

A promising future

Ricardo Arango and Julianne Canavaggio of Arifa
examine recent changes to the tax regime and the
country's adoption of new antitrust regulations

The Panamanian economy has experienced a period of unprecedented growth with a noteworthy spike in foreign direct investment. The influx of foreign capital has become one of the principal drivers of business in Panama and it has arrived in the way of foreign businesses establishing themselves in Panama and investors looking for local opportunities.

Panama has an investment rate of 30%, much higher than the rest of the region's 22.7% average. However, the increased rates of investment in the region have also fed into Panama's growth. Latin America's economy grew at approximately 6.1% in 2010 and for 2011, economists forecast an 8% growth for Panama, which would make it the fastest growing country in the region.

The approval of the \$5.25 billion expansion of the Panama Canal, and other mega infrastructure projects in the works (such as the proposed underground metro transportation system), have contributed to this spurt in foreign investment. Major multinational companies have established regional offices or headquarters in Panama. As a result, while the international financial crisis caused many regional economies to shrink, Panama was one of the few Latin American countries that avoided recession and experienced a GDP growth rate of approximately 4.5% in 2010. The rate for 2011 is expected to be around 6.7%.

It is no coincidence that, through 2010, the Panamanian economy's most important sectors have seen plenty of cross-border M&A activity in the last two years. In the first quarter of 2010, for example, the banking sector saw the purchase of BNP Paribas Panama Branch's commercial and private banking business, by the Bank of Nova Scotia. Likewise, there was also significant activity in the insurance and reinsurance, industrial services, telecoms and media, and dairy sectors.

With the increase in foreign direct investment and the spike in capital markets transactions, Panama also saw the strategic reorganisation of the Panama Stock Exchange (*Bolsa de Valores de Panamá*) and Latin Clear (*Central Latinoamericana de Valores*). This reorganisation aims to crystallise the evident synergies between the exchanges, and better position the two to compete as part of a unified group in the Central American and Andean markets. Following the successful reorganisation, the resulting group will leverage the competitive position of Panama's financial centre (by far, the largest banking centre in Central America, measured in terms of assets) and its liquidity to become also one of the leading regional stock exchanges of Latin America.

Some of these recent transactions have been driven by the usual needs to consolidate, control costs, and exploit synergies in very competitive environments. However, increasingly, M&A activity in Panama, and across the region, is being driven by the slow, but steady, upturn in the global economy, and the need to develop new international markets and expand market share. Significantly, some of the most important transactions in Central America have included a Panamanian target, whether it is an operating company or a holding company registered in Panama with operations in the region.

M&A taxation

One of the main drivers of any sell-side deal structuring is taxes. The structure of an acquisition is usually influenced to a large extent by a need to make the transaction tax effective for the seller, without causing adverse tax consequences to the buyer. As Panama generally follows a territorial system of taxation, only Panama-source income (generally income and capital gains realised in connection with a trade, business or real estate transaction in Panama) is taxable in Panama. Thus, mergers or acquisitions of companies organised in Panama that do not carry-on any trade or business or own assets within Panama are generally not taxable.

In Panama, mergers or acquisitions are generally structured as either stock-for-stock transactions, stock-for-cash transactions, or a combination of both. Acquisitions can also be fashioned as a straight

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purchase of shares or a purchase of assets. A brief description of the tax treatment of each follows.

Stock-for-stock/Stock-for cash mergers

In Panama, stock-for-stock mergers are tax-free transactions, provided that (i) no cash is paid out (except up to 1% of the value of the transaction for adjustments of fractional shares) and (ii) certain other accounting parameters are followed. In a stock-for-stock merger, the shareholders of the merged company keep a tax basis on the shares of the surviving company that they receive equal to their average pre-merger tax basis of the surrendered shares.

Stock-for-cash mergers are not tax-free transactions. Gains realised by selling shareholders in these transactions, which are deemed to be gains from Panama-source income, are subject to a 10% capital gains tax. The capital gain is the difference between the selling price allocated to Panamanian sources and the tax basis of the shares owned by the selling shareholder.

Notwithstanding the foregoing, the law requires buyers to withhold 5% of the total purchase price allocated to Panamanian sources, as an advance of the capital gains tax and directly pay this amount to the tax authorities within 10 days of the transfer of the shares. It is important to note that the buyers, as well as the target company whose shares are being acquired, are jointly and severally liable with the buyer for the payment of the 5% advance capital gains withholding. If the 10% capital gains tax on the realised capital gain is less than the 5% advance withholding, sellers can request a tax credit for the difference. This credit must be used the same fiscal year than the capital gain is realised.

Alternatively, sellers can choose to treat the 5% advance capital gains withholding as the final and definitive capital gains tax payable in connection with the sale of the shares. In practice, most sellers pay the 5% purchase price capital gains withholding, as it is difficult for most sellers to request and use the tax credit on the same year that the transaction took place. Notably, although the capital gains tax only applies to gains from Panamanian sources, to this date no rules regarding purchase price and/or income allocation have been enacted.

Stock purchases

Stock purchases are subject to a 10% capital gains tax on Panama source gains in the same manner that stock for cash mergers are taxed, including the 5% advance with-

“Companies with both Panama-source income and non-Panama-source income present a unique tax issue”

holding obligation. The Department of Revenue of the Ministry of Economy and Finance has repeatedly taken the position that capital gains tax applies to the sale of the shares not only of Panamanian corporations, but also of any upstream company, regardless of its jurisdiction of incorporation, as long as this company, directly or through one or more subsidiaries, has Panama-source income.

Asset purchases

Asset purchases are generally taxable events in Panama. Gains realised on the sale or disposition of assets located in Panama are generally subject to a 10% capital gains tax. In addition, the transfer of chattel property, such as inventory or equipment, is subject to a value added tax equal to 7%, and the transfer of real estate is subject to a 2% transfer tax. In addition, buyers of an ongoing business concern must be aware that they will become liable for past taxes of the business, even if they are buying the assets of the business and not the stock of the company.

Taxation of dividends for companies with operations in Panama

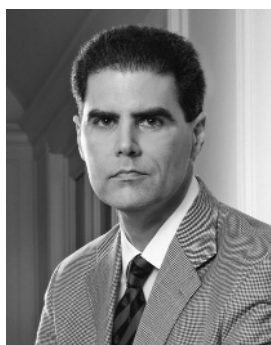
Frequently, M&A transactions involve either a pre-closing dividend to exclude assets from the transaction or a post-closing dividend to distribute gains to shareholder. In this regard, as a general rule, corporations in Panama are subject to a 10% dividend tax (20% if the shares are issued to bearer), on Panama-source income. Thus, income that is not Panama-source income is generally not subject to dividend tax in Panama. However, due to a recent tax reform, if the company paying the dividend engages in commercial or business activities in Panama that requires the company to obtain a business license (*aviso de operación*), then in addition to paying the 10% dividend tax on Panama-source income, it is also subject to a 5% dividend tax on non-Panama-source income.

Goodwill

Goodwill is another frequent point of conflict between buyers and sellers. Buyers generally want to be able to claim a tax deduction for the amortisation of any goodwill paid in the acquisition. However, amortisation of goodwill is only deductible in Panama if the seller recognises the goodwill as income on its annual tax return.

Purchase price allocation

Companies with both Panama-source income and non-



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His practice focuses on securities regulations; banking and finance; mergers, acquisitions and joint ventures; corporations; and taxation. He has been instrumental in the creation of many financial structures that are common place in Panama today and has acted as lead counsel in connection with the largest M&A transactions in the country.

Arango been endorsed as leading corporate/M&A lawyer in Panama by several international publications, and was ranked "star performer corporate /M&A lawyers in Panama" by one. He has an LLM from Yale Law School, a LLM

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Panama-source income present a unique tax issue. Since Panama taxes only apply to Panama-source income, any gain realised on the sale or disposition of stock or assets of these companies should be allocated between the two kinds of income (Panama- and non-Panama-source). In the case of an asset sale, such an allocation is relatively easy to do, based upon the location of the asset. However, Panama has yet to adopt rules of income allocation for stock purchases. As such, in cross-border stock purchases or mergers, transactions are often structured so that the sale of Panama-based assets or operations are segregated and sold separately from the operations in other jurisdictions.

Corporate authorisations

Mergers

Panama law allows a company to be absorbed by another company, regardless of the jurisdiction of incorporation of the companies (merger by way of absorption), and also allows two companies to merge forming a new consolidated entity. Under Panama law, upon a merger becoming effective, the absorbed company ceases to exist as a legal entity by operation of law, and the surviving company assumes all the assets, rights, licences, capital, liabilities and obligations of the absorbed company by universal succession.

Unless the articles of incorporation state otherwise, for a merger to become effective in Panama, a merger agreement must be executed by at least a majority of the directors of each company and approved by the holders of at least a majority of issued and outstanding shares of each company. The merger agreement must then be registered with the Registry of Companies in Panama, whereupon the merger becomes effective, unless a later effective date is defined in the merger agreement.

Stock and asset purchases

Unless the articles of incorporation state otherwise, the acquisition of a company, regardless of whether it is structured as a stock or an asset purchase, generally requires approval from a majority of the directors of the acquiring company. On the other hand, the sale of a company, if it represents all or substantially all of the assets of the seller, generally requires approvals from both a majority of the

directors and from the holders of at least a majority of all the issued and outstanding shares with the right to vote of the selling company.

Antitrust and competition

In Panama there is no mandatory merger control approval process; the process is entirely voluntary. That said, with the new antitrust and competition regime established by Law 45 of 2007 (Competition Law), as amended and regulated, economic concentrations created by the mergers of conglomerates within the Panamanian market have come under increasing, albeit still limited, scrutiny by regulators.

The Competition Law prohibits economic concentrations whose effects may unreasonably restrict or harm free competition. An "economic concentration" is defined as the merger, acquisition of control, or any other act pursuant to which corporations, associations, shares, trusts, establishments or any other kind of assets are combined, and which occurs between suppliers or potential suppliers, customers or potential customers, and other competing or potentially competing economic agents. The law applies to any acts or practices that may unreasonably restrict or harm free competition, and whose effects take place in Panama, regardless of where those acts have been carried out or perfected.

The Competition Law does not prohibit all economic concentrations but only those whose effects may unreasonably restrict or harm competition. In addition, the Competition Law expressly provides that the following business combinations shall not be deemed prohibited economic concentrations: (i) joint ventures formed for a definite period of time to carry out a particular project, which is also contemplated in other jurisdictions; (ii) economic concentrations among competitors that do not have harmful effects on competition and the market; and (iii) economic concentrations involving an economic agent that is insolvent, if certain conditions are met, which is, roughly speaking, equivalent to the so-called failing company exemption prevalent in other jurisdictions.

Moreover, economic concentrations with restrictive effects on competition may obtain clearance from the Competition Authority if the restric-

tive effects of the concentrations are outweighed by their contribution to obtaining further efficiencies, such as: (i) improvements in the commercialisation and production systems; (ii) fostering technical and economic progress; (iii) improvements in the competitiveness of the industry; and (iv) contributions to consumer interests.

If advance verification for the economic concentration is sought and approved, the economic concentration cannot be subsequently challenged. If no advance verification is sought, and after the consummation of the transaction the Competition Authority considers the economic concentration to unreasonably restrict or harm free competition, within three years following the effective date of the transaction the Competition Authority may file a lawsuit with a specialised superior court seeking that conditions be imposed on the parties to ensure competitiveness in the marketplace, or seeking a partial or complete divestiture of the concentration (or both).

Regulatory approvals

Regulated entities

Governmental approvals, consents, filings and/or notices are required in connection with the merger or acquisition of companies that operate in certain regulated industries. For instance, the merger or acquisition of the stock or assets of a bank or trust company licensed to operate in Panama must obtain prior approval by the Superintendence of Banks. Similar prior approval is required from the National Securities Commission for the acquisition of companies licensed to operate as broker-dealers in Panama. Other similar approvals or notices are required for companies in the insurance, public utilities, and radio and TV industries, among others. Bank mergers and acquisitions may also generate additional potential regulatory issues, as the acquiring company must meet post-merger capitalisation and lending limit requirements.

Publicly-held companies

A host of issues and reporting obligations are triggered where one of the companies in a merger or acquisition is a publicly held company - a company whose shares are registered with the National Securities Commission. For example, a publicly-



About the author

Listed among leading players identified by the top publication *LatinLawyer* 250 in its 2010 edition, Julianne Canavaggio received top reviews from clients and peers alike for its M&A sustained achievements and has been praised as a lawyer "increasing in prominence".

Canavaggio's practice focuses on mergers, acquisitions and joint ventures; corporations; banking and finance; and securities regulation. Before joining ARIFA, she worked as an associate with Baker & McKenzie in Houston.

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held company is required to make immediate public announcements of material events which are reasonably expected to have a significant effect on its stock price, unless the board of directors or management has reasonable grounds to believe that such disclosure would be seriously prejudicial to the interest of the company. Thus, acquiring and target companies frequently face the issue of determining when negotiations have advanced to such a point that a disclosure is necessary.

In addition, if the proposed merger or acquisition must be approved by the shareholders of a publicly-held company, any proxy solicitation by the board of directors of the company or by another person or group of persons is subject to special proxy solicitation rules and filings. Further, when a buyer of a publicly-held company elects to make a tender offer, the offer is subject to special tender offer rules intended to guarantee fair treatment to all shareholders and transparency of the transaction. The offer must remain open for no less than 30 days, creating a risk of competing offers being made.

Foreign ownership restrictions

Generally, there are no foreign ownership restrictions in Panama. However, for reasons of national security and national interest, ownership of local companies by foreign governments or foreign nationals is restricted in certain industries, including aviation, radio and TV, and companies engaging in retail trade, among others.

Restrictions on retail trade

The Constitution limits retail trade to: (i) Panamanians by birth; (ii) individuals who on the date the Constitution came into force (October 1972) were naturalised and married to a Panamanian national or had children with a Panamanian national; (iii) Panamanians by naturalisation who did not fall under (ii) above, three years after receipt of their definitive letter of naturalisation; (iv) Panamanian or foreign legal entities or foreign individuals who on the date the Constitution came into force were lawfully engaged in retail trade; and (v) legal entities formed by (a) Panamanians or (b) foreigners authorised to carry out retail trade under relevant provisions, and those entities that although not constituted in the manner expressed in (a) and (b), carried out retail trade at the time the Constitution came into force. The relevant article also states that foreigners who are not allowed to carry out retail trade may have a participation in companies which sell products they have manufactured. As such, foreign participation in Panama's retail services market is generally prohibited.

Notwithstanding the foregoing, there are three alternatives to this general rule which may be available to foreign parties wishing to acquire local targets engaged in retail trade: (i) the acquisition of a legal entity which on the date the Constitution came into force was lawfully engaged in retail trade (a grandfathered company); (ii) participation in a company which sells products it has manufactured; or (iii) dividing the target company's operation into various companies so that a Panamanian strategic partner is the sole shareholder of the operating company which engages strictly in retail trade and the foreign shareholders own entities that hold the valuable assets of the target operation (real estate, right to use trademarks, and so on).

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Labour considerations

In a merger scenario, the surviving company assumes the labour relations and liabilities of the absorbed company. Similarly, in stock acquisitions the target company retains responsibility for labour relations and liabilities. However, asset acquisitions present a special case. If the sale comprises all, or substantially all, of the assets so that the business operation is transferred, both the buyer of the assets (as the new employer), and the seller of the assets are, for a one year period following the acquisition, jointly and severally liable for all labour liabilities arising before the acquisition of the assets or business. Furthermore, employees retain all their rights and benefits and no adverse changes can be made to their terms of employment. Thus, in many asset acquisitions, and insofar as may be legally feasible, buyers require sellers to terminate all or certain labour relations as a condition precedent to closing, in order to be able to rehire some employees on more favourable terms to the extent permitted by law.

Increasing complexity

The Panamanian legal system is a civil legal system: historically, in transactions and other commercial dealings the contract parties relied heavily on statutory law. That is, the parties would contractually address the main obligations, and Panamanian law would fill out the gaps on other issues, which resulted in purchase and sale agreements, or even financing agreements, running to only five to 10 pages. As the Panamanian economy grew and attracted foreign investment, however, local M&A was taken over by common-law-style concepts. Now, in traditional deals regarding a Panamanian target company, you will encounter preliminary agreements such as letters of intent or memorandums of understanding, as well as confidentiality/non-disclosure and/or exclusivity agreements. These preliminary agreements are typically followed by a due diligence process dealing with both the legal, operational, financial and technical aspects of the target. The main transaction agreement – whether a stock purchase agreement, asset purchase agreement or merger agreement – will address all relevant aspects of the transaction in detail. It will contain exhaustive representations and warranties, detailed conditions precedent, mechanisms for purchase price adjustments, escrows, remedies for breach, non-competition, termination, confidentiality, and so on. It is unusual to leave an aspect largely unregulated and leave it to the general laws to settle such issues should a dispute arise.

As Panama continues to attract significant regional economic groups, and foreign and multinational corporations seeking to take advantage of its unique geographical position, its free markets, and its investor-friendly climate, cross-border M&A in Panama and across Central America are likely to increase. Undoubtedly, the body of legislation affecting M&A in Panama will continue to evolve as transactions involve more international parties and they become more and more complex.