



Meijburg & Co
Tax & Legal

Carbon Border Adjustment Mechanism

Impact on industry & next steps

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Carbon pricing has been around for much longer than many realize. In 1990, Finland was the world's first country to introduce a carbon tax. Carbon trading mechanisms are almost 20 years in the making. The world's first carbon market, the European Union (EU) emission trading system (ETS)⁽¹⁾, was established in 2005. It should, therefore, come as no surprise that, on the back of the 2015 Paris Agreement (a treaty of international law whereby signatories set emissions reduction targets), various measures and methods have been proposed and implemented by governments globally to combat climate change and achieve climate neutrality.

In fact, the scope of carbon pricing initiatives through carbon taxation is increasing rapidly and is becoming a significant part of country policy strategies to achieve the nationally determined contributions under the Paris Agreement.

As of 1 April 2022, 68 global carbon pricing initiatives, which includes both carbon taxes and ETS, have been implemented⁽²⁾.

As even more countries introduce initiatives to decrease their emissions, failure to respond to and control GHG emissions could lead to a loss in international competitiveness and increased vulnerability for trade and investment as increased pressure is placed on businesses to operate more sustainably and more environmentally manner. However, as expected, different countries and regions have progressed at different rates through various measures.

EU-led initiatives

As a front-runner in climate protection and a driver of the global environmental agenda, Europe aims to become the world's first climate-neutral continent by 2050. The European Green Deal, introduced in 2019 and adopted in 2020, is a roadmap of tax and non-tax policy initiatives designed to achieve this ambitious target. The EU's milestone target is to reduce EU greenhouse gas (GHG) emissions by 55 per cent, when compared to 1990 levels, by 2030.

The first set of legislative proposals, which were designed to facilitate the necessary acceleration of GHG emissions reduction by 2030 and align the EU's climate, transport, land use, energy and taxation policies with this milestone target, was adopted by the European Commission (the Commission) in July 2021 under the "Fit for 55 package" banner.

One component of the Fit for 55 package is the revision of the EU's current ETS, which, amongst other proposed changes, includes expanding the scope to include new sectors, reducing the overall quantity of allowances (annual cap) and phasing out the annual allocation of free allowances. While encouraging industrial decarbonization, this revision simultaneously drives carbon prices upwards. Such an increase in emissions pricing risks carbon leakage, which would occur if consumers switched from buying EU-produced goods to purchasing substitutes from non-EU countries where a lower (or no) carbon price is levied, or firms shifted production activities from the EU producers to such countries.

While the EU is implementing measures to achieve climate neutrality and is already successfully reducing GHG emissions, it recognizes that many other countries have not yet made reductions or are increasing emissions.

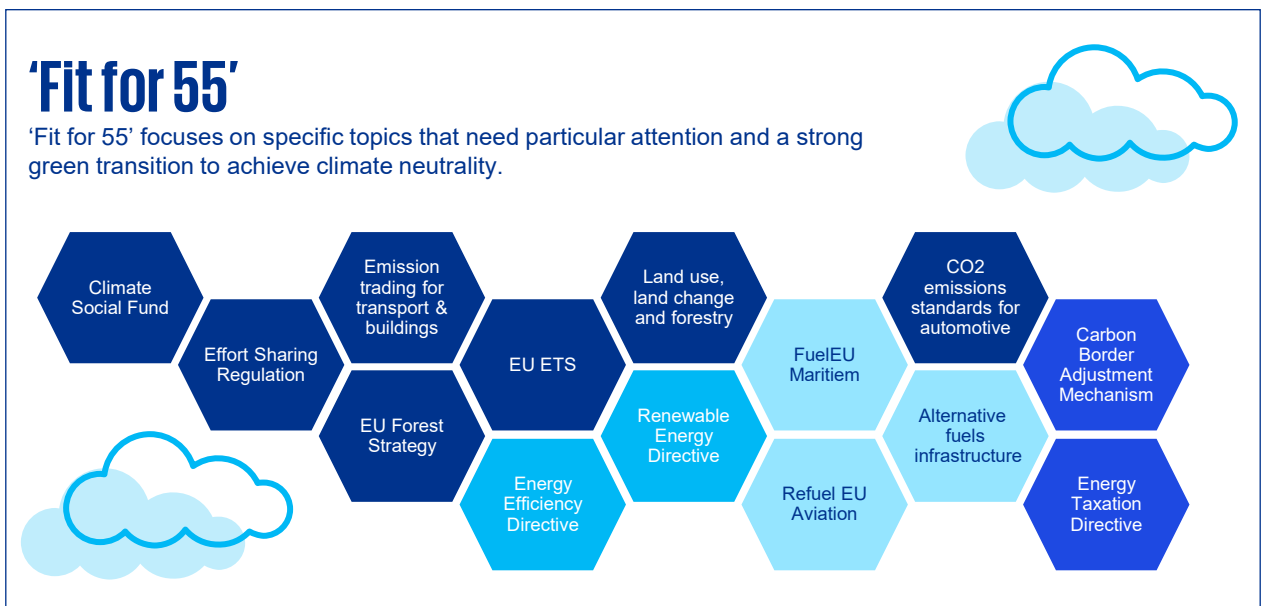
The EU, therefore, hopes to both exert global influence on combatting climate change and address potential carbon leakage concerns through

the implementation of a Carbon Border Adjustment Mechanism (CBAM), which was first proposed in 2019 within the EU Green Deal and is an essential element to the Fit for 55 package.

Carbon pricing at the EU's borders

The CBAM, which is a supplementary measure to, and mirrors the EU ETS, operates by imposing a charge on the embedded carbon content of certain imports that is equal to the charge imposed on domestic goods under the ETS, with adjustments being made to this charge to take into account any mandatory carbon prices in the exporting country⁽³⁾. To ensure that there is no double benefit afforded to EU producers, the CBAM will replace the free ETS allowances currently granted to EU producers assessed to be at high risk of carbon leakage. Therefore, by imposing an equivalent carbon price on the imports of covered goods, the playing field is leveled for both EU producers and EU importers of such goods as partner countries are encouraged to decarbonize their production processes.

Currently, the initial scope of CBAM proposed by the Commission covers imports of goods from five emissions-intensive sectors deemed at greater risk of carbon leakage into the EU customs territory: electricity, iron and steel, cement, aluminum and fertilizers⁽⁴⁾. The target industries and the list of covered commodities are expected to be extended in the future.



The inner workings of the mechanism

The Commission proposed that the CBAM would be gradually implemented: During a three-year transitional phase commencing 1 January 2023, affected importers would only be required to fulfill reporting obligations. From January 2026, importers would have to start purchasing CBAM certificates⁽⁵⁾, the price of which will be equivalent to an average trading price of EU ETS allowances in the week before the import (expressed in €/tonne of CO₂ emitted). The number of CBAM certificates held must be equal to the total emissions embedded in the CBAM goods imported, reduced to account for carbon prices already paid in the country of origin⁽⁶⁾ and adjusted to reflect any free allowances still allocated under the EU ETS. Full implementation will only be achieved in 2035 when free allowances are completely phased out.

The following key fundamentals of the CBAM process are as follows:

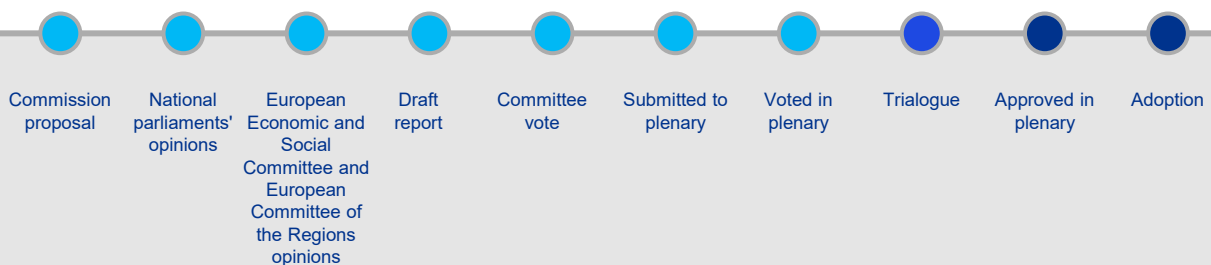
- Only authorized importers may import covered CBAM products. EU importers must, therefore, apply for authorization and be authorized by the competent national authorities before importing such goods.
- During the transitional period, importers of covered goods are mandated to submit a CBAM report quarterly that details the quantity of covered products imported, the actual total embedded emissions associated with these products, and any carbon price paid in the country of origin (which is not subject to an export rebate or other form of compensation on exportation).

- From 1 January 2026, importers of covered goods are required to submit, by 31 May of each year, a CBAM declaration (for the calendar year preceding that declaration) containing information about the total quantity of covered products imported, the total embedded emissions associated with these products, and the total adjusted⁽⁷⁾ number of CBAM certificates, corresponding to the total embedded emissions, to be surrendered (the quantity of embedded emissions, calculated according to established EU methodologies, must be independently verified).
- The CBAM will be enforced in the same manner as EU customs laws, meaning that affected EU importers must classify the imported goods using the EU's classification system at customs (i.e., according to the Combined Nomenclature (CN) codes) and the origin must be determined correctly (in accordance with the customs rules on non-preferential origin).

Proposed but not finalized

The legislative process underpinning the Green Deal and Fit for 55 Package is still underway – the European Commission is reviewing every EU law to ensure its alignment with the EU emission reduction targets. This review is intended to be completed and effective by the time EU Member States start updating their national energy and climate plans in 2023 so that the new EU climate ambition is reflected within these plans.

CBAM legislative progression⁽⁸⁾



However, before most EU legislation can be passed that is binding on the Member States, approval by all Member States and the European Parliament (Parliament) is required. (Although environmental legislation is under the ordinary procedure, there are exceptions, especially regarding tax legislation, which requires a unanimous agreement of the Council of the European Union, with Parliament only undertaking a consultative role.) Legislating the CBAM is no exception.

At the time of writing, the Commission, Parliament and the Council of the EU (representing all Member States) have entered into trilogue negotiations to find common ground on the different positions that have been taken by each of the three parties on different elements of the CBAM proposal. Once the final text has been agreed upon, the CBAM will become binding EU legislation. The most significant aspects to be agreed upon and the different positions adopted by each party are summarised as follows:

Topic	Commission proposal (original, before amendments)	EU Parliamentary position	Council position
Ending free allowances for sectors covered by CBAM	Gradually phase out free allowances over 10 years (10 percentage points every year from 2026 to 2035)	Free allowances are to be phased out from 2027(100% free allocations between 2023 and 2026; reaching up to 50% in 2030) and disappear by 2032.	Slower reduction at the beginning of a ten-year period (2026 – 2035); accelerated reduction rate at the end.
Transitional period	3 years (2023 – 2025)	4 years (2023 – 2027)	3 years (2023 – 2025)
Initial covered products	Cement, iron and steel, aluminum, fertilizer, electricity.	Include polymers (plastics), organic chemicals, hydrogen, and ammonia.	In agreement with the Commission proposal.
Covered emissions	Direct emissions only (European Commission to evaluate, at the end of the transition period, whether the CBAM scope should be extended to include indirect emissions).	Include indirect emissions (i.e., emissions from electricity used during the production process of in-scope products).	At the end of the transitional phase, indirect emissions could be included.



Impact on a global scale

While it may take some time for the legal process to run its course (once adopted by Parliament, there is still an additional period during which Member States must transpose this EU legislation into national laws), and there remains some uncertainty over the exact scope of the CBAM, there are rapidly evolving consequences for businesses involved with the cross-border imports of goods with GHG-embedded emissions in the EU. This means that not only EU-based companies that should be sitting up and taking note.

CBAM, as a new carbon pricing framework in the EU, is certain to have a transformational impact on companies engaged in international trade of the foreseeable growing list of covered commodities codes and is expected to re-shape global trade at large.

Some of the immediate, direct impacts that EU companies may feel include potential higher import prices of covered goods (e.g., steel) and increased prices of secondary goods that include components of covered goods (e.g., vehicle manufacturers buying parts from another EU manufacturer that contain imported higher-priced steel/ aluminum). To sell covered goods to the EU, non-EU companies will have to implement carbon accounting to track the embedded emissions associated with these products (and have these embedded emissions independently verified), as this product-specific information must be provided to the authorized declaration upon importation.

Additionally, supply chain disruptions may occur if imported goods are stopped at the border due to imported covered goods not being declared to customs by an authorized declarant or incorrect classification of goods according to the CN codes.

The CBAM is only in its infancy – potential future impacts may involve the extension of covered emissions to include scope 2 and a broader impact on businesses as the scope of CBAM is extended to include additional targeted industries and covered commodities. This may consist of downstream products that undergo complex manufacturing processes and finished products (e.g., white goods).

Next steps

Businesses should already start preparing to adapt to the upcoming changes that are almost upon us. Amongst the most urgent for EU companies to align themselves with the CBAM regulation is the adherence to reporting obligations from 1 January 2023. As mentioned previously, businesses are required to report for the embedded emissions in the imported goods every quarter (during that quarter of a calendar year), detailing the direct and indirect emissions and any carbon price effectively paid in the country of origin.

For businesses to achieve a smooth roll-over in the upcoming transition period and minimize the disruption to their business model and costs, all EU importers of initial covered products (both those included (i.e., cement, iron and steel, aluminum, fertilizer, electricity and those potentially included (i.e., polymers, organic chemicals, hydrogen, ammonia)) must be ready for these transitional period reporting obligations.

As more products fall into the scope of the expanded execution of CBAM, more and more businesses will need to prepare for its implementation. It is critical for companies and importers of CBAM goods in the EU to remain well-informed of these developments and begin evaluating the overall impact on their business activity, which may not be limited to a view on their customs data only, but also impact their sourcing and supply chain.

Notwithstanding the administrative costs associated with this tax measure, businesses will have to begin focusing on the quality and availability of their data elements, prepare for a global supply chain review and assess the implications of CBAM on their business model, set-up and trade flow to stay competitive.

Key actions and considerations

Actions	Considerations
Identify and create a core team to manage this topic.	Who should be responsible and take the lead? Who should be part of this core team? Tax, customs, sustainability, operations?
Review the global supply chain to determine the potential impact of CBAM.	Are the products in scope imported? Does CBAM apply?
Review the CN and HS codes and check where the product comes from.	Is the product on the list (annex I of the CBAM regulation)? If not, the product is, in principle, out of the CBAM scope.
Prepare to register for CBAM in collaboration with customs.	Which entity needs to register? Global or per country? What about the representation? Is the entity permitted to be an authorized declarant?
Determine data availability.	Are embedded (direct and indirect) emissions calculable (annex III)? Is there insight into actual emissions, or should the standard (default) values be relied upon?
Prepare for the reporting obligations.	Should systems be implemented for CBAM administration, quarterly reports, yearly declarations, and the verification of embedded emissions?
Prepare to pay for CBAM.	Calculate the financial impact.
Develop ongoing insight into carbon pricing in third countries (carbon prices paid outside of the EU on imported goods may be credited).	Which countries are products imported from? Do these countries have a carbon pricing system in place?
Improve business and contact suppliers to reduce carbon emissions and create a sustainable, environmentally friendly supply chain.	Should the supply chain be restructured, or should new partnerships be formed?
Engage with in-scope vendors.	What kind of GHG emissions data has been collected? Can in-scope suppliers provide verification reports on the carbon footprints of the products sold? Do in-scope suppliers have due Monitoring, Reporting and Verification ("MRV") systems in place for the upcoming CBAM? Should vendor engagement programs (or other programs) be implemented to collect product-level GHG emissions data from suppliers?
Importers of products that CBAM does not currently cover: Continuously monitor CBAM developments, especially regarding expanding the scope to include additional covered products.	Should the carbon content of imported goods start to be monitored in preparation for future developments?

- Source:
- (1) The EU ETS, which currently applies to limited energy-intensive, high emitting industries, is a cap-and-trade system that sets an annual cap on the amount of greenhouse gases that companies in covered sectors may emit. This amount is covered by allowances, which are tradeable. Within the cap, companies either receive emission allowances for free or buy them, and unused allowances can be sold or used the following year.
 - (2) Carbon Pricing Dashboard | Up-to-date overview of carbon pricing initiatives ([worldbank.org](#)).
 - (3) The CBAM charge would cover imports of covered goods from all third countries, except those participating in, or which are linked to, the EU ETS (Iceland, Norway, Liechtenstein, Switzerland and five other minor territories).
 - (4) Annex I of the CBAM regulation
 - (5) One CBAM certificate will correspond to one tonne of GHG emissions measured in the covered CBAM goods.
 - (6) Certified by an independent person.
 - (7) Reduced to account for the carbon price paid in a country of origin and the adjustment necessary for the extent to which EU ETS allowances are allocated free of charge.
 - (8) EU carbon border adjustment mechanism ([europa.eu](#))

Contact us

The KPMG Global Trade and Customs Practice provides specialized assistance in global trade and customs matters, including CBAM. Alongside our global network of Trade and Customs experts, KPMG's ESG, sustainability and green taxes subject matter experts can assist you with an initial assessment of the CBAM implications for your business and, if required, conduct a more comprehensive supply chain review.

KPMG professionals are ready to work collaboratively with clients on the journey to a low carbon future.

For more information about the impact of CBAM on your company, don't hesitate to get in touch with one of our experts.

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