



# Carbon Border Adjustment Mechanism (CBAM)

## Introduction

KPMG IMPACT is a platform to support and empower KPMG professionals to assist clients in fulfilling their purpose and helping deliver on the UN Sustainable Development Goals (SDG).

One focus of KPMG IMPACT is on the latest global climate policy developments and their possible impact on international business. To assist with these issues, we have decided to produce a newsletter (on an occasional basis) for those who are alert to the latest climate and decarbonization developments. This first newsletter focuses on proposals for the carbon border adjustment mechanism (CBAM) — most notably from the EU.

## Background

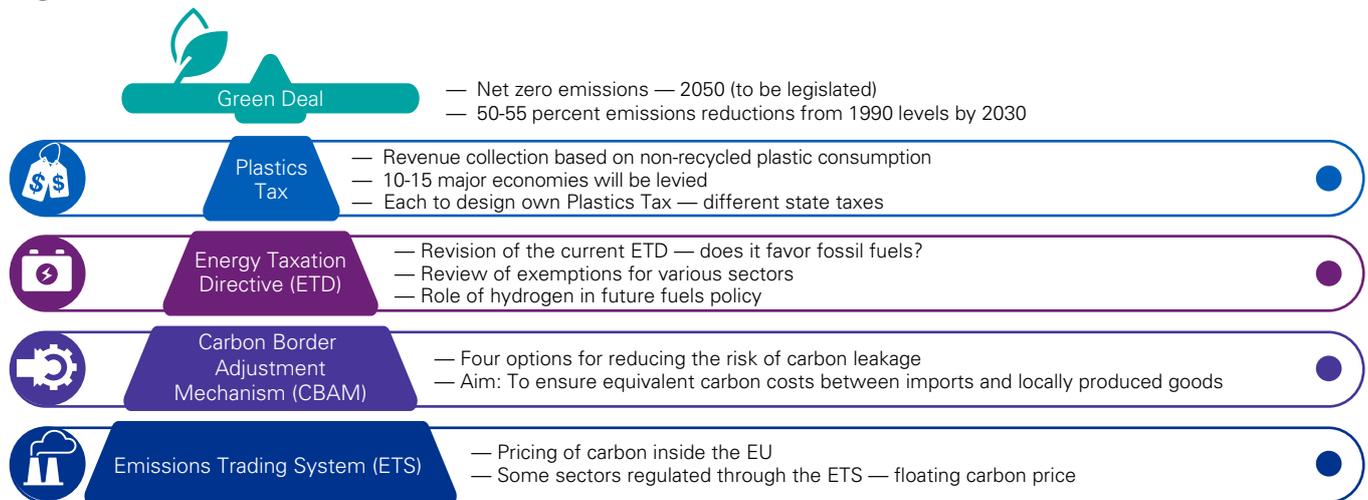
According to the UN, as of June 2021 there are 195 signatories to the Paris Agreement to limit their CO<sub>2</sub> emissions.<sup>1</sup> However, the Paris Agreement permits countries to set their own ambitions within certain parameters. Some jurisdictions or regions have undertaken to cut carbon emissions faster than others. The EU, in particular, has stated its ambition to cut emissions by 2030 by 55 percent in comparison with 1990 levels.<sup>2</sup>

This commitment has been made as part of the EU Green Deal, which is a comprehensive package of tax and non-tax measures.<sup>3</sup>

The CBAM is one of several tax and carbon price reforms proposed as part of the Green Deal. The key tax reform measures are set out in Figure 1 below. These include:

- Extension of the Emissions Trading System (ETS), including possible phasing out of existing free permit allocations for many participants;<sup>4</sup>
- Introduction of the CBAM;<sup>5</sup>
- Reform of the Energy Taxation Directive (ETD);<sup>6</sup> and
- Plastics Tax.<sup>7</sup>

**Figure 1: Tax measures in EU Green Deal**



<sup>1</sup> [https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg\\_no=XXVII-7-d&chapter=27&clang=\\_en](https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXVII-7-d&chapter=27&clang=_en)

<sup>2</sup> [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_20\\_1599](https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1599)

<sup>3</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1588580774040&amp;uri=CELEX%3A52019DC0640>

<sup>4</sup> [https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12660-Updating-the-EU-Emissions-Trading-System\\_en](https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12660-Updating-the-EU-Emissions-Trading-System_en)

<sup>5</sup> [https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism/public-consultation\\_en](https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism/public-consultation_en)

<sup>6</sup> [https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12227-EU-Green-Deal-Revision-of-the-Energy-Taxation-Directive\\_en](https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12227-EU-Green-Deal-Revision-of-the-Energy-Taxation-Directive_en)

<sup>7</sup> [https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L\\_.2020.424.01.0001.01.ENG](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2020.424.01.0001.01.ENG)

## Carbon leakage

Increasing ambitions for emissions reduction raise concerns about potential “carbon leakage”. This is the concern that consumers in a high ambition emission reduction jurisdiction will be encouraged to purchase imports produced in low ambition jurisdictions where the cost of production is lower. Alternatively, producers in a high ambition jurisdiction may consider they have to move some, or all, of their production to new locations. The consequence is that carbon leakage reduces the impact of carbon reduction measures in a high ambition jurisdiction. In an extreme situation, it could potentially lead to an overall increase of emissions if the result was increased production in a location with lower emission standards than already existed in the high ambition jurisdiction. It may also lead to job losses and lack of competitiveness in affected industries in the high ambition location.

Although significant carbon leakage has never been found in empirical studies, there is a concern among policy makers that — if carbon prices are increased in high ambition countries — it will start to become a reality. While final decisions have not been made, the EU is also considering phasing out the free permit allocation under the ETS, which has assisted the transition to the carbon price and to date reduced the salience of carbon leakage concerns for trade-exposed heavy emitters.

## CBAM options

In order to address risks of carbon leakage from these developments, the European Commission (EC) released a consultation process in 2020 on the design features of alternative approaches to introducing a CBAM. This could take a number of forms, and four distinct options were included in the consultation process, including:<sup>8</sup>

- A tax on imports (sometimes referred to as *Carbon Border Tax*), most likely imposed through the Tariff system;
- Importers being incorporated within the existing ETS;
- A mechanism based on the ETS but involving a separate system for importers; or
- A new (excise-style) tax charged both within the EU and on imports, based on the average carbon intensity of certain products (sometimes referred to as a Carbon Excise Tax).

If the CBAM is based on the EU ETS, it is possible that it would be either:

- Simply a type of tax on imports (imposed possibly through the tariff system) charged according to the prevailing price of ETS permits; or
- It might be a shadow ETS system under which an importer would buy permits, again at a price based on the prevailing EU ETS price.

## European Parliament approval in-principle

The EU Parliament has recently adopted a formal resolution towards the development of the CBAM.<sup>9</sup>

The precise form which the proposed CBAM will take will only become clear once the EC tables draft legislation in the form of a proposed directive. The requirements for a directive to become law in the EU depend upon a number of factors, including whether or not it relates to a fiscal matter.

If the CBAM proposed is structured as a tax (e.g. a tariff) it would have to be passed by the so-called special procedure. This means it would be necessary for all member states in the EU, voting in the Council of the European Union, to agree unanimously to the text. The EU Parliament would only have a consultative role in the process.

However, if the CBAM was not a tax proposal — for example, if it was structured as a shadow ETS — the so-called ordinary procedure would apply. In this case, the Council of the European Union and the EU Parliament would have joint responsibility. The Council of the European Union would act by qualified majority vote, which means 55 percent of the EU Member States would have to approve the directive and those states would also need to represent 65 percent or more of the EU population.

At this preliminary stage, it is understood that the products proposed to be covered in the first instance will include aluminium, steel, cement, glass, paper, and heavy chemicals.

The EU Parliament has not yet made decisions about the related issues of free permit allocations to high emissions industries.

It is understood that the EC has now prepared draft CBAM Regulations adopting the shadow ETS permit approach. However, the date for release of the final proposed regulations is 14 July 2021.

## WTO issues

It should be possible to design a CBAM around a carbon tax or excise tax which would be WTO compliant. Potentially the same is true if it is based on an ETS, although this raises further complexities.

While there is a general prohibition on a jurisdiction applying taxes on imports (other than in accordance with the General Tariff Schedule), there is an exception for taxes which are equivalent to internal taxes, provided they are not charged in a discriminatory way on imports (*General Agreement on Trade and Tariffs*, Article II.2.a). An excise tax charged at predetermined rates on particular products — both domestic and imported — should therefore satisfy this condition.

However, a CBAM based on a carbon tax or ETS could potentially breach the non-discrimination rule as it could result in a higher tax being placed on imported products which were identical to domestic products — except for the fact they were produced with greater embedded

<sup>8</sup> <https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12228-Carbon-Border-Adjustment-Mechanism/public-consultation>

<sup>9</sup> [https://www.europarl.europa.eu/doceo/document/TA-9-2021-0071\\_EN.pdf](https://www.europarl.europa.eu/doceo/document/TA-9-2021-0071_EN.pdf)

carbon emissions. Therefore, it is also the case that a CBAM based on these two approaches would have to rely on the General Exemptions in the *General Agreement on Trade and Tariffs*, which would mean its purpose would have to be exclusively environmental and not economic protection.<sup>10</sup>

This means that it should be possible to make a Carbon Border Tax WTO compliant, provided it was similar to a domestic carbon tax.

## Carbon Excise Tax

One option for developing a solution, would be to develop a Carbon Excise Tax. The design of the Carbon Excise Tax will depend upon each country's constitutional and taxation law architecture for excise. In Australia, for example, excise duty can only apply to domestic production. However, the system architecture allows for an excise-equivalent import duty to be levied (in addition to any separate *ad valorem* import duty) under the Customs Tariff. This mirrors the excise duty on domestic production.

In many countries, excise laws allow for excise to apply to both domestic production and imports (sometimes they give the excise tax a different name, e.g. *Special Consumption Tax*, as in Vietnam, until recently). The final outcome is equivalency in the application of the excise on both domestic consumption versus imports.

## Competitiveness of exports

There are more challenges under current WTO rules in designing measures (or refunds) within the CBAMs for exports per se. However, an excise-based tax would only be charged on domestic consumption and not exports, and so should not impact the competitiveness of exports.

## Developing countries

The World Bank has already formed a Coalition of Finance Ministers for Climate Action, (Finance Ministers' Coalition) to discuss carbon pricing.<sup>11</sup> It is understood that the Finance Ministers' Coalition has been actively discussing CBAM in the context of their consideration of carbon prices.

Such international cooperation on carbon pricing (beyond CBAM measures, in particular) may also assist in developing the principle of common but differentiated responsibilities. Such an approach would enable developing countries to take measures to increase carbon prices proportionately while taking account of their specific needs to protect domestic industry.

## What does the CBAM mean for business?

Many EU-based corporates will be monitoring the emissions performance of their supply chain in order

to meet the monitoring, verification and reporting standards now expected of most corporate entities. However, few companies will know in what country the actual emissions, relating to the development of their goods, were generated in. Companies that consume products covered within the scope of the EU ETS, e.g. manufacturing, could face significant additional cost pass-through from existing suppliers if the CBAM is implemented, due to the significant emissions occurring in geographies without commensurate low carbon policies and the emissions associated with transport of the goods to the EU. Corporates should ensure that they understand the geographical composition of their emissions to enable them to undertake a supply chain review, where required, making conscious cost versus carbon trade-offs and ensuring the resilience of their pricing model to the proposed changes.

## Governance of climate change (and CBAM) response and preparedness

Many global corporates have established Climate Change Transition Committees (or similar), for governance purposes, with lead representatives from Environmental, Social and Governance (ESG), supply chain, strategy, finance corporate affairs, tax and indirect tax. These corporates have acknowledged the need for the issue to be approached holistically and many are doing this via the implementation of the Taskforce on Climate-related Financial Disclosures (TCFD). Horizon scanning for regulatory changes as a consequence of climate change should be considered a core part of scenario analysis relating to meeting the recommendations of this framework.

## KPMG IMPACT

KPMG IMPACT is a platform to support and empower KPMG professionals to assist clients in fulfilling their purpose and helping deliver on the UN Sustainable Development Goals.

KPMG IMPACT includes a Virtual Center of Excellence (VCOE) for Excise and Environmental Taxes, comprising more than 100 excise and environmental specialists globally.

KPMG's [Responsible Tax Project](#), together with KPMG IMPACT, has been exploring CBAMs for several months and has now hosted three events. A first roundtable with professionals to discuss the details of a CBAM, the write-up of which can be found [here](#) and a second roundtable with clients to discuss what practical implications the introduction of a CBAM may have, the write-up of which can be found [here](#). A recording of the webinar can be found [here](#) and a write-up of this will appear on the website in due course.

<sup>10</sup> *Making Carbon Border Adjustment proposals WTO-compliant* Craig Emerson and Stefano Moritsch

<sup>11</sup> The Coalition of Finance Ministers for Climate Action

## Service offerings for clients

KPMG IMPACT's service offerings for corporates in relation to CBAM include:

- **Regulatory Strategy Advisory services**, including advising on current proposals and policy options and their potential impact;
- **Climate change and supply chain impacts**, as well as responses and strategies, to enable financial planning and effective supplier management in pursuit of net zero targets.
- **Impact measurement, assurance and reporting services**, helping clients to develop and implement methods, tools and frameworks to better track and measure carbon and climate risks and opportunities.

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