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PANAMA
Transfer Pricing

In June 2010, the Legislature of the Republic of Panama passed the general statutory framework for its transfer pricing regime in Law 33 of June 30, 2010 [Panama's Transfer Pricing Statute]. Such rules shall serve as complementary to the international tax framework contained in those treaties to avoid double income taxation [DTTs] to which Panama is a signatory. Therefore, Panama's Transfer Pricing Statute shall apply only to arrangements between related parties insofar as the non-Panamanian related party is a resident of a Panama's treaty partner. Panama recently signed DTTs with Mexico, Barbados and Portugal and completed negotiations of DTTs with Italy, Spain, Belgium, the Netherlands, Qatar, France, Luxembourg, South Korea and Singapore.

The obligations contained in Panama's Transfer Pricing Statute shall become enforceable for the fiscal years commencing after the DTTs enter into effect. However, all of these treaties are still pending legislative ratification.

1. ***The arm's length principle***.

This short article purports to inform the multinational community in Panama, and the international tax community at large, of the general rules contained in the recently enacted Panama's Transfer Pricing Statute. In that sense, let us start by saying that Panama adopted the majority approach to transfer pricing, that is, ***the arm's length principle*** which is also the paradigm recommended by the Organization for Economic Cooperation and Development [OECD] as opposed to the formulary approach that has not yet made it out of heated academic discussion even though it is not lacking high-caliber supporters. This academic discussion, needless to say, is not the object of this informative article. The OECD Transfer Pricing Guidelines – as amended from time to time - shall also be applicable in Panama to the extent they do not conflict with the Panamanian Transfer Pricing Statute and regulations yet to be issued.

The arm's length principle purports to prevent evasion of income tax and double taxation. Thus, the Panamanian taxpayer must report taxable income measured by the arm's length standard when deriving from dealings with treaty partner related parties. Under the arm's length standard in Panama, a price would be considered appropriate if it is within a range of prices [the arm's length range] that would be charged by independent parties dealing at arm's length, meaning a price that an independent buyer

would pay an independent seller for a comparable item under comparable terms and conditions, where neither is under compulsion to act.

The arm's length price has become a global expression [adopted by the OECD fiscal committee]. It is important to highlight that in French and in Spanish [like in Panama], the arm's length principle has been typically translated as the principle of competition, but it is an utterly inaccurate translation. The arm's length principle is not the principle of competition which corresponds to other area of the law and shall not be confused with it. The arm's length principle is really a principle based on comparable transactions between unrelated parties [uncontrolled transactions] not on competition law principles. ***The arm's length principle is about independence not about competition.***

On a separate note, whether the Panamanian Transfer Pricing Statute as enacted in domestic legislation to complement Panama's DTT network and supplemented by the OECD Transfer Pricing Guidelines, provide the Panamanian Tax Administration with the legal ground to look for economic substance in corporate structures and transactions between related parties [controlled transactions] is a matter that might give rise to some debate in the future. In other words, shall the Panamanian Tax Authority have the duty to recharacterize items of Panamanian source income on economic substance grounds before applying transfer pricing rules to a specific cross-border transaction between related parties?

2. ***Valuation methods – conceptual framework***.

Under the arm's length paradigm, depending on the characterization of the asset, the valuation approach of the same may vary. This is also particularly important in the case of intangibles where the income approach applies[1]. Besides, having different methods (different valuation approaches) provides flexibility to the taxpayer and the tax authorities on which road to take to reach the most accurate arm's length price of the asset or service.[2]

There are three main approaches to valuation: the cost approach, the market approach and the income approach; and the different transfer pricing methods as enacted in Panama pertain to these different approaches.

[1] It is not clear whether the Panamanian legislature intended the requirement of hindsight for the valuation of intangibles. This is an issue that should be expressly clarified in regulations to come even though the OECD rejects the requirement of hindsight.
[2] Under formulary apportionment, the total profits of the world wide activities of a multinational enterprise would be distributed among the relevant jurisdictions according to a predefined allocation key.

The ***cost approach*** implies that nobody would pay more for an asset than what it would cost to duplicate it. However, in the case of intangibles, there is usually no link between the cost and the value of an intangible.

On the other hand, the strength of the ***market approach*** lies in its use of external markets [comparables] since these are considered to give the most objective result. It works best with tangible goods and services. When it comes to intangibles, however, the need for external markets is also the weak point of the market approach.

Third, the estimated future income of an asset is the base of the ***income approach***. Applying this approach includes estimating the future benefits that the asset will bring to the enterprise. The disadvantages of the method are linked to the extreme difficulties in predicting the future, both when it comes to the life span of the asset and the future benefits it will produce.

Therefore, the most common valuation approaches: the cost, market, and income approach, respectively, are in various degrees suitable for transfer pricing purposes depending on the nature of the asset. Accordingly, the different transfer pricing methods as applied to each different type of asset serve the purpose to make feasible, at least in theory, the determination of an arm's length price.

3. *The Best Method Rule in Panama*.

Interestingly, Panama's Transfer Pricing Regime adopted the Best Method Rule, partially; giving preference to transactional methods over profitability based methods for ascertaining the arm's length price, but without establishing a hierarchy among transactional methods themselves and among profitability based methods. Generally, under the Best Method Rule, the arm's length result of a controlled transaction must be determined under the valuation method that, under the facts and circumstances, provides the most reliable measure of an arm's length price. Thus, there is NO strict priority of methods within the transactional methods themselves and among the profit based methods; and NO method within each category will invariably be considered to be more reliable than the others. The Best Method Rule in general means that, if two or more valuation methods are permissible, the arm's length result must be determined under ***the one that provides the most reliable arm's length measure under the facts and circumstances of the transaction***. Consequently, the Panamanian Tax Administration will hold the authority to challenge the method used by the taxpayer and argue that the method used by the taxpayer does not clearly reflect Panamanian source income because it does not provide an acceptable arm's length price in the view of the tax authority. Moreover, the Best Method Rule implies – from a practical point of view -that the taxpayer should run his numbers through all methods before choosing which one better reflects the arm's length price to be reported. However, this latter issue should be clarified in regulations. Additionally, it is not clear which party bears the burden of proof of the arm's length price in case the Tax Administration decides - as a

result of an audit of the taxpayers transfer pricing reporting and documentation - that the method used by the taxpayer was not the best method for his particular case.

The primary factors to be considered in selecting the best method normally include the ***degree of comparability*** between the controlled and uncontrolled transaction[3] and the quality of the data and assumptions used in the analysis.

The comparability of controlled and uncontrolled transactions is typically evaluated by the following factors included in the Panamanian Transfer Pricing Statute. Please know that the order and brief description below of each factor derive not only from the Panamanian statute but also from the OECD Transfer Pricing Guidelines and comparative law:

- **i.** ***Functions*** –the economic functions carried out and resources employed by the parties involved in the controlled and uncontrolled transactions must be identified and compared.
- **ii.** ***Contractual Terms*** – the terms of the controlled and uncontrolled transactions must be analyzed. Relevant terms may include the forms of consideration, volume of sales, scope of terms of warranties, rights to updates or modifications, duration of the agreement, collateral transactions or ongoing business relations and credit payment terms.
- **iii.** ***Risks*** – the comparability of risks involved in the controlled and uncontrolled transactions must be weighed. These may include market risks, risks associated with the success or failure of research and development activities, financial risks, credit and collection risks, product liability risks.
- **iv.** ***Economic Conditions*** – The conditions of the controlled and uncontrolled transactions must be weighed. These include the similarity in size and composition of geographic markets, the market level, market shares, location-specific costs of the factors of production, extent of competition, economic condition of the industry and alternatives reasonably available to the parties.
- **v.** ***Nature of Property or Services*** **–** the property or services that are the basis of both the controlled and uncontrolled transactions must be compared. The regulations yet to be enacted should emphasize that any intangible property embedded in tangible property must be included in such comparison.

Special circumstances like the ones specified below may affect the analysis:

- **vi.** ***Market Share Strategy*** – Price differentials attributable to attempts to enter a market or expand a market share may be considered.

[3] Transaction not made in the ordinary course of business and transactions in which a principal purpose is to establish a basis for comparison typically are not considered a reliable measure of an arm's length result.

vii. ***Difference in Geographic Markets*** – If it is necessary to compare transactions from another market, difference in the market that might affect the comparison should be considered.
viii. ***Location Savings*** – If different geographical locations account for cost differentials, they should be weighed in the comparison.

4. The Statutory Transfer Pricing Methods.

The Panamanian Transfer Pricing Statute introduces methods for calculation of arm's length prices that are internationally recognized and each of them may be suitable for pricing depending on the nature of the assets and the availability of comparables, locally and internationally.

As said, Panama favors transactional methods over profitability based methods. The transactional methods expressly established in the Panamanian Transfer Pricing Statute are: the Comparable Uncontrolled Price (CUP) Method, the Resale Price Method (also called Resale Minus in other jurisdictions) and the Cost Plus Method. On the other hand, the profitability based methods adopted by the Panamanian Transfer Pricing Statute are the Profit Split Method and the Transactional Net Margin Method. However, it is still to be determined whether the Panamanian Transfer Pricing Statute - which incorporated by reference the OECD Transfer Pricing Guidelines - would also allow unspecified methodologies or other methodologies - expressly permitted by the OECD Transfer Pricing Guidelines – should the methodologies indicated in the statute not be deemed adequate for determining the arm's length price by the taxpayer and/or the tax administration in certain cases. We should keep in mind that intangibles are especially difficult to price and that the specified methods may not be adequate in some cases. Maybe, the Panamanian Executive should consider the possibility of requiring hindsight [without retroactive effect] when issuing regulations for the pricing of intangibles under the Panamanian Transfer Pricing Regime Statute.

5. Final comments.

Hopefully, this informational article has been of use to the reader. We intentionally made it succinct to provide a general and quick overview of the Panamanian Transfer Pricing Statute while highlighting its main features and conceptual background. Additionally, please know that the content of this work shall not be construed as legal or tax advice to any extent but as a piece of general information only. Moreover, the content of this work reflects only the personal views and opinions of the author on the subject at bar.