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EBA: Report and Action Plan on dividend arbitrage trading schemes such as Cum/Ex and Cum/Cum within the EU

On 12 May 2020, the European Banking Authority - EBA - published its report on the measures and reactions of the addressed authorities in the EU Member States on dividend arbitrage trading, such as Cum/Ex and Cum/Cum schemes.

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The report states that the relevance of dividend arbitrage trading schemes for the risk management of credit institutions is viewed differently. This is due, in particular, to the different tax systems of the Member States. Nevertheless, the EBA concludes that facilitating tax fraud is detrimental to the integrity of the financial system across the EU as a whole. The EBA is therefore presenting an action plan connected to recent legislative changes in the areas of the Capital Requirements Directive (CRD IV/V) and the Anti-Money Laundering Directive. The Action Plan, with steps taken by the EBA itself as well as and other measures suggested by the EBA, complement existing instruments used by competent authorities and credit institutions.

Background

As part of the European System of Financial Supervision, the EBA's mission is to safeguard financial stability and ensure the integrity of the banking sector through harmonized su-pervision and regulation of banks within Eu-rope. In particular, the EBA formulates draft regulatory and implementing technical stand-ards, issues guidelines (EBA guidelines) and recommendations to the competent authori-ties and credit institutions. In addition, the EBA investigates inadequate application of EU law by national supervisors and acts as an independent advisor to the European Parlia-ment. A key priority for the EBA in 2020 is to strengthen and increase consistency in anti-money laundering supervision.

On 28 November 2018, the EU Parliament mandated the EBA and the European Securi-ties and Markets Authority (ESMA) in the form of a resolution to review the players, significance and possible breaches of national and European law with regard to dividend arbitrage transactions such as Cum/Ex and Cum/Cum schemes. From the point of view of the EBA, the objective was to:

- To assess potential threats to the integrity of financial markets and national budgets,
- to determine the nature and scale of the players in these arbitrage trading schemes,
- to assess whether there have been in-fringements of national or EU law,
- to evaluate the measures taken by the fi-nancial supervisory authorities in the Member States, and
- to make appropriate recommendations for reform and action to the competent authorities concerned.

The EBA then launched a first round of dis-cussions in December 2018. It was found that few national supervisory authorities had de-veloped an awareness of these trading schemes and were therefore more likely to assume that they were a matter for the tax authorities.

Nevertheless, the relevance for the supervisory authorities was seen on two levels: on the one hand, with regard to the prevention of money laundering and the financing of terrorism where such offences have been committed and,on the other, with regard to general govern-ance as an aspect of prudential supervision.

The Report

The EBA then decided to conduct two surveys in 2019. One survey in May 2019 was ad-dressed to the

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authorities responsible for combating money laundering and terrorist financing. It asked whether dividend arbi-trage trading schemes were treated as tax offences in the Member State concerned and whether the treatment of the proceeds of the trading schemes was treated as money laun-dering. A second survey in July 2019 was ad-dressed to the competent supervisory authori-ties. The main question that arose here was to what extent the participation of credit institu-tions in such trading schemes is compatible with the requirements of their internal governance.

Not all authorities replied and those who did had not always dealt with the risks of such trading schemes. The EBA identified one rea-son for this in the different tax systems of the Member States.

In only four Member States did the competent authorities verify the way in which credit in-stitutions deal with such trading schemes as part of their ongoing inspections.

Only one competent authority has issued guidelines for the detection of tax offences.

Most of the authorities responsible for com-bating money laundering and terrorist financ-ing had not taken measures in relation to the proceeds of dividend-end arbitrage transac-tions. Some are waiting for the investigation results of the tax authorities or public prose-cutors.

From the responses from supervisors, the EBA concluded that few of them have linked inter-nal control system (ICS) weaknesses to more general governance arrangements and tax offences. Few authorities in the Member States have also considered tax offences as a money laundering and terrorist financing risks, irrespective of whether these tax offenc-es have been committed domestically or abroad. In particular, it should be noted that dealing with the proceeds of tax offences may constitute money laundering, regardless of where the offence was committed. The EBA also noted that cooperation between the vari-ous supervisory authorities or between the tax authorities and the supervisory authorities only took place in a few isolated cases.

Action Plan

In response, the EBA expects a holistic ap-proach in the future. National anti-money laundering authorities should be allowed to approach tax authorities and ask whether dividend arbitrage trading schemes constitute tax offences. If so, they should approach the relevant national supervisory authorities and report these tax offences. However, this re-quires cooperation from the authorities, which has not yet been taken into account in the CRD. Cooperation agreements may be necessary according to the report.

In addition, the EBA announced its own steps. A ten-point plan will adjust EBA guidelines on internal governance and the Supervisory Re-view and Evaluation Process (SREP).

On the basis of adapted EBA guidelines, credit institutions will, for example, be obliged to define principles and conduct in their internal governance procedures, in particular with respect to tax offences through arbitrage.

In addition to the effectiveness of internal controls, the focus is also on the EBA guide-lines for the

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assessment of managerial suita-bility and, for example, the EBA guidelines for risk-based money laundering monitoring. All the proposed adjustments share the common view that greater attention should be paid to risks arising from tax offences. These measures should essentially be completed by 2021. In addition, the EBA announced that an investigation will be carried out in accordance with Article 22 of the EBA Regulation with regard to compliance with the above-mentioned requirements. However, no target date has been set for this.

First Estimate

The report and the Action Plan put Cum/Ex and Cum/Cum schemes on an equal footing and thus pose practical challenges. At least from a German point of view, it is important to differentiate between the individual divi-dend- arbitrage trading schemes in terms of tax law. It makes a difference whether the transactions are aimed at optimizing with-holding tax (Cum/Cum) or if they are aimed at a multiple imputation of tax which had been withheld only once (Cum/Ex). Cum/Cum trading schemes, which were previously known in essence as "dividend stripping", are regarded by the tax authorities in certain constellations as abusive structuring under Section 42 Ger-man Fiscal Code (see BMF letter of 17 July 2017). However, they do not in themselves constitute tax evasion. Therefore, the han-dling of proceeds from Cum/Cum trading schemes should not constitute money launder-ing under German law.

In addition, in view of the different taxation systems, the assessment in many member states depends on the specific individual case and court decision. A framework for individu-al treatment can only be developed at the Eu-ropean level. These include the existing in-struments of administrative cooperation in the field of direct taxation. In this context, the DAC 5 Directive provides for access by tax authorities to information, procedures, doc-uments and mechanisms for combating mon-ey laundering. It is understandable that EBA is now also encouraging the creation of condi-tions for intensive support by the tax authori-ties for the bodies responsible for combating money laundering. The report and the Action Plan do not disclose the individual countries where information is already being exchanged between agencies and authorities.

It is to be welcomed that, from a supervisory point of view, greater clarity is being provided on the governance aspect of tax-induced trad-ing schemes.

For some years now, credit institutions within the EU have been attaching increasing im-portance to tax compliance management. The German market has certainly taken on a pio-neering role here, where tax compliance man-agement systems have been intensively devel-oped and optimised for several years. And not least from the perspective of a sustainable tax function, good tax governance should become even more important. Good tax governance can be expressed, for example, in regular con-sultations of the tax management with the risk management and compliance functions. In this way, tax compliance management is synchronized with the supervisory review and evaluation processes. This considerably re-duces the risk of a credit institution being instrumentalised for tax offences and unin-tentionally carrying out money laundering activities.

In recent years, credit institutions in Germany have also implemented regulatory measures aimed at

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clarifying and avoiding undesirable arbitrage.

These include for purposes of risk manage-ment, for example, extended retention periods for documents and chat protocols, which were recorded in the relevant trading system. In this way, internal and external auditors, espe-cially in the trading area of a credit institu-tion, are provided with better information and a preventive effect is achieved. In addition to any internal requirements of the credit insti-tutions to limit arbitrage trading schemes shortly before and after the dividend distribu-tion date, these measures include the use of IT-supported monitoring systems for accounts and market conformity checks for transac-tions. To combat money laundering and ter-rorist financing, credit institutions also oper-ate an account retrieval system (Section 24c German Banking Act). The BaFin and tax authorities have access to the data in this ac-count retrieval system in order to fulfil their supervisory tasks and their duties under the Money Laundering Act.

In addition, the mandatory disclosure of a credit institution's tax expenses broken down by individual countries, already introduced under CRD IV, should be mentioned. Manda-tory disclosure should make it more difficult for credit institutions to reduce the tax burden of cross-border transactions unnoticed by the public.

In the view of the EBA, it is therefore plausible to require credit institutions to take a holistic approach to arbitrage trading schemes in addition to individual measures. However, the implementation of the Action Plan will be a challenge due to the different tax systems in the EU Member States. Moreover, the legisla-tive bases specifically cited by the EBA refer explicitly to the fight against money launder-ing and terrorist financing. Thus, only arbi-trage practices that are relevant to criminal tax law can be subsumed under this heading. This depends on the individual constellation and is often controversial. The courts regular-ly have the last word here. For cross-border credit institutions in particular, this means that they must constantly review and update their tax governance and risk management systems.

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