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## Commerce Department Clarifies Second Incorporation Rule for Reexports

by Thomas M. deButts and Stephan E. Becker

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*On January 6, 2010, the U.S. Department of Commerce, Bureau of Industry and Security (BIS) published a redacted advisory opinion dated September 14, 2009 that clarifies the application of the Export Administration Regulations (EAR) to foreign-made products incorporating other foreign-made products with U.S.-origin content. The written guidance in some circumstances will simplify the application of the EAR de minimis exemption to foreign-made products.*

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### **Second Incorporation Principle**

The second incorporation principle has long been an unpublished policy of BIS when applying the *de minimis* exemption to foreign manufactured products incorporating U.S.-origin content. As BIS explained in its recent advisory opinion:

The second incorporation principle generally states that U.S.-origin components that are incorporated into a foreign-made discrete product will not be counted in *de minimis* calculations when the foreign-made discrete product of which they are part is itself incorporated into a subsequent foreign-made item (*i.e.*, after the second foreign incorporation).

BIS further noted that the principle may be employed only if a first incorporation has actually been completed that resulted in a foreign-made discrete product. Specifically, the U.S.-origin components must be incorporated into a first discrete product before a “second incorporation” can occur. Until such a second incorporation occurs, the original product must be analyzed with all of its U.S.-origin content for the purpose of applying U.S. re-export controls.

### **Discrete Product**

Before the principle can be applied, it must be determined that the prior incorporated U.S.-content is contained in a “discrete product.” The advisory opinion states that evidence that a foreign-made item was pur-

chased in an arm's-length transaction, or that the item is regularly sold by itself—either as a stand-alone product or as an identifiable replacement—would tend to indicate that the item is a “discrete product.” In the opinion, BIS used flight data recording equipment as an example of a discrete product that can be secondarily incorporated into aircraft. However, BIS cautions that if a purchaser “participated in the design or manufacture of the product or chose the parts that were to go into the foreign product, then that indicates that the foreign-made product was in fact part of a larger manufacturing or production process and therefore not a discrete or completed product when further processing or manufacturing commenced.”

### **Benefit for Foreign Manufacturers**

As BIS explains, “[t]he purpose of the second incorporation principle is to minimize the burden on foreign parties who purchase foreign-made products and typically have little or no means to determine how much, if any, U.S.-origin content those foreign-made products contain.” Accordingly, the advisory opinion is for the benefit of non-U.S. companies who purchase components from unrelated suppliers for their manufacturing operations. Nonetheless, there are certain exceptions to the scope of the rule and each situation should be examined individually before concluding that the second incorporation principle is applicable.

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If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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