The taxation of participating loans with special reference to the effects of forgiveness

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1. Introductory remarks

As is well known, the Corporate Income Tax Act 27/2014 introduced a substantial change in the taxation of participating loans (also called profit-sharing loans). Prior to this amendment, art. 14(2) of the Corporate Income Tax (Consolidation) Act regulated these loans, incorporating in 2004 the legislative provisions previously contained in Royal Decree Act 7/1996 of 7 and setting forth the deductibility of "interest, both fixed and variable, accrued from a participating loan that meets the requirements set out in article 20(1) of Royal Decree Act 7/1996 of 7 June on urgent business activity advancement and liberalisation measures of a tax nature".

In this manner, the legislature chose to confer to this finance method, halfway between a share capital and a loan, the tax treatment attached to the latter.

However, there were several cases where both the Administration[1] and the courts[2] questioned the deductibility of the interest generated by these transactions, postulating that they did not have the nature of participating loans and ascribing to them, despite the name given by the parties, the nature of contributions to the borrower's assets (incorporated in the borrower company's equity), thereby excluding the possibility of deduction provided for lending transactions.

It is precisely in this context, introducing by way of article 15 of its regulating statute a differentiation in taxation depending on whether or not the companies taking part in the transaction belong to a same group, that the partial amendment to the tax treatment of the transactions that concern us for the purposes of corporate income tax has its potential. And it is precisely with respect to transactions conducted between such group companies that the change has been made, since in these cases the stipulated earnings are no longer regarded as interest, but as income from equity, barring their deductibility.

2. The taxation of participating loans

2.1. *Participating loans not between companies belonging to the same tax group*

As noted above, as of the mentioned statutory amendment, the element to be taken into account in determining the taxation of participating loans focuses on the characteristics of the persons involved in these; the taxation remaining unaltered, in respect of what occurred prior to the amendment, when those involved in the taxation do not belong to the same tax group.

It is in the latter context that the Directorate-General for Taxation (DGT) has expressed

[1] *Vide* Directorate-General for Taxation's binding response to a taxpayer's query V0055 99.

[2] *Vide* Judgment of the Supreme Court of 27 September 2013, RJ 2013\6534.

itself in its binding response V2007 15 of 26 June 2015 to a query from a company which had concluded a participating loan with an individual resident in Malta. The terms of the loan included as payment, in addition to a fixed interest rate during its duration, 50% of the profits made from the real estate project that the borrower would develop with the financing obtained.

To determine the taxation applicable to said transaction, the DGT analysed the new art. 15(a) of the Corporate Income Tax Act, since, according to the seventeenth transitory provision thereof, this provision may be applied to participating loans granted after 20 June 2014, as was the case[3].

In this regard, the DGT recalls that the financial burden and any other payments under participating loans may be tax deductible to the extent that such amounts are regarded as expenses - in accordance with the accounting rules to be applied (also examined in the response) - and provided that they are not regarded as non-tax deductible expenses under article 15 of the General Tax Act.

In this case, and given that the lender has the status of an individual, the participating loan cannot be found amongst those granted by companies belonging to the same group, so the prohibition of deductibility does not operate, without prejudice to the need of considering the provisions of art. 16 of the General Tax Act in relation to the limitations set out therein regarding the deduction of financial expenses. Recall that, summing up this provision, financial expenses are deductible only to the limit of 30% of the operating profit for the year, with an exemption of one million euros and the possibility of tax deduction in the following tax periods of expenses not deducted by application of the said limit.

Apart from the above, and having ruled out the application of art. 15(a), third paragraph, to the examined case, the DGT advises on the need to comply with the provisions of art. 18 of the Corporate Income Tax Act if the lender and the borrower are related parties.

After resolving the above question, the DGT addresses the taxation of the payments arising from the transaction in respect of the recipient, an individual resident in Malta. In that regard, and after analysing the concept of interest contained in both art. 11(3) of the Convention between Spain and Malta for the Avoidance of Double Taxation and in the commentaries of the OECD Model Convention with respect to this issue, the DGT raises no doubts as to the nature of interest of the income earned by the lender in the transaction. According to such classification, and pursuant to art. 11(1) of the aforementioned convention, the DGT concludes that Spain has no authority to tax such income and, therefore, it is not subject to withholding.

2.2. *Participating loans between companies belonging to the same tax group*

Before the amendment, there is no doubt that it was in this subjective sphere where most questions could be raised about the true economic substance of the transaction, leading both the Administration and the courts to dispute the nature of the loans of some transactions that, eventually, were reclassed as participation in a company's equity. However, as noted above, disputes arising because of this issue may have caused the amendment by reason of which, according to art. 15(a) of Act 27/2015, the earnings from participating loans, comprising both fixed and variable interest, may be deducted at the tax base unless - and here is where we find the change - said transactions have been carried out between companies belonging to the same group, as per the criteria set out in this respect by art. 42 of the Code of Commerce. In these cases, the stipulated payments shall be regarded as income from equity and the borrower group company must equate the earned interest to dividends for the purpose

[3] Moreover, the DGT has pointed out that this transitory provision will equally apply in the event of novations amending initially granted loans, being therefore applicable in the event of extensions of the aforementioned participating loans (binding response V1664 15).

of the tax exemption under art. 21 of the Act (art. 2(2)), applicable if the remaining requirements of said article are met.

The legislature has thus homogenized the taxation of profits from intragroup participating loans, making it unnecessary, for these purposes, to analyse the economic substance of these transactions with reference to the contractual terms agreed by the parties.

3. A reference to the tax consequences of forgiveness of a loan

It is precisely on the possible consequences of the stipulations agreed by the parties to a loan agreement - with the features of those loans which occupy us - that the German *Bundesfinanzhof* (Federal Tax Court) has pronounced itself in its judgment of 14 April 2015 (case no. IR 44/14). In that case, the parent company had granted to one of its group companies, over-indebted at the time, two loans documented in an agreement which provided that the lender made its right to collect the agreed payments conditional on or subordinate to the borrower reporting profits in the future.

The German authorities and, ultimately, the Federal Court did not, however, recognize the liability that the borrower recorded in its accounts, given that under the subordination agreement the absence of revenue or profits determined the inability to pay or collect the agreed profitability. It follows, in the court's opinion, that subordination agreements entered into to prevent the insolvency of the borrower, arranged under certain circumstances and wordings, lead to the conclusion that the amounts lent have been forgiven, so that, under German tax law in force at the time of the dispute, those amounts translated into taxable income for the debtor.

The harmful effects that may result from a determination such as that of the German court are not hard to divine, inasmuch as companies in distress that rely on intragroup financing transactions may end up with positive tax bases, and even payable tax rates, without the means to meet these payments.

Taking into account the above, we could consider what would be the outcome, under our tax system, of a transaction as that described. In this regard, it should be borne in mind, as noted by the aforementioned binding response V2007-15 to the extent it examines the accounting treatment of participating loans, that "if the terms of the transaction reveal that a grant or gift is inherent in the agreement, such must be recorded in accordance with the 18th recognition and measurement standard of the National Accounting Plan".

Indeed, the National Accounting Plan provides a specific treatment for "non-refundable grants, gifts and bequests" and, considering the relationship between accounting and tax rules for the purposes of corporate income tax, in principle we must refer to the accounting outcome of such transactions when determining, subsequently, whether to introduce a nuance for tax purposes.

From that perspective, and taking into account the provisions of the National Accounting Plan in the aforementioned recognition and measurement standard, we have to distinguish the cases in which these transactions are carried out between independent companies from those other cases in which they are arranged between companies in the same group – the context in which the dispute settled by the German court arose – and, within the latter, a differentiation must also be made according to the lender parent company's degree of ownership of the borrower subsidiaries:

a) *Loan arranged between independent companies*

Thus, when the transactions are arranged between independent companies, if on the basis of the stipulations agreed by the parties a conclusion can be reached similar to that reached by the German court, that in view of the economic substance of the transaction we can only but infer a gift, the consequences would be similar to those held there, as the animus donandi present in the transaction would entail the recording in the profit and loss account of an expense for the donor and the correlative revenue for the donee.

b) *Loan arrangement between wholly owned group companies*

The situation is different when the context in which the transaction must be examined involves companies belonging to the same group, as was the case reviewed by the German court. In these cases, and in accordance with the 18th recognition and measurement standard of the National Accounting Plan, non-refundable grants, gifts and bequests given by shareholders or owners do not constitute revenue, but must be recorded directly in equity, regardless of the type of grant, gift or bequest in question.

In accordance with the above, the DGT has been of the opinion that, as a result of the capitalization or forgiveness of the loan, in such cases no revenue is generated for tax purposes in respect of the borrower. Thus, the binding response V3003-14 of 5 November, following the criterion of previous responses (e.g., V0191-14 or V0192-14), states that "there being a 100% shareholder-company relationship between the lender and the borrower, even if later said receivable is impaired for accounting purposes as a result of the difficulties the borrower company may have to meet the payment commitments, it should be noted that the forgiveness or capitalization of such receivable (whichever legal form is used) should not generate any revenue or expense, from a tax point of view, between the companies concerned. That is, said forgiveness or capitalization, in a comprehensive examination of the transaction from a tax point of view, is nothing but the reflection of the mere conversion into equity of a receivable existing between the lender and borrower companies, for an equivalent amount between both parties and for which the borrower's difficulties in repaying the same is of no relevance, as the capitalization or forgiveness precisely demonstrates that such repayment will no longer need take place. That is, there has been a transfer of assets in the amount of the debt assumed at the time of its production, and it is irrelevant for tax purposes that the receivable that is now the subject of contribution is impaired for accounting purposes".

The same reasoning is used in the binding response V0758-15 of 9 March and, earlier, in binding response V0541-14, which states that the mentioned conditions shall be valid both where the transaction has been concluded between a subsidiary and its parent, as well as where it has been made between two subsidiaries of the same group, both 100% owned by the parent.

c) *Loan arranged between partially owned group companies*

As we have seen, if a case similar to that examined by the German court arose in our country, where wholly owned subsidiaries of the parent took part in the underlying transaction, the conclusions would be quite different here. However, the problem is harder when the parent of a group arranges a loan with a subsidiary that has minority shareholders that do not take part in the transaction and the loan is subsequently deemed forgiven.

In these cases, and from an accounting point of view, the Spanish Auditing and Accounting Standards Board (abbrev. ICAC) has concluded that the solution should be offered in terms of proportion. That is, the part of the forgiven loan that does not correspond with the lender parent's actual ownership of the borrower subsidiary shall be regarded as an expense for the former and revenue for the latter.

To conclude, the tax perspective of such transactions has been recently examined by the DGT in its binding response V2278-15 of 20 July, applying the above criterion when pointing out that when there are other shareholders in the subsidiaries, if the contribution is made in a proportion higher than that which is appropriate for the parent by reason of its actual shareholding in the subsidiary, the excess over such shareholding shall be regarded as "an expense for the donor and revenue for the donee".