Cum-Ex Scandal

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Abstract

This paper revises existing literature on the recent tax scandal in the EU. The purpose of the paper is to describe how the scandal unfolded, what was the cause and repercussions. We will use the case of Germany, the central country in this scandal, to show the mechanism, which enabled cum-ex traders to steal at least €55 billions from the tax authorities between 2001 and 2012. This is one third of the EU budget and more than half of Poland's annual budget for 2020. The scandal has already been described as Germany's biggest post-war fraud investigation. The cum-cum scheme will be avoided in this paper.

1 Introduction

Cum-Ex scandal is a massive stock trading scam involving bankers, brokers, hedge funds, international tax firms, investment companies, lawyers and insurance companies, which acted as promoters to help their clients get a refund for the tax that they never actually paid for. Among the most prominent banks are: Germany's Deutsche Bank, Commerzbank, Hypovereinsbank and Warburg Bank, Britain's Barclays, France's BNP Paribas, UBS, Bank of America, JPMorgan, Merrill Lynch and Morgan Stanley. The investment companies like BlackRock and the accountancy firm EY are also under the spotlight [5].

The fraud affected many EU countries, but on a different scale. At the latest count, at least 11 member states have been tricked by this scam plus Switzerland [5]. Germany suffered the most, as the estimated loss is €31.8 billion. For other countries the losses are following, at least €17 billion for France, €4.5 billion for Italy, €1.7 billion for Denmark [3]. The US authorities were also concerned with the issue, so they have launched an inquiry into the scandal.

The cum-ex scheme gained notoriety in recent years, although it presumably commenced in the 1990's. The CumEx trading model migrated from Germany to Austria from 2011 to 2012, then to Denmark from 2012 to 2015 and finally to Belgium and Switzerland until 2017 [3]. It was initially discovered in Germany in 2012. The expose itself came to light when a non-profit consortium of investigative journalists from the German CORRECTIV group helped bring the scandal to wider public attention. Then a collective of European media outlets, led by the CORRECTIV group have worked together to investigate the so-called cum-ex files.

2 Withholding Tax

Before proceeding to a description of the scheme itself, it is essential to introduce the concept of the withholding tax in the meaning of German law. In Germany taxes are administered on the two levels, the local and the federal. Local offices are responsible primarily for PIT (Personal Income Tax), CIT (Corporate Income Tax), VAT (Value Added Tax) and RETT (Real Estate Transfer Tax). The Federal Central Tax Office, among other things, oversees foreign taxpayers. Particularly important in our case, that it is responsible for the exemption and tax refund of withholding tax according to double tax treaties and EU directives, as well as the imposing of tax regulations for foreign investors.

In general, corporations must withhold taxes for all dividends and other profit distributions, regardless of corporate's tax residence. The withholding tax amounts to 25%. On top of that 5.5% solidarity surcharge is charged, which results in 26.375% aggregate tax. In other words, the company pays approximately 75% of the value of a dividend payment to a shareholder, and the remaining amount is automatically transferred to the tax authority [2]. Under some criteria the tax can be reduced, exempted or reclaimed. Reclamation applies under double tax treaties, which serve to protect a tax payer from paying tax twice both in a operating country and in a country of residence. In this case, the mentioned earlier shareholder additionally receives withholding tax certificate, which gives a right to reimburse paid tax. Until January of 2012 the shareholder's bank had been responsible for the issuance of such certificate[2], thereby creating the vulnerability, which was consequently exploited by the fraudulent traders.

One more important thing to mention is, that not all dividend payments are subject to withholding tax in Germany. So, the dividends which are paid from capital reserves are tax exempted, but dividends paid from current profits are taxable[2].

3 Cum-Ex Trading Scheme

The scheme is based on the dividend arbitrage strategy. While, conventionally, the dividend arbitrage strategy is associated with put options, in the most cases a little bit altered short selling transaction was employed[6]. However, the recent research[2] showed, the trading volumes before the ex-date[1] for cum-ex suitable stocks was significantly higher, than after. It may indicate the extend usage of derivatives on the OTC market by the cum-ex traders as well. In general, the cum-ex scheme cannot be generalized, as it varies from case to case.

The classical short selling transaction is defined as follows. A trader borrows a stock from a dealer for the set period of time and reward. Further, the trader sells the stock, and at the final date of the transaction, he repurchase the stock and returns it to the dealer. The difference between the stock prices minus transaction cost is the trader's gain or loss. Usually such transactions are settled via the automatized clearing process, which takes place only on the level of book accounts, but not physical delivery. Physical deliveries occur seldom.

Preliminary, we should also introduce the dividend calendar. At the declaration date, a company's board of directors announces the amount of dividend to be paid, a record date and a payment date. On the record date a special electronic system, or a registrar, records all the share owners entitled to the dividend. The entitlement itself is assigned only to those shareholders who hold the share at the beginning of an ex-date. The ex-date is typically set 2 days prior to the record date, and shares, which are bought during or after it, do not give a dividend right. Additionally, the stock must be bought 2-3 days before the ex-date, because of the common settlement practices. The dividends are finally transferred to the accounts of entitled shareholders only at the payment date, which is about 1-2 months after the ex-date. It is

[1] The ex-date is explained later in the text.

important to emphasize, that theoretically the price of the stock should drop by the dividend amount after the ex-date.

At last, we can proceed to the description of the scheme. The main purpose of it is to obtain an additional withholding tax certificate. At least two parties are required for that transaction, a short-seller and a short-buyer. Also, typical short selling transaction requires the existence of a coverage for it, i.e. the seller have to posses a share at the moment of settlement, but according to the German law, the transaction can be uncovered if the delivery occurs in 2 trading days[2]. Thereby, in our case, the short-seller does not have to borrow a stock from a dealer to conduct the transaction. Instead he receives money upfront from a short-buyer with a promise to deliver the stock in 2 trading days. Since the transaction has been settled 1-2 days prior to the ex-date, the short-buyer is entitled to a dividend payment or compensation. The delivery date falls on the ex-date or a day after. The short-seller repurchase the stock for the current price, which must be lower than initial by the amount of the dividend. After, the short-seller delivers the stock to the stock-buyer and compensates him the dividend payment with the subtraction of the withholding tax. Later the depository bank of the short-buyer issues a withholding tax certificate for him. Since the short-seller bought the stock ex-date, the previous holder was also entitled to the dividend, and he also received a withholding tax certificate. Eventually, the short-seller and short-buyer share the profits.

In case of the clearing process, a clearing house deducts the current price of the stock plus dividend payment after withholding tax from the short-seller's account, and transfers them to the short-buyer's account, additionally granting him a withholding tax certificate. Not without reason, such dividend compensations are often called 'manufactured dividends', since they are synthetically created.

4 Conclusions

Deliberate exploitation of the loophole in the tax codes makes cum-ex trades illegal. The mentioned earlier research proves that the cum-ex transactions would have not been profitable under normal conditions, since the price drop ratio for tax-exempted stocks is not significantly different from 1[2], there-

[2]The price drop ratio is calculated as a difference between a stock before the ex-date and after it, and divided by the dividend payment.

fore any arbitrage opportunity is eliminated. Additionally, it supports the fact, that the trading volumes on the cum-ex suitable stocks was statistically higher in comparison to tax-exempted stocks before and after the ex-date [2].

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