The EU's Carbon Border Adjustment Mechanism: the practical implications

Environmental | Indirect Tax



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The EU’s Carbon Border Adjustment Mechanism will impact many exporters to EU member states. We consider the practical implications.

Key Points

What is the issue?

The concept of carbon pricing and the EU’s Carbon Border Adjustment Mechanism (CBAM) has implications for many exporters to EU member states, including those who are based in the UK.

What does it mean to me?

Importers into the EU now have to track all imports of iron and steel, aluminium, fertiliser, concrete, hydrogen and electricity with their first CBAM declaration due by 31 January 2024, and quarterly thereafter. The regime will apply to any importer of covered goods with a consignment value of over €150.

What can I take away?

Whether or not tax departments take the lead on CBAM, they need to play a full role as some tax authorities in the EU will be administering it.

A previous article in this series, ‘A sustainable future: the role of environmental tax strategies’ (September 2023), made the case for the prominent role that tax – and tax professionals – should play in driving a sustainable future.

It pointed out that to be able to play this role, tax departments will need to learn a new sustainability lexicon, rife with alien acronyms and confusing concepts. It also introduced the concept of carbon pricing and the EU’s Carbon Border Adjustment Mechanism (CBAM). The EU CBAM has implications for many exporters to EU member states, including those based in the UK.

With that regime now in force, we thought it would be useful to examine the practical implications for businesses of the EU CBAM.

A quick recap

The CBAM entered into force on 1 October 2023. It represents one of the biggest shifts in the EU’s trade regime for more than 30 years and places extensive new compliance and reporting requirements on businesses supplying and importing certain products into the EU.

Aiming to be the first ‘green continent’, the EU has been imposing ever more regulation on EU business to encourage them to decarbonise. This puts the EU at

risk of ‘carbon leakage’, which occurs when carbon-intensive production moves away from the EU to countries where less stringent climate policies are in place; or when EU products are replaced by more carbon-intensive imports.

Even if EU businesses don’t leave, the need to be held to higher, cleaner standards mean that EU-produced inputs to the economy are likely to be more expensive than those being imported (steel being one example). To help even up the playing field, the EU is imposing an adjustment – a tariff – at its border for certain high carbon intensity products that enter the EU.

The EU maintains that its CBAM is consistent with international trade law set at the World Trade Organisation. Several countries have already voiced their objections to CBAM, notably India and China. However, if any country were to formally challenge the regime, any trade dispute would take years to settle.

In the meantime, importers into the EU now have to track all imports of iron and steel, aluminium, fertiliser, concrete, hydrogen and electricity with their first CBAM declaration due by 31 January 2024, and quarterly thereafter. The regime will apply to any importer of covered goods with a consignment value of over €150, meaning there is essentially no *de minimis* level.

These reporting requirements require a mix of product data, customs-related data and calculated embedded carbon emissions data. The latter will only be available upstream in the supply chain itself. This will be a significant compliance challenge for any affected businesses (particularly those with December year ends, which have to gather this data in the midst of their annual reporting cycle).

Then from 2026, when the ‘transition period’ ends, businesses will need to buy CBAM certificates to offset the cost of the embedded carbon and other greenhouse gas emissions based on the weekly price of the EU’s Emissions Trading Scheme (ETS). Credit will be given (within certain parameters) for carbon prices/taxes already paid in the country of origin. In addition, the CBAM reports will need to be independently verified by an accredited verification body.

The new regime introduces enforcement obligations. Businesses will have their CBAM-covered goods stopped at the EU border if they have not registered to be an Authorised CBAM Declarant by 31 December 2024.

There are penalties for non-compliance of €10 to €50 per tonne of unreported emissions during the transition period and higher penalties will apply for two or more incomplete or incorrect CBAM declarations. Separately, an additional penalty regime for failing to purchase and/or surrender the correct amounts of CBAM certificates will also be introduced.

Practical organisational challenges

CBAM is a regime that blends aspects of supply chain (embedded emissions), customs duties (the covered products are identified by HS customs codes) and tax – or at least a 'pseudo-tax' – where payments are made to a central authority (by way of the purchase and surrender of CBAM certificates).

In practice, the data needed to comply with the rules is likely to be spread across multiple enterprise resource planning (ERP) or accounting systems, in the hands of group/local finance, procurement or operations teams, as well as external upstream suppliers and customs brokers or agents.

This data soup, with so many ingredients, means that tax, finance, sustainability, procurement, supply chain, operations, legal (and eventually Treasury) functions may all have a role to play in setting policies, agreeing processes and gathering data. This lack of clarity often creates a void where departments are slow to assume accountability, may be overlooking strategic decisions that need to be made and are introducing avoidable inefficiencies. Even for those businesses which are clear on allocating responsibilities, identifying the data and establishing the processes for compliance is already creating a significant amount of work.

Assigning ownership of CBAM in complex businesses is a challenge. The question for tax departments is whether they should drive the effort or be a part of the larger team? We are often asked: who *should* be accountable? The answer, as so often it is in tax, is: it depends.

It depends on the particular organisation, including its culture and C-suite strategy; the complexity of the supply chain; the relative capability and capacity of the different functions; and, last but not least, the willingness of particular individuals to

step up.

There are likely to be lots of right – or at least pragmatically workable – answers for any given organisation. In nearly all cases, it will require a high-degree of cross-functional collaboration.

Practical implementation challenges

As well as allocating accountability, the implementation challenges of CBAM can also vary widely based on a business's structure, import profile and supplier relationships. Below, we set out some of the common challenges we are seeing as clients ready themselves for CBAM.

Tracking imports of CBAM products into the EU

The first challenge for businesses is to set up a process for tracking imports of CBAM products into the EU from 1 October 2023 for the first reporting period. Many will have had consignments shipped prior to 1 October but clearing customs in the EU after that date. It is important to ensure that these imports are captured as part of the first CBAM declaration. This also applies to goods that are currently stored in bonded warehouses in the EU but are customs cleared after 1 October.

Data collection for embedded emissions

Data collection has been, and is likely to continue to be, one of the main challenges for businesses. For the first two quarterly CBAM declarations, the use of default values for embedded greenhouse gas emissions will be allowed by the EU. However, from 31 July 2024 the use of the approved EU framework for reporting emissions will be required, which is based on actual emissions data.

For many businesses, there is a mismatch between the emissions data that they may already collect as part of emissions trading schemes (which require reporting on an annual basis) and the per consignment basis which is needed for CBAM. Also, the methodology for calculating embedded carbon emissions is far more involved than businesses will be used to for Scope 3 reporting purposes under Task Force on

Climate-Related Financial Disclosures (TCFD) rules. Those calculations are often done on a ‘spend basis’, rather than detailed embedded emissions data. Prioritising the identification of any data gaps should be a priority.

Engaging with suppliers

Where businesses are not the producer of products, but instead are trading entities or distributors, engaging with suppliers is essential to obtain the necessary emissions data. The EU has provided standard data requests for installation operators for importers to use which will need to be updated on a quarterly basis and incorporated into the CBAM declarations; however, this does not cover all participants in the supply chain.

Businesses should be looking to actively engage with their suppliers to understand the data collection requirements and address any existing data gaps. Where multiple suppliers are used across supply chains, keeping track of different emissions intensities embedded in CBAM products will be needed.

Amending contracts and INCOTERMS

Existing supply chain contracts may not be adequate for the additional requirements under the CBAM regime. The inclusion of embedded emissions data requirements, agreeing the balance of risks, allocating liability for incorrect or incomplete data, and Internationally Commercial Terms (Incoterms) may all need to be examined to ensure compliance with CBAM.

We are seeing some businesses perform a wholesale audit to compare their supplier contract terms with their actual customs data (often with some surprises) to ensure they know for which consignments they are in fact importer of record.

Northern Ireland: liability for an EU tax *within* the UK?

Whilst a little more niche, the position for businesses with operations in Northern Ireland is currently unclear.

The Windsor Framework (which replaced the Northern Ireland Protocol) is introducing a ‘green lane’ with streamlined customs procedures for some products going from Great Britain to Northern Ireland; and a ‘red lane’ with full customs

procedures products at high risk of entering the EU’s Single Market.

Additional talks will be needed between the UK and EU to resolve how CBAM will apply to trade between Great Britain and Northern Ireland.

Considerations in the run-up to the first reporting period

There is wide variation in the approach that businesses are taking towards CBAM. Many companies are focused on being able to ensure compliance, whereas others are looking to make strategic decisions to reduce the embedded emissions within their supply chain. After all, one of the regime’s key aims is to accelerate the decarbonisation of supply chains.

Cost implications

From 2026, CBAM certificates will need to be bought and surrendered to offset the embedded emissions contained within imported products into the EU. Businesses will need to ensure that they have accurate forecasts of trading activity each year to financially plan for these additional costs and to buy the right number of certificates. Companies are likely to need new mechanisms to manage this new task. Will this be the responsibility of the Treasury team, or local finance teams, or others?

Whatever the outcome, as the costs of CBAM phase in gradually over time – from 2026 to 2035 – the implications are likely to become more significant. We have seen some estimates based on a prudent cost of carbon in 2035 that suggest CBAM could add around 40% to the cost of steel over today’s prices. 40% inflation on the cost of a key component could have huge margin implications, heightening the need for CFOs to take an interest.

Registering the right legal entity as the Authorised CBAM Declarant

Some businesses have dozens of entities across Europe, necessitating multiple reporting. CBAM may prompt discussions around restructuring, procurement, importation and supply chain activities. Ensuring that the right entity is registered as the Authorised CBAM Declarant should be a key consideration when looking at legal

entity rationalisation.

If UK companies import directly into the EU, they will need an EU presence or indirect representative who is authorised to do so on their behalf.

Supply chain restructuring

To accelerate decarbonisation efforts (while simultaneously mitigating CBAM costs), businesses should be looking to move supply chains toward less emission-intensive products or processes. This may involve changing product components, suppliers or supply routes. The R&D or procurement functions may become more valuable and, if so, tax departments will need to consider the impact on transfer prices. Supply chains may reorganise – EU for EU, non-EU for non-EU – with all the international tax implications that follow.

Streamlining compliance processes across multiple regulations

For businesses operating in the EU, there are several new supply chain regulations being implemented over the coming years, not just CBAM. Other regulations to take account of include plastic packaging taxes, extended producer responsibility, deforestation, supply chain due diligence and forced labour.

Taking a holistic approach should be a priority for businesses, ensuring that internal processes, procedures and technology can integrate the right data and generate the necessary compliance reports across the entire regulatory landscape.

Final thoughts

CBAM is an opportunity to proactively shape sustainability strategies and work towards a sustainable future. Businesses in the vanguard of ESG change are approaching CBAM not merely as a compliance burden but rather as an opportunity to reduce their carbon footprint and support their wider ESG objectives. Tax departments may or may not take the lead on CBAM, but come what may it is essential they play a full role in meeting the strategic objectives – another way in which tax professionals can, and should, help drive a sustainable future.

The authors’ views are their own and not necessarily representative of those of EY.

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