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Cum-Ex: An Introduction to the 55 Billion Euro Heist That Is About to Hit the Headlines

By *James Siswick and Alexandra Will**
Guidehouse Consulting
London, England

“Cum-ex” is a term that many people outside trading floors have not (yet) heard of. It refers to an aggressive variation of dividend arbitrage in various European jurisdictions, now considered illegal in most countries. Between 2002 and at least 2012,¹ tax authorities were defrauded of an estimated 55 billion euros. The true risks from these dealings for participating financial services firms around the world are now starting to emerge.

This article introduces cum-ex and highlights the complexity and magnitude of the issue and the associated risks for financial services firms. We will continue to explore the topic in a series of articles over the coming months. In the series, we will explain the functioning of the schemes, assess the key risks in de-

* James Siswick is a Guidehouse partner based in London, where he leads the European Financial Services practice. Alexandra Will, a German qualified lawyer, is a director in Guidehouse’s Financial Services practice based in London.

¹ While it is asserted in some sources that cum-ex schemes may have continued in Germany until 2016, possibly in a slightly amended form (see *Cumex Files — a Cross-Border Investigation*, available at: <https://cumex-files.com/en/>) the predominant understanding is that with the changes to the German tax laws in 2012, which also led to changes in the operational processes for collection of dividend tax and the issuance of tax certificates, the cum-ex schemes stopped in Germany in 2012. They may have continued in other jurisdictions beyond this point.

tail, discuss the actions senior management and heads of legal and compliance should take to protect their organisations, and how an internal investigation could successfully be conducted in light of the complex issues at hand.

A NATIONAL TAX ISSUE WITH GLOBAL DIMENSIONS

Germany is at the centre of what the media has called the biggest tax fraud scandal in German history,² with similar but smaller-scale schemes existing in jurisdictions including Denmark, the Netherlands, Austria, Belgium, France, and Italy. Cum-ex’s relevance, however, is not limited to these jurisdictions. Many beneficiaries were financial services firms around the world, with many well-known global financial institutions implicated. The United Kingdom played a key role as a major European trading hub.

The topic has gained substantial traction recently with the European Banking Authority (EBA) publishing a report on dividend arbitrage trading schemes (EBA Report) and a 10-point action plan to enhance its future regulatory framework,³ German authorities and prosecutors stepping up their efforts (not at least

² Dr. Christoph Spengel, professor of business taxation at the University of Mannheim, who had prepared a report for the 4th Enquiry Committee of the German Bundestag, concluded that cum-ex was “the biggest tax theft in the history of Europe” (see Julian Klinkhammer and Markus Pohlmann, *Organized Crime in Pinstripes? — The Tax Robbery With Cum-Ex and Cum-Cum Deals* (Nov. 23, 2018), available at: <https://heigos.hypotheses.org/10541>), a term that has since been picked up by the press globally (see, e.g., David Segal, *It May Be the Biggest Tax Heist Ever. And Europe Wants Justice*, N.Y. Times (Jan. 23, 2020); Christopher Cermak, *The Great Tax Robbery*, Handelsblatt Today (June 9, 2017); and *Erster Prozess Wegen Cum-Ex-Geschäften Hat Begonnen*, Der Spiegel (Apr. 9, 2019)).

³ European Banking Authority, *EBA Publishes an Inquiry Into Dividend Arbitrage Schemes (“Cum-Ex/Cum-Cum”) and Announces a 10-Point Action Plan to Enhance the Future Regulatory*

due to the statute of limitations otherwise barring prosecutions), and Dutch⁴ and Danish⁵ authorities actively pursuing claims.

WHAT IS CUM-EX?

Cum-ex schemes were first disclosed to the public in 2012 when European journalists, led by the German group CORRECTIV, investigated and published a documentary on the so-called Cum-Ex Files.⁶

In summary, cum-ex schemes were complex equity trading transactions in which multiple institutions collaborated to receive multiple refunds of dividend withholding tax from the tax authorities that had only been paid once. Cum-ex transactions thereby generated profit margins substantially above “normal” dividend arbitrage transactions, to the detriment of the tax authorities.

The term “cum-ex” refers to the trading of shares with (cum) or without (ex) entitlement to dividend after a company has declared but not yet paid the dividend.

German Shares and Global Participants

The schemes emerged in Germany from 2002 and reached their height of activity during 2007-2012, before being forbidden by German law.⁷

In Germany, dividend tax was levied in the form of a withholding tax, which was withheld at source, i.e., deducted by the corporation prior to distribution of the net dividend to shareholders. Institutional investors were exempt from the tax and could reclaim the withheld tax through the tax certificates issued by their custodian banks.

While shares needed to be traded on the German stock exchange, cum-ex schemes were not limited to German institutional investors. Lists published by German authorities of alleged participants include funds, asset managers, private banks, and large financial institutions from across the globe.

ryFramework (May 12, 2020).

⁴ James Thomas, Morgan Stanley Ordered to Pay €39 Million in Dutch Cum-Ex Case, *Global Investigations Review* (May 14, 2020).

⁵ Bloomberg Tax, After \$350 Million Lawyers’ Bill, Denmark Steps Up Cum-Ex Chase (May 13, 2020).

⁶ *Cumex Files — a Cross-Border Investigation, How Europe’s Taxpayers Have Been Swindled of €55 Billion*, available at: <https://cumex-files.com/en/>.

⁷ See comments under n.1, above.

The Basis of Cum-Ex: Separation of Economic and Legal Ownership in Shares

Cum-ex schemes were developed by tax and financial advisors and backed by legal opinions from reputable law firms⁸ based on an alleged loophole in German tax legislation resulting from the separation of economic and legal ownership of shares. This made it possible for two parties to reclaim dividend tax that had only been withheld at source once, whilst tax authorities were unable to detect and prevent the multiple repayments.

Landmark Decision by a German Court

For a long time, the legality of cum-ex schemes was unclear. In a recent landmark decision,⁹ a German court held that there had never been a gap or loophole under the then-prevailing German tax laws. The court held that cum-ex schemes had always been illegal and — as should have been obvious to all participants — that cum-ex transactions constituted serious tax fraud. In addition to suspended prison sentences for the two former London-based investment bankers who were found guilty of tax evasion offences, the private bank M.M. Warburg was ordered to repay 176 million euros to the tax authorities as part of the judgment.¹⁰ M.M. Warburg has appealed the decision.¹¹ The case will be heard before the German Federal Court of Justice.

Some institutions have made voluntary repayments to limit their exposure. These include HypoVereinsbank,¹² HSH Nordbank (now Hamburg Commercial

⁸ Karin Matussek, Second Ex-Freshfields Partner Charged in German Tax Probe Bloomberg (June 24, 2020);

Juve, Cum-Ex: Staatsanwaltschaft Erhebt Anklage Gegen Weiteren Ex-Freshfields-Partner (June 24, 2020).

⁹ Judgment by the District Court Bonn, case reference 62 KLs 1/29.

¹⁰ M.M. Warburg was not the accused in these criminal proceedings but included in the proceedings as an additional party, as specifically provided for under German law. M.M. Warburg was one of five organizations originally included in the process. In order to conclude the process in a timely manner, in light of the coronavirus crisis, the court decided to drop the involvement of the other four parties. Legal Tribune Online, LG Bonn Verkuerzt Cum-Ex Prozess (Mar. 16, 2020).

¹¹ M.M. Warburg has filed an appeal against the judgment. Legal Tribune Online, Bonner Cum-Ex-Urteil Wird den BGH Beschaeftigen (Mar. 23, 2020).

¹² HVB voluntarily repaid 140 million euros in 2016, in addition to a fine of 9.8 million euros. It was considering steps to recoup these monies from three ex-managers for their alleged role in these schemes. Volker Votsmeier, Sonke Iwersen, and Kerstin

Bank), LBBW,¹³ and the three main shareholders of Canada's Maple Bank, which became insolvent in 2016 as a result of its involvement in cum-ex.¹⁴

CRIMINAL PROSECUTION AND CIVIL PROCEEDINGS

It has been reported that nearly 900 individuals and firms are under investigation in connection with cum-ex schemes and that this number continues to rise.¹⁵ As the national tax authorities and thus, ultimately, states and their people suffered the losses, reclaiming these monies also bears a political dimension.

In addition, there appears to be an increasing number of legal proceedings brought by participants in the schemes against other involved parties. The current lawsuits are expected to be only the beginning of legal action.

The EBA Report: Robustness of Anti-Money Laundering Controls and Internal Governance

The EBA recently raised an additional dimension of cum-ex: The EBA Report comments that there appears to be no uniform understanding by the domestic prudential authorities of dividend arbitrage schemes, which is attributed to differences in the domestic tax

Leitel, HypoVereinsbank Case — A Question of Accountability | Handelsblatt Today (Mar. 1, 2016).

¹³ HSH Nordbank is said to have repaid 127 million euros and LBBW is said to have repaid approximately 150 million euros. Sonke Iwersen and Volker Votsmeier, Wie der Cum-Ex-Informant Auspackte. Der Datenschatz des Mister Smith, Handelsblatt Today (Jan. 28, 2016)

¹⁴ Juve, Cum-Ex-Gewinne: Kanadische Eigner der Maple Bank Einigen Sich mit Behoerden (Jan. 16, 2020).

¹⁵ Number current as of June 2020. Eva von Schaper Cum-Ex: Number of Individuals and Firms Under Investigation Nears 900, Law.com — Int'l edition (June 10, 2020).

regimes.¹⁶ Nonetheless, the EBA concludes that the responses by the survey participants suggest that the “handling of the proceeds from tax crimes is likely to amount to money laundering, irrespective of where the tax crime took place.”¹⁷ It urges institutions to critically assess the adequacy of their anti-money laundering systems, internal controls, and internal governance arrangements considering the risks highlighted through dividend arbitrage cases such as cum-ex, and mandates the prudential authorities to consider this in their reviews.

FUTURE RISKS AND CHALLENGES

Cum-ex presents substantial legal, financial, and reputational risks for institutions with a significant number of additional investigations, criminal prosecutions, and civil proceedings expected. In addition, regulatory reviews are now also likely to assess what action institutions have taken in response to the issue.

The biggest challenge for many current senior management teams and heads of legal and compliance will likely be to ascertain whether and to what extent institutions may have been involved in cum-ex in the past. Cum-ex schemes are complex, and it is difficult to identify transaction patterns where individual transactions appear legitimate and the overall picture was deliberately concealed. Fortunately, there are some indicators and pointers that can guide your internal investigation.

A successful investigation should provide the necessary clarity and, if necessary, allow for the early development of an action plan to prepare for an investigation by the relevant authorities, to pursue the path of proactive disclosure or to prepare for potential exposure to civil liability.

¹⁶ European Banking Authority, Report on Competent Authorities' Approaches to Tackling Market Integrity Risks Associated With Dividend Arbitrage Trading Schemes (Apr. 2020), §3, ¶28.

¹⁷ *Ibid.*, ¶29.