CLIENT ALERT #9/2020 04-15-2020

Participative Loans

What is a Participative Loan?

Participative loans (regulated in RD Law 7/1996, modified by Legislative Royal Decree 4/2004) are a type of loan characterized by the fact that the lender will receive an interest, the amount of which will vary depending on the results obtained by the activity of the financed business by virtue of the aforementioned loan.

Similar figures

Participative loans resemble, on the one hand, the "Participating Contracts or Contribution Agreements – Cuentas en Participación" and, on the other hand, the "Contribution in the share capital of the company", since the consideration for both the lender and the contributing party / participating lender, as well as for the investor, depend on the progress of the business being financed. The difference of the Participative Loan against said figure, is that the lender only risks the interests, given that maintains the right to recover the loaned amount.

What interest does a participative loan generate?

The interest generated by a participative loan is variable and it depends on the progress of the business, it is usually determined based on the net profit, the volume of business, and the total assets or any other freely agreed by the contracting parties.

Nevertheless; the interest that is established in a participative loan can be mixed, that is to say that it can be fixed in one part and variable in the other.

Characteristics of participative loans

- Early repayment by the lender or the borrower may be penalized by agreeing a compensation. This prevents the borrower from deciding to repay the loan immediately before the business begins to generate profits.
- It will be considered net equity for the purposes of share capital reduction and winding up of companies.
- In order of the priority of credits in insolvency proceedings, they will be placed after the ordinary creditors.
- It is customary practice to grant the lender the possibility to choose between being repaid the borrowed amount or obtaining shares or participations in the borrowing company.

Can a subsidiary be financed through a Participative Loan? Pros and cons.

When a company requires financing from its parent company, especially if it is a foreign company, two options may be considered: 1º through a participative loan; or 2º by increasing the share capital of the subsidiary.
Both types of financing are correct, but from a tax perspective the following must be taken into account:
The accrued interests will be deductible for the subsidiary, while the generated dividends will not be deductible.

However, in order to be deductible the paid interest for the subsidiary:

- The loan cannot be used to acquire shares-participations, nor to share capital increases in other entities.
- Interest cannot exceed the greater of: 30% of the subsidiary's operating profit, or one million euros.
- The interest agreed between parent and subsidiary should be the market interest rate (that is, the interest agreed by independent parties).
- The interest received by the parent company must be subject to tax in its country at a minimum rate of 10%.

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