

U.S. and Japan Reach Agreement on Critical Minerals and Treasury Releases Guidance on EVs

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On March 28, 2023, the United States and Japan signed an [agreement](#) on trade in critical minerals used in electric vehicle (“EV”) batteries (“Agreement Between the Government of Japan and the Government of the United States of America on Strengthening Critical Minerals Supply Chains”). The agreement builds on the United States’ limited trade [accord](#) with Japan reached in 2019 and the goal is to address China’s dominance of the global supply of critical minerals that are necessary for the production of EVs, as well as to address the U.S. government’s recent restrictions on new subsidies for EVs.

The Inflation Reduction Act of 2022 (“IRA”) overhauled a tax credit for purchasing EVs and introduced certain sourcing requirements for EV components. The goal of the IRA is to encourage companies to develop new supply chains for critical minerals such as lithium, graphite, cobalt, and nickel outside of China. Currently, the majority of lithium is produced in China, Australia, and Chile. China is also the world’s largest producer of graphite.

Under the IRA, consumers can get a tax credit of up to \$7,500 for qualifying vehicles. In order to qualify, a certain percentage of the EV battery needs to be built in North America, and much of the critical minerals in a vehicle’s battery must be sourced from the United States or a country that has a “free trade agreement” with the United States.

Because the United States does not have traditional free trade agreements with many of its allies, including Japan, the European Union, and the United Kingdom, the Biden Administration is pursuing limited trade deals such as the one signed with Japan. Among other things, the United States and Japan have agreed not to levy export duties on critical minerals and to coordinate labor standards in producing minerals. The United States is currently negotiating similar agreements with the European Union and the United Kingdom.

Efforts to reach these deals with U.S. allies has raised the question of whether such narrow agreements will meet the definition of “free trade agreement” under the IRA. While the provision of the IRA that requires vehicles to be assembled in North America went into effect immediately when the IRA was signed in August 2022, the battery sourcing provisions were left to be decided by the Treasury Department. On March 31, 2023, Treasury issued long-awaited [proposed guidance](#) on the critical mineral sourcing requirements for the EV tax credit under the IRA. According to the guidance, to meet the critical mineral requirement, the applicable percentage of the value of the critical minerals contained in the battery must be extracted or processed in the United States or with a country with which the United States has a “free trade agreement,” or be recycled in North America. The qualifying critical minerals sourcing requirement will increase from 40 percent in 2023 to 80

percent by 2027.

Importantly, the guidance includes a set of principles to identify countries with which the United States has a free trade agreement in place, since the term is not defined in statute. According to the Treasury Department's proposed definition, "free trade agreement" as used in the IRA could include newly negotiated limited agreements, such as the deal reached with Japan, to ensure that minerals from these trading partners will meet the sourcing requirement for the tax credit. Treasury's guidance also specifically lists the following countries as already having a free trade agreement with the United States: Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru, and Singapore.

The guidance also sets forth applicable percentages for the value of the battery components that must be manufactured or assembled in North America for the vehicle to qualify for tax credits under the IRA, ranging from 50 percent in 2023 to 100 percent by 2029. The four-step process for determining the value of the battery components includes: (1) identifying the battery components that are manufactured or assembled in North America; (2) determining the incremental value of each battery component, including North American battery components; (3) determining the total incremental value of battery components; and (4) calculating the qualifying battery component content by dividing the total incremental value of North American battery components by the total incremental value of all battery components.

Further, beginning in 2024, an eligible vehicle may not contain battery components that are manufactured by a foreign entity of concern, and beginning in 2025, an eligible vehicle may not contain any critical minerals that were extracted, processed, or recycled by a foreign entity of concern. Treasury intends to provide further guidance on this particular provision.

The guidance will be published in the Federal Register on April 17, 2023, and vehicles placed in service on or after April 18, 2023, will be subject to the critical mineral and battery component requirements in the rule. The Treasury Department and the Internal Revenue Service ("IRS") will consider public comments, due by June 16, 2023, before issuing a final rule.