

European Commission releases a number of 'green taxation' measures

July 16, 2021

In brief

The European Commission has published a number of green taxation measures as part of a package called the 'Fit for 55' Package. This Fit for 55 Package intends to set the European Union on the path to a greenhouse gas emissions reduction of 55% by 2030 compared to 1990 levels and, ultimately, climate neutrality by 2050. It is a key component of the European Green Deal of 11 December 2019. The Commission plans to introduce new incentives to encourage increased green behaviour in areas such as renewable energies. It also seeks to discourage behaviour that uses scarce resources, through increased carbon pricing and punitive costs for climate-unfriendly activities.

This announcement includes three major new emission pricing initiatives, including the revised Emissions Trading Scheme (ETS), a Carbon Border Adjustment Mechanism (CBAM) and an amended Energy Taxation Directive (ETD). It also provides for updates to existing EU laws in areas such as renewable energy, energy efficiency, land use change and forestry, alternative fuels and CO2 emission standards for vehicles. Finally, it will provide legislation for a new EU forest strategy, sustainable aviation fuels, measures to green Europe's maritime space and a Climate Action Social Facility.

In detail

Background

The European Commission, as part of its Work Programme published earlier this year, declared that it wanted more targeted measures to address key environmental concerns. The European Union has set ambitious goals to become climate-neutral by 2050 and it believes that it needs to leverage all of its resources, including aligning tax and climate policies, to ensure that this objective is met.

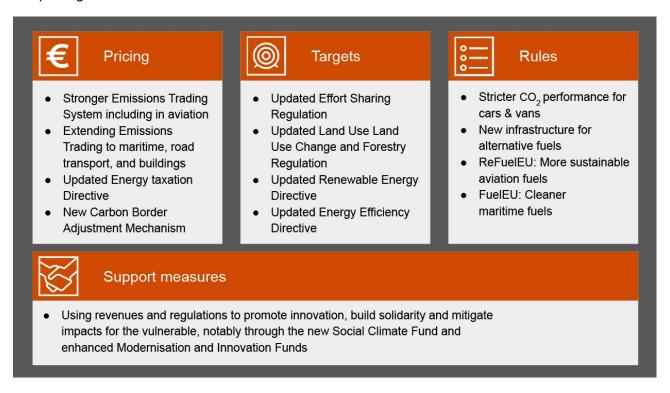
At the same time, the Commission needs to <u>raise funds</u> in order to repay the cost of financing the NextGeneration EU plan, which is a recovery package to support EU Member States hit by the <u>COVID-19 pandemic</u>, and it understands that part of these funds must come from new taxes. The Commission is simultaneously progressing its green tax agenda, and planning to raise additional taxes on a 'polluter pays' model. In total, green measures are expected to raise in the region of EUR 22-31bn per annum for the EU Budget when they are fully established and



are also expected to result in a significant change in behaviours from EU-based companies and EU citizens when it comes to using natural resources.

Fit for 55' Package

The announcements further outline the full suite of green taxation measures that are planned in the coming years. In terms of outgoings, 30% of expenditure and investment programmes under the combined NextGeneration EU and 2021-2027 Multiannual Financial Framework budget of EUR 2 trillion are dedicated to supporting climate action. Some of these proposals leverage existing rules and regulations, while others are new and would require either primary or secondary EU law in order to become effective. Below are the building blocks which make up the overall package:



Support from G20 countries

On 9 and 10 July 2021 the G20 countries met for their latest summit. The communiqué published after the G20 addresses that there should be a policy mix to shape just and orderly transitions to achieve the goal of low-greenhouse gas emissions. The communiqué notes: "This mix should include a wide set of tools, such as investing in sustainable infrastructure and innovative technologies that promote decarbonisation and circular economy, and designing mechanisms to support clean energy sources, including the rationalisation and phasing-out of inefficient fossil fuel subsidies that encourage wasteful consumption and, if appropriate, the use of carbon pricing mechanisms and incentives, while providing targeted support for the poorest and the most vulnerable." Pascal Saint-Amans, Director OECD Tax policy and Administration, responded to the communiqué that this would be the next big cooperation challenge in the tax field.

Although there seems to be broad support for the direction of travel by the G20 countries, a number of EU Member States are concerned about the impact of the Commission's proposed measures on their citizens.

Summary of the three key emission pricing measures announced

EU Emissions Trading Scheme: Extension of scope and reduction of the 'cap'

Businesses may be familiar with the existing EU ETS which has been in place for a number of years, particularly its 'cap and trade' model. Under the scheme, businesses are given purchase allowances for emissions up to a certain limit (the cap). The taxpayer surrenders these allowances in respect of every tonne of emissions released for the year in question. Taxpayers could carry forward unused allowances to other years or could sell the unused allowances (the trade).

The proposal would strengthen the existing EU ETS by reducing the overall quantity of allowances and expanding the scope to new sectors. The maritime transport sector would be gradually but fully included in the existing EU ETS. Free allocations of allowances for aviation would be phased out, meaning that taxpayers would be required to pay for allowance allocations and any subsequent run-overs in emissions would also cost the taxpayer.

To address the lack of emissions reductions in the building and road transport sectors, a new separate ETS would be introduced for fuel distribution for road transport and buildings. According to the self-standing ETS plan for buildings and road transport, the 'regulated entities,' who would be required to limit greenhouse gas emissions to a certain cap or else purchase additional allowances, would have to obtain emission permits in 2025 as well as report their emissions for 2024 and 2025. The obligation for regulated entities to surrender allowances, thereby reducing the levels of emissions they are permitted to release, would only apply from 2026.

The amended Directive is expected to be in effect from 1 January 2024. It requires support from both the European Parliament and the EU Council to be accepted as EU law. Revenues generated by the ETS would be made available to EU Member States, who are directed to spend these funds on climate and energy-related projects, or, in the case of the standalone ETS plan for buildings and road transport, minimising the social impact of additional fuel costs on vulnerable users of home heating and transportation fuel (see more below).

Observation: If adopted, there is concern by some large EU Member States that the proposed changes may have significant financial impact on the sectors (to be) included in the EU ETS. By design, therefore, the incentives for investing in carbon efficient alternatives may be shifted. Assessing this impact and contemplating structural shifts are important steps in preparation for the potential implementation of the rules. The starting point could be an inventorisation of the carbon footprint of current business operations, of (technical) possibilities available to reduce the footprint and the effects on a business's supply and value chain.

Carbon Border Adjustment Mechanism: EU border system to prevent carbon leakage

The CBAM will be a levy on the importation of certain specified goods (cement, electricity, fertilisers, iron & steel and aluminium) into the European Union. The role of the CBAM is to address the risk of carbon leakage (e.g. by relocating carbon intense production processes outside the EU) and to reinforce the EU ETS. It is designed to ultimately replace the existing free allowances mechanism applied in the EU ETS. The current EU ETS contains substantive free allowances which are meant to safeguard competitiveness of EU industry and to avoid carbon leakage. That system has been effective in addressing the risk of leakage but it also dampens the incentive to invest in greener production. In the Commission's new proposal for a revised ETS, however, the number of free allowances for all sectors would decline over time so that the ETS can have more impact in fulfilling the EU's climate goals. Without accompanying measures this would mean that the risk of carbon leakage would increase. To address this risk of carbon leakage in a different way, the CBAM is introduced, which aims to put a leveling carbon price on the import of certain goods from non-EEA countries (including Switzerland) if certain conditions are met.

Based on EU ETS, allowances are granted for carbon emissions caused by power generation, industry and aviation sectors within the European Union. The mirroring with EU ETS means that the price of the CBAM certificates for the goods in scope would be aligned with the price of EU ETS allowances.

The CBAM, unlike the ETS and the ETD, would be presented as a Regulation. If it is approved at all legislative stages, it would have binding legal force in each EU Member State and enter into force on a set date in all EU Member States. This date is currently projected to be 1 January 2023. There would be a transition period up to 2026, when the CBAM would only apply as a reporting obligation for the declarant without the levy being due.

In the proposal the European Commission mentions that the measure has been designed to comply with World Trade Organisation ('WTO') rules and other international obligations of the European Union.

Observation: It is very likely that the CBAM will have a significant impact on a wide variety of internationally operating businesses. Hence, an important next step for companies importing (or relying on the importation of) any of the goods in scope of CBAM (or expected to become in scope of CBAM) is to understand the potential impact of the costs of CBAM on their supply chain and ultimately on the costs of produced goods. It is furthermore essential to make sure the correct formalities are taken into account to be able to arrange for a smooth import of goods at the EU border complying with the CBAM to avoid potential penalties. Despite the European Commission's expectations on the compatibility of the CBAM with WTO rules, the CBAM might be seen as a protectionist measure by other countries and possibly spark retaliatory responses.

Energy Taxation Directive: providing clarity on elements of the existing Directive

The amended ETD aims to ensure that the taxation of motor and heating fuels ('energy products') better reflects the impact they have on the environment and on health, by removing disadvantages for clean technologies and introducing higher levels of taxation for inefficient and polluting fuel.

Some aspects of the current ETD lack clarity, relevance and coherence, including the definition of taxable products, uses that are out of scope for the Directive, and the interpretation of the exemption related to motor fuels used in air and water navigation. The amended Directive would seek to provide greater clarity on these points but also to provide sufficient incentives for investments in clean technologies. The revised ETD may result in changes to the taxation of energy generated or used, leading to changes in cost price.

This measure could be introduced as early as 1 January 2023 if it can find unanimous support from the EU Council.

Additional measures announced

A number of additional measures were also announced in the areas of renewable energy, changes to the Energy Efficiency Directive, reducing methane emissions, deployment of alternative fuels infrastructure, effort sharing regulations, ensuring appropriate CO₂ emissions standards for cars and vans, a new EU forest strategy, and measures to improve the fuel quality used in the aviation and maritime sectors, amongst others.

To tackle the potential social impact of the new ETS, the European Commission proposed to introduce a new Social Climate Fund. Of the expected revenues generated by the ETS for buildings and road transport, 25% would be earmarked to the new fund. The new fund would provide EU Member States with funds to support their measures and investments intended to increase energy efficiency of buildings, to carry out building renovation, to finance zero- and low-emission mobility and transport, and to decarbonise heating and cooling of buildings, including the integration of energy from renewable sources. The measures should benefit vulnerable households, micro-enterprises and transport users who would be particularly affected by the change. Planned actions would

need to be laid out in the national energy and climate plans that are submitted every year to the European Commission.

The takeaway

The above announcements are a major step forward by the Commission aimed at achieving its climate change objectives. The impact of these measures, when in force, would impact all EU businesses and citizens, as well as suppliers of certain products from outside the European Union. Carbon pricing and taxing carbon is likely to play a greater role in modifying user behaviour into the future. As noted above, however, there may be opposition both inside the European Union and from non-EU countries that could affect the progress of a number of these measures.

For the business community, the announcements could affect supply chains involving heavy emission goods or activities, it may result in additional administrative requirements and it may require business to consider the extent to which the business can absorb the costs. Businesses would need to assess their supply chain, value chain and the related carbon footprint (direct and indirect) and investigate options available to reduce their carbon footprint.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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