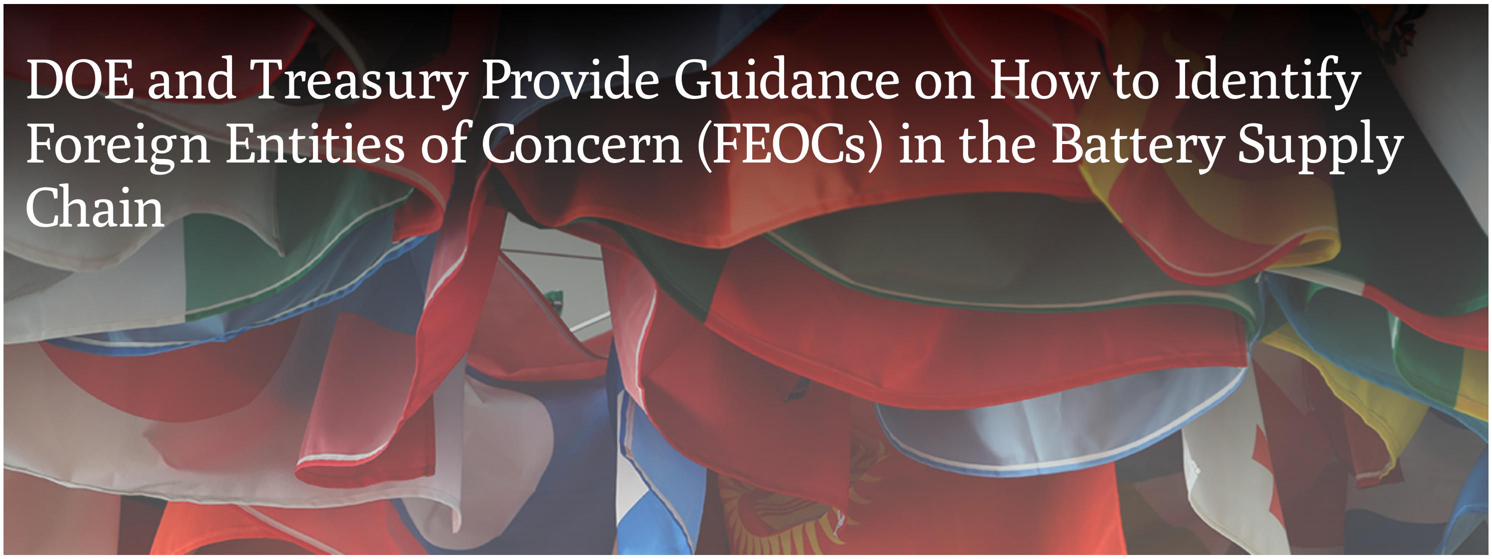
BLOG



DOE and Treasury Provide Guidance on How to Identify Foreign Entities of Concern (FEOCs) in the Battery Supply Chain

DECEMBER 18, 2023

On December 4, 2023, the U.S. Department of Energy (DOE) published its proposed interpretation of the statutory definition of "foreign entity of concern" (FEOC) in the Infrastructure Investment and Jobs Act of 2021, commonly known as the Bipartisan Infrastructure Law (BIL).

The same day, the U.S. Department of Treasury (Treasury), acting through the Internal Revenue Service (IRS), issued proposed regulations providing guidance to electric vehicle (EV) manufacturers on how to ensure their supply chains do not contain FEOCs (as defined in the BIL), which would make their vehicles eligible for tax credits under Section 30D of the Internal Revenue Code, as amended by the Inflation Reduction Act of 2022 (IRA).

Interested persons must submit comments on DOE's interpretative rule by January 3, 2024, and on Treasury's proposed regulations by January 18, 2024. Please contact the authors or your Winston & Strawn relationship attorney if you have any questions or need further information.

WHY IS THIS SIGNIFICANT?

The BIL and IRA provide substantial financial incentives for companies to help build an advanced battery supply chain in the United States. Specifically, Section 40207 of the BIL provides US$6B in taxpayer funding to DOE to award grants to eligible entities to carry out certain energy projects, including constructing new commercial-scale facilities for processing battery materials in the United States, or constructing new commercial-scale facilities for manufacturing and recycling advanced batteries and battery components in the United States. Similarly, the IRA amended Section 30D of the Internal Revenue Code to provide a maximum of $7,500 tax credit to taxpayers who purchase EVs that have batteries containing a certain amount of critical minerals or battery components that were made in the United States (or a country with which the United States has a free-trade agreement).

However, a company's ability to obtain government funding for itself or tax credits for its customers is reduced or outright prohibited if the company has a FEOC in its supply chain.

- The BIL expressly states that DOE will give "priority" in awarding grants to eligible entities that "will not use battery material supplied by or originating from a [FEOC]." For entities that will use their DOE grant for battery recycling, the BIL states that DOE will give "priority" to eligible entities that "will not export recovered critical materials to a [FEOC]."

- The IRA similarly states that Section 30D tax credits are not available for "any vehicle placed in service after December 31, 2024, with respect to which any of the applicable critical minerals contained in the battery of such vehicle . . . were extracted, processed, or recycled by a [FEOC]," or "any vehicle placed in service after December 31, 2023, with respect to which any of the components contained in the battery of such vehicle . . . were manufactured or assembled by a [FEOC]."

Accordingly, if an individual entity wants to receive grants under the BIL, or if an EV manufacturer wants to ensure that its vehicles qualify for Section 30D tax credits under the IRA, then they need to know whether there are any FEOCs in their supply chain. DOE's proposed interpretation is intended to make it easier for companies to evaluate whether upstream suppliers will or will not be considered FEOCs.

WHAT DOES DOE'S PROPOSED GUIDANCE SAY?

Section 40207(a)(5) of the BIL provides that the term "foreign entity of concern" means a foreign entity that is:

A. designated as a foreign terrorist organization by the Secretary of State;

B. included on the list of specially designated nationals and blocked persons maintained by the Office of Foreign Assets Control of Treasury (commonly known as the "SDN list");

C. owned by, controlled by, or subject to the jurisdiction or direction of a government of a foreign country that is a covered nation;

D. alleged by the Attorney General to have been involved in activities for which a conviction was obtained under certain federal criminal statutes, including the Espionage Act and the Economic Espionage Act of 1996; or

E. determined by the Secretary of Energy, in consultation with the Secretary of Defense and the Director of National Intelligence, to be engaged in unauthorized conduct that is detrimental to the national security or foreign policy of the United States.

DOE's proposed guidance pertains solely to paragraph (C) in the definition of FEOC. Under that paragraph, an entity is a FEOC if it is:

i. a "foreign entity"; and either:

ii. (a) "subject to the jurisdiction" of a covered nation; or

(b) "owned by, controlled by, or subject to the direction" of a covered nation government.

The "covered nations" are the People's Republic of China (PRC), the Russian Federation, the Democratic People's Republic of North Korea, and the Islamic Republic of Iran. However, given that Russia, North Korea, and Iran are comprehensively sanctioned countries, this provision appears to apply primarily to China.

Under DOE's proposed guidance, DOE would define "foreign entity" as a (i) foreign government; (ii) foreign individual; (iii) foreign company; or (iv) a U.S. entity that is subject to the ownership, control, or direction of an entity that qualifies as a "foreign entity" in paragraphs (i)–(iii). DOE would define "control" as 25% of the equity, voting rights, or board seats of an entity. Thus, under DOE's proposed definition, a U.S. entity would qualify as a "foreign entity" if it has a foreign shareholder with a direct or indirect ownership stake of 25% or more.

However, as noted above, not all "foreign entities" are FEOCs. To be a FEOC, a foreign entity must be either (a) "subject to the jurisdiction" of a covered nation or (b) "owned by, controlled by, or subject to the direction" of a covered nation government.

SUBJECT TO THE JURISDICTION OF A COVERED NATION

The proposed guidance would interpret "subject to the jurisdiction" of a covered nation to mean a foreign entity that is incorporated in, or has its principal place of business in, a covered nation. In addition, under the proposed guidance, a foreign entity would qualify as a FEOC if it processes or manufactures battery components or materials in a covered nation. In other words, under DOE's proposed interpretation, an EV battery manufacturer could not have a Chinese entity as an upstream supplier in order to be eligible for financial incentives under the BIL and/or IRA. In addition, an EV battery manufacturer desiring such eligibility could not have a non-Chinese foreign entity as an upstream supplier if that entity is processing or manufacturing relevant battery materials and components in China. Put differently, the proposed guidance provides clarity to manufacturers that removing FEOCs from their supply chain means not only removing Chinese entities but also removing battery materials and components that are made in China (regardless of whether the foreign entity that makes them is a Chinese company).

DOE's proposed guidance also makes clear that when an entity is a FEOC due to it being "subject to the jurisdiction" of a covered nation, subsidiaries of the FEOC are not automatically considered to also be FEOCs solely based on their parent being a covered-nation jurisdictional entity. A subsidiary of a FEOC would be a FEOC itself if it is also either (i) "subject to the jurisdiction" of a covered nation, or (ii) "controlled by" a covered nation government.

OWNED BY, CONTROLLED BY, OR SUBJECT TO THE DIRECTION OF A COVERED NATION GOVERNMENT

Under the BIL, a FEOC also includes a foreign entity that is "owned by, controlled by, or subject to the direction" of a covered nation government. DOE's proposed guidance sets forth two tests to determine whether a foreign entity is "owned by, controlled by, or subject to the direction" of a covered nation government; (i) an equity test and (ii) a contract test.

Under the **equity test**, DOE proposes to create a bright-line rule that a foreign entity qualifies as a FEOC if 25% or more of the entity's equity, voting rights, or board representation is owned (directly or indirectly) by a covered nation government. Moreover, DOE's proposed guidance would interpret a covered nation government broadly to include national and subnational governments, agencies and instrumentalities, political parties, and current and former government officials (and their family members). That means, under DOE's proposal, a foreign entity would qualify as a FEOC if a current or former government official of a covered nation government (or one of their family members) owns 25% or more of a foreign entity's equity, voting rights, or board seats. In many cases, a foreign government will not directly own a foreign entity, but it may have indirect ownership. DOE's proposed guidance includes rules for how to calculate ownership where a covered nation government is an indirect owner of a foreign entity that has a tiered ownership structure.

Under the **contract test**, a foreign entity would qualify as a FEOC if it has entered into a contract or licensing agreement with a FEOC (controlled by a covered nation government), and the contract or license gives the FEOC the ability to exercise "effective control" over the non-FEOC's operations. The contract test exists because DOE is concerned that a covered nation government will try to evade the application of the 25%-equity test by controlling a FEOC and then having the FEOC enter into a contract or licensing agreement with a non-FEOC that gives the FEOC effective control over the non-FEOC's operations. Under those circumstances, the foreign nation government could still have de facto control over an entity in the U.S. battery supply chain.

To provide a reasonably bright-line test for evaluation of upstream battery supply chains that include many contracts and licenses, DOE has proposed a type of "safe harbor." A non-FEOC entity will not be deemed a FEOC solely based on a contractual or licensing relationship if it can demonstrate that it has reserved for itself or another non-FEOC **<u>all</u>** of the following rights in the relevant contract or license:

i. To determine the *quantity* of critical mineral, component, or material produced (subject to any overall maximum or minimum quantities agreed to by the parties prior to execution of the contract);

ii. To determine, within the overall contract term, the *timing* of production, including when and whether to cease production;

iii. To *use* the critical mineral, component, or material for its own purposes or, if the agreement contemplates sales, to sell the critical mineral, component, or material to the entities of its choosing;

iv. To *access* all areas of the production site continuously and observe all stages of the production process; and

v. At its election, to independently *operate, maintain, and repair* all equipment critical to production and to access and use any intellectual property, information, and data critical to production, notwithstanding any export control or other limit on the use of intellectual property imposed by a covered nation subsequent to execution.

In other words, if a non-FEOC enters into a contract or license with a FEOC (controlled by a covered nation government), the non-FEOC will not be converted into a FEOC if the contract or license reserves all the rights listed above to the non-FEOC.

Finally, DOE's proposed guidance emphasizes that the subsidiary of a FEOC (controlled by a covered nation government) is not automatically a FEOC. Rather, to be a FEOC, the subsidiary itself must either be (1) "subject to the jurisdiction" of a covered nation; or (2) "controlled by" a covered nation government. Thus, a FEOC that is controlled by a covered nation government may hold an interest in a subsidiary, even an interest above 25%, and that subsidiary may still not be a FEOC if the covered nation government's level of control of the subsidiary falls below 25%. For example, if the PRC owns 25% of the equity of a subsidiary, the subsidiary would be a FEOC. If the FEOC owns 40% of the equity of a U.S. business in the battery supply chain, the U.S. business would be a "foreign entity," but it would not be a FEOC. Under that scenario, the CCP would indirectly own 10% of the U.S. business in the battery supply chain, which is below the 25% threshold required to make that business a FEOC. However, for "majority" ownership of 50% or more of equity interests, voting rights, or board seats, the proposed guidance assumes a heightened level of control by the parent entity of its subsidiary, and the subsidiary is deemed to be one and the same entity as the parent for purposes of the FEOC equity test. As a result, the dilutive effect of tiered ownership is eliminated as between the parent and its subsidiary. For example, if the CCP owns 50% or more of the equity of a subsidiary and the subsidiary owns 25% of the equity of a U.S. business, rather than the CCP having less than 25% of the ownership of the equity interests in the U.S. business (as dilution in a tiered ownership structure would typically operate), the U.S. business is deemed to be a FEOC due to the CCP and subsidiary being one and the same and the ownership by the subsidiary of 25% of the equity interests of the U.S. business.

WHAT DO TREASURY'S PROPOSED REGULATIONS SAY?

Treasury's proposed regulations note that the definition of FEOC in the IRA is the same as the definition of FEOC in the BIL and any regulations issued by DOE thereunder. Thus, DOE's proposed interpretation discussed above is equally important to EV manufacturers that want to ensure their EVs remain eligible for Section 30D tax credits.

Under Treasury's proposed regulations, EV manufacturers would be required to certify that their relevant supply chains are FEOC-compliant. Before certifying, manufacturers would be required to perform due diligence on all battery components and applicable critical minerals in their supply chains. According to the proposed regulations, such due diligence must comply with the standards of tracing for battery materials available in the industry at the time of the certification that enable the manufacturer to know with "reasonable certainty" the provenance of applicable critical minerals, constituent materials, and battery components. Treasury's proposed regulations further note that "reasonable reliance" on a supplier attestation or certification would be considered due diligence if the qualified manufacturer does not know or have reason to know after its due diligence that such supplier attestation or certification is incorrect.

KEY TAKEAWAYS

Companies in the U.S. battery supply chain will need to be fluent in the regulations governing the definition of FEOCs.

Eligible entities that want to obtain BIL money to build battery-processing or manufacturing facilities in the United States should obtain representations and warranties from their upstream suppliers that those suppliers are not FEOCs. Eligible entities that want to use BIL money to construct a battery recycling facility in the United States should obtain similar representations from their customers.

Investment funds and companies looking to form joint ventures or partnerships in the United States to take advantage of BIL grants will need to conduct due diligence on their co-venturers and partners and obtain representations and warranties that none of them qualify as FEOCs. If a joint venture or partnership wants to enter into a contract with a third-party contractor to operate and maintain a battery processing, manufacturing, or recycling facility in the United States, those contracts should include the safe harbor provisions identified above.

If an EV manufacturer wants to ensure that its vehicles are eligible for Section 30D consumer tax credits, then it will need to perform due diligence on its upstream suppliers to confirm that none of them are FEOCs. We expect manufacturers will require representations and warranties relating to this issue whenever contracting with EV battery manufacturers, and that EV battery manufacturers will require similar representation and warranties when contracting with their upstream suppliers.

DOE's proposed interpretation of FEOC does not completely exclude China from the U.S. battery supply chain. Chinese entities can own equity in a U.S. business and enter into contractual or licensing agreements with a U.S. business without necessarily converting that business into a FEOC. For example, suppose Company A is a U.S. battery cell manufacturer and one of its upstream suppliers is Company B, a U.S. company that processes critical minerals such as lithium for use in EV batteries. Company B could have a Chinese investor with as much as 24% of the equity without making Company B a FEOC. Indeed, if the Chinese investor does not have a foreign-government-controlled entity anywhere in its ownership structure, the Chinese investor may be able to own more than 24% of Company B's equity. DOE's proposed interpretation of FEOC places limits on the extent to which Chinese entities can participate in the EV supply chain in the United States—e.g., you cannot have a Chinese entity as an upstream supplier—but it does not eliminate it.

10+ Min Read

Related Topics

U.S. Department of Energy

U.S. Department of Treasury

Infrastructure Investment and Jobs Act (IIJA)

Electric Vehicles

Bipartisan Infrastructure Law

Related Capabilities

International Trade

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.