THE DIFFERENT "FLAVOR" OF TAX RESIDENCY IN PANAMA, AS A COUNTRY WITH EXCLUSIVE SOURCE TAXATION SUBJECTION CRITERIA

BY PUBLIO CORTÉS

Let us first take for example the case of Spain.

In the case of individuals or natural persons, the Spanish tax collector, i.e., the Tax Agency (AEAT), applies the Consolidated Text of the Individual Income Tax Law[1] (IRPF), according to which (article 2), the tax is levied on the income, yields and profits of the taxpayer "*regardless of the place where they were produced*". This is then linked to articles 8, 9 and concordant articles of the same law, according to which taxpayers are those who have their residence for tax purposes in Spain.

In the case of corporations, the AEAT applies article 4 of the Consolidated Text of the Corporate Income Tax Law (IS)[2] on the basis of which it is understood that the taxable event is "*the obtaining of income by a taxpayer, whatever its source or origin*", an idea that is repeated in paragraph 2 of article 7 which states "*Taxpayers will be taxed on all the income they obtain regardless of the place where it was produced and whatever the residence of the payer*". This normative concept is interpreted jointly with articles 7 (paragraph 1), 8 and other concordant articles of the same law, which provide that corporations, temporary joint ventures and funds described therein, are taxed "*when they have their residence in Spanish territory*".

In view of the above, it is logical to think that both the AEAT and the General Directorate of Taxes (DGT), each within their respective areas of competence, in the event of doubts, whether by individuals or corporations, will have a

[1] BOE-A-2006-20764
[2] BOE-A-2014-12328

view that will always be, within the Law, favorable to the consideration of persons as Spanish Tax Residents, since this will increase the number of taxpayers that will eventually have to pay some tax to the Spanish Treasury, no matter in which part of the world the income is produced.

The taxation of non-residents is not object of analysis because, as its name indicates, it does not depend on the criteria of personal subjection based on the Spanish tax residency.

Let us take the case of Colombia

Regarding the individuals and the Income Tax and complementary, the Colombian tax collector, National Tax and Customs Directorate (DIAN), would apply the first paragraph of Article 9 of the National Tax Statute of Colombia (ET)[3], according to which "*the national or foreign natural persons resident in the country and the illiquid successions of deceased persons with residence in the country at the time of their death, are subject to the income tax and complementary with respect to their income and occasional gains, both from national and foreign sources.*"

DIAN
POR UNA COLOMBIA MÁS HONESTA

In the case of corporations, the DIAN will apply Article 12 of the ET, based on which "*national companies and entities are taxable, both on their income and occasional gains of national source as well as on those originating from sources outside Colombia.*"

Similar to Spain, in the case of Colombia it is logical to think that the DIAN, in case of doubts, whether by individuals or corporations, will have a vision that will be, always within the Law, favorable to the consideration of individuals as Tax Residents of Colombia and in the case of corporations, "*as national companies and entities*", since this will increase the number of taxpayers that would eventually have some tax to pay to the Colombian Treasury, no matter where in the world the income is produced.

The taxation of non-resident individuals and corporations considered as "*foreign companies and entities*" is not subject to analysis because it does not depend on the criteria of personal subjection.

This pattern should be similar in all those countries and jurisdictions that apply the criteria of personal subjection, more commonly known as "Worldwide Income", which is the most generalized link with the taxing power, at least in this planet.

[3] We are consulting the version of the Lejister.com site.

The case of Panama

Panama is within the smallest number of countries that use, with exclusivity character, real territorial source subjection criteria for the income tax on individuals and corporations.

Having said that, it is good to say, with a constructive and didactic purpose and for the benefit of some of our dear countrymen, that in Panama we did not invent the exclusive territorial source criteria, that we are not the only great creatives that still use it, that its existence as a factor of unique connection with the taxation power is in the Law and not in the Constitution, that the sovereignty of the country does not depend on it and that it is not true that the OECD wants to take it away from us.

In addition, it is important to mention that countries that use the personal (worldwide income) subjection criteria also use it jointly, generally applied to non-residents.

Based on the above, article 694 of the Panamanian Fiscal Code, applicable to individuals and corporations, provides that income tax is levied on income produced "*within the territory of the Republic of Panama, regardless of the place where it is received*" and adds that "*Taxpayer... is the natural or legal person, national or foreign, that receives the taxable income subject to the tax*". There is no applicable income tax regulation that additionally links the power of the Panamanian Treasury to collect taxes, which has any relation with personal criteria, based on the connection point of Tax Residency.

Well, everything is clear up to this point. However, the same Panamanian Fiscal Code in the subsequent article 762-N and its regulations, sets up definitions of Tax Residency for individuals and corporations, which is also Law. At first impression, for an unsuspecting reader, this may generate confusion and some may even think that the status of Tax Resident may turn the holder into a taxpayer in the Republic of Panama. However, this is not so.

What does Panama use the Tax Residency Certificate for? Why does the Law define it and why does the Tax Administration (DGI) issue them?

To address these questions let us first say what it is NOT: The Tax Residency Certificate is NOT a condition to acquire the status of taxpayer in Panama, in fact, you can have the Tax Residency in Panama and not be a taxpayer. The opposite can also happen, but there is no relationship of condition in it.

The existence of persons that Panama recognizes their status of Tax Residents does not change the legal reality that in Panama only the real subjection criteria is used in income tax matters, that is: that only acquires the status of "taxpayer", the individual or corporation, national or foreign, that receives income within the territory of Panama, either because it is evidently so or because its wealth generating activity is subsumed in some diffuse assumption, but that by the simple mandate of Law is coated with the characteristic of being considered "*as of Panamanian source*", being subject to the tax.

Having said that, we highlight then that the inclusion of definitions of Tax Residency for individuals or corporations in Panama, had a very different objective than the determination of the persons who may or may not be taxpayers in Panama. Those definitions were included for the purpose of the Double Tax Conventions (DTC) as explained below.

It seems that in Panama sadly all International Taxation issues in some way lead us to Tax Transparency and the exchange of information for tax purposes. In fact, around 2009, the international standard considered it viable for a country to qualify as compliant if it had signed a certain number of bilateral tax treaties that allowed the exchange of information for tax purposes and that they were effectively applied.

Driven by that reason Panama undertook in 2010 the task of complying with the signing of the required quota of treaties, using to a large extent the way of signing DTC on income tax and on capital, under the Model Convention of the OECD (with one or another clause a bit "new yorker") taking advantage that such Model Convention includes a clause 26 of exchange of tax information applicable to "*Taxes of any kind and description*".

Well, in order to those DTCs signed by Panama could be applied, after they entered into force and began to take effect, Panama introduced for the first time through Law 33 of 2010, Article 762-N of the Fiscal Code, later amended, with definitions of Tax Residency for individuals and corporations, which was necessary because the mentioned agreements provide that they will be applicable "*to persons who are residents of one or both of the Contracting States*". That is to say, without a definition of Tax Resident, Panama could not apply the conventions.

In short: that both the legal and regulatory definition of Tax Residence in Panama and the issuance of said certificates were made only to identify the persons that could invoke the

application of benefits of a DTC in which Panama is a party. Subsequently, also by law, the use of the aforementioned definition of Tax Residence was ordered, for the purposes of exchange automatic information system under the CRS standard that Panama also applies.

Approach of the Panama Tax Administration to the issuance of Tax Residence Certificates, in case of doubt

Unlike what happens in Spain and Colombia, the Panama Tax Administration (DGI) does not see its database of registered taxpayers increased due to the fact that more Tax Residence Certificates are granted. That is to say: for Panama, the collection expectation does not increase due to increasing the issuance of Tax Residence Certificates.

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But it is not just that there is no expectation of higher collection, but, on the contrary, the more Certificates of Tax Residence Panama issues, the possibility of reduction in collection increases, because this means that would increase the options for applying the DTC by Panamanian taxpayers or responsible parties. By increasing the possibility of application of the DTC there are more potential cases where Panamanian Tax Residents, who are also taxpayers or liable persons in Panama, apply the special and more comfortable tax rates offered by DTCs. For example: in a hypothetical case, the DGI of Panama would stop receiving 10% withholding tax on dividends paid to a Tax Resident of a country with which Panama has a DTC, to instead receive 5% withholding.

Regarding the CRS standard for Automatic Exchange of Information, the issuance of Tax Residence Certificates in Panama in an unclear manner could generate a situation of care that needs to be addressed. In fact, since the "*Panamanian financial entities subject to report*" have to verify who are the "*persons subject to report*", that is, persons who are tax residents in countries other than Panama with

which Panama has the exchange relationship activated, since they met a Panama Tax Resident, there are reasons not to report it.

There is another element of risk in the increase in the issuance of Tax Residence Certificates by Panama and this has nothing to do with the application of DTCs or with the automatic exchange of information. It turns out that the Law also allows obtaining a Certificate of Tax Resident in Panama, for the simple fact that the requirements of the legal definition were met, although it is not intended to be used to apply the benefits of a DTC.

The risk factor here is that there will be no shortage of those who intend to use a Panamanian Tax Residence Certificate to appear before their country of previous Tax Residence and argue that they are no longer a taxpayer of that country, because they are now a Panamanian Tax Resident. If it turns out that they do not generate income from a Panamanian source and in the other country they believe the argument, eureka!!!, they would not pay anywhere and would have achieved double non-taxation, an ideal dream that is increasingly difficult to achieve.

The truth is that in the real world these versions of aggressive tax planning are less viable because the affected countries and the international community in general, have already promoted anti-abuse regulations that, in principle, block these behaviors.

However, reputational risk exists for Panama. Because if it were the case that in a massive way the anti-abuse alarms of the world were being activated at every moment, because there are many people trying to flee from their tax obligations, putting a Panamanian Tax Residence Certificate as a shield, that would generate another front of affectation of the image for our country.

Obviously, the DGI of Panama must grant or not the issuance of Tax Residence Certificates, neutrally applying the Law. In case of doubts, however, it seems logical to think that the attitude of the Tax Administration of Panama, being a country with a criterion of exclusive real subjection of territorial source, should be different and less flexible than what we could expect in friendly countries such as Spain or Colombia, because in them, the use of the criterion of personal subjection (world income) inclines them to be more complacent when issuing Certificates of Tax Residence.

Final Comments

In the DNA of many of the public policies that all the governments of Panama have implemented, it is common to find some investment attraction policies that repeat patterns that have already been overcome, such as giving away tax exemptions that the investor has not asked for and that do not concern them much, but obviously they are not going to reject, when there are really more important elements such as the institutional framework, the modernization of labor legislation or the level of English, training and education of the workforce, which are the true magnets of investment, especially in Panama, which is one of the Latin American countries with the lowest tax burden.

Well, one of those "attractive" assumptions that sometimes emerges as the "great idea" is to promote the granting of the Panamanian Tax Residence in a massive way, as if it were a "bonus", without there being greater clarity about the links of substance. This simplistic view of the matter may have repercussions in terms of international reputation for Panama. It is my recommendation that this risk be taken into account.

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PUBLIO CORTÉS
ABOGADO - LAWYER

WWW.LEGALADVISORPANAMA.COM

M: +507 6679-4646 E: CORTES@LEGALADVISORPANAMA.COM

@PUBLIOCORTES.LAWYER