TAX MANAGEMENT

TRANSFER PRICING

REPORT

Panama's Statutory Framework for Transfer Pricing

The author examines the country's transfer pricing regime—which will apply once a number of double tax treaties enter into force—and notes areas needing clarification, such as the application of the best method rule and the use of unspecified methods.

BY JOSE ROMERO, MAUAD & MAUAD, PANAMA CITY

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.[1] The rules will complement the international tax framework contained in the country's treaties to avoid double taxation. 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 treaty partner.

Panama recently signed double tax treaties with Mexico, Barbados, and Portugal and completed negotiations of such treaties with Belgium, France, Italy, Luxembourg, the Netherlands, Qatar, Singapore, South Korea, and Spain.[2]

The obligations contained in Panama's transfer pricing statute will become enforceable for the fiscal years beginning after the treaties enter into force. However, all of the treaties are still pending legislative ratification.

Arm's-Length Principle

The new regulations adopt the arm's-length standard. In Panama, this means that a price would be considered appropriate if it is within a range of prices that would be charged by independent parties—that is, prices an independent buyer would pay an independent seller for a comparable item under comparable terms and conditions, where neither is under compulsion to act.

It is important to highlight that in Spanish (and French as well), the arm's-length principle typically has been translated as the principle of competition. This is an inaccurate translation as the principle of competition applies to other areas of the law. The arm's-length principle is based on comparable transactions between unrelated parties—uncontrolled transactions—and thus is about independence, not competition.

On a separate note, whether the Panamanian transfer pricing statute (as enacted in domestic legislation to complement Panama's tax treaty network and supplemented by the OECD transfer pricing guidelines) legally allows the Panamanian tax administration to look for economic substance in corporate structures and

[1] See 19 *Transfer Pricing Report* 300, 7/15/10.

[2] The country will sign a tax information exchange agreement with the United States Nov. 30, Economy and Finance Vice Minister Frank De Lima said in a statement Nov. 19. The news release (in Spanish) is available from the Panama Finance Ministry's website at https://www.mef.gob.pa/Portal/index.html.

José Romero is the director of international practice with the law firm Mauad & Mauad (www.mauad.com.pa) in Panama City.

 ISSN 1063-2069

transactions between related parties (controlled transactions) is a matter that might give rise to some debate. That is, the question may arise whether the Panamanian tax authority must recharacterize items of Panamanian source income on economic substance grounds before applying transfer pricing rules to a specific cross-border transaction between related parties.

Valuation Methods—Conceptual Framework

Under the arm's-length paradigm, the valuation approach may vary depending on the characterization of the asset. This is particularly important in the case of intangibles, where the income approach applies.[3] In addition, 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.[4]

Three Approaches

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

The cost approach implies that the price for an asset should not exceed what it would cost the entity to duplicate it. Because in the case of intangibles there usually is no link between cost and value, this approach works best for tangible goods and services.

The market approach relies on external markets and, like the cost approach, is more appropriate for tangible goods and services than for intangible assets.

The income approach, which is the preferred approach for intangibles, requires 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.

Best Method Rule

Panama's transfer pricing regime adopted the best method rule, but only in part. The regime gives preference to transactional methods over profit-based methods for ascertaining the arm's-length price, but without establishing a hierarchy among transactional methods themselves and among profit-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 automatically be considered 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 using 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 taxpayer's method 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 its numbers through all methods before choosing the one that best 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[5] and the quality of the data and assumptions used in the analysis.

Comparability Factors

The comparability of controlled and uncontrolled transactions typically is evaluated by the following factors included in the Panamanian transfer pricing statute. 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.

[3] 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.

[4] Under formulary apportionment, as opposed to an arm's-length approach, the total profits of the worldwide activities of a multinational enterprise would be distributed among the relevant jurisdictions according to a predefined allocation key.

[5] Transactions 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.

  TMTR ISSN 1063-2069

- **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.
- **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.

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 profit-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. The profit-based methods adopted by the statute are the profit split method and the transactional net margin method.

Other Methods, Intangibles

It is still to be determined whether the Panamanian transfer pricing statute—which incorporated by reference the OECD transfer pricing guidelines—also would allow unspecified or ''other'' methods when the specified methods are inadequate. This may be the case for intangibles transactions, which are especially difficult to price.

Perhaps the government should consider the possibility of requiring hindsight (without retroactive effect) when issuing regulations for the pricing of intangibles under the Panamanian transfer pricing statute.