



MERGERS AND ACQUISITIONS

Panama

Taxation of Cross-Border
Mergers and Acquisitions

2010 Edition

TAX

Panama

Introduction

The signing of several Free Trade Agreements (FTAs) and the ambitious Panama Canal expansion project are tangible signs that Panama's economy is opening itself to the global market. As a consequence, Panamanian companies have been obliged to increase their competitiveness. It is, therefore, no surprise that mergers and acquisitions (M&A) have become increasingly common in Panama in recent years, and are being seen as the best way for companies to position themselves in the regional and global economies. Panama's largest banks have merged during a period of strong growth in practically every industrial sector, which is expected to continue.

Merger procedures in Panama are mainly governed by Law No. 32 of 1927, which regulates corporations in general, but also by Executive Decree 18 of 1994, which established the accounting procedures that must be applied to effect a tax-exempt merger.

Recent Developments

Although there have been no recent legal developments relating to M&A from a formal or procedural point of view, tax reforms have recently been implemented and some of the modifications could affect M&A procedures, particularly the increase in the commercial license tax.

Asset Purchase or Share Purchase

The sale of shares and of assets is subject to a 10-percent capital gains tax, but in Panama most mergers take the form of share purchases. This usually results in lower taxes, because buyers are required to withhold 5 percent of the transfer price as an income tax advance. This can be regarded as the final tax for the vendor and is often lower than the tax that would have been paid if the 10-percent rate was levied on the actual gain arising from the sale of the shares or the assets.

But the opposite could also apply, because, in some cases, 10 percent of the gain from the sale of the assets can be less than 5 percent of the purchase price of the shares. In such cases, a merger by means of an asset purchase would be preferable.

Purchase of Assets

When a merger by absorption takes place by means of a purchase of assets, it is subject to the payment of taxes that may arise from the purchase of both real estate and chattels.

The taxable income in a real estate purchase is the result of subtracting from the purchase price the basic cost of the asset, the value of the improvements made to it, and the costs and expenses associated with the sale operation. If the purchase and sale of real estate is not part of the company's ordinary business operations, it will pay a 10-percent income tax, which shall be paid before the property deed is registered at the public registry. The latter is a mandatory requirement for the purchase to be legally effective. Moreover, as of 17 September 2009, taxpayers will be obliged to pay a sum equivalent to 3 percent of the total value of the transfer or of the cadastral value, whichever is higher, as an income tax advance. This advance can be considered as the final tax, but if it is higher than the result of applying the 10-percent rate on the profit arising from the transfer, the vendor could file a tax refund or tax credit request.

If such tax is paid, the income from the sale will not be considered as part of the company's taxable income. The purpose of this provision is mainly to protect natural persons from being taxed at inappropriately high rates, because of abnormally high personal income resulting from the sale of a property. This provision is of less significance for companies.

Purchase Price

There are no rules that set the prices at which such transactions should be made. Pricing is set by the parties involved, because there are no transfer pricing rules in Panama.

Goodwill

There is a legal provision that allows the deduction of certain intangibles, although not specifically goodwill. There is a possibility that the tax authorities may object to the deduction of goodwill, but they have yet to do so.

Depreciation

Panamanian tax laws envisage three methods of depreciation calculation, which can be chosen individually for each asset. Taxpayers are not required to apply the same depreciation method to all of their assets:

- Direct or straight line calculation, in which a fixed percentage is applied on the value of the original cost.
- Decreasing value, applying a fixed percentage on the decreasing remnant of the cost value.
- Digit sum, in which the number of years the asset is expected to last are added up and the original cost value is then divided between them. Each year the result of that division is multiplied by the digit of that year, in either an increasing or decreasing order.

Real estate cannot be depreciated in less than 30 years, and chattels, in less than three years.

Tax Attributes

Mergers have no effect on fiscal rights or benefits, or on the amortization of assets that can be used by the new company in the future. Losses from the year in which the merger took place can be used as deductible expenses by the new company, but losses carried forward cannot.

Value-Added Tax (VAT)

The sale of real estate is not subject to ITBMS (Panama's VAT). Asset purchases will be subject to ITBMS if assets other than immovable property are involved in the transaction (buildings, machinery, etc.). Mergers that take place in accordance with Executive Decree No. 18 of 1994 are specifically excluded from ITBMS.

Transfer Taxes

Mergers in accordance with the above-mentioned Executive Decree are not subject to stamp tax, a share purchase agreement will be, but an asset sale agreement will not, as long as it is taxed with ITBMS.

Purchase of Shares

The sale of shares, bonds, quotas, and other securities is taxable, and when income arises from a public offer of stock, it will be treated as capital gains and taxed at a fixed rate of 10 percent. The buyer must withhold 5 percent of the purchase value and send it to the tax authorities within 10 days of the payment date, as an

advance income tax payment. The seller will be entitled to consider the withheld amount as the final income tax payment. If the advanced sum exceeds 10 percent of the total purchase value, the seller can submit a request to the tax authorities for the excess to be deemed an income tax credit for the year in which the purchase of shares took place, but no cash refund of such excess payments can be obtained.

Tax Losses

In a share purchase, losses can be used as deductible expenses by the selling company, but not by the purchaser.

Pre-Sale Dividend

If a company has withheld profits and it is about to be sold, it could be better to distribute the profits, pay the corresponding 10 percent dividend tax, and deduct the profits from the sale price. By distributing the profits, the taxable basis for the 5 percent capital gains withholding would be reduced, and since the company has probably already paid the dividend tax advance known as complementary tax, the applicable dividend tax would not be 10 percent, but rather a maximum of 6 percent. This could result in a lower overall tax than would be the case if the company was simply sold without distributing the retained profits.

Transfer Taxes

The share purchase agreement would be subject to stamp tax at a rate of USD 0.10 per USD 100 of the purchase price stated in the agreement.

Choice of Acquisition Vehicle

There are several possible acquisition vehicles, but some are more convenient than others. The characteristics of each vehicle are summarized later in the chapter.

Local Holding Company

A Panama holding company would have to pay dividend tax at 10 percent of the dividends it received from the purchased company. It can also be merged with the purchased company, to use the goodwill as a deductible expense.

Foreign Parent Company

A foreign company would also be subject to a 10-percent dividend tax on the profits the acquired Panamanian entity distributed, but unlike in the previous case, a merger could not take place, since Panamanian corporate law does not allow mergers between local and foreign entities, unless the foreign entity is itself

registered in Panama. That being the case, the goodwill could not be used as a deductible expense.

Non-Resident Intermediate Holding Company

A non-resident intermediate holding company would also be subject to a 10-percent dividend tax, and could not be merged with the Panamanian entity. The result would be the same; the goodwill could not be treated as a deductible expense. Because Panama does not have any tax treaties in force, an intermediate holding company provides no benefit.

Local Branch

A Panama branch could merge with the acquired company and treat the goodwill as a deductible expense.

Joint Ventures

Joint ventures cannot be used as acquisition vehicles in Panama.

Choice of Acquisition Funding

The purchaser may choose to fund the acquisition with either debt or equity. The details and characteristics of each option are summarized later in the chapter.

Debt

When funding a merger with debt, interest deductibility and withholding taxes (WHT) are key factors that have to be taken into account.

The Panamanian Fiscal Code states that all costs and expenses necessary for the production of income and the conservation of its source are deductible from income tax. Thus all interest arising from loans necessary for any of the above mentioned purposes would be considered deductible expenses, but tax authorities have questioned, during the course of audits, whether loans taken out to purchase the shares of other companies generate deductible interest.

If the loan has been granted by a foreign banking or financial institution, the interest it charges to the Panamanian company will be subject to WHT at 15 percent.

Deductibility of Interest

The acquiring company cannot, in principle, deduct the interest paid on a loan obtained to purchase the acquired company, unless they merge, and the resulting company treats such interest as deductible expenses related to the production of its taxable income.

Withholding Tax on Debt and Methods to Reduce or Eliminate

Interest, commissions and other charges paid to foreign creditors on loans or financing are subject to a 15-percent effective income tax rate, which must be withheld by the person making the payments. Since Panama currently has no tax treaties in force, it is not possible to reduce or eliminate WHT.

Checklist for Debt Funding

- The headquarters lends to a local bank.
- The local bank, in turn, lends the same amount to the local subsidiary.
- The local subsidiary repays the loan to the bank.
- The local bank subsequently repays the loan to the headquarters. These payments will not be subject to WHT.

Equity

Capital contributions are not taxable, but if they are distributed, they will be subject to WHT at 10 percent. There is, however, a legal vehicle that allows shareholder to avoid the payment of this tax. Through capitalization of utilities, dividend tax will not be applicable, as long as the company does not re-acquire its own shares or grant any loans to its shareholders for a period of five years following the capitalization. Any loans granted to the shareholders before the capitalization must be cancelled during the six months following the capitalization, unless the company carries out banking or financial activities. This tax advantage has been eliminated.

It is worth noting that Panama does not tax the issue of shares or corporate capital contributions. The commercial license tax is levied on the patrimony, not only on the capital, at a maximum of USD 60 million.

Deferred Settlement

If the shares are going to be paid in several installments over a period of time, it could be agreed that they are to be transferred proportionately, to avoid having to pay income tax for the whole transaction when the first payment is made.

Other Considerations

The buyer is obliged to withhold 5 percent of the transfer price as an income tax advance. If it doesn't, the tax authorities can demand that the selling company pays the corresponding tax.

Concerns of the Seller

The seller's main concern would be to obtain a tax refund if the 5-percent withholding made by the buyer turns out to be higher than 10 percent of the actual gain.

Company Law and Accounting

Mergers that do not comply with the above provisions shall be considered, unless proven otherwise, as taxable transactions. The merger agreement between the merging companies must comply with the provisions of Law 32 of 1927, which regulates companies, and for the merger to become effective, the agreement must be registered at the public registry. All registered properties of the merging companies shall be registered under the name of the surviving or merged company, according to the merger agreement, and subject only to the payment of the applicable public registry rates.

The Directorate General of the Revenue shall be informed of a merger within 30 days of its registration at the public registry. The surviving or merged company will acquire the tax obligations of the merging companies, but will not be entitled to deduct the losses of the merging companies from its income tax.

Mergers by creation (consolidation) are subject to the tax rates applicable to the registration of a new company, and mergers by absorption are subject to the tax rates applicable on the increase of authorized capital, if any, of the surviving company. If there is no increase in capital, the applicable tax rate will be that for the registration of company minutes.

Shareholders of the extinguished company will not be subject to income tax, income tax on dividends, or complementary tax if they only receive share certificates in return for the shares they held in the extinguished company. They will also be exempt from the above mentioned taxes, if they receive small cash payments to avoid the elimination of the surviving company's stock, as long as the said payments do not exceed one percent of the value of the shares the shareholders receive in return of their shares in the extinguished company.

Foreign Investments of a Local Target Company

Mergers involving one or more foreign companies are duly recognized by Commercial Code, subject to the condition that those companies are registered at the Public Registry of Panama. If the surviving company is a

foreign company, a five-year period of registration is required after the merger has taken place.

If the Panama target company has operations outside of Panama, it may have foreign source income. Foreign source income is exempt from income tax for the company, but the dividends it may distribute out of that foreign source income are subject to dividend tax.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

If the capital gain is low, the applicable 10-percent tax on the gains may be lower than the 5-percent tax on the total value of the transfer that would apply in a share transfer.

Disadvantages of Asset Purchases

The transfer of real estate is subject to a 2-percent transfer tax.

The tax is ultimately levied on the capital gain, at a rate of 10 percent. Nonetheless, the taxpayer will be obliged to pay 3 percent of the total value of the transfer as the capital gains tax, and if such an amount were higher than 10 percent of the actual gain, a refund or a tax credit may be requested before the Tax Administration.

Advantages of Share Purchases

The seller may choose to treat the 5 percent withholding on the purchase price as the final tax.

It is not subject to any other taxes.

Disadvantages of Share Purchases

In some circumstances the 5 percent withholding on the transfer value will be higher than the 10 percent of the actual gain. If such were the case, the withholding would have to be made anyway, and the seller would then have to ask the Tax Administration for a refund. The refund process may be a lengthy.

Withholding Tax Rate Chart

Regardless of the country, payments made to foreign creditors will be subject to, if applicable, a 15-percent income tax withholding rate.

Panama is currently in the process of negotiating several Tax Information Exchange Agreements. So far, an agreement has only been reached with Mexico.

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