCIB-related and result in the loss of tax benefits – unless. The “unless” is a provision under which it is the burden of the taxpayer to “clearly demonstrate” that other operations of tax consequence were “clearly separate and identifiable” and that no PCIB occurred in connection with such operations.

To the extent that operations related to these tax benefits remain tainted under section 999, the tax consequence is the application of a complex “international boycott factor” by which benefits are reduced by a percentage based on the relationship of tainted operations to worldwide operations. Successful demonstration that separate and identifiable operations are untainted permits limitation of the disallowance of tax benefits by identifying tainted tax benefits under the “specifically attributable income and taxes method.”

Treasury has issued section 999 “guidelines” on several occasions, most recently in 1987. These guidelines, some 100 in all, were published in the Federal Register, but information on them may now be most readily available through commercial tax report services. Such services are also the most convenient source for “temporary” regulations, never finalized, dealing with application of the international boycott factor. The several pages of instructions for Form 5713, the IRS report form, are also instructive.

Now we move on to the harder part!

**Commerce Provisions**

There are detailed regulations under the antiboycott section of the Export Administration Act (EAA). A helpful feature of the antiboycott part of Commerce’s Export Administration Regulations (EAR) is that, like the Treasury guidelines, they illustrate the rules with a large number of examples of how the rules would apply to various scenarios. In addition, several official interpretations are appended to the regulations. Anyone wanting to acquire a good grasp of the Commerce rules cannot do better than to read through these regulations and interpretations, all of which can be found in Title 15 of the Code of Federal Regulations. Further helpful guidance is provided by the Office of Antiboycott Compliance on the website of the Bureau of Industry and Security. www.bis.doc.gov.

Keep in mind that, for these antiboycott regulations to apply, the action must be that of a “United States person” and the action must be in the “interstate or foreign commerce of the United States.” A controlled in fact foreign subsidiary of a U.S. corporation or an overseas branch of a U.S. bank is a U.S. person under the regulations. An individual U.S. national is not a U.S. person for purposes of the regulations while resident outside the United States and working for or under the direction of a non-U.S. person.
Consider, for example, a situation in which the French subsidiary of a U.S. firm receives an order from Syria that contains a boycott agreement clause. If the order is filled with equipment that contains components from the U.S. that were from inventory, the “U.S. commerce” element would not be present and the order could be filled without violating the EAR. Note, however, that this request would be reportable under IRC section 999 and that compliance with the boycott request in filling the order would taint the revenue for purposes of U.S. tax benefits.

Another important distinction relates to what the EAR calls “ancillary services.” These are services that a controlled foreign subsidiary acquires from a person in the United States primarily for its own use rather than for the use of a third person. Financial, legal, accounting, and transportation services to the subsidiary are examples of ancillary services that will not cause the subsidiary’s underlying transaction with the third party to be in U.S. commerce. On the other hand, if, for example, the subsidiary has a construction contract for a project in a boycotting country, supporting engineering service supplied by U.S. home office engineers to the subsidiary with respect to the project places the subsidiary’s contract activity in U.S. commerce.

U.S. persons are prohibited from refusing to do business with anyone (not just with U.S. persons or boycotted country persons) pursuant to an agreement, requirement, or request from or on behalf of a boycotting country. Refusal may be implied by a pattern or course of conduct. The request may come from a non-government source, including a firm or individual outside of a boycotting country.

The prohibitions against discriminatory action and against furnishing discriminatory information apply where the discrimination or information relates to an individual U.S. person or to any owner, officer, director, or employee of a U.S. firm. These prohibitions apply even if the discrimination is not based on a boycotting country requirement or request, but there must be “boycott intent,” which is discussed below. Although discrimination with respect to non-U.S. persons is not covered by these two prohibitions, discriminatory action affecting such persons could constitute a prohibited refusal to do business.

Two other prohibitions refer to boycott-related furnishing of information. The furnishing of information about one’s own or another person’s relationships with a boycotted country or a blacklisted person is prohibited, as is the furnishing of information about associations with any charitable or fraternal organization which supports a boycotted country.

The last prohibition is against implementing letters of credit containing prohibited conditions or requirements. The most common prohibited condition is that a “negative certificate of origin” relating to Israel be included with the documentation for payment. With respect to letters of credit, the EAA goes beyond imposing the prohibition and provides an
absolute defense in an action brought on account of failure, in compliance with the antiboycott law, to honor a letter of credit.

Exceptions to the prohibitions in the EAA fit into three categories. Some exceptions relate to deference to the right to maintain a primary boycott. Exceptions in this category permit not only compliance with prohibition of trade between a boycotting country and Israel, but also with the prescription of shipping routes and with exclusion of carriage on Israeli vessels.

An exception of great practical importance is that which permits compliance with a “unilateral and specific selection” of goods or services by the boycotting country or by a national or resident thereof. A U.S. supplier may know that its customer in the Middle East is specifying that equipment from a named manufacturer shall be used because an alternative manufacturer is blacklisted, but the exception permits compliance. The selection would not be “unilateral” if the buyer had selected from a list that the supplier had provided and from which the supplier had excluded blacklisted sources. The exception would also not apply if the selection were not just boycott based but involved discrimination against a U.S. firm on the basis of, for example, the religion of its owners.

A third category of exceptions pertains to compliance with local law and country entry requirements. For example, a U.S. person who is a bona fide resident of a boycotting country may comply with that country’s laws with respect to activities exclusively within the country, but not if discrimination against a U.S. person is involved. Another example is that an individual U.S. person may comply with a requirement that religion be stated on a visa application, but that individual’s United States employer may not supply such information for the employee.

There is no violation of the prohibitions in the EAA unless the action is taken with intent “to comply with, further, or support an unsanctioned foreign boycott.” Inadvertent action, without boycott intent, is not a violation. To prove a violation, the government must establish that boycott intent was at least one of the reasons for taking prohibited action. The EAR state that reason or purpose can be established by circumstantial evidence. The regulations state, further, that action will be “deemed” to have been taken with intent to comply if the person knew that the action was required or requested for boycott reasons. There are many examples in the regulations to illustrate the intent requirement. One example has been selected because it shows how some provisions in the regulations are counterintuitive and can be traps for the unwary. In this example of “intent,” U.S. manufacturer A receives a boycott questionnaire from country Y that asks whether A has any plants in boycotted country X. A, which has never supported the boycott, responds to the questionnaire that it does have plants in X and that it intends to continue to have plants there. This example concludes: “A’s responding to Y’s questionnaire is deemed to be action with intent to comply with Y’s boycott because A knows that the questionnaire is boycott related. It is irrelevant that A does not also wish to support Y’s boycott.”
It is important to understand that reporting of a boycott request to the Department of Commerce may be required even if the recipient has no intention of responding to the request and even if the regulations permit compliance with the request. To be reportable, the request must be received by a U.S. person in connection with a transaction or activity in the interstate or foreign commerce of the United States. “Boycott intent” on the part of the recipient, or the absence thereof, is not a factor. Rather, the request is reportable if the person knows that the request is boycott related. The receipt of an unsolicited invitation to bid that contains a boycott request is not reportable if not responded to, but a request unrelated to a particular transaction is reportable if the recipient anticipates business in a boycotting country. The regulations list ten types of boycott related request that are not reportable, most of which relate to the primary aspect of the boycott.

Reportable requests must be filed quarterly with Commerce. Filed reports and the documents containing boycott requests are accessible by the public, so take advantage of the opportunity to submit a public inspection copy from which you may redact certain content, including the identity of your foreign customer. One way in which violations are detected is when one party reports receipt of a boycott request, say a bank with respect to letter of credit instructions, and another party receiving the same request fails to report it.

There are criminal and civil penalties for violation of either the prohibitions or the reporting requirements. The Department of Commerce is authorized to impose civil penalties administratively, and there have been fines imposed in scores of cases. During the protracted lapse of the EAA, the authority of the International Emergency Economic Powers Act (“IEEPA”) has been used to maintain the EAR, including the antiboycott provisions. 2006 legislation extending the USA PATRIOT Act increased civil penalties under IEEPA to a maximum of $50,000 per violation. The EAR have been amended accordingly. (71 Fed. Reg. 44189, August 4, 2006.)

Unwelcome publicity also attends antiboycott enforcement, as press releases are issued even when a penalty is imposed pursuant to a settlement. Moreover, when the Department of Commerce believes that there has been a violation, but decides to issue a warning letter instead of a charging letter, each warning letter is posted on a website. Criminal sanctions have been imposed in only one case.

Commerce published a proposed rule with antiboycott penalty guidelines in June 2006. These guidelines have much similarity to those that have been in effect for export control violations, and both emphasize voluntary self-disclosure procedures. The proposed guidelines divide violations into three categories. Category A, the most serious, includes discrimination against U.S. persons and boycott related refusal to do business. Category C covers failure to make timely reports of the receipt of boycott requests.
Staying out of Trouble

The appropriate level of investment by a firm in antiboycott compliance measures will depend upon where and how the firm does business. It is a good idea for any company that does business across national borders, physically or electronically, to take at least some steps to enable staff to spot and seek advice on possible boycott problems. Such problems can arise in unusual places and ways – such as in a contract to supply a project in Asia that is financed by an Arab investment fund.

Essential to effective compliance efforts is the creation of a corporate culture of compliance through clear communication of company policy and visible backing by management. It is especially important that this policy reach staff abroad in countries where local law and policy with respect to the boycott may be quite different and any restrictions on business due to U.S. law may be resented.

It should be obvious that the combination of the antiboycott provisions of the IRC and the Commerce regulations demands coordinated compliance systems. Units that are handling accounting and tax will need boycott-related information from operating units that is unlike the normal financial data flow. The need to preserve tax benefits by being able to demonstrate the “separate and identifiable” character of certain operations in boycotting countries will require informed tax advice in the planning of business.

Many companies will find that they need several levels of antiboycott know-how. A large group of employees may need to be alerted to boycott issues so that the flow of documents and correspondence can be screened and questionable matters can be brought to the attention of staff with more training. A smaller number of trained antiboycott trouble-shooters will normally be able to determine whether a request must be reported. Tax and accounting people will need specialized training. Legal counsel should be consulted before taking action in an uncertain or unusual situation, and expert outside counsel should be brought in when needed. The need for antiboycott due diligence must be taken into account when making acquisitions or entering into joint ventures or other alliances.

I would like to close with some upbeat observations. One is that it is sometimes possible to get problematic boycott terms removed from contracts and other documents. You are permitted to ask for this, but do not in the process furnish prohibited information or indicate prohibited compliance. Beyond what you may do for yourself, there is help that the U.S. Government may provide. I.R.C. section 999 provides for the issuance to a taxpayer through a private letter ruling of a binding Treasury determination as to whether a particular operation will constitute PCIB. Both Treasury and the Office of Antiboycott Compliance at Commerce respond by telephone to inquiries about their programs. The latter office also
cooperates with the Department of State in efforts to persuade a boycotting government to modify or remove provisions that are obstacles to business opportunities for U.S. firms.