

1974

## Panama and Multinaitonal Corporation: Tax Haven and Other Considerations

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### Recommended Citation

Robert Y. Stebbings, *Panama and Multinaitonal Corporation: Tax Haven and Other Considerations*, 8 INT'L L. 626 (1974)

<https://scholar.smu.edu/til/vol8/iss3/16>

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## **Panama and the Multinational Corporation: Tax Haven and Other Considerations**

In an internal paper prepared for INTAL,<sup>1</sup> the Republic of Panama was considered as an incorporation situs and headquarters jurisdiction for what was defined as a Latin American holding corporation. The point of view of the present analysis remains Latin in the sense that Panama's attractions are of special interest to a multinational corporation involved in the region. However, most of the following discussion should also be relevant to business entities interested in using Panama as an operations base for activities outside the hemisphere.

For tax as well as for other reasons, Panama has long been one of a number of so-called tax-haven jurisdictions used by extra-regional firms in organizing their international operations. Given regional concern over economic dependency and the feeling that local alternatives must be developed to counter the power of multinational corporations from the developed countries, an examination of some of the operating devices of these outside firms seems especially desirable. A country by country comparative analysis will not be attempted here although something of the kind would be imperative in devising an operating structure in a given case.

### **General Considerations**

Aside from the existence of the Canal and its Zone controlled by the United States, Panama is unique and not necessarily unfortunate for its use of a currency, the Balboa, which is the equivalent of the U.S. dollar. The main disadvantage of this use of the dollar from a Latin American regional point of view is probably emotional. It suggests economic dependency, but for headquarters

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<sup>1</sup>The "Instituto para la Intergración de América Latina," an international organization headquartered in Buenos Aires, Argentina and dedicated to furthering the economic integration of Latin America. It is principally supported by the Inter-American Development Bank. The author served as a lawyer in the legal section of INTAL during 1972 and 1973 and was supported by grant from the International Legal Center of New York City.

purposes it is likely to be considered a point in Panama's favor.

In the countries in which operations are conducted, local currency will be used while the dollar may or may not be used as an accounting mechanism at Panama headquarters. What dollar zone status may provide the outside investor is easier access to international capital, including the Eurodollar market as well as a variety of rather sophisticated financial institutions and techniques. Panama itself benefits from the arrangement at least on a certain level, although the country has recently suffered an unfortunate degree of internal inflation as a result of its role as an international financial center.<sup>2</sup> The effect on Panama of the dollar's changing position in the world has not yet been adequately analyzed.

Panama has virtually no exchange control, has never blocked the transfer of funds, and only imposes taxes on such transfers in the case of dividends and other payments derived from profits earned within the country. Banking facilities, which will be discussed below, are exceptionally good and well-suited to international operations. Legal, accounting, trustee, management and secretarial services are generally considered of a high order and are also well suited for international operations. Knowledge of foreign languages, especially English, is widespread.

Panama is favored by good communications with the rest of the world. It offers daily air services to all of the major cities in the Americas, good ports and excellent telegraphic and international telephone services.

### **Political Considerations**

It seems unlikely that political instability will present a problem, especially for Latin American interests operating from Panama. The question of the canal, the nationalization of the public utility in 1972,<sup>3</sup> and considerable strongly worded rhetoric have all involved the United States. President Torrijos has, in fact, gone out of his way in his search for Latin American support, perhaps partly as a result of his disagreements with the United States. Nevertheless, it is doubtful that the government would drastically interfere with what has become a profitable banking and commercial center in spite of the aforementioned internal inflation. The *New York Times* quotes a banker as pointing out that the government of Panama knows "that the moment the banks are threatened we can move the money out overnight by Telex. After all, modern banking does not involve handling cash."<sup>4</sup>

These considerations should apply to North American operations in Panama as readily as to any others. Panama's general economic success during the last

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<sup>2</sup>The *New York Times*, New York, N.Y., January 28, 1973, part II, p. 41.

<sup>3</sup>La Opinión, Buenos Aires, Argentina, July 1, 1972, p.2.

<sup>4</sup>The *New York Times*, *op. cit.*, note 1.

years may be another reason to hope that the boat will not be rocked unnecessarily or unduly. According to a recent study prepared for a seminar at the Institute for Latin American Integration (INTAL) in Buenos Aires, "Panama has figured among the few Latin American countries which have attained annual economic growth rates well above 6 percent during the last twelve years (7.8 percent)."<sup>5</sup>

### **Corporate Law<sup>6</sup>**

The corporate law of Panama is streamlined and convenient for use by the outsider. It easily permits a locally organized firm to direct operations elsewhere. The usual civil law forms for doing business exist in Panama. In addition to the sole proprietorship, these five possibilities are the *sociedad colectiva* (collective company or general partnership), the *sociedad en comandita simple* (simple limited partnership), the *sociedad en comandita por acciones* (stock-issuing limited partnership), the *sociedad anónima* (corporation), and the *sociedad cooperativa* (cooperative company). Outside firms normally choose the corporate form (*sociedad anónima*), although in some cases tax considerations outside of Panama may suggest operating through a Panamanian branch. The formation of a Panama corporation as regulated by the Ley 32 de 1927 (de 26 de Febrero) is extremely simple and rapid.

Two physical persons of any nationality may act as founders, each subscribing to at least one corporate share ("una acción del capital social"). It is not necessary to be present in the country or even appear before a Panamanian consul outside of the country. Local founders carry out the formalities and immediately cede their corporate shares to the real owners. Ownership may reside in a single individual and there is no requirement that any part of the capital be held by Panamanians. Three directors and three officers are required, but one person may hold two offices. Panamanian nationality is not required nor need directors or officers be shareholders. A Panamanian attorney or law firm must be appointed as resident agent to represent the corporation before local authorities.

The corporate charter is admirably simple and is easily modified. It may be executed in any language either within or without the country and need not be published. There is no minimum capital requirement, bearer shares are permitted, as are no-par shares, and authorized capital may or may not be paid-in or may be partially paid-in. Registration is simple and books may be maintained outside the country. According to the Price Waterhouse & Co.

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<sup>5</sup>Porfirio Morera Batres, Consideraciones sobre el desarrollo economico en los paises de menor dimension economica que no participan en ningun esquema de integracion Latinoamericana, El caso de Panamá, prepared in Mexico and dated September 25, 1973 for a seminar at INTAL (Instituto para la Integración de América Latina), Buenos Aires, Argentina, page 4.

<sup>6</sup>Ley 32 de 1927 (de 26 de Febrero), sobre Sociedades Anónimas.

accounting firm, incorporation costs are between \$500 and \$750.<sup>7</sup> According to a letter from the Banco Fiduciario de Panama, the fees of the registered agent are around \$200 per year.<sup>8</sup> A practitioner in Buenos Aires, the Latin American commercial center most distant from Panama, has indicated that a Panama subsidiary can be established from abroad in as little as two days.

### Tax Considerations

Panama is a long-standing member of that group of countries called "tax havens." It was used as such by a large number of United States companies until the 1962 United States Revenue Act caused most to leave. Many international companies have since returned both for tax reasons and for the other features which make Panama a convenient base for regional management, sales and distribution.<sup>9</sup>

Virtually any discussion of tax havens begins by pointing out that their tax features are not identical. They are usually categorized in four groups, roughly as follows:

- (a) The traditional tax havens which impose no taxes at all, as the Bahamas, Bermuda and the Cayman Islands;
- (b) Those with low taxation as the British Virgin Islands;
- (c) Those which do not tax foreign source income such as Panama; and
- (d) Countries which allow special privileges such as Luxembourg.<sup>10</sup>

Incidentally, a Canadian tax expert points out that any country at some time may conceivably find itself used as a tax haven for some reason, even the United States and Canada.<sup>11</sup>

As seen above, Panama falls into that category of taxing jurisdiction which specifically exempts from all taxes that portion of a local corporation's income derived from its operations outside of the country. The first words of the Income Tax Law stipulate that this territorial or source principle shall be applied throughout.<sup>12</sup> The Income Tax Law continues specifically to exempt from local taxes those operations involved in directing from the country the purchase, sale and movement of merchandise which does not enter the country. Thus, the law provides that income:

<sup>7</sup>Information Guide for Doing Business in Panama, Price Waterhouse & Co., Accountants (USA, September 1972).

<sup>8</sup>Letter from Legal Department, Banco Fiduciario de Panamá, SA., January 27, 1972.

<sup>9</sup>Roger Beardwood, *Sophistication Comes to the Tax Havens*, FORTUNE MAGAZINE, February 1969, p. 95 at 174.

<sup>10</sup>*Tax Havens*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, 1969, p. 458. Also see: MILTON GRUNDY, GRUNDY'S TAX HAVENS (London, New York, 1972). Eduardo Crawley, La Opinión, Buenos Aires, Argentina, December 26, 1972, p. 8. Roger Beardwood, FORTUNE MAGAZINE, *supra*. Marshall J. Langer, *Tax Havens of the World*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, 1970, p. 423 at 424-5. Marshall J. Langer, *1972 Survey of Caribbean Taxation*, 4 LAWYER OF THE AMERICAS, p. 220 (Miami, Florida, 1973).

<sup>11</sup>Alexander B. McKie, *Tax Havens—Use and Abuse*, XXI THE TAX EXECUTIVE 73 at 73-4 (Washington D.C., January 1969).

<sup>12</sup>Código Fiscal, Panamá, Ley No. 9 de 23 de Diciembre de 1964, Capítulo 1, Artículo 694.

. . . shall be deemed not to have been produced within the territory of the Republic of Panama if derived from the following activities:

- (a) Invoicing, from an office established in Panama, the sale of merchandise or products for a sum higher than at which said products or merchandise had been invoiced to the office established in Panama, provided that said merchandise or products are handled exclusively abroad.
- (b) Directing, from an office established in Panama, operations which are completed, consummated or take effect abroad; and
- (c) Distributing dividends or participations from juridical persons when said dividends or participations are derived from income not produced within the territory of the Republic of Panama, including the income derived from activities mentioned in subdivisions (a) and (b) of this paragraph.<sup>13</sup> (Translation from Spanish by the present author.)

In addition, the Panamanian Ministry of Finance has specifically ruled that management functions do not alone constitute a source of income.<sup>14</sup>

There is no income or withholding tax on dividends, interest, royalties, trading profits, commissions or other income received or paid out as long as such funds are not derived from Panamanian sources. There is no tax on bank interest earned on local deposits, and nonresidents may maintain bank accounts in either Balboas or foreign currencies. The country subscribes to the principle of banking secrecy permitting numbered accounts. Unlike most of the rest of the world, Panama has almost no exchange restrictions. The same corporation or office may conduct business in Panama simultaneously with its tax-free international operations, paying taxes only on that portion of its income derived from local operations.

As Panama does not tax foreign source income, it is not a party to any tax treaties, since the object of such treaties is the prevention of double taxation.<sup>15</sup> This may be an advantage in certain cases because Panama is thus not obliged to disclose information to the tax authorities of other countries interested in preventing tax avoidance. In other cases, the lack of treaties may be distinctly disadvantageous, since it renders impossible the use of the country as an intermediary for the reduction or withholding of dividend, royalty and other income.

This well-known practice involves the supposition that payments are to flow from country A to country B and that A imposes a high withholding tax rate on payments to B. The object is to identify country C, payments to which from A can be made at a low tax treaty rate. Country C must then permit tax-free or low-tax payments to B. Panama of course permits the C to B payment tax-free but lacks treaties with the A countries which would impose advantageous rates of withholding on payments from A. Obviously, an entirely legitimate corporate

<sup>13</sup>*Ibid.*, paragraph 2.

<sup>14</sup>Panama, Ministry of Finance Resolution No. 38, October 5, 1949.

<sup>15</sup>See generally: Yitzhak Hadari, *Tax Treaties and Multinational Enterprise*, 20 *AMERICAN JOURNAL OF COMPARATIVE LAW* 111 (Winter 1972). Also see: McKie, *op. cit.* note 8, and Tony Doggart and Caroline Voûte, *Tax Havens and Offshore Funds*, *THE ECONOMIST INTELLIGENCE UNIT* 10 (Great Britain 1971).

enterprise should not be concerned with protecting information desired by tax authorities interested in questions of tax avoidance. On the other hand, the lack of tax treaties might be unfortunate, depending upon the operational idiosyncracies of the corporation involved.

Prominent practitioners from two Latin American countries have privately expressed the view that the above tax-haven characteristics of Panama should hold little interest for a truly legitimate Latin American multinational committed to conforming to the legislation, tax and otherwise, of the jurisdictions in which it operates. They first point out that operating from Panama may create a bad image. Panama has been used by Latin Americans as a place to which, like Switzerland, money fleeing from tax or other national authorities may find its way, since there is no question of taxation upon entry or exit, and corporate and banking laws permit complete secrecy in all operations. The situation is reportedly such that certain of Panama's neighbors are wary in their approval of business dealings with the country. Mexico, for instance, will not allow royalty payments to a Panama-based company unless fully documented.<sup>16</sup>

A common procedure involves the flow to Panama of *dinero negro* which is then loaned to a real or dummy corporation in another country which can then relend the funds to the original party in the first country or elsewhere without arousing the suspicions that a loan made directly from Panama would create. The person or firm which makes this complete circle thus illegally sends money from his country to Panama without paying taxes, earns tax-free interest on it while it is in a Panama bank and eventually may pay himself tax-free interest when he borrows it back from a dummy company in another country. (Actually there may be withholding on the interest payments.) Additionally, he may deduct his interest payments as business expenses in the country in which he is operating.

Freedom to conduct such illegal or questionable operations may be an important element in Panama's success as an international business and financial center. However, there may be other reasons for setting up headquarters in Panama: the country's tax policies permit a legitimate company's presence in the country for non-tax reasons while not penalizing it for its decision to be there.

### **Financial Considerations**

Many important financial considerations have already been referred to or are closely related to the tax-haven characteristics: namely, lack of exchange controls, banking secrecy and use of dollar resources. The topic deserves expansion, however, as Panama in the last few years has become an important

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<sup>16</sup>Investment, Licensing & Trading Conditions Abroad, Panama, Business International Corporation, August 1972 update, p. 10.

regional financial center and that importance appears to be increasing. Like Singapore, although so far on a smaller scale, Panama's unique features have led to the formation of a Euro-currency or Latindollar market. As of March 1973, Panama reportedly had 51 banks, 36 of which were affiliated with foreign financial institutions.<sup>17</sup> These banks had total deposits of between \$1.3 and \$1.9 billion depending upon one's source of data. In any case, the sum represented an increase of nearly \$1 billion since the end of 1967. This total compares with an estimated \$70 billion total in the Eurodollar market.<sup>18</sup>

The government has imposed very limited regulation on banking in Panama. Although bank reform legislation was enacted in 1970 creating a National Banking Commission and imposing minimum reserve requirements, Morgan Guaranty Trust Company indicated that in practice this has not significantly changed the situation.<sup>19</sup> Of fundamental importance is the fact that interest on the Panama bank accounts of foreigners is not subject to taxation by Panama. Equally, the interest income on bonds held by foreigners is not subject to Panama taxes which makes the country a feasible jurisdiction for the establishment of so-called finance subsidiaries<sup>20</sup> by means of which loan funds may be raised on international or regional capital markets.

This sort of operation (an international bond flotation) would not require the establishment in Panama of headquarters for a regional multinational, but merely the creation of such a finance subsidiary. Similarly, banking services and bank loans eventually destined for another country should be just about as easily obtainable without going to the trouble of incorporating in Panama, and in fact might be equally or more readily available in the country of destination through the local branch of one of the international banks operating in Panama. If the fact that unregulated lending rates which reflect international market forces and the fact that funds may simply be more available in Panama make direct recourse to that country's banks desirable, mail, telex, telephones and airplanes may be the easiest way to tap the source.

Obviously, the government of Panama has strongly supported the country's development as a regional financial center. Of additional interest, the government has encouraged two other developments. In July 1970 it created a five-member National Securities Commission headed by the Minister of Commerce and Industry. The other four members come one each from banking, industry, and commerce plus the manager of the government controlled Banco Nacional.

The initial idea was the eventual creation of an over-the-counter regional stock market with the possibility of price-quotations on the New York Stock

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<sup>17</sup>Business Latin America, Business International Corporation, July 5, 1973, p. 212.

<sup>18</sup>Statistics are from: *Ibid.*, p. 212; New York Times, *op. cit.*, note 1; World Financial Markets, Morgan Guaranty Trust Company, March 1973.

<sup>19</sup>World Financial Markets, note 17.

<sup>20</sup>Business International, Business International Corporation, April 9, 1971, p. 116.



Exchange.<sup>21</sup> Reportedly, by early-1972, a real securities market had not yet developed. Such trading activity as existed was managed by banks directly between buyer and seller. The Securities Commission had found it necessary to concentrate on investor education and brokerage training. Initial steps were taken to stimulate investor interest in the public capital market with Decree 30 of February 24, 1972. The decree eliminated the capital gains tax on sales of stocks registered with the Commission and created other fiscal incentives for companies to register their stocks or bonds with the Commission including tax reductions.<sup>22</sup>

Another 1970 decree authorized the establishment and governed the activities of mutual funds including off-shore or foreign funds.<sup>23</sup> Presumably the troubles of such giants as International Overseas Services (IOS) have changed the mutual fund climate. At the moment there does not appear to be much creative activity in the field, but at least the possibility remains open.

The previous commentary primarily relates to the attitude of Panama's government and to the financial climate being sought within the country in those instances when sales or manufacturing within Panama is not contemplated. Based within or outside of Panama, by definition a firm would be able to take advantage of a *regional* stock market or an *off-shore* mutual fund. It is to be hoped that Panama's banking and financial features are recapturing some of the flight capital from other Latin American countries in order to put it back to work in the region.

### Colon Free Zone

Panama's Colon Free Zone is worthy of mention as a special factor of interest to a firm in search of a centralized customs' free area for the physical handling and/or processing of goods. Merchandise or raw materials may be brought into this segregated area free of customs duties for virtually any purpose from storing or repacking to manufacturing. Profits generated from the wholesale sale of goods to the rest of Panama are taxed at internal rates equal to those paid by any enterprise doing business within the country. Processing earnings derived from activities in the Free Zone and foreign sales are taxed at approximately 10 percent of the normal corporate rates. Even this 90 percent reduction may not prevent an operation whose profits can be largely attributed to manufacturing activities from seeking a more favorable tax climate. A case is Syntex which incorporated in Panama and used the Free Zone as a base for distribution of pharmaceutical products to the United States and Europe. The firm chose the Grand Bahama free port for construction of a manufacturing facility, because it

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<sup>21</sup>Business Latin America, Business International Corporation, September 24, 1970, p. 307.

<sup>22</sup>*Op. cit.*, note 15, at 12.

<sup>23</sup>*Ibid.*

is reportedly thus able to conduct its international sales on an entirely tax free basis.<sup>24</sup>

### **Conclusion**

For a multinational business enterprise which conducts business in complete accordance with the law, Panama's tax-haven features alone probably do not constitute sufficient reason for incorporating a headquarters or base company in that country rather than in one of the countries in which business is conducted. This is especially true if the earnings generated in each country by the local subsidiary are retained for expansion within that country, perhaps the most logical pattern.

A tax-haven jurisdiction may make some sense in the case of a parent holding company which receives dividends from its various national subsidiaries for re-investment according to its view of best earnings prospects or for dividend distribution to its shareholders. Choosing a tax haven in this case may somewhat facilitate operations. There would be no question of imposing taxes on payments to or earnings of the Panama parent attributable to sources outside of the country nor would there be any question of withholding or taxes on dividends or other distributions of these funds made from Panama. Of course, earnings in the countries where the subsidiaries do business would be subject to normal corporate taxes and dividend payments made to Panama would be subject to local withholding taxes. Once these funds reach the Panama corporation, the latter's complete control over their disposition may be viewed as reason enough for operating from Panama.

It should be noted that in any country which strictly follows the source principle of taxation, the tax results would also be as described above. However, exchange controls, capital export restrictions and other problems may complicate the situation in a way which is not the case in Panama.

Reference has already been made to the illegitimate use of tax havens for the absorption of dirty money and its reintegration in apparently legitimate business activities in the country of origin or elsewhere.

If other reasons to come to Panama exists, the special tax and financial features of the country may make it a logical headquarters site, especially if sales or manufacturing operations are conducted there. This could make it a leading and legitimate contender amongst a number of possibilities. Other attractions include the availability of the country as a site from which to conduct international sales and distribution and the possibilities inherent in the Colon Free Zone.

Perhaps obvious is the reminder that any decision involves a detailed consideration of alternatives. A quite different international structure may prove

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<sup>24</sup>Business International, Business International Corporation, June 18, 1971, p. 193 at 194.

preferable or indispensable in any given case. Circumstances might require a network of national corporations without a holding company using interlocking directorships or contractual arrangements as a means of common policy formation and control. Or they might lead to incorporation in one country in which business is conducted with branches elsewhere. In some cases local restrictions may make further consideration superfluous.

If it happens that all or most of the operations of the multinational take place in some or all of the countries composing the Andean Common Market, there may be special reason for establishing headquarters in one of these countries rather than in Panama. As long as certain minimum capital and other requirements are met (for instance, at least 60 percent of the total equity must be contributed from member countries)<sup>25</sup> the company would benefit from a number of privileges in each member country which is responsible for at least 15 percent of the firm's total capitalization.<sup>26</sup>

The head of the Andean Group's legal section summed up these advantages as follows:

The Andean multinational corporation receives special treatment fundamentally different from that accorded the foreign corporation (as the latter is defined in Decision 24). It is given a treatment similar to that which each member country accords its most favored national corporations, particularly with respect to tax matters, credit, government purchasing, reinvestment of profits and investment in sectors reserved for local firms. As for the subregional investor in an Andean multinational corporation, he is not subject to any obligation to sell his shares to local investors in the country where the firm is established; he can remit all profits to his country of origin; and he benefits from the Double Taxation Treaty amongst the member countries.<sup>27</sup> (Translation from Spanish by the present author.)

It is further pointed out that in those member countries from which a minimum 15 percent capital contribution has not been made, the advantages provided by the *Acuerdo de Cartagena* are enjoyed even though the advantages cited above are not available.

The present discussion has been confined to the multinational corporate investor's point of view. There remains the broader question of desirability from a regional public policy point of view, since both Latin American international organizations and individual countries can and do effectively influence the decisions of investors or potential investors. One view holds that:

Multinational corporations will have to contribute to fulfillment of the principle of balanced and harmonious development, to the equitable distribution of the benefits of integration and to the reduction of differences in development among countries.<sup>28</sup> (Translation from Spanish by the present author.)

<sup>25</sup>Comisión del Acuerdo de Cartagena, Decisión No. 46, Artículo 10 (1971) ("Régimen uniforme de la empresa multinacional y reglamento del tratamiento aplicable al capital subregional"), published in *Derecho de la Integración*, INTAL, No. 10, April 1972, Buenos Aires, Argentina, p. 190 at 192.

<sup>26</sup>Decisión No. 46, *ibid.*, Artículo 11.

<sup>27</sup>Gustavo Fernández Saavedra, "El Régimen Uniforme de la Empresa Multinacional en el Grupo Andino," *Derecho de la Integración*, INTAL, No. 11, October 1972, Buenos Aires, Argentina, p. 11 at 37.

<sup>28</sup>*Ibid.* at 20.

In determining whether the Panama option should be encouraged or discouraged the regional or national policy maker must consider whether a Panama headquarters is likely to be the means of creating new regionally capitalized multinational corporations embodying the very features considered objectionable in the case of the traditional multinational corporation. Decision-making is removed from the region where sales and manufacturing take place while the usual objections to outside economic control may surface: policies relating to capital formation, price and technology transfer are established independently of national and regional development goals and capital may be illegally exported from the region by import overinvoicing and the collection of royalty and patent fees.<sup>29</sup> On the other hand, the policy maker may conclude that the freedom of action afforded the investor by permitting him to operate from Panama is an inducement leading to desirable investment which would otherwise escape the area entirely.

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<sup>29</sup>Business Latin America, Business International Corporation, April 12, 1973, p. 114.