Updates
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IRS Clean Vehicle Tax Credit Rule Adds Hurdles for Domestic Electric Vehicle Manufacturing

The Internal Revenue Service (IRS) published a final rule on May 6, 2024, defining eligibility requirements for the clean vehicle credit under Section 30D of the Internal Revenue Code, enacted by the Inflation Reduction Act of 2022 (IRA).

Among other things, the new rule establishes (1) a more stringent test to determine the amount of qualifying critical minerals used in a vehicle's battery, which governs whether a vehicle qualifies for one half of the $7,500 tax credit; and (2) how to demonstrate compliance with section 30D(d)(7)'s prohibition on sourcing critical minerals and battery components from "foreign entities of concern."

The new rule reflects the Biden administration's tightrope walk between promoting electric vehicles to combat climate change while ensuring that a significant portion of critical minerals and battery components needed for those vehicles are sourced within the United States or from its trade allies.

The Proposed Rule

On April 17, 2023, the IRS published a Notice of Proposed Rulemaking requiring that, to qualify for half of the $7,500 Section 30D clean vehicle tax credit, at least 50% of the value of the vehicle's battery components must be manufactured or assembled in North America in 2023, increasing by 10% each year through December 31, 2028, after which 100% of the value of the battery components must be manufactured in the United States.

To qualify for the other half of the credit, the proposed rule provided that in 2023, at least 40% of the value of the critical minerals in the battery of a new clean vehicle must be either extracted or processed in the United

States; extracted or processed in any country with which the United States has a free trade agreement (*i.e.*, a trade ally); or recycled in North America. This percentage increased to 50% for vehicles placed into service in 2024 and is set to increase by 10% annually through December 31, 2026, after which 80% of the critical minerals must be extracted or processed in the United States or one of its trade allies.

Under the 2023 Proposed Rule, the critical minerals requirement was determined through the "50% Value Added Test," which allowed manufacturers to claim all of a "qualifying critical mineral" if 50% or more of the value added to the critical mineral by extraction, processing, or recycling occurred in the United States or its trade allies.

Key Changes in the Final Rule

The final rule tightens requirements related to critical minerals by adopting the "Traced Qualifying Value Test" in place of the 50% Value Added Test. Additionally, the final rule further clarifies the statute's prohibition on sourcing critical minerals for electric vehicles from "foreign entities of concern."

The Traced Qualifying Value Test To Determine Critical Minerals Content

The final rule adopts a new test for determining the qualifying critical mineral content of a clean vehicle battery, changing the process from the prior 50% Value Added Test to a new Traced Qualifying Value Test.

The Traced Qualifying Value Test is decidedly more stringent than the 50% Value Added Test. A manufacturer must fully trace *any* value added in a procurement chain. But the manufacturer may only treat the *actual* percentage of the value of a critical mineral as qualifying, rather than the full value as it could under the 50% Value Added Test.

The IRS claims this more stringent test will incentivize value-add activities in the United States and allied countries by counting incremental value that would otherwise be lost under the 50% Value Added Test.

To address concerns about the stringency of the test, the final rule gives a manufacturer the option to use the 50% Value Added Test prior to January 2027 if the manufacturer provides periodic written reports regarding the critical mineral content of the battery used in its electric vehicles.

DOE Guidance on the Definition of "Foreign Entity of Concern"

In addition to the critical mineral and battery components requirements, a vehicle cannot obtain a Section 30D tax credit under the IRA if any critical minerals or battery components originate from a "foreign entity of concern" (FEOC), as defined in section 40207(a)(5) of the Infrastructure Investment and Jobs Act. Concurrent

with this final rule, the U.S. Department of Energy (DOE) finalized its interpretive guidance related to the definition, which the IRS adopted in the final rule.

A FEOC includes foreign entities "owned by, controlled by, or subject to the jurisdiction or direction of a government of a foreign country that is a covered nation." As of the final rule, "covered nations" include China, Russia, Iran, and North Korea.

DOE guidance clarifies that an entity would be "owned by, controlled by, or subject to the direction" of another entity if such other entity cumulatively holds 25% or more of the entity's board seats, voting rights, or equity interest. Importantly, the IRS notes that licensing agreements or other contractual agreements may also create control.

Demonstrating FEOC Compliance

A three-step process demonstrates FEOC compliance with respect to clean vehicles. In step one, the manufacturer determines whether and to what extent the applicable critical minerals and battery components are FEOC-compliant (*i.e.*, not manufactured in, extracted from, or processed in a FEOC). In step two, the FEOC-compliant battery components and critical minerals are physically tracked to specific battery cells or allocated to battery cells without physical tracking. In step three, the battery components are tracked to specific clean vehicles.

Importantly, the IRS now allows "allocation-based accounting," in which manufacturers allocate the mass of FEOC-compliant critical minerals acquired from a supplier to battery cells without physically tracking the critical minerals to specific battery cells. For example, if a manufacturer procures 20,000,000 kilograms (kg) of an "applicable critical mineral" for a battery cell production facility, of which 4,000,000 kg are FEOC-compliant and 16,000,000 kg are not, 20% of the battery cells in the product line may be treated as FEOC-compliant.

FEOC Due Diligence Requirement and Reliance

As with the proposed rule, the final rule makes clear that to determine whether critical minerals and battery components were manufactured in a FEOC, manufacturers are required to conduct due diligence in a manner that enables the qualified manufacturer to know "with reasonable certainty the provenance" of applicable critical minerals and battery components.

The final rule provides that a qualified manufacturer can rely on the attestation of the critical minerals or battery component supplier if the manufacturer does not know or have reason to know that such supplier attestation is incorrect. The IRS added in the final rule that third-party manufacturers or suppliers who conduct diligence can likewise reasonably rely on a supplier's attestation on the same grounds.

Key Takeaways

The final rule highlights the balancing act that the Biden administration must perform to achieve its climate and economic goals. All tiers of the electric vehicle supply chain should carefully review these final rules to ensure their products can benefit from the Biden administration's tax and economic incentives to boost electric vehicle manufacturing and adoption.

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