



How Korean auto and battery joint ventures must deal with worrisome IRA, FEOC regulations and U.S. election risk

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Last year, Korean vehicle manufacturers and battery makers were busy forming joint ventures with Chinese companies, on the one hand, and with U.S. companies, on the other hand. This was in response to the Inflation Reduction Act of 2022 (the “IRA”) which, among others, required that for a “new clean vehicle” to qualify for the U.S. federal tax credits such vehicle’s “critical minerals” must be “extracted or processed in the United States or in any country with which the United States has a free trade agreement (FTA) in effect”, and such vehicle must undergo “final assembly” in North America.

As the IRA essentially limited the subsidy (in the form of tax credits) to electric vehicles and parts produced in the United States, there was fear that Korean vehicle manufacturers and battery makers will miss business opportunities in the fast-growing U.S. market. And such fear has driven Korean companies to rush to enter the U.S. market in various forms, whether joint ventures with the U.S. companies or direct investments into the U.S. (such as building production facilities and plants).

At the same time, Chinese companies and Korean companies had mutual need to pursue joint ventures. This was because China currently does not have an FTA concluded with the U.S., but Korea does, so the Chinese companies was seeking for ways to work around the IRA restrictions and access the U.S. market indirectly, while the Korean companies wanted a stable supply of raw materials and parts from the Chinese companies.

The IRA disqualifies the vehicles containing critical minerals or battery components from a “foreign entity of concern” (“FEOC”) from being eligible for the tax credits. Although the earlier versions of the proposed regulations had left the details of the excluded entity provisions to be addressed in the future, it was widely expected that the scope of FEOC will include companies owned or controlled by the Chinese government. Thus, most if not all of the joint venture agreements entered into between the Korean companies and the Chinese companies at the time likely have included some type of shareholding adjustment mechanism. Because these are private agreements not disclosed to the public, their terms are unknown. It is possible that some of them might only contain a simple clause that generically require each party “to do all things necessary” for the products produced by joint venture to obtain and maintain the IRA tax credits, while other agreements might contain more detailed provisions entitling Korean companies to acquire shares

from their Chinese counterparts at a fixed price as necessary to qualify under the IRA tax credit requirements. In the latter cases, Korean companies would have a chance to meet the IRA tax credit requirements without going through a complicated negotiation process regarding sales terms and immediately purchase the necessary shares from the Chinese counterparts pursuant to the pre-agreed terms without much difficulty. This would reduce time and costs necessary for additional negotiations as well as provide greater certainty in business operations.

When the U.S. Department of Treasury and Department of Energy issued further guidances on the interpretations of FEOC on December 1, 2023 (the "Guidance"), it became evident that it was indeed necessary for the joint venture agreements to include such shareholding adjustment mechanism. The Guidance interpreted the scope of FEOC very broadly by including all foreign entities that are "owned by, controlled by, or subject to the jurisdiction or direction of a government of a covered nation (i.e., China, Russia, Iran and North Korea)," where the term "government" includes both national and subnational governments and current or former senior political figures, and the term "owned by, controlled by, or subject to the direction of" covers not only having 25% or more of board seats, voting rights, or equity interest but also having an "effective control" via contractual agreements. Moreover, a parent entity directly holding 50% or more of a subsidiary's board seats, voting rights or equity interest is treated as equivalent to the subsidiary, hence all holdings of such subsidiary are fully (not proportionately) attributed to the parent.

As facilities for producing and processing battery components like cathodes or precursors require tens of trillions of Korean Won in capital expenditures, it is customary for the joint venture partners to each cover half of the expenditures and the shareholding ratio is typically set at 51-49 ratio, with the Korean company holding the 51% stake. In such case, to comply with the Guidance, Korean companies will need to buy shares from their Chinese counterparts to bring down their shareholding to below 25%. Korean companies should also be mindful that the scope of FEOC includes the concept of "effective control" which could still be triggered even if the 25% threshold is met. To ensure the "effective control" provision does not apply, it would be prudent to rely on the safe harbor provision specified in the Guidance. To do so, Korean companies should ensure that their joint venture agreements expressly reserve the right to make decisions regarding all of the following matters to the Korean companies: (i) the determination of production quantity, (ii) the determination of production timing, (iii) the use of minerals or components or their sale to other entities of their choosing, (iv) the access to and observation of production; and (v) 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.

The Korean domestic battery industry has been known to have established or jointly invested in more than 20 joint ventures with Chinese companies to produce key battery materials such as precursors and cathodes, with the investment amounts reaching tens of trillions of won. For example, LG Chemical and Zhejiang Huayou Cobalt have jointly invested about 1.7 trillion won to build a battery precursor plant in Saemangeum, Korea. SK On is also jointly building a battery precursor plant with EcoPro Materials and GEM in Saemangeum and plans to invest up to about 1.21 trillion won. POSCO Holdings and POSCO Future M have entered into a joint venture with CNGR Advanced Materials for the production of nickel and precursors for secondary batteries and decided to invest about 1.5 trillion won.

Based on the foregoing, it is very likely that Korean companies will have to purchase additional shares from the Chinese counterparts for the Korea-China joint ventures to be eligible for IRA tax credits. This would require Korean companies to potentially incur significant expenditures. At the same time, it is likely that the Korean companies will also incur additional financial burden in funding capital expenditures going forward, as such funding will typically be made in proportion to their increased shareholding.

Just as the cost burdens imposed on the Korean companies are expected to increase substantially, there is an emerging risk that the expected profits of the Korean companies from the US-Korean joint ventures could decrease significantly in the future. While the business operations through joint ventures with Chinese companies are subject to significant restrictions under the IRA, the importance of U.S. joint venture partners for the purpose of being eligible for the IRA benefits is increasing over time. In such context, there is a growing possibility that the U.S. joint venture partners may ask their Korean counterparts to share IRA tax benefits in a manner that is not in line with the shareholding ratios. Recently, GM has asked LG Energy Solution to share up to 85% of their joint venture's tax benefits in the U.S., which largely exceeds their shareholding of 50%.

In addition, if Donald Trump is re-elected as the president in the November 5th U.S. election, there is a possibility that the benefits under the IRA may be reduced, which will further increase the difficulties Korean automobile and battery manufacturers will face. Although it is highly unlikely that the IRA will be totally repealed (as such total repeal will require approvals of both chambers of Congress), it is possible that the Trump administration may reduce the existing benefits afforded under the IRA or impose additional tariffs or taxes on non-US companies under a facade of "levelling the playing field".

All these potential risks can significantly increase the financial and operational burdens imposed on the Korean automobile and battery manufacturers. In the face of these risks, the most imminent task at hand for the Korean companies would be to find additional funding sources. Potential solutions include traditional strategies like selling assets (such as real estate, intellectual property rights, etc.) or finding additional investors to join the existing joint ventures. In addition, companies could also look into new ways to raise funds, such as monetizing various tax credits under the IRA. For example, First Solar has secured additional financing by selling up to \$700 million of advanced manufacturing production tax credits (AMPC) for \$0.96 on the dollar.

It remains to be seen what the final FEOC rules will say but it is unlikely that the restrictions placed on the Chinese companies' participation in joint ventures will be lessened to any significant degree. Of course, the United States is not the only market, and China is not the only supplier. But undeniably, the United States is one of the largest markets for Korean automobile and battery manufacturers, and China is one of their major suppliers. Fortunately for Korean companies, neither country can afford to eliminate or reduce their reliance on Korean companies to generate profits and secure stable supply chains in short term, and the Korean companies will need to devise various solutions as quickly as possible in the time that they have.

Key Contacts

Michelle W. Sul

Senior Foreign Attorney

+82-2-316-7971

mwsul@shinkim.com

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