# How Panama M&A will grow

**Ricardo M Arango and Andrés N Rubinoff of Arias Fabregas & Fabregas explain why competition and tax changes will affect mergers in Panama**

The Panamanian economy has experienced a period of unprecedented growth with a noteworthy increase in the establishment of foreign businesses and investors looking for local opportunities. The approval of the expansion of the Panama Canal at a cost of approximately $5.25 billion and other mega infrastructure projects, such as the proposed underground metro transportation system, have contributed to this positive increase. Major multinational companies such as Procter & Gamble, Caterpillar, AES, Halliburton, LG, Hewlett-Packard, and 3M have also established regional offices or headquarters in Panama. As a result, while the international financial crisis caused many regional economies to shrink during 2008 and 2009, Panama experienced a gross domestic product (GDP) growth rate of approximately 2.4% for 2009, compared to 8% in 2008. The GDP growth rate for 2010 is expected to be around 4.5% to 5.5%.

It is no coincidence then that towards the latter half of 2009 and through 2010, Panama has enjoyed a resurgence in M&A activity. Indeed, the Panamanian economy's most important sectors have seen cross-border merger and acquisition activity. In the first quarter of 2010, for example, the banking sector, which is Panama´s economic stronghold, saw the purchase of BNP Paribas, SA Panama Branch´s commercial and investment banking business by the Bank of Nova Scotia. Likewise, in the insurance and reinsurance business, Mapfre America, SA, a Spanish based global insurer, acquired a majority of the shares of Aseguradora Mundial, SA, Mundial Desarrollo de Negocio, SA and their respective subsidiaries from Grupo Mundial Tenedora, SA.

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In the services industry, worldwide industrial services company Harsco Corporation acquired the leading engineering and equipment services provider to the infrastructure sector and the number one market leader in Central America and the Caribbean, ESCO Interamerica. The acquisition of ESCO formed an integral part of the Harsco Infrastructure group's Americas operations, immediately expanding the group's existing Latin America presence in Mexico, Chile and Peru with seven additional countries, including Colombia, Costa Rica, El Salvador, Guatemala, Panama, Trinidad and Tobago and Puerto Rico.

Locally, Panama saw the sale of Empresas Hopsa, SA´s majority interest in Mortero Seco Panama, SA a premixed dry mortar plant, to local and regional investors. Similarly, in the telecommunications and media industry, Medcom Holdings, merged its indirect subsidiary Cable Onda, SA with Telecarrier, resulting in a combined entity owned 51% by Medcom. and 49% by Telecarrier and related shareholders. This merger resulted in the only 100% Panamanian-owned telecommunications services provider of paid-TV, telephone, broadband internet and telecom affiliated services.

Some of these recent transactions have been driven by the usual need to consolidate and control costs and exploit synergies in very competitive environments. However, M&A activity in Panama and across the region is increasingly being driven by the slow but steady upturn in the global economy and the need to develop new international markets and expand market share. 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. So M&As 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 transaction, stock-for-cash transaction, or a combination of both. Acquisitions can also be fashioned as a straight purchase of shares or a purchase of assets.

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.

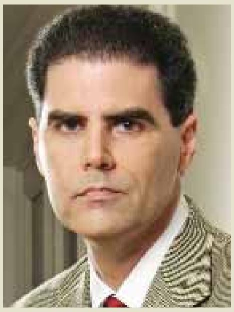
However, stock-for-cash mergers are not tax-free transactions. Gains realised by selling shareholders in these transactions, which are deemed to be gains from Panama source income, are subject to a 10% capital gains tax. The capital gain is the difference between the selling price allocated to Panamanian sources and the tax basis of the shares owned by the selling shareholder. Notwithstanding the above, 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 that the capital gain is realised. Alternatively, sellers can choose to treat the 5% advance capital gains withholding as the final and definitively capital gains tax payable in connection with the sale of the shares. In practice, however, most sellers end up paying the 5% of the purchase price, 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 income allocation have been enacted.

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 withholding obligations. It is worth mentioning that the Department of Revenue of the Ministry of Economy and Finance has repeatedly taken the position that the capital gains tax applies to the sale of the shares of not only Panamanian corporations, but to the sale of any up-stream 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 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 5% tax (increasing to 7% from July 1, 2010), 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 under current tax laws, 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.

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 shareholders. 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. 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 a 10% dividend tax on Panama source income, the company is also subject to a 5% dividend tax on non-Panama source income.

## Author biographies

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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.

Companies with both Panama-source income and non-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-source 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 Panamanian-based assets or operations are segregated and sold separately from the operations in other jurisdictions.

### Corporate authorisations

Panama law allows a company to be absorbed by another company, regardless of the jurisdiction of incorporation of the companies (straight merger) and also allows two companies to merge into a newly created entity (consolidation). 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, licenses, 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.

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.

### Regulatory approvals

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.

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

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 the aviation industry and the radio and TV industries, among others.

## Antitrust and competition

In Panama there is no mandatory merger control approval process. The process is entirely voluntary. That said, with the new

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antitrust and competition regime established by Law 45 of 2007 (the 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 restrictive 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 is 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.

## 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 prior to 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.

As the Panamanian economy continues to grow, it will continue to attract significant regional economic groups, foreign, and multinational corporations seeking to take advantage of its unique geographical position, its free markets, and its investor friendly climate. As a result, cross-border mergers and acquisitions in Panama and across the Central American region, are likely to increase. Undoubtedly, the body of legislation affecting mergers and acquisitions in Panama will continue to evolve as transactions become more and more complex.