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## German Cum/Ex-Trades: Enhanced Risks and Industry-Wide Challenges

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The German and international financial industries and their advisors have come under new pressure to investigate so-called 'cum/ex' trades conducted between 2000 and 2012. For many years, tax authorities and criminal prosecutors have pursued banks and their advisors for claiming tax refunds in connection with stock trades conducted around the time of a company's dividend date. According to some estimates, cum/ex trades generated more than USD 10 billion in tax refunds for banks, investors and other counterparties in the financial industry. Now, new risks for the financial industry are emerging as a result of a series of recent events.

Cum/ex trades raise multiple legal, compliance and regulatory issues for a variety of institutions and individuals. Banks, brokers, clearing houses, tax advisors, lawyers and investors could find themselves confronted with tax reimbursement claims, criminal prosecution, fines and imprisonment, and damages claims. Moreover, cum/ex trades carry reputational risk for anyone involved in such transactions.

Banks and other financial institutions should set up an inventory of all trades in German stock and ancillary transactions conducted around the time of dividend payment dates between 2000 and 2012. Based on this, a thorough analysis should be carried out to evaluate tax and criminal law risks for the company and its employees, directors and officers. It is advisable to assess the necessity of amending past tax declarations (section 153 of the German Fiscal Code (*Abgabenordnung*)), and of opting for voluntarily disclosing tax liabilities (sections 371, 378 of the German Fiscal Code).

Before we highlight the key legal issues, we will first provide a brief overview of recent events in this area that some observers believe have the potential to be game changing.

### Spotlight on Recent Events

In February 2016, investigations of cum/ex trades have gained additional momentum.

- The German financial supervisory authority, BaFin, has sent out a questionnaire to almost all of the 1,800 banks based in Germany. In the questionnaire, BaFin asks respondents to disclose details of all stock trades conducted around dividend dates between 2000 and

2012, to state whether multiple tax refunds were obtained, to explain whether any internal investigations were conducted, etc.

- The German Parliament has set up an investigation committee to clarify the role of the German Ministry of Finance and the banking industry in amending tax legislation that was in force between 2000 and 2012. The last three secretaries of the Treasury and the presidents of the German Banking Association will be asked to testify before the committee. Members of the committee claim that tax refunds generated through cum/ex trades were illegal.
- A tax court with jurisdiction over the district of Frankfurt, the center of Germany's financial industry, ruled that banks bear the burden of proof that they were entitled to tax credits generated through cum/ex trades.
- The German subsidiary of a major Canadian bank was closed down by BaFin because of the threat of balance-sheet indebtedness at least partly caused by tax reimbursement claims relating to cum/ex trades.
- The premises of a private bank in Hamburg were raided by prosecutors based on allegations of tax evasion. In total, prosecutions against seven financial institutions and more than 60 individuals are publicly known.

Although all this happened just in February 2016, investigations and prosecutions of a similar nature have been going on for many years. In November 2015, prosecutors purchased highly confidential data from a whistleblower for approximately USD 5 million. The recent developments are just the latest in a series of major challenges for the financial industry. The issues are not limited to persons and institutions subject to German tax jurisdiction. Many cum/ex trades involved banks, brokers and advisers in other jurisdictions, which could face the risk of criminal prosecution for aiding and abetting tax fraud, as well as damages claims by banks.

### **Forms of Cum/Ex Trades**

In the years between 2000 and 2012, cum/ex trades were a widespread practice in Germany. The trades took many forms and should be examined on a case-by-case basis. Most importantly, cum/ex trades are not illegal per se. Rather, tax authorities and prosecutors have called into question certain related practices, whereby several market participants systematically made arrangements to generate multiple tax refunds.

The opportunity of cum/ex trades evolved from tax rules entitling a person subject to capital gains tax to claim a tax refund or reimbursement on capital gains tax levied on dividend payments. In general, they involved an investor (which could be a bank or investment fund) based in Germany, and a seller of shares in German stock, as well as third parties providing some form of hedging transaction, such as futures or options. Typically, the German investor purchased shares with (cum) a dividend close to, or on, a dividend payment date. Many trades were agreed with the seller over the counter

(OTC). In some cases, the seller did not have the stock when the deal was made, but entered into a short sale. Under the rules of the German stock exchange, stock is delivered into the purchaser's deposit account two days after purchase (t+2). As such, the stock was not yet in the purchaser's deposit account at the time when the dividend was paid (and became subject to capital gains tax). In certain cases, which allegedly involved foreign depository banks, German tax authorities and prosecutors allege it was possible to obtain multiple refunds of capital gains tax although the tax was levied only once. Allegedly, multiple tax refunds became possible due to technicalities in the process of settling and routing stock market transactions.

According to some estimates, more than USD 10 billion in capital gains tax was traded through these tax arbitrage transactions between 2000 and 2012.

### **Legal Issues**

Cum/ex trades raise multiple legal issues, which are far from being resolved, including the following:

#### ***Tax Statements***

Tax authorities treat tax refunds generated through cum/ex trades as unjustified, especially when the trades involved foreign counterparties, short sellers and foreign bank deposit accounts. When the tax authorities detect cum/ex transactions during a tax audit, they refuse to acknowledge the refund and claim it back (plus interest of 6 per cent per year). In extreme cases, tax refunds may be reclaimed going back more than 10 years.

Some purchasers have opposed the tax authorities' legal position, citing jurisprudence of the German Federal Tax court and legislative history. They argue that the legislator deliberately acknowledged that cum/ex trades involving foreign short sellers and depository bank accounts could generate multiple refunds.

#### ***Judgment of the Tax Court Dated 18 February 2016***

However, the tax court with jurisdiction over the district of Frankfurt, Germany's financial center, gave a ruling on 18 February 2016. Some observers believe that this ruling is a major setback both for banks and those who advised that cum/ex trades were an easy and legal method of obtaining tax refunds.

The text of the judgment has not yet been published, and will need to be analyzed in detail once it is available. From the court's official press release, it appears that the tax court ruling follows and refines the reasoning of an earlier decision. In 2012, the same court found that banks may only claim capital gains tax refunds if there is proof that those capital gains taxes were in fact deducted by the issuer of the shares or by the seller's custodian bank. In the 2016 case, the tax court went on to confirm that an over-the-counter stock trade agreed on or shortly before the dividend payment (cum dividend) with the acquired stock being physically delivered to the purchaser post-dividend payment (ex dividend) leads to the assumption that capital gains taxes have not been deducted. According to the judgment, tax certificates presented by the purchaser merely serve as *prima facie*

evidence of capital gains tax deductions. The purchaser claiming the tax refund bears the full burden of proof that the capital gains tax has actually been deducted.

The judgment is subject to appeal, and if it is appealed, it will take some time before the German Federal Tax Court issues a ruling. Meanwhile, it puts banks in a difficult position in tax proceedings, with interest on tax claims potentially accruing at 6 per cent and the prospect that tax refunds may be reclaimed for more than 10 years.

Moreover, the judgment provides a basis for administrative offense proceedings that can lead to fines and disgorgement orders.

### ***Risks of Criminal Prosecution***

On top of the tax proceedings, criminal prosecutors take the view that claiming tax refunds for cum/ex trades amounts to tax fraud unless it can be shown that capital gains tax was properly levied at an earlier stage. In 2015, this view was confirmed by a criminal court in Cologne, where the German Federal Central Tax Office is located. The judgment of the court related to an interim search order and did not result in a conviction. However, its reasoning was fairly detailed and it currently provides a starting point for further analysis of the position under criminal law.

State prosecutors' offices in Cologne, Frankfurt, Hamburg, Munich and Stuttgart are currently pursuing more than 60 individuals in at least seven major cases. Premises of at least 10 banks and countless individuals have been raided during the past months and years. One former advisor to a bank has left Germany and is hiding in Switzerland.

### ***Damages Claims***

Investors are claiming damages from banks and advisors for their role in setting up these transactions. In 2015, a case settled for more than USD 50 million.

Cum/ex trades may also raise questions of liability of traders who carried out the trades, as well as of directors and officers overseeing capital market transactions and tax departments.

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