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Panama tax reform includes changes to withholding tax rules

Law 27, which applies as from 5 May 2015, makes some important amendments to Panama's tax code, including changes to the withholding tax treatment of payments made to nonresidents and the introduction of rules for such persons to qualify for a withholding tax exemption on certain types of income.

Withholding tax

Payments made to nonresidents (whether individuals or entities) are subject to withholding tax where the payments relate to the generation of Panamanian taxable income or the preservation of capital and are deductible for Panamanian income tax purposes by the payer. In line with this principle, withholding tax generally has not applied if a Panamanian entity treats the payment as a nondeductible expense or if the payments are associated with an exempt or a foreign-source type of income that is not subject to taxation in Panama.

Law 27 does not change the fundamental withholding tax principles, in the sense that the applicability of the tax depends on whether the payment affects the generation of Panamanian taxable income or the preservation of capital and whether the payment is treated as a deductible expense. However, the scope of the withholding tax obligation is extended to apply to all payments made by governmental entities, companies owned 51% or more by the Panamanian government, "noncontributing" entities (i.e. entities not subject to income tax) and taxpayers incurring losses. It appears that the broadening of the scope of the tax will require companies operating under a tax incentive regime to withhold tax on remittances abroad, regardless of whether they earn income subject to tax in Panama; under the principles described above, these companies previously were not required to withhold income taxes. The Finance Ministry is expected to issue guidance that will clarify which types of noncontributing entities are subject to these revised withholding tax rules.

Withholding tax exemptions

Law 27 introduces new requirements regarding income tax on dividends, interest, royalties, fees or similar payments made to nonresidents by persons or entities domiciled within Panama, when such payments are exempt from withholding tax under any special domestic law. The exemptions will not apply, however, if the recipient of the payment would be able to credit the taxes paid in Panama against the tax payable in its home country if the exemption were not available. The Panamanian tax authorities will allow an exemption only where the recipient of the payments presents a written opinion issued by an independent "tax expert" (a term that is undefined in the law, but that likely will mean an individual who, under the laws of his/her country, is allowed to provide advice on tax matters) in its home country as evidence that withholding tax paid in Panama could not be credited against the tax due in the recipient's country under the domestic law of the country. The same requirement will apply to obtain a partial tax exemption in Panama if the law of the recipient's home country permits only a partial credit for withholding tax paid in Panama.

Law 27 also introduces limitations on the access to tax benefits for branches of foreign companies, which will prevent the application of an income tax exemption in Panama if a foreign tax credit can be claimed in the foreign entity's country of residence for taxes that would be payable in Panama if no exemption applied. As indicated above, the lack of availability of a foreign tax credit will have to be supported by a formal opinion from an independent tax expert.

Other provisions

Other relevant provisions of Law 27 include the following:

Dividends on preferred shares: Panama's tax legislation previously included specific rules applicable to cumulative preferred shares; the treatment of dividends paid from these shares differed from that applicable to the payment of dividends from shares of common stock. Dividends paid on preferred shares by resident companies to other resident companies were exempt from the dividends tax (which generally applies at a 10% rate), but, under certain conditions, a tax deduction for the dividends distributed was allowed to the distributing company. Law 27 repeals the provisions that exempted these shares from dividends tax, as well as the option to take a tax deduction for any distributions made.

Distributions from real estate investment trusts (REITs): According to legislation introduced in 2010, REITs are exempt from income tax and their shareholders are exempt from capital gains tax on disposals of REIT shares if certain conditions are satisfied. However, shareholders are required to pay income tax at a 5% preferential rate (levied via a withholding mechanism) on distributions made by the REIT. Law 27 increases the withholding tax on distributions to shareholders to 10%.

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