COMMENTS FOR THE RECORD

Comments on Credits for Clean Vehicles in the Inflation Reduction Act

TORI K. SMITH[1] | OCTOBER 24, 2022

Introduction

The Inflation Reduction Act's clean vehicle tax credits include rules of origin for a vehicle to qualify for the credit. Specifically, there are requirements for final assembly to occur in North America, as well as for batteries and critical minerals to be sourced from certain countries and regions, that discriminate against many automobiles produced abroad and vehicles with foreign components. The clean vehicle tax credits, as currently proposed, could violate U.S. trade commitments under the World Trade Organization (WTO) and the U.S.-Korea Free Trade Agreement (KORUS).

Violating commitments under these agreements would likely put the United States at risk of facing disputes, which could subject Americans to retaliation from trading partners. Retaliation could target the automotive sector, but historically such retaliation has hit politically sensitive sectors, quintessential American products, and agricultural goods. It could also incentivize other countries to add similar restrictions to their clean vehicle tax credits, discriminating against U.S.-produced vehicles.

The efficacy of tax credits for electric vehicles is debated, however. The application of credits, such as those found in the Inflation Reduction Act, could harm unrelated industries and damage relationships with allies around the world. At the very least, the Department of Treasury and Internal Revenue Service (IRS) should propagate rules to implement the Inflation Reduction Act's clean vehicle credits that are in line with U.S. trade commitments under the World Trade Organization and the U.S.-Korea Free Trade Agreement.

New Tax Credits Are Discriminatory and Violate U.S. Trade Commitments

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As passed, the clean vehicle tax credits in the Inflation Reduction Act would not be available to vehicles that do not meet strict rules of origin for the manufacturing of vehicle batteries and components and for final vehicle assembly. Rules of origin are common in trade agreements, but when applied unilaterally these rules should be applied in accordance with the U.S.'s international agreements. Generally, legislation that might violate trade commitments contains a provision to leave room for the relevant federal agency to write rules that keep the policy in line with trade agreements. Such a provision was left out of the Inflation Reduction Act, and if regulations by Treasury and the IRS are not carefully written, the application of this law could violate such trade commitments.

The clean vehicle tax credits could violate U.S. trade commitments in three key areas. First, a vehicle must undergo final assembly in North America to qualify for a credit. This automatically disqualifies vehicles assembled abroad, including in free trade agreement partner countries such as South Korea. Second, restrictions on sourcing of critical minerals for vehicle batteries would start in 2024 at 40 percent sourcing from free trade partners and increase to 80 percent by 2026. Critical minerals such as lithium, as well as essential battery components such as anodes and cathodes, are largely produced outside of the country and most foreign production is not located in countries with which the U.S. has a free trade agreement. Finally, the batteries themselves will be required to have at least 50 percent North American content by 2024 and be of 100 percent North American origin by 2028. Virtually all cathode and anode production – which represents an estimated 40 percent of the total cost of a battery – is concentrated in China, Japan, and South Korea.

World Trade Organization and National Treatment

The Inflation Reduction Act's rules of origin could violate the national treatment principle found in Article III:4 of the General Agreement on Tariffs and Trade (GATT), one of the core WTO agreements.[2] This provision of the GATT states that products imported between WTO members:

> Shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

This provision prevents WTO members – of which there are 164 including the United States – from favoring domestically produced goods over imports. The clean vehicle tax credits would likely violate the principle of national treatment in each of the three areas of rules of origin. The North American assembly provision excludes all foreign nations except Canada and Mexico. While the critical mineral rules allow for imports from free trade agreement countries, the United States has only 14 such agreements with 20 countries. Disqualifying vehicles with batteries produced in countries outside of North America would also discriminate against imports from all WTO members except Canada and Mexico. Should these regulations be enforced as the law's text suggests, the United States would likely face a challenge at the World Trade Organization.

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[2] https://ielp.worldtradelaw.net/2022/08/electric-vehicle-tax-credits-and-non-discrimination-the-inflation-reduction-act.html

Allies such as the United Kingdom, the European Union, Japan, and South Korea have already questioned the permissibility of the new clean vehicle tax credits. A spokeswoman for the European Commission said in August that the credits are "discriminating against foreign producers" and went on to call them "incompatible with the WTO." Anita Rajan, general director of the Japanese Automobile Manufacturers Association in Washington, D.C., told Auto News in September they are "anxious that the EV tax credit score's more and more stringent battery-related restrictions might restrict the applicability of the tax credit score for electrified autos."

U.S.-Korea Free Trade Agreement

In addition to violating WTO commitments, the clean vehicle tax credits will likely run afoul of the U.S.-Korea Free Trade Agreement (KORUS). Currently, all electric vehicles made by Korean automotive brands Hyundai and Kia are assembled in South Korea and exported to the United States. Automobile and automobile part trade represents an estimated 25 percent of trade between the United States and Korea. Under KORUS, cars from Korea enter tariff-free (rather than face a 2.5 percent tariff), but truck imports are charged a 25 percent tariff.[3] The rule of origin to qualify for the new U.S. tax credits would discriminate against these imported vehicles and could violate Chapter 2, Article 2.2 of KORUS[4] which states that the WTO national treatment rule shall apply to goods traded under KORUS. South Korea's Industry Minister Lee Chang-yang expressed they were "actively [reviewing] whether to bring the case to the WTO" and said the credits "would violate WTO and bilateral free trade deal rules." The United States and South Korea have ministerial-level talks established to mediate this violation of U.S. commitments under KORUS, but so far, no clear progress has been announced.

Hyundai is currently building a factory in Georgia where it plans to produce electric batteries and electric vehicles, but production is not anticipated to begin until 2025. Even after these vehicles come into the market, they still may not qualify for the clean vehicle tax credits because of the critical mineral and battery requirements. Moreover, the inability to sell existing electric vehicles into the U.S. market with a tax credit for consumers could reduce sales for Korean automakers and impact their ability to allocate resources toward their Georgia factory.

The United States Risks Trade Disputes and Retaliation

Under both the WTO and KORUS, countries could file disputes against the United States for violating its trade commitments. The disputes themselves create uncertainty for businesses and consumers as they await a ruling on the legality of the rules of origin for these clean vehicle credits. The more troubling issue for Treasury and the IRS when considering regulations to implement the credits is that poorly crafted rules could result in the United States losing those cases and facing threats of retaliation. Should the United States be targeted with a WTO dispute, there would be a high likelihood of success for the petitioner, after which retaliation could occur if the United States fails to remove the rules of origin. In the case of KORUS, success for South Korea in challenging the credits could be quite high. If Korea won and the United States did not quickly respond by modifying the law or regulations, Korea would have the

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[3] American car and truck exports to Korea do not face tariffs. https://sgp.fas.org/crs/row/IF10733.pdf

[4] https://ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file904_12701.pdf

ability to issue retaliatory tariffs or measures. Historically, retaliatory measures are imposed on products of political importance to the offending country. For example, when the United States imposed tariffs on steel and aluminum in 2018, the European Union responded with retaliatory tariffs on a variety of products, but especially targeted politically sensitive and quintessential American products such as Harley Davidson motorcycles, Kentucky bourbon, and Levi's jeans.

Retaliation from allies (which could include South Korea, the United Kingdom, the European Union, and Japan) could take many forms if the discriminatory nature of the clean vehicle tax credit rules of origin are not resolved. A Korean embassy official told *Politico* that "Korea may become less enthusiastic in accepting the U.S. priorities [in the Indo Pacific Economic Framework] to set higher labor and environmental standards and helping sell them to other participants, in particular, to the developing countries." The French Foreign Minister suggested that Europe should respond by limiting "electric vehicle bonuses either for cars produced on European territory or for vehicles that strictly and rigorously meet new environmental standards."

Conclusion

The clean vehicle tax credits, as currently proposed, could violate U.S. trade commitments under the World Trade Organization and the U.S.-Korea Free Trade Agreement. Doing so could subject the United States to challenges and retaliation in the form of tariffs on politically sensitive sectors, quintessential American products, and agricultural goods. It could also incentivize other countries to restrict similar clean vehicle tax credits, discriminating against U.S.-produced vehicles. At the very least, the Treasury and the IRS should propagate rules to implement the Inflation Reduction Act's clean vehicle credits that are in line with U.S. trade commitments.

Respectfully submitted,

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