Cum-Ex could have serious consequences for banks – if the scheme was illegal

European tax authorities and state prosecutors are presenting the cum-ex dividend-stripping scheme as serial and systematic tax fraud taking place over years. But it is far from clear that the controversial transactions were even illegal in all cases.

German and Danish authorities are referring to their respective investigations into cum-ex dividend withholding tax schemes as the biggest investigation into tax fraud in their countries' histories. That remains open to question.

The cum-ex scandal has become a political as well as a tax and bank regulatory matter. It was the subject of a plenary debate in the European Parliament in October 2018. The parliamentary resolution that followed (which accused the Association of German Banks of exacerbating the problem rather than helping resolve it) focused on exhorting governments to improve cross-border information-sharing and collaboration.

Parliament also asked the EBA and ESMA to conduct inquiries into dividend-arbitrage schemes and withholding-tax regimes "to assess potential threats to the integrity of financial markets; to establish the nature and magnitude of actors in these schemes; to assess whether there were breaches of either national or Union law; to assess the actions taken by financial supervisors in Member States; and to make appropriate recommendations for reform and for action to the competent authorities concerned". ESMA's initial report was published in July 2019.

At their heart, the cum-ex transactions were conceptually simple (see Annex 1). They were dividend arbitrage strategies where parties traded, short-sold and repo-ed equities in a period straddling cum and ex-dividend dates. Parties to the transactions claimed more than one tax refund for the same dividend distribution via a complex of several related transactions that – via short selling – created two or more owners of the same number of shares in the same companies at the same time.

The scheme was made possible by differentiated notions of legal versus economic ownership in the German tax system. Deals were facilitated by margin loans from banks, operationalised by tax certificates issued by banks and custodians to investors and confirms that tax had been paid (when that wasn't always the case) and sanitised by legal opinion from major law firms and advisors.

The scheme involved a large circle of traders and stock lenders; prime brokers; custodians, depositaries, clearing houses and settlement agents; inter-dealer brokers; asset managers, pension funds and hedge funds; law firms; accounting firms; tax specialists; financial advisors; and a network of boutiques and SPVs (the latter ostensibly set up with the express purpose of perpetuating the practice). It is by no means clear, though, that participating parties were even aware that transactions they were dealing with were cum-ex let alone illegal, while some elements of the audit trail were automated and involved no direct human intervention for review purposes.

The sums involved are staggering: European tax authorities may have paid out as much as EUR 60bn in dividend withholding-tax rebates relating to cum-ex trades. Germany alone, where some 500 deals are reportedly under investigation, could have paid out up to EUR 32bn; France EUR 17bn; smaller multi-billion amounts in Italy and Denmark; and lower rebates in countries including Austria, Belgium, Czech Republic, Finland, Luxembourg, Netherlands, Norway, Poland, Spain, Switzerland and potentially others.

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Investigations gathering pace

Authorities throughout Europe have multiple parallel ongoing investigations. Criminal test cases are starting to be heard, prosecutors have carried out multiple raids and searches of banks, other financial institutions, law firms and other premises. Several hundred individuals are under investigation including bank CEOs and senior executives. As many as 130 financial and other institutions may knowingly or unknowingly have been involved in or have facilitated this widespread practice (see Appendix 2).

"In certain conceptual aspects, Cum-Ex is reminiscent of Libor manipulation in that it was a common and widespread practice conducted by a large number of banks in a number of countries and it wasn't always crystal clear to those involved that it may even have been illegal. That doesn't make it right; if Cum-Ex is in fact found by the courts to have been illegal the consequences could be significant," said Dierk Brandenburg, head of the financial institutions rating team at Scope Ratings.

"This is certainly another stark reminder of the credit implications of conduct risk in banks. Even if many of the deals under investigation are ultimately found to have been legal; as egregious examples of aggressive tax strategies they hardly portray the banks in a positive light."

Consequences

Two small banks have already been declared insolvent in Germany as a result of liabilities stemming from the cum-ex saga – Maple Bank GmbH in 2016 and Dero Bank AG in 2018. Another German bank, North Channel Bank GmbH & Co. KG (called Bankhaus Oswald Kruber until 2009), agreed to a DKK110m (EUR 14.7m) fine in September 2019 relating to cum-ex activities in Denmark.

The bank accepted the involvement of former management in transactions with US pension plans that resulted in DKK 1.1bn of tax rebates being paid, on which the bank reportedly earned DKK 55m in fees. The North Channel case was the first criminal judgement relating to cum-ex brought by Denmark's State Prosecutor for Serious Economic and International Crime (SØIK).

European authorities have reclaimed a significant amount of tax payments that should not have been paid. Some banks have repaid in response to official demands; some are contesting the demands; others have claimed ignorance and are suing other banks to cover the claims. MM Warburg said earlier this year that it was suing Deutsche Bank, in DB's capacity as a custodian, with regard to tax demands relating to cum-ex transactions, for example. A case involving Societe Generale and damages it was ordered to pay in 2018 after the French bank was sued by Helaba is currently in the German appeals court.

In yet other cases, banks such as DZ Group or HVB/UniCredit, which have repaid rebates, are testing the limits of personal liability where executives have been shown to have been complicit in conducting cum-ex trades on an industrial scale.

North Rhine-Westphalia has taken the lead on pursuing the matter in the German courts, having built a criminal case on evidence from whistleblowers and insiders, including two British equity finance specialists – Martin Shields and Nicholas Diable – who are alleged to have been behind a large number of fraudulent cum-ex trades while at HVB. Shields has turned state's evidence and is appearing in the ongoing criminal case being heard in the Bonn Regional Court as principal witness and defendant.

An important nuance of this case is whether the banks that were counterparties to their trades can be forced to repay the tax owed under new German profit disgorgement legislation, specifically Article 73 of the criminal code (*Strafgesetzbuch* or StGB), regardless of their own culpability. This could open up the banking sector to very significant redress claims.

But was it fraud?

Screaming fraud, however, seriously underplays a raft of complex issues. At its heart, the widespread region-wide incidence of cum-ex transactions throughout Europe over many years fundamentally brings into question the intent and purview of tax codes across Europe, including interpretations of what is allowable under them and how elastic those interpretations are.

"What has emerged as contributing factors as investigations have progressed are huge gaps in tax-code interpretations, a relaxed attitude among authorities dealing with a problem that has been known about for several years, and the lack of due and proper process for verifying applications for rebates, which in many cases were granted automatically," said Brandenburg. "The lack of a co-ordinated multilateral response from or co-operation between euro area authorities to deal with a scheme that had a significant cross-border element has led to pressure for EU-wide action."

Cross-border elements

The case also throws open, certainly in Germany, the question of potentially discriminatory tax treatment of non-domestic institutional investors owning German equities relative to domestic institutions. The cross-border element has particularly riled German policymakers and prosecutors, since as they see it, it enabled non-German institutional investors to siphon a huge amount of money from German taxpayers.

But it was differentiated tax treatment that gave rise to Cum-Cum deals (also under investigation), a variant of Cum-Ex whereby non-German entities holding German equities engaged in short-term equity repos with domestic German entities, which then claimed refunds on dividend tax that would not have been payable to foreign entities.

In a variant on the practice (outlined in the case of Germany's Federal tax office v joint special administrators of MF Global UK heard in the UK High Court this year), UK-domiciled institutional beneficial owners of German shares engaging in cum-ex trades claimed a refund of the difference between the 25% dividend tax withheld by German companies and the 15% UK dividend tax levied under the double tax treaty between the UK and Germany.

Authorities have been aware of cum-ex since the beginning of the 2000s or even earlier. Yet the separate investigations in several European jurisdictions only really gathered speed in recent years. The peak of cum-ex activities took place in the years leading up to and after the global financial crisis. The time factor could become critical, since in Germany certainly, Federal tax authorities are running up against statutes of limitations that apply to prosecuting cases.

Tax loopholes

For the banks and other parties involved, a key question in the serial ongoing investigations is whether cum-ex trades amount to tax fraud (illegal) or aggressive tax-driven strategies that enhanced investment returns (legal). Despite the official cries of fraud, it is not clear. In fact, a European Parliament cum-ex information document shows the high level of legal ambivalence around the practice:

"Institutional investors in Germany … may claim back dividend tax (in part) from the government. For years, however, investors in Germany made use of *a loophole in German tax law*, *enabling multiple parties to reimburse the same dividend tax*. Until Germany changed its tax law in 2012, dividend tax (25% of the gross dividend) was collected by the corporation issuing shares, whereas the certificate for tax reimbursement (if applicable) was issued by the shareholder's bank …

"… Depository banks did not (necessarily) know whether the transactions they handled were ordinary transactions or cum-ex transactions, and consequently issued reimbursement certificates for both. *This system allowed multiple investors to claim back tax returns even though only one party actually paid the dividend tax*," the Parliament's cum-ex file noted [Scope italics].

In similar vein, EMSA's preliminary July 2019 report noted that the cum-ex scheme "*exploited an interpretation of the German tax code* that apparently allowed multiple persons to claim ownership of the same shares and the corresponding right to receive a refund of the same amount as the taxes withheld from dividend payments. Two or more investors may have received certificates corresponding to taxes that were in fact withheld only once" [Scope italics].

No market abuse

In retrospect, having tax certificates not refer to underlying dividend distributions and having a company withhold tax while banks issued tax certificates was a glaring inconsistency. Since updates to the German tax code in 2012, there is now automatic linkage and a single entity is responsible for collecting taxes and issuing tax certificates, eliminating multiple issuance of certificates for the same dividend distribution thereby closing the loophole.

"Beyond the vexed question of whether cum-ex actually constituted fraudulent activity at all, multiple parallel investigations have thrown up a host of other factors, not just inconsistencies and gaps in European tax codes but gaps between regulations designed to stamp out fraudulent market activity and those designed to eliminate tax fraud," said Brandenburg.

Case in point: in a letter about the matter to German Green MEP Sven Giegold (who had asked ESMA to initiate an inquiry), ESMA Chair Steven Maijoor said ESMA analysis at the time indicated "that the 'cum-ex' and 'cum-cum' schemes represent essentially a tax-related issue. In this context, no evidence of abusive practices related to financial markets regulation have been identified".

Appendix 1: Functioning of a multiple WHT-reclaim scheme based on basic Cum/Ex trading in Germany

Step 1

Investor A owns shares worth EUR 15m in Company X, a highly-liquid share listed on a German regulated market.

Step 2

Shortly before the dividend is paid, Investor B short-sells shares X to Investor C *cum dividend* for the same amount held by Investor A. Investor B enters into an arrangement to ensure that the shares sold short are delivered in time for settlement (T+2, given that the transaction has been executed on-exchange).

Figure 1: Starting point

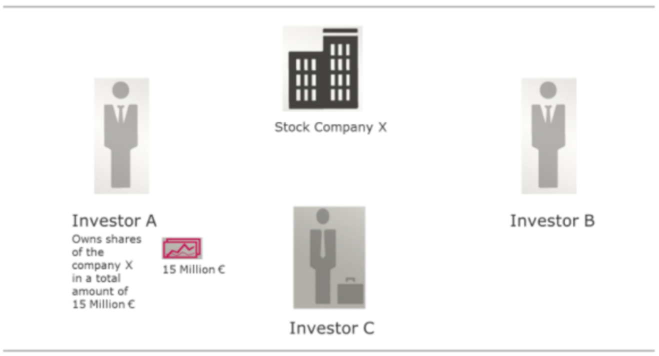
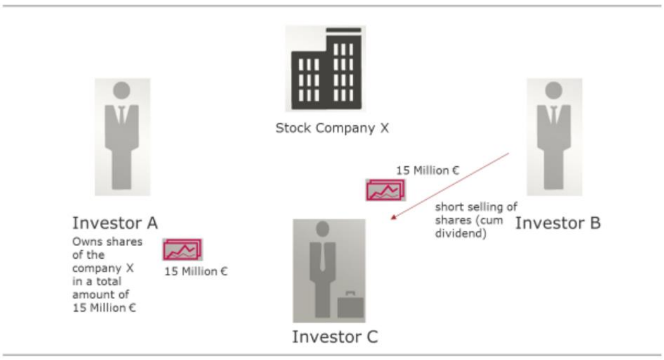


Figure 2: Before dividend record day



Source: ESMA

Step 3

On the day Company X distributes dividends, it withholds 25% tax directly paid to the German government. Investor A receives a tax certificate from its custodian bank allowing it to claim a tax refund for the amount withheld. (In Germany, the tax certificate does not contain details of the transaction.)

Step 4

After the distribution of dividends, Investor B buys shares over-the-counter in Company X from Investor A in order to benefit from a reduced settlement time (shorter than the T+2 settlement for regulated markets) to deliver the shares to Investor C (to whom they were sold short). The shares obtained by Investor B are now *ex-dividend*.

Figure 3 Dividend record day

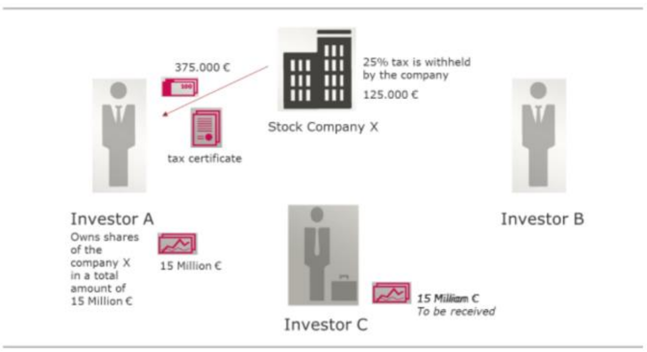
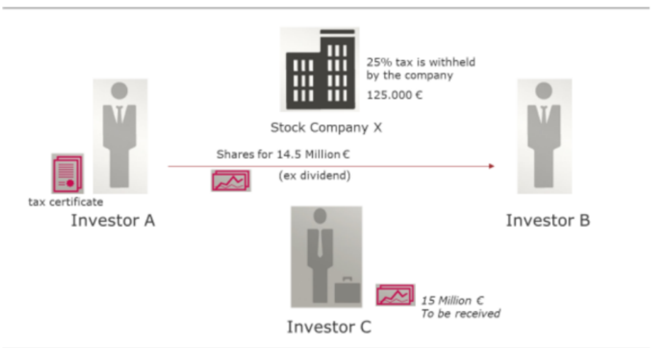


Figure 4: After dividend record day - 1



Source: ESMA

Step 5

Investor B delivers shares to Investor C in time for settlement. Given that Investor B should deliver to Investor C shares *cum dividend* but can only deliver shares *ex-dividend*, Investor B pays Investor C compensation of EUR 0.375m, which it can pay since it received EUR 15m from Investor C.

Investor C receives shares for EUR 14.5m *ex-dividend*, but in addition is given cash compensation of EUR 0.375m and a tax certificate from its custodian bank for EUR 0.125m that Investor C will claim from the Government. However, Investor C did not receive the actual dividend but compensation for not receiving it. The actual dividend was received by Investor A, which should be the only party entitled to receive the tax certificate.

The custodian bank is able to issue a tax certificate owing to the concept of economic ownership used in the German tax system as opposed to the legal ownership. In this scheme, Investor C is the economic owner of the shares at the moment of the distribution of dividends, as it bought the shares before the dividend distribution. Therefore, at that time, Investor C would bear any economic consequence attached to the ownership of the shares, even if legal ownership would only be transferred at settlement.

According to BaFin, until 2012, a controversial reading of the German tax provisions created the possibility that the economic owner should be entitled to the dividend, and therefore to the related tax certificate.

Step 6

At the end of the scheme Investor C sells back the shares to Investor A. The result of the whole scheme is that Investor A re-takes possession of shares in Company X, but the series of transactions has resulted in two tax certificates being issued against a single dividend distribution, with an overall profit that amounts exactly to the value of the tax certificate.

As the double issuance of a tax certificate is the only profit realised with the series of transactions (EUR 0.125m to the benefit of Investor B), the participants share it at completion of the scheme.

According to German tax authorities, despite all possible interpretations regarding the concept of economic ownership, the fact that at the end of the scheme the shares revert to the initial owner (Investor A) showed that the scheme represented a potential tax fraud, as it served no other purpose than obtaining a second tax certificate from a single distribution of dividends.

Figure 5: After dividend record day - 2

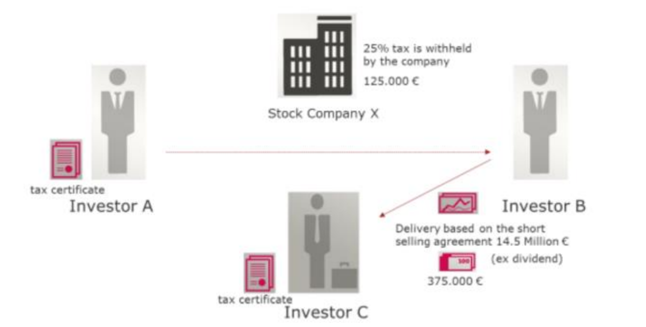
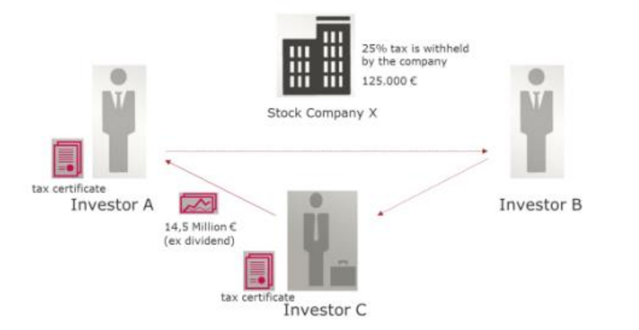


Figure 6: After dividend record day - 3



Source: ESMA

Appendix 2: Banks and other institutions in the Cum/Ex supply chain

Institutions mentioned in media reports, press releases and other sources as having been involved in the cum-ex supply-chain – though not by extension having been found necessarily to have been involved in any intentional or unintentional wrongdoing.

In alphabetical order:

Banco Santander	HSBC
Bank of America Merrill Lynch	HSH Nordbank (Hamburg Commercial Bank)
Bank of Ireland	HVB (UniCredit)
Barclays	Investec
Blackrock	JP Morgan
BNP Paribas	LBBW
BNY Mellon	Macquarie Bank
Clearstream (Deutsche Börse)	Maple Bank (declared insolvent)
Commerzbank	MF Global (in administration)
Credit Suisse	MM Warburg
DekaBank	Morgan Stanley
Dero Bank (declared insolvent)	North Channel Bank
Deutsche Apotheker- und ärtzebank	TP-ICAP
Deutsche Bank	Bank Sarasin
DZ Bank	SE-Banken
EY	Societe Generale
Freshfields	State Street
Hansa Invest	UBS
Helaba	WestLB

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