

CHAPTER X: INCOME TAX

In the Republic of Panama, it is an essential constitutional principle that no one has to pay any contribution or tax unless it is legally established, and unless its collection is carried out as prescribed by law (Article 48 of the National Constitution).

In 1991, Legislature passed Law No.31, known as the “Tax Reform Act”. According to the National government, the provisions set forth in this law had for purpose promoting tax fairness by reducing tax rates, and modernizing the fiscal administration. Furthermore, in October of 1993, Executive Decree No.170 whereby provisions contained in the Fiscal Code concerning Income Tax are regulated was passed and then amended by Executive Decree No. 198 of December 30, 1993. Also, in June of 1995, the Legislature enacted Law No.28, otherwise known as the “Law for the Universalization of Fiscal Incentives”. Basically, this law contains several provisions that amend the Fiscal Code of the Republic of Panama, in an effort to introduce tax incentives in the productive area, in order to standardize all producers and manufacturers status.

Because of the on going necessity for the adaptation of the Panamanian Tax System to international demands, at the end of 2002 was enacted the Law No. 61, whereby is promoted the reorganization and simplification of the Panamanian Tax System. As indicated by its denomination, this law has framed the reorganization and simplification of the Panamanian Tax System and the creation of different aspects concerning tax legislation, as Income Tax, Real Estates and Chattels Transfer Tax, Consumption Selective Taxes, Tax Incentives, and Revenue Stamps, among others.

The Internal Revenue Service of the Ministry of Economy and Finance is the government office in charge of overseeing and collecting revenues, services, rights, taxes, tolls, fees, duties, and excise taxes on account of the National government.

1. Basic Principles Governing Income Taxes

The Panamanian Fiscal Code definition of taxpayer is “any person or legal entity (corporation or partnership), national or foreign, receiving taxable income”.

a) Income Source

According to the Fiscal Code, any income that is generated from any source within the territory of the Republic of Panama is subject to income tax, regardless of the place where it is paid or received, of who may be the payer of the same and independently of the nationality, domicile or residence of the recipient.

Incomes from a source in the Republic of Panama are:

i) Income generated from civil, commercial, industrial or similar activities and from the practice of professions, occupations, and any other kind of service rendered, performed or exercised within the territory of the Republic of Panama.

When the services rendered implies the performance of work both inside and outside the National territory, only those services rendered within said National territory shall be considered of Panamanian source, and their amount shall be determined according to the proportion of the man-hours worked inside and outside the National territory, or according to some other economic criteria, duly proven and accepted by the Internal Revenue Administration.

ii) Income generated from goods produced or rights economically used in the Republic of Panama or from capitals or securities economically invested in the National territory,

such as interests on loans, interest on monetary deposits, interest on securities and documents, dividends and other distribution of profits among shareholders or partners; profits from branch offices established in Panama by borne offices located abroad, lease payments from movable goods economically used in Panama, royalties, periodic subsidies, income from the assignment of manufacturer's or merchant's trademarks, patents of invention, life annuities and any other income or rent obtained from (sources) within the Republic of Panama, either through the use of goods or the rendering of services.

b) Foreign Income Source

Exclusively for income tax purposes, income derived from the following activities is not considered as produced within the territory of Panama:

i) Interest, financial commissions or other similar captions earned by natural or juridical persons, independently of their place of organization or domicile, coming from loans, money deposits or any other financial operation, carried out with borrowers domiciled outside the national territory, as long as the service rendered and the use of the money are made outside Panama, even though, the capital or interest reimbursement is effected in the country.

ii) Interest, financial commissions or other similar captions, arising or resulting from loans, lines of credit, or any other kind of financial operation executed with juridical persons, independently of their place of organization or domicile, while these persons exclusively receive or earn income not produced or not considered to be produced within the territory of the Republic of Panama, including those earned in the Republic of Panama by non-taxable interest, financial commissions or similar, shall not be deemed of Panamanian source.

iii) Re-invoicing, merchandise that arrives to Panama's National Ports or Airports in transit to another destination (by transit meaning merchandise or products that arrive in Panama's Airports or Ports only to continue on to another foreign destination, with documents that indicate that they are consigned to persons not resident in the Republic of Panama, and with shipping documents that indicate that such merchandise or products shall be shipped abroad immediately after arrival). These merchandises shall remain under the official custody of Customs Authorities, who will ensure that such merchandises are not illegally introduced into the fiscal territory of Panama.

iv) Re-invoicing or invoicing merchandise or products from an office established in Panama for sums exceeding the amount charged to the company located in Panama, as long as the merchandise or products sold are handled exclusively abroad.

v) Managing, from an office established in Panama, operations that are formalized completed, or that take effect abroad.

vi) Dividends or profits-sharing earnings received from corporations if they are derived from income not produced within the territory of the Republic of Panama.

c) Gross Income

Gross income refers to the total income, before deductions, that the taxpayer receives from whatever source and under whatever form (in money or in kind). Items to be included in gross income are provided by law such as: salaries, wages, overtime, commissions, bonuses, fees, rental payments, retirement payments and pensions, profits from industrial, commercial and agricultural activities, royalties, goodwill, trademarks and patents, interest and revenues, dividends, profits from sale of realty and/or personal

property, rewards for denouncing illegal practices, and the unsubstantiated increase of capital or equity.

2. Exemptions

The following are some types of incomes exempted from taxation:

- Income of churches of any denomination, seminaries and religious or charitable societies, when such an income is obtained as a direct result of worship or charity.
- Income of asylums, houses of charity, orphanages, foundations and non-profit organizations duly recognized, provided that such income is destined exclusively to social assistance, public welfare, education or the promotion of sports.
- Taxable income received by individuals from any source that does not exceed three thousand dollars (US\$ 3,000.00) annually.
- Gross income of wage-earning natural persons not exceeding US\$ 10,400.00 annually, and whose monthly remuneration average during working months over the fiscal year does not exceed US\$ 800.00.
- Interest earned over certificates of deposit or savings banking accounts.
- Interest earned over bonds, notes and other debt instruments issued by the Government.
- Interest and dividends paid on private bonds and stock registered with “Comisión Nacional de Valores” (Securities and Exchange Commission) and with an authorized exchange, as well as capital gains thereof.
- Income from Maritime International Commerce or national merchant vessels lawfully registered in Panama.
 - Income of sums received or collected by persons abroad for royalties derived from the Colon Free Zone.

3. Taxable Corporations Income

Taxable income of corporations is the balance of gross income less deductible disbursements and expenses.

4. Deductible Expenses

Deductible expenses are disbursements incurred in the production of taxable income or in the maintenance of its source. The expenses incurred must be related to Panamanian income source. Consequently, expenses incurred to produce foreign source of tax exempt income are non-deductible. If the proportion that actually corresponds to each kind of income cannot be determined, the expenses incurred to obtain both taxable and nontaxable income shall be deductible from taxable income, in the proportion with respect to total or gross income.

All disbursements related to expenses must be supported by proper documentation in order to be deductible, and it is understood that “proper documentation” is the one meeting the specifications set forth for the implementation of Law No.61 of 2002 by the General Directorate of Internal Revenue.

Deductibility of expenses originated between a corporation and its subsidiaries and affiliates, or its directors, officers, executives and shareholders, or their blood relatives within the fourth degree, and in-laws within the second degree, are restricted when both parties do not use the same accounting system, being then only deductible in the taxable

year in which they are actually paid.

a) Interests and Royalties

Interests and royalties are deductible expenses under the general principle and are taxable income to the recipient. When payments are made to non-resident individuals or corporate entities, income taxes must be withheld by the payer. Payments are considered on an aggregate basis for separate calendar years. Royalties paid by companies located in the Colon Free Zone to non-residents are not taxable and thus, not subject to withholding.

b) Depreciation

Concerning this matter, it is appropriate to point out that the annually permitted depreciation due to wear and tear or exhaustion is that which is affected over fixed assets employed by the taxpayer in its business, industry or profession and activities linked with the production of taxable income.

As a rule of thumb, the correct value of the asset over which depreciation is to be calculated upon shall be that of its cost, and also that of the permanent improvements incorporated to said asset, if that is the case. The value of its cost shall also include, besides the value of the invoice, all expenses associated with the purchase, installation and assembly of said asset, such as purchase commissions, insurance and freight expenses, introduction taxes and other expenses related with the purchase and installation and interests incurred during the period of construction.

To calculate the depreciation of a particular asset, the useful economic life of a particular asset has to be taken into consideration, which shall depend on the activity and conditions under which said asset is used, the regular turns of activity, the quality of maintenance, the possibility of obsolescence and the depreciation tables of technical value. Nonetheless, in no case shall it be permitted to have useful economic life of less than three (3) years for personal property and less than thirty (30) years for real estate property.

Methods for calculate depreciation that contemplate the useful economic life of the asset are: a) direct or straight line calculation, which applies a fixed percentage over the original cost; b) decreasing value, which applies a fixed percentage to the decreasing balance of the value in terms of cost; c) that which employs the digit sum of the years of useful life and, dividing its original value cost from said sum, and multiplying, each year, the quotient by the digit of that particular year be it in a decreasing or increasing manner.

Notwithstanding the above described methods, in Panama there is the concept of flexibility in depreciation, which permits the tax payer to depreciate an asset using any depreciation method that is accepted in accordance with the generally accepted accounting principles, and also permitting the tax payer to apply one method to a particular asset and a different method for another.

In financial leasing contracts, it is up to the lesser to depreciate the asset over the term of the contract, which must be at least for three years, using the depreciation criteria provided by the law. The base for the calculation of the depreciation will be the acquisition value including sales taxes.

c) Other Deductible Expenses

Other deductible items are:

- i) Donations to non-profit educational and charitable institutions of Panama, provided that these institutions have been previously approved for such purposes by the corresponding authority.
- ii) Donations to the central government, its institutions, the Municipalities and the community Boards.

5. Dividends

Corporations distributing dividends or profits to their shareholders must withhold ten percent (10%) of such amounts, which corresponds to the dividend tax. If dividends or profits are not distributed, or the total dividends or profits distributed are less than forty percent (40%) of the net income, dividend taxes must be withheld over forty percent (40%) of the net income after taxes; or in other words, at a four percent (4%) rate over the total net income after taxes. This four percent (4%) rate is known as the "Complementary Dividend Tax". The other six percent (6%) will be paid when such dividends or profits are actually distributed. Branches of foreign corporations shall withhold and pay ten percent (10%) of their total net income. The tax rate subject to withholding will be twenty percent (20%) if the stock of the corporation is issued in bearer form. In case the corporation has both types of stock, the tax must be paid according to the rates for each kind; unless the dividends distributed were less than forty percent (40%) of the net profits, or if no distribution were made, in which case the rules for the complementary tax will apply regardless of the type of stock issued.

Distribution of profits from non-taxable or foreign source income, as a general rule, is not subject to the dividend tax. Distribution of earnings derived from export and re export sales from companies established in the **Colon Free Zone** is not subject to dividend taxes. However, distribution of earnings derived from internal sales of those companies in the Republic of Panama is subject to the dividend tax.

Distribution of profits derived from the disposition of securities pertaining to companies registered before the National Securities Exchange Commission ("Comisión Nacional de Valores"), whose securities are negotiated in an stock exchange or are issued as the result of mergers & acquisitions, will not be either subjected to the payment of neither dividend taxes nor complementary dividend taxes.

6. Capital Gains

Profit obtained from the sale of any personal property is considered taxable income, with the exception of capital gains over debt and equity registered with the "**Comisión Nacional de Valores**" (Securities and Exchange Commission) and listed on an authorized exchange.

7. Tax Rates for Corporations

The Law for the Universalization of Incentives passed in June of 1995, modified the Tax Reform Act of 1991, which provided for a progressive corporate tax rate which was to be gradually eliminated through 1994, and then, corporations would be taxed at an only rate of 30% for net income up to US\$500,000.00 and another rate of 34% plus US\$ 150,000.00 for amounts exceeding the first US\$500,000.00 of those same corporations. However, the new Law implanted a uniform tax rate for corporations of 30%, regardless of the amount of income earned by said corporation.

Some exception to the rule hereinbefore are the corporations recorded in the Industrial Registry, corporations having executed contracts with the Government pursuant to Cabinet Decree No.413 of 1970, or companies having executed contracts implemented

as national laws in order to develop an industry. The companies shall pay taxes at a rate of 30% over net income up to US\$500,000.00, and other rate of 34% plus US\$ 150,000 for the sums exceeding US\$500,000.00.

8. Tax Rates for Natural Persons

The Law for the Reorganization and Simplification of Taxes added, as a new form of income tax exemption, the gross income causes by a natural person not exceeding ten thousand four hundred dollars (US\$10,400.00) annually, provided that the said income constitute the sole income source of the concerned person, and the monthly average of his/her remuneration for the months worked during the fiscal year does not exceed eight hundred dollars (US\$800.00). If the gross income of a wage earning individual does exceed ten thousand four hundred dollars (US\$10,400.00) annually, the tax to be paid shall be limited in a way that after its deduction from the said income, the resulting amount shall not be inferior to the said ten thousand four hundred dollars (US\$10,400.00).

9. Special Tax Rates and Regulations

For tax purposes, branches of foreign corporations established in the Republic of Panama must keep their accounting records for Panamanian operations separated from head office or other branch records. Foreign corporation branches must withhold ten (10%) of their total net income after taxes. This withholding tax is paid along with the annual income tax return. Other than this, there are no special rules for taxing branches of foreign corporations, and all general rules apply to them.