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PANAMA

Law and Practice

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form. From a tax perspective, Panamanian and foreign entities must comply with the same basic requirements to conduct commercial activities within and from the Panamanian territory.

The most common corporate vehicles in Panama are as follows:

- corporations (S.A.), which are taxed directly on the income produced within the Panamanian territory; shareholders are subject to a 10% dividend tax, withheld by the company, if said dividends are paid out of income produced in Panama;
- partnerships (LLC), which from a tax perspective are subject to the same regime as corporations; and
- branches.

The legislation also considers trusts, joint ventures and private interest foundations as non-corporate vehicles, which are also taxed as separate legal entities.

1.2 Transparent Entities

In Panama, transparent entities are known as civil corporations, whose owner is taxed rather than the entity itself. Civil corporations are commonly used as transparent entities, particularly in the legal services business. Income produced by legal civil corporations is taxed through the individual owners.

1.3 Determining Residence

As a general rule, entities duly registered at the Public Registry are recognised as being tax resident in the Republic of Panama if they have material ways of direction and administration within the Panamanian territory, meaning that the entity performs commercial activities or supports other entities in the development of such activities from the Panamanian territory, and therefore has a local establishment and staff.

Entities that cannot perform commercial activities within the Panamanian territory because of their nature should at least have material ways of direction and administration.

1.4 Tax Rates

The main taxes applicable in Panama for incorporated businesses are as follows:

- income tax, either as a direct tax or as a withholding tax;
- dividend tax and complementary tax;
- Operations Notice Tax;
- franchise tax; and

- VAT (tax on transfers of movable goods and rendering of services).

For individuals, the income tax calculation shall be based on a progressive rate as follows:

- income from USD11,000 to USD50,000: 15%; and
- income above USD50,000: a fixed amount of USD5,850 for the first USD50,000 plus 25% on the excess.

Corporations are subject to income tax at a rate of 25% on net taxable income. Due to specific activities or special conditions, some businesses will be subject to 30% corporate income tax on net taxable income.

Incorporated businesses whose annual taxable income is greater than USD1.5 million may perform two calculations and the payable tax will be the net taxable income calculated on the normal basis at 25%, or 4.67% over the gross taxable income, whichever is higher.

Professional services fees, interest and royalties paid to a non-resident entity are subject to withholding tax of 25% on 50% of the amount remitted abroad (ie, an effective tax rate for corporations of 12.5%).

Dividends paid out of local taxable income trigger a 10% dividend tax, withheld at source. If dividends are not distributed during a tax year, the company must pay complementary tax in advance of the dividend tax. The complementary tax rate is 4% over the local taxable income.

The operations notice tax rate is 2% of the net worth of the company, with a minimum payable of USD100 and a cap of USD60,000 as a standard.

The rendering of services or the transferring of movable goods triggers VAT at a standard rate of 7%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

According to Panamanian law, any income that is produced from any source within the territory of the Republic of Panama is subject to income tax.

The taxable income is the result of the deduction of the costs and expenses, the foreign-sourced income, the non-taxable income

and the exempted income from the gross income or general revenue.

As a main rule, a taxpayer can deduct all costs and expenses incurred during the tax year, as long as they are necessary for the production of Panamanian income or for the conservation of its source. There is a direct link between the taxable incomes and the deductible costs and expenses. To be considered as deductible, the costs and expenses must indeed be incurred or caused, duly supported in a document as an invoice or any equivalent document, and caused or incurred during the same tax year.

If a company has local and foreign income, the costs and expenses must be attributed to its source, applying the rule of the maximum of deductible costs and expenses.

2.2 Special Incentives for Technology Investments

The City of Knowledge is a special gated area targeting innovation, communication and information technologies (IT). Companies based in the City of Knowledge that produce, assemble or process hi-tech goods or provide services of equal vocation destined for sale in the local or international market will enjoy some incentives.

The most common tax breaks granted for corporations established in the City of Knowledge are as follows:

- the exemption of import duties on machinery, equipment, furniture, vehicles, appliances and supplies;
- the exemption of VAT on machinery, equipment, vehicles, appliances and supplies;
- exemption from any tax, duty or tax levied on the remittance of money abroad when such remittance or transfer of funds is carried out for the purposes of Technopark; and
- an exemption on income tax for businesses, and Operations Notice Tax.

2.3 Other Special Incentives

Other special incentives for particular industries are mostly granted through the establishment of the operations of the company in a special tax regime or a free trade zone, as follows:

- Multinational Headquarters Regime, for regional companies headquartered in Panama. At a corporate level, the tax incentives are reduced rates on income taxes and exemption from Operations Notice Tax, dividend and complementary taxes, and sales tax for services rendered to related corporations abroad or corporations that do not declare taxes in Panama. At the staff level, foreign executives with a Permanent Executive Visa for a Multinational Headquarters Company will not trigger a remuneration-related tax

burden, as long as payment is recorded in the accounting records in the local payroll.

- Panama Pacific Special Economic Area, for the trade of goods between related parties, logistics services, hi-tech production, call centres and other services. Tax exemptions granted under this regime include import duties (unless goods are sold within Panama), income tax exemption for specific business activities carried outside Panama, VAT (sales tax) and dividend tax exemption for specific business activities, and no withholding tax on interest income for companies in the area, and on payments made to foreign creditors, among others.
- Oil free trade zone – the introduction, exportation or re-exportation of crude oil or any of its derivatives, natural gas and biofuels, among others, are tax exempted if said products are introduced within the zone.

2.4 Basic Rules on Loss Relief

In Panama, the only carry forward in force is as a loss relief. The net loss can be carried forward during the subsequent five taxable years, deducting a maximum of 20% of the loss each year. Such deduction cannot reduce the net taxable income by more than 50% each year. The portion not deducted in one tax year shall not be deducted in the subsequent tax years, neither can it be subject to a refund from the Tax Authority.

The deduction can only affect the income tax and not the estimated tax. Losses and the right to carry them forward cannot be transferable among tax payers, even in mergers and acquisitions.

2.5 Imposed Limits on Deduction of Interest

There are no limits on the deduction of interest by local corporations, if such interests are related to the production of income or are necessary to preserve its source. Also, as with any other deductible expense, it should be duly supported in the corresponding documents.

2.6 Basic Rules on Consolidated Tax Grouping

There is no consolidated tax grouping regime in Panama.

2.7 Capital Gains Taxation

The capital gains tax rate is 10%, although the sale of properties, movable goods or stock has a special tax treatment.

Taxation on the sale of real estate properties depends on the condition of the seller. If the seller does not sell as an ordinary business, the tax will be based on a rate of 10%. Nevertheless, the vendor must make an advance payment of 3% of the gross value of the transaction or the cadastral value, whichever is higher. The taxpayer may consider the advanced payment as the definitive tax. If the advance payment ends up being higher than the

10% on the net gain, the taxpayer can claim a refund over the excess advanced.

If the sale of real estate is the ordinary business of the seller, the capital gain will be taxed as a regular income tax, with the same rates applicable to individuals or corporations, depending on the case. However, if the property is new and is being sold for the first time, the sale will be taxed at the following rates:

- real estate with a value up to USD35,000: 0.5%;
- real estate from USD35,000 to USD80,000: 1.5%;
- real estate with a value higher than USD80,000: 2.5%; and
- commercial establishments: 4.5%.

The transfer of securities, bonds, shares and other participation quotas of corporations or associations that generate taxable income in Panama is taxed at a 10% rate over the profit. The purchaser must make a 5% withholding on the selling price and remit it to the tax authority within ten days of the payment date. The seller can consider the tax withheld as the final tax payment. If the 5% withheld in advance is higher than the 10% of the capital gain, the seller can claim a refund.

If there is a change in ownership, the transaction would be subject to capital gains tax. To pay the capital gains tax a form must be filed with the information of the seller and the buyer, meaning that both parties should have a taxpayer ID number. When the parties are from abroad, a temporary taxpayer ID number must be requested. For these purposes, the certificate of incorporation, the contract, and a copy of the legal representative's passport are usually required, and every document coming from abroad needs to be duly legalised or apostilled and later translated into Spanish in Panama by a certified public translator.

However, a transfer of shares that does not generate a profit for the seller is exempt from capital gains tax. Therefore, the withholding will not proceed. In such cases, even though the withholding is not applied, the parties shall make a filing with the General Directorate of Revenues, accompanied by documentation such as an affidavit of the parties and a certificate of a certified public accountant, and the share purchase agreement, in addition to the capital gains form showing that no profit has been produced from the transaction.

Also, there is a special regime applicable to transactions in which shares are transferred at no cost. In these cases, a similar filing to that of no profit for the seller shall be made with the General Directorate of Revenues.

The sale of property or goods is also taxed at a 10% rate on the profit obtained from the sale of such assets. The 10% is applied

on the selling price minus the acquisition price, less the accumulated depreciation.

2.8 Other Taxes Payable by an Incorporated Business

Agreements or any other document involving consideration, and only when such obligation is not taxable with VAT, shall be subject to Stamp Duty, which is calculated at USD0.10 per every USD100 of the total amount of the agreed obligation.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses might be subject to eventual taxes, depending on the activities undertaken and the tax regime applicable, as follows:

- Import duties: all imports are subject to import duties, unless specifically excluded by law. Import duties must be paid within three working days of the day the import documents are filed with the custom authorities. Rates vary according to the harmonised codes.
- Export duties: exports are not subject to taxes, except for some goods such as silver, gold and platinum; iron, copper, bronze and metal scraps; natural resources; and raw sugar. The export of those products requires a special licence from the Ministry of Commerce and Industries.
- Municipal taxes: incorporated businesses producing income within the jurisdiction of a district are subject to municipality taxes, calculated over the annual gross income on a progressive rate and depending on the activity performed by the corporation. Trade signs of establishments will be affected by such tax, according to the size of the commercial sign.
- Social security contributions: corporations acting as employers shall withhold the corresponding contributions from the remuneration of employees, and pay their own contributions over the salaries paid. Employers shall pay 12.25% for Social Security, 0.56% to 7% for Professional Risk, and 1.50% for Educational Tax.
- Real estate taxes: all land and real estate improvements in Panama are subject to real estate taxes over the total cadastral value, applying the progressive rates. Improvements are exempt or can obtain exemption. All real estate is exempt for the first USD30,000.
- Tax on the transfer of real estate: this is applied at a rate of 2% over the value fixed in the transfer deed or the current cadastral value, whichever is higher. Donations between relatives are exempt, subject to a prior request being made to the tax authority.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most of the commerce in Panama is developed through incorporated businesses. Even though corporations have a higher income tax rate, the legislation recognises some special regimes for those corporations producing incomes below USD200,000, which can pay income tax at the same rate as individuals, subject to some special requirements and condition.

For public bids, the most commonly used non-corporate form is the joint venture. For such purposes, the joint venture shall be filed as a juridical person at the Tax Authority and will be subject to the same rates as apply to corporations.

3.2 Individual Rates and Corporate Rates

Corporate income tax rates are higher than individual rates. Therefore, incorporated businesses are usually created for corporate structures rather than benefits on lower tax rates.

3.3 Accumulating Earnings for Investment Purposes

Local legislation taxes the distribution of profits with the dividend tax. However, profits retained by the company – ie, not distributed to its shareholders – shall incur complementary tax as an advanced payment of the dividend tax. Consequently, the tax administration will receive at least an advanced tax over the profits declared by incorporated businesses.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Panamanian legislation taxes capital gains and dividends at the same rate for corporations and individuals. Both taxes are imposed over different events.

Capital gains tax shall apply whenever a share is transferred. The legislation recognises several scenarios where the transfer of shares or other values does not represent a gain for the seller. In those cases, it is necessary to file a notification explaining the reason why there was not a gain on the transaction.

Dividend tax shall apply over profits distribution. Once the seller has transferred the shares, the corporation will assess its profits, if any, and the dividend shall be paid when the distribution occurs.

Loans granted to a shareholder (corporations or individuals) are subject to the regular dividend tax rate.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

For income tax purposes, dividend and complementary tax shall not be considered as taxable profits, and the losses from the transfer or sale of shares and other values are not deductible if such value is registered at the Superintendence of Securities Market and traded in the stock exchange.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Service fees, interest and royalties paid to a foreign entity are subject to a withholding tax of 25% over 50% of the remittances (ie, an effective tax rate for corporations of 12.5%). Fees paid to foreign individuals are subject to a withholding tax over 50% of the remittance at the same individual progressive rates (15% to 25%).

Withholding shall be applied over income received by natural or legal persons domiciled outside the territory of the Republic of Panama, for any service or act, whether documented or not, that benefits natural or legal persons, national or alien, located within the Republic of Panama, to the extent said services affect the production of Panamanian source income or the conservation of such income. Therefore, if such remittance is not considered as deductible for the Panamanian taxpayer, the withholding shall not apply.

Dividend tax is withheld by the corporation, at the moment of distribution, at a rate of 10%. If dividends distributed are paid out of foreign income, such distribution shall be subject to the dividend tax at a rate of 5%.

4.2 Primary Tax Treaty Countries

Panama has signed several treaties to avoid double taxation, and tax treaties exclusively to allow the exchange of tax information. As a general rule, a person who is considered a taxpayer in one Contracting State may obtain credit for the taxes paid in the other State, with the benefit to cover, in some cases, only the lower rate. Each treaty includes different applicable conditions.

Panama has signed treaties to avoid double taxation with the following countries:

- Barbados;
- Korea;
- the United Arab Emirates;
- Spain;
- France;
- the Netherlands;

- Ireland;
- Israel;
- Italy;
- Luxembourg;
- Mexico;
- Portugal;
- Qatar;
- the United Kingdom;
- the Czech Republic;
- Singapore; and
- Vietnam.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The use of the benefits established in a treaty to avoid double taxation is subject to prior authorisation by the tax authority. In addition, it is necessary to prove the tax residency of the individual or corporation in the other contracting State, meaning that only tax residents of one of the contracting States can apply the benefits of the treaty.

4.4 Transfer Pricing Issues

Transfer pricing rules apply only over transactions made with related parties established abroad. Transactions between related parties locally are not subject to such rules, with the exception of the Multiregional Headquarters Regime; however, the rest shall be duly documented to be considered as taxable income or a deductible expense or cost.

The application of transfer pricing rules by the Panamanian Tax Authority is recent compared to other jurisdictions, with the rules becoming effective in 2011.

The first transfer pricing litigation took place in 2018, after an appeal process. To date, Panama has not signed any transfer pricing agreement, and this triggers a contingency due to the discretion of the tax criteria that the tax authority might apply, especially on the application of comparable entities or transactions.

There is not sufficient jurisprudence in Panama, and many of the litigation processes are evaluated under foreign experience that might not apply to the local market.

4.5 Related-Party Limited Risk Distribution Arrangements

Panama does not have special rules for such agreements. Nevertheless, any agreement that involves transactions with related parties established abroad is subject to the general transfer pricing rules. In addition, any distribution cost reallocated to the Panamanian taxpayer shall be duly documented and related to the taxable income declared.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Panama follows OECD standards for transfer pricing rules, with no significant variations. International tax regulation matters in Panama are generally also subject to such standards.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

There have not yet been any Mutual Agreement Procedures in Panama at the Tax Authority, although the Double Taxation Treaties include such a negotiating procedure.

5.2 Taxing Differences

There is only one different treatment, for dividends tax. By virtue of the Law, a branch is considered to be subject to the dividends tax as soon as it reports a gain on its income tax return. Local subsidiaries of non-local corporations may be subject to the dividends tax only when the earning is actually distributed.

5.3 Capital Gains of Non-residents

Capital gains of non-residents on the sale of stock in local corporations is a taxable event. The capital gains tax is triggered on stock owned directly or indirectly, regardless of whether the owner is local or not. Treaties alleviate the tax burden on the capital gains clause.

5.4 Change of Control Provisions

There are no change of control provisions as such, other than the transfer of stock in the case of capital gains.

5.5 Formulas Used to Determine Income of Foreign-owned Local Affiliates

In Panama, formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

Management and administrative expenses incurred by a non-local affiliate can be considered as deductible expenses whenever they are needed for the production of local-sourced taxable income, or for the conservation of the source of the taxable income, incurred in the same tax period as the deductibility is enjoyed.

5.7 Constraints on Related-Party Borrowing

Such transactions are subject to the transfer pricing regulation, and the interest may be subject to income tax withholding if such amount is considered a deductible expense. Such transac-

tions also trigger VAT, withheld at source whenever the creditor is not a financial entity.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Income produced in Panama is taxable event in Panama; therefore, income produced abroad may not be regarded as local income, so is not subject to income tax in Panama. However, whenever the taxpayer has multiple sources of income, the dividend tax is triggered at a different rate on the portion generated abroad.

6.2 Non-deductible Local Expenses

The allocation and split of the different sources of income, costs and expenses need to be recorded in Panama. Whenever a taxpayer has multiple sources of income, there is a Maximum of Deductible Costs and Expenses (MCGD for its acronym in Spanish) calculation, which is $MCGD = (IG / IT) \times CGT$, where MCGD stands for Maximum of Deductible Costs and Expenses, IG stands for Taxable Income, IT stands for Total Income (taxable, exempted, foreign sourced), and CGT stands for Total Costs and expenses incurred by the taxpayer.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are not included in the amount of earnings that is subject to dividend tax on the local entity. If such dividends have already cleared dividends tax abroad, they are not considered to be taxable in Panama for dividends tax purposes.

6.4 Use of Intangibles

There is no tax rule regarding non-local subsidiaries' use of intangibles developed by local corporations that differs from the transfer pricing rules. If the local corporation records an expense, cost or income in connection with the corresponding intangible, a tax contingency arises.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

There are no CFC-type rules in Panama.

6.6 Rules Related to the Substance of Non-local Affiliates

There is no special substance rule for non-local affiliates in the domestic tax regulation, but certain substance rules must be observed locally under the international tax regime.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

In general, the gain derived from the sale of shares in non-local affiliates is a non-taxable event in Panama under domestic tax rules; nevertheless, if such non-local affiliate has Panamanian-sourced income, the proportion thereof will be subject to capital gains tax rules.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are no special overarching anti-avoidance provisions in place.

8. Other

8.1 Regular Routine Audit Cycle

There is no routine audit cycle in place from the Tax Authority, which carries out random audits within a three-year term for income tax purposes. It is mandatory for taxpayers to have independent audited financials within 120 days after the year end.

9. BEPS

9.1 Recommended Changes

Panama has been part of the Inclusive Framework on BEPS since October 2016. Therefore, Panamanian legislation has improved its special economic regimes in order to comply with BEPS – Actions 5, 6, 13 and 14. As a result, there is no Harmful Practice in Panama, and the Country-by-Country Report is mandatory, beginning in 2019.

9.2 Government Attitudes

Panama is willing to co-operate and has already taken the first steps.

9.3 Profile of International Tax

International tax law has a high public profile in Panama, which is committed to BEPS Actions 5, 6, 13 and 14 as a start.

9.4 Competitive Tax Policy Objective

Panama has historically provided services to all nations across the world for more than a hundred years, supported by a developed multilingual international operations platform and superb legal, accounting, fiduciary, logistics and maritime services, gathering more than 150 multinational headquarters with worldwide activities aligned with the rule of law. The Foreign Direct Investments established in Panama have to comply with

BEPS in their countries of origin, and bring their BEPS standards to Panama.

9.5 Features of the Competitive Tax System

There is no key feature to adjust, as the main changes occurred last year with the implementation of BEPS Actions 5, 6, 13 and 14.

9.6 Proposals for Dealing with Hybrid Instruments

There are not currently any initiatives to specifically rule hybrid instruments under BEPS.

9.7 Territorial Tax Regime

There is no restriction on interest deductibility, as long as it refers to the production or conservation of the taxable income.

9.8 CFC Proposals

To date, there has been no local or foreign law initiative regarding CFC proposals, but it is important to mention that Panama does not have a low rate on profits and that the applicable rates for the special regimes have been approved by the OECD. If such a potential rule may be applicable to the exempted operations established in Panama, the taxpayer will be subject to worldwide taxation, as many are used to.

9.9 Anti-avoidance Rules

The limitation on the benefits established under the double taxation treaties is not currently addressed by the Tax Authority, although it is included in the BEPS actions.

9.10 Transfer Pricing Changes

The taxation of profits from intellectual property has not been under particular discussion at the present time.

9.11 Transparency and Country-by-country Reporting

Panama is in favour of the proposals for transparency, and the CbC Report is mandatory as of 2019.

9.12 Taxation of Digital Economy Businesses

No specific digital taxation is yet being discussed.

9.13 Digital Taxation

No public position has been released regarding digital taxation.

9.14 Taxation of Offshore IP

No specific provision has yet been introduced on this matter.

9.15 Other General Comments

There are no other general comments.

PANAMA LAW AND PRACTICE

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Morgan & Morgan is a full-service Panamanian law firm, with a solid legal department experienced in advising clients on matters related to M&A, joint ventures, project finance (real estate, energy, mining, public infrastructure), syndicated lending, guaranteed loan facilities, due diligence related to credit facilities contracts, insolvency and reorganisation processes, judicial processes for the collection of unpaid high-risk credits, taxation, and general corporate and regulatory matters. On tax law, the firm mainly addresses consulting, litigation and

compliance before the Tax Authority, the Social Security Institution, the Customs Authority and the Tax Court. The team advises on both domestic law and international tax law, and direct and indirect taxes; it also advises on special taxes regimes for multinational companies when doing business in Panama, and provides guidance on individuals' tax issues related to remuneration, tax compliance assessment, and tax residency. The firm also has ample knowledge in the reporting and exchange of tax information requirements, such as FATCA and CRS.

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