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INSIGHT

Foreign Entity of Concern Requirements in the Section 30D Clean Vehicle Credit

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The Inflation Reduction Act (P.L. 117-169; IRA) made significant changes to the clean vehicle credit (CVC) in Section 30D of the Internal Revenue Code. The CVC allows individuals and businesses to reduce their federal income taxes by either $7,500 or $3,750 for purchases of qualifying new electric vehicles (EVs).

To qualify for the CVC, vehicles acquired after 2023 cannot use battery components manufactured or assembled by a "foreign entity of concern." Similarly, for vehicles acquired after 2024, critical minerals in the vehicles' batteries cannot have been extracted, processed, or recycled by a foreign entity of concern. This Insight describes both the CVC's foreign entity of concern (FEOC) requirements and the Internal Revenue Service's (IRS's) regulatory enforcement of those requirements.

Foreign Entities of Concern: Definition and Key Issues

The term "foreign entity of concern" describes nonstate actors potentially posing economic or security threats to the United States. Terrorist groups, for example, are classified as FEOCs; so too are businesses significantly influenced by the governments of China, Russia, North Korea, or Iran (known as "covered nations").

At present, the input markets for battery components and critical minerals are dominated by China. Recent research finds that 65% of all EV battery components are made in China, and China refines roughly two-thirds of the nickel, lithium, and cobalt used in EV batteries. Department of Energy and U.S. Geological Survey data also suggest that China produces most of the world's aluminum, gallium, graphite, magnesium, and silicon—all of which are used in EV batteries.

There are two questions regarding the regulatory interpretation of the FEOC requirements. First, for companies that operate in multiple countries or have owners in multiple countries, it is not clear at what point the company is deemed to be significantly influenced by an FEOC. The CHIPS and Science Act (P.L. 117-167) subjects companies to certain restrictions if 25% or more of their stock, voting shares, or board seats are owned by individuals or businesses in a covered nation. In general, organizations pushing for greater EV uptake have called for higher ownership thresholds, while proponents of domestic manufacturing have called for lower thresholds. The maximum ownership share would apply not just to

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the companies receiving the CVCs but also to companies they purchase materials from (as part of their supply chains).

Second, EV producers (and their supporters) have argued that they should be allowed to draw a small share of critical minerals from FEOCs without violating the ban. They argue that it is difficult to trace all critical minerals back to their original sources, so companies should not be penalized if their FEOC mineral sourcing remains under a low *de minimis* threshold. Domestic energy suppliers and miners have argued against such a threshold.

How Leased EVs Evade the FEOC Bans

The FEOC bans apply to the clean vehicle credit (IRC §30D) but not the credit for qualified commercial clean vehicles (IRC §45W). The latter credit is claimed by businesses using EVs in the ordinary course of business or leasing EVs to customers. Car dealers may therefore claim the §45W credit for vehicles that do not meet the FEOC requirements; they may then pass the gains to consumers by leasing non-FEOC-compliant vehicles at reduced prices. No similar option exists for consumers purchasing rather than leasing EVs. Dealers and customers alike reference *the EV leasing loophole*.

Proposed IRS Regulations

On December 4, 2023, the IRS published a proposed rule defining foreign entity of concern and setting limits on interactions with FEOCs for purposes of the CVC.

Under the proposed regulations, a business will be classified as an FEOC if it is "incorporated in, headquartered in, or performing the relevant activities"—the relevant manufacturing, production, extraction, etc.—in a covered nation. The proposed regulations would also classify businesses as FEOCs if 25% or more of their "board seats, voting rights, or equity interest" are cumulatively held by a covered nation's national government, a covered nation's subnational governments, or "certain current or former senior foreign political figures" from a covered nation. Finally, the regulations stipulate that a business may be classified as an FEOC if it has licensing agreements or contracts with an FEOC that effectively "create control" of the business for the FEOC. Recent analysis has noted that, based on these regulations, "foreign subsidiaries of privately-owned Chinese companies in non-FEOC countries" could form part of credit-eligible businesses' supply chains "so long as they are not controlled by the Chinese government." The world's largest nickel producer and largest cobalt miner, respectively, are both privately owned Chinese companies that operate in foreign countries and would not be classified as FEOCs.

Based on the proposed regulations, if a vehicle manufacturer intentionally violates the FEOC ban, its unsold vehicles will become ineligible for the CVC. At its discretion, the IRS could render other future vehicles produced by the firm ineligible as well.

The proposed regulations include a *de minimis* exception through the end of 2026 for certain low-value critical minerals that are often comingled in the production process and that firms do not currently trace to their original sources along the supply chain. The IRS indicated that this exception may apply to "applicable critical minerals contained in electrolyte salts, electrode binders, and electrolyte additives" and to "associated constituent materials." The IRS stated that it is merely considering the *de minimis* exception as a transitional rule but may not adopt it.

Initial Effects of the FEOC Battery Components Ban

Although the FEOC critical minerals ban is not to take effect until 2025, the FEOC battery components ban went into effect on January 1, 2024. Many EV models immediately became ineligible for the CVC, including many widely selling EVs. As of January 24, 2024, 18 EV models were eligible for the full $7,500 CVC, down from 27 at the end of 2023; 9 EV models were eligible for partial credits of $3,750, down from 16 last year. Year-over-year changes are not exclusively attributable to the FEOC battery components ban, as the CVC changed in other minor ways in January, but multiple news reports indicate that it is the primary driver of the decrease. The long-term effects of the FEOC bans may differ from their short-term effects as supply chains have additional time to adjust.

Author Information

Nicholas E. Buffie
Analyst in Public Finance

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