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THE ISSUE OF SOURCE

A PRELIMINARY APPROACH TOWARDS A TREATY TO AVOID DOUBLE INCOME TAXATION BETWEEN PANAMA AND THE UNITED STATES

1. Introduction.

The present common understanding in the Panamanian business and political *fora* favors the position that Panama should respond to the current pressures from the Organization for Economic Cooperation and Development (OECD) by negotiating treaties to avoid double taxation with some of the OECD member states rather than by signing executive agreements to exchange fiscal information - as originally demanded by the OECD[i]. Accordingly, this article builds from such understanding and does not address the preliminary discussion of which approach would better serve the purpose of being delisted as a tax haven by the OECD while protecting the Panamanian International Banking Center and its economy overall. Additionally, we also assume in this work that Panama does not presently consider to undertake - in anticipation to treaty negotiations – an overall historical reversal of its long-standing internal income tax legislation which has defined Panama as a source jurisdiction country since its foundation. That is, we assume that Panama is not considering a major tax law reform towards taxation of the world wide income of its nationals and residents. However, we have taken into account the recent [September 2009] legislative reform imposing income taxation on foreign source dividend income paid by Panamanian corporations. Thus, this work rests primarily on current and long-established Panamanian income tax policy and elaborates from the current Panamanian trend towards negotiation of treaties to avoid double taxation with OECD member states.

In particular, we aim at kicking-off the necessary taxation thought process[ii] that - in our opinion – is mandatory in anticipation to a negotiation of a bilateral treaty to avoid double income taxation with the United States of America (the "U.S."), even though - to the best of our knowledge - the U.S. is not yet in the list of countries that Panama has formally approached to negotiate a treaty to avoid double income taxation. Accordingly, this work does not purport to present an exhaustive study of all the issues that should be paid attention to in anticipation to a particular treaty negotiation between Panama and the U.S. However, this article does intend to illustrate on the path of analysis that shall be undertaken prior to and during negotiations of a treaty to avoid double income taxation between Panama and the U.S. In doing so, we will also prove to be technically unfounded the – sometimes vehemently defended - cliché that Panamanian source income is automatically shielded against international double taxation by Panama's "territorial income tax system".

Negotiators from each country[iii] must first examine the domestic tax laws of the other country in order to indentify instances of potential double taxation and the need for harmonization of the same. Consequently - Panama being a source jurisdiction country primarily – after some general considerations, we will focus on certain items of income from the Panamanian perspective. Second, we will look at the same items of income under U.S. sourcing rules and indentify potential events of double taxation, if any, regarding such items of income. This work will also procure a comparison of the source treatment afforded to such certain items of income by the 2006 United States Model Income Tax Convention and the 2008 OECD Model Income Tax Convention, both models of which would be of pertinent use in negotiating with the United States a treaty to avoid double income taxation. The items of income used in this article as examples for our analysis are: interest, dividends and royalties.

The last part of this article will draw upon the discussion in order to arrive to some conclusions and formulate some recommendations.

2. *Panamanian Income Taxation and U.S. Federal Income Taxation – Brief reference to the respective general rules on gross income.*

The most basic question confronted in any domestic income tax system is "What is income"?[iv] . In the absence of an international treaty to avoid double income taxation, this question will always receive an answer based purely on domestic tax law that builds on the domestic rules used to source income. Gross income is a term of art in each jurisdiction and cannot be assumed to hold the same meaning in two different jurisdictions. Therefore, overlapping domestic concepts of "gross income" - insofar as such concepts derive their content and concretize their meaning from the likewise domestic rules of sources of income - are a primary cause of international double or multiple income taxation that may remain unalleviated under domestic law.

2.1 *Panamanian income taxation - The general rule on gross income.*

Article 694 of the Panamanian Fiscal Code provides for the Panamanian general statutory definition of taxable income which is calculated departing from gross income. The statute imposes the tax on all "*taxable income*" <u>derived from any source located within the Panamanian</u>

territory. Article 9 of the regulations thereunder supplement the statute by stating that the tax is imposed on "*income produced*" within Panamanian territory. So, peculiarly, Panamanian law refers to income as that derived from any source insofar as such source is located within Panamanian territory. So, gross income is not really all income from whatever source derived but all income from whatever source derived as long as such source is located within Panamanian territory. The concept of source takes an interesting twist in Panamanian tax law making the connection between the production of income and the Panamanian territory of the essence for the tax to apply. This is why the Panamanian income tax is commonly referred to as a territorial income tax, meaning that, in principle, all income produced by economic activities carried out within Panamanian territory shall be sourced in Panama and shall be subject to Panamanian income tax. Generally, the residence or citizenship of the taxpayer is of no relevance in Panama when sourcing income. What is relevant for Panamanian income tax is whether a specific item of income is to be sourced domestically because of it being "produced" within the Panamanian territory. Panamanian income tax sourcing rules elaborate on when specific items of income are to be regarded as being produced within Panamanian territory and hence sourced domestically. Accordingly, all exceptions to the general rule are designed and all exemptions are granted only with respect to domestically sourced income since what would be regarded as foreign source income under Panamanian tax law is, generally, not the object of Panamanian income taxation.

2.2 U.S. Federal Income Taxation – The general rule on gross income.

In contrast, § 61 of the U.S. Internal Revenue Code establishes in general terms that *"... gross income means all income from whatever source derived ..."*. Accordingly, § 1.61-1 of the

Income Tax Regulations parallel the statutory regulation using substantially the same language *"…Gross income means all income from whatever source derived , unless excluded by law …".*

Unlike Panamanian "territorial" income tax law, these provisions assert U.S. worldwide tax jurisdiction by including in gross income that from sources within the U.S. (U.S. source income) and that from sources without the U.S. (foreign source income). So, it is not hard to imagine a situation in which a U.S. citizen, resident or corporation obtains Panamanian source income (as determined under Panamanian income tax law) and is likewise obligated to include such income in her U.S. federal income tax return, regardless of the U.S. tax treatment of the same as either U.S. or foreign source income. Double taxation may arise as - for U.S. purposes - the geographical source of income of U.S. citizens, residents and corporations is irrelevant with respect to its inclusion in gross income. However, it is important to highlight that the U.S. affords international double tax relief via the foreign tax credit that is available to U.S. citizens, residents and corporations who pay foreign (i.e. Panamanian) income tax on foreign source income as determined under U.S. federal income tax law. Thus, double international income taxation may arise and remain without relief [via the U.S. foreign tax credit] when the same item of income is sourced in Panama under Panamanian tax law and is nevertheless treated as income deriving from sources within the U.S. under U.S. federal income tax law. Such a situation would involve a clear conflict of source rules in addition to the problem of international double taxation.

3. *<u>The issue of source</u>.*

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Let us continue addressing the matter by stating that domestic source rules of each jurisdiction establish whether specific items of gross income shall be treated as derived from domestic source or foreign source; and that domestic rule makers design their particular legal criteria of source by paying subjective attention to what they regard as the actual source of income from a practical hence economic and/or social observation of facts. That is, the domestic concepts of source of one country are not necessarily conceived to harmonize with domestic source rules of other countries. On the contrary, domestic source rules are established to reflect tax policy which primarily favors the national interests of the enacting country. Each country independently decides the circumstances under which specific items of income are domestically sourced and when items of income are foreign sourced. Hence, the potential international conflict among source concepts and the consequential need for harmonization to avoid or ameliorate potential double or multiple income taxation.

Generally speaking, it is clear then that while the income tax laws of one jurisdiction may treat an item of income as domestically-sourced it may likewise be seen as domestically-sourced by another country to which the same person is tax wise connected. In other words, the taxpayer being one and the same, may be taxed twice on the same item of income being regarded as domestically-sourced by the tax laws of two different jurisdictions to which such taxpayer is connected. For example, the source of personal services may be the country where services <u>are physically performed</u> or the source of personal services may be the place where services <u>are used</u>. If the source rules of two countries conflict with each other, international double taxation may arise.

On the other hand, the same item of income may be taxed twice in those instances where there is no conflict of source rules, but one of the jurisdictions to which the taxpayer is connected claims a taxing right on the foreign-source income of such taxpayer because of her/his citizenship or resident status in such jurisdiction. In such case, the same item of income may be taxed at the country of source and also at the country of citizenship/residence of the taxpayer. Therefore, double taxation may arise also in those cases where source rules do not collide but where both jurisdictions claim a taxing right: one country as the jurisdiction of source of the specific item of income, and the other country as the jurisdiction of citizenship or residence of the taxpayer. In the latter case, the residence/citizenship jurisdiction [personal jurisdiction] taxes the foreign-source income of its nationals or residents in addition to the domestic source income of such persons.

Moreover, cases may arise where two or more different jurisdictions claim personal jurisdiction over the foreign-source income of the same taxpayer because of the personal ties of such taxpayer to such jurisdictions. For example, one individual may be a citizen of one or more countries and resident of one or more countries and all countries coincide in asserting their right to tax the same item of foreign-income of such taxpayer. Obviously, circumstances aggravate even more when also the country of source claims its due right to tax the same income, which is more likely to happen than not. Taxation beyond double taxation may also come into play then in the international arena.

Treaties to avoid double taxation may be used to harmonize source rules among signatory countries since – normally – treaty source rules override domestic source rules in providing such harmonization. However, treaties do not dissolve all source conflicts. In negotiating a treaty, it has to be kept in mind that treaties usually leave the income classification rules to domestic laws of the signatory countries. That is, domestic income characterization rules - the rules that classify and name the various items of income – may affect the application of the source rules contained in the treaty because the domestic income characterization rules are to be applied before the treaty source rules to a specific taxable event. At least to that extent, the domestic income characterization rules also represent potential cause for double or multiple income taxation even after a treaty has entered into force. For example, income from a sale of a copyright may be classified as royalties in one country and as income from the sale of intangibles in the other country. Thus, two signatory States may classify the same income as a different item of income under their respective domestic tax laws and consequently apply different treaty source rules to the same income. However, for the sake of simplicity, the domestic income characterization rules of each jurisdiction are not analyzed in this article.

It is clear then that the issue of source is an essential matter to be taken into account by Panamanian authorities when negotiating a treaty to avoid double taxation with the U.S. and with any other country. The domestic tax laws of both countries need to be examined by both negotiation teams in order to procure effective harmonization through a treaty to avoid double taxation.

In the following section, we address the source rules contained in Panamanian income tax law (embedded in Panamanian statutes and regulations) applicable to three specific items of income: interest, dividends and royalties. Subsequently, we compare them to the U.S. federal income tax source rules applicable to the same items of income. In that sense, the following section purports to establish the general framework for the latter comparison in the succeeding section among the U.S. and OECD model treaties' source rules applicable to our three examples of items of income.

4. *Interest, dividend and royalty income: Panamanian and U.S. sourcing rules*.

4.1 *Interest income*.

4.1.1 *Panamanian sourcing rules on interest income*.

Under Panamanian income tax law, interest income is sourced according to the following general rules:

Panamanian source:

- Interest from loans whose proceeds are "economically invested" within Panamanian territory. Article 9(ch) of the Panamanian income tax regulations.
- Interest from deposits made within Panamanian territory. Article 9(ch) of the Panamanian income tax regulations.
- Interest from securities issued in exchange for funds "economically invested" within Panamanian territory. Article 9(ch) of the Panamanian income tax regulations.
- All interest income derived from funds "economically invested" within Panamanian territory . Article 9(g) of the Panamanian income tax regulations.

Foreign source:

- Interest from loans, deposits or any other financial transaction entered into with lenders of foreign domicile, as long as the lending and use of money occur outside Panamanian territory. Article 10(d) of the Panamanian income tax regulations.
- Interest from loans, credit facilities or any other financial transaction entered into with a legal entity, regardless of the domicile of such legal entity, as long as such legal entity's income is comprised of only foreign source income. Article 10(d) of the Panamanian income tax regulations.

4.1.2 U.S. sourcing rules on interest income.

Under U.S. federal income tax law, interest income is sourced according to the following general rules:

U.S. source:

- In general, all interest received on an obligation of non-corporate residents of the U.S. or domestic corporations. §861(a)(1) of the Internal Revenue Code.

Foreign source:

- In general, all interest received on an obligation of non-resident aliens or foreign corporations. §862(a)(1) of the Internal Revenue Code.
- Interest received on an obligation of a resident alien individual or domestic corporation if 80% or more of the U.S. obligor's gross income is derived from the active conduct of a foreign trade or business. §861(a)(1)(A) and (c)(1) of the Internal Revenue Code.

- Interest received from a foreign branch of a U.S. bank when the branch is also engaged in the commercial banking business. §861(a)(1)(B)(i) of the Internal Revenue Code.
- Interest paid by the foreign trade or business of a foreign partnership (look-through entity) predominantly engaged in such active conduct of a foreign trade or business but also engaged in the active conduct of a U.S. trade or business. §861(a)(1)(C) of the Internal Revenue Code.[v]

4.1.3 Comparison between Panamanian and U.S. sourcing rules on interest income.

Panama uses its territory as the connecting factor between interest income and the taxpayer regardless of the citizenship, residence status or place of incorporation of neither the lender nor the borrower. That is, in general, all interest deriving from funds used within Panamanian territory is sourced in Panama regardless of who is the lender and who is the borrower. In contrast, the U.S. sources interest income for federal income tax purposes on the basis of who is the borrower. That is, in general, all interest arising from an obligation of a U.S. resident, citizen or corporation is to be sourced in the U.S., regardless of where the borrowed or deposited funds are used or invested. So, the conflict between the Panamanian and U.S. sourcing rules on interest income is evident hence the potential international double income taxation on interest income arising in Panama under Panamanian domestic tax law. For example, generally, interest deriving from funds borrowed by a U.S. corporation and then "economically used" in Panama would be sourced in Panama under Panamanian income tax law and in parallel would be sourced in the U.S. under federal income tax law the borrower being a U.S. corporation. Double taxation may occur. This conflict of source rules on interest income could be harmonized through a treaty to avoid double income taxation between Panama and the U.S. whereby common rules on interest income were bilaterally adopted.

4.2 Dividend income.

4.2.1 Panamanian sourcing rules on dividend income

Under Panamanian income tax law, dividend income is sourced according to the following general rules:

Panamanian source:

- Dividends derived from capital "economically invested" within Panamanian territory, that is, dividends sourced in Panama correspond to business profits produced within Panamanian territory. Article 9(ch) of the Panamanian income tax regulations.

Foreign source:

- Dividends corresponding to business profits produced without Panamanian territory. Article 10(ch) of the Panamanian income tax regulations.

4.2.2 U.S. sourcing rules on dividend income.

Under U.S. federal income tax law, dividend income is sourced according to the following general rules:

U.S. source:

- In general, dividends <u>received from a domestic corporation</u> (corporation established under State law) constitute U.S. source income. §861(a)(2)(A) of the Internal Revenue Code.
- Dividends <u>received from a foreign corporation</u> "if 25% or more of the corporation's gross income from all sources was, for the preceding 3 years, effectively connected with the conduct of a trade or business in the U.S"[vi]. §861(a)(2)(B) of the Internal Revenue Code. "When the 25% threshold is reached or exceeded, dividends from the foreign corporation are U.S. source income in an amount equal to the dividends multiplied by:

$$\frac{\textit{Effectively connected gross income for testing period}}{\textit{All gross income for testing period}}$$"[vii]

<u>*Foreign source*</u>*:*

- Dividends <u>received from a foreign corporation</u> are entirely from foreign sources unless the 25% effectively-connected-income test referred to immediately above is met or exceeded. §861(a)(2)(B) and §862(a)(2) of the Internal Revenue Code.

4.2.3 <u>Comparison between Panamanian and U.S. sourcing rules on dividend income</u>.

Panama also uses its territory as the connecting factor between dividend income and the taxpayer regardless of the citizenship, residence status or place of incorporation of neither the paying legal entity nor the beneficiary of the dividend. That is, in general, <u>all dividends deriving from capital invested within Panamanian territory is sourced in Panama regardless of who is the paying entity or who is the beneficiary</u>. [However, when the dividend derives from foreign source it is subject to 5% withholding and when derives from Panamanian source it is subject to

10% withholding.] So the same Panamanian entity [withholding agent] is to apply two different withholding rates on dividends depending on source. In contrast, the U.S. sources income for federal income tax purposes on the basis of who is the paying corporation. That is, in general, <u>all dividends paid by a corporation incorporated in the U.S. under State law shall be sourced in the U.S., regardless of where the underlying trade or business is located</u>. Here, the conflict between the Panamanian and U.S. sourcing rules on dividend income is also evident although the potential for distortions is lesser than in the case of interest because the U.S. normally will consider dividends from a foreign corporation as deriving from a foreign source [unless the 25% threshold mentioned above is met or exceeded] and credit relief would be available. This conflict of source rules on dividend income could also be solved however through a treaty to avoid double income taxation between Panama and the U.S. whereby common or harmonizing rules on dividend income are adopted[viii].

4.3 <u>Royalty income</u>.

4.3.1 <u>Panamanian sourcing rules on royalty income</u>

Under Panamanian income tax law, royalty income is sourced according to the following general rules:

<u>Panamanian source:</u>

- Royalties derived from the "<u>economic use" within Panamanian territory</u> of intangible property like intellectual property rights [copyright, trademark, patents, secret processes, franchises, etc.] are sourced in Panama under Panamanian income tax law. Article 9(ch) of the Panamanian income tax regulations.

Foreign source:

- In contrast, royalties derived from the "economic use" without Panamanian territory of intangible property like intellectual property rights are sourced without Panama.

4.3.2 U.S. sourcing rules on royalty income

Under U.S. federal income tax law, royalty income is sourced according to the following general rules:

U.S. source:

- Royalties derived from intangibles used in the U.S., including royalties for the actual use of or for the right to use in the U.S. intellectual property rights, are sourced within the U.S. §861(a)(4) of the Internal Revenue Code.

Foreign source:

- Royalties derived from intangibles used without the U.S., including royalties for the actual use of or for the right to use without the U.S. intellectual property rights, are sourced without the U.S. §862(a)(4) of the Internal Revenue Code.

4.3.3 Comparison between Panamanian and U.S. sourcing rules on royalty income.

Interestingly, the Panamanian and U.S. sourcing rules on royalty income do not clash as they do when dealing with interest and dividend income. The domestic source rules of both countries harmonize naturally because both countries use substantially the same criterion for sourcing royalty income, not because of the particular tax system of either country individually considered. That is, each country sources royalty income, domestically, only if the intangible from which the royalty derives is used within their respective territories. Panama applies to royalty income the same territorial "economic usage" connection devised throughout its entire income tax legislation to source all income whilst the U.S. reaches out to such criterion in the case of royalty income but not in the case of interest and dividend income. However, despite the fact that source rules on royalty income do not collide, double taxation may arise anyway because the U.S. taxes both U.S. source income and foreign source income. That is, royalties perceived by a U.S. taxpayer from intangibles used in Panama by a licensee would be taxed both in Panama (as Panamanian source income) and in the U.S. (as foreign source income – outbound transaction from the U.S. perspective); although generally in this case the U.S. taxpayer may obtain double taxation relief via the domestic mechanism of the U.S. foreign tax credit for taxes paid in Panama. §901 - §908 of the Internal Revenue Code.

5. The source of interest, dividend and royalty income in the 2006 United States Model Income Tax Convention and the 2008 OECD Model Income Tax Convention.

5.1 Interest income – the issue of source in Article 11.

Article 11 of the USMITC and Article 11 of the OECD Model allocate the taxing rights over interest income between the signatory countries[ix]. In that sense, although **the USMITC does not address the issue of source itself**, the OECD Model does in paragraph 5 of Article 11 laying down that *"Interest shall be deemed to arise in a Contracting State when the payer is a* *resident of that State …"*. Such principle conforms to OECD policy but does not reflect Panamanian tax policy accurately. Therefore, attention to such matter under domestic laws of the signatory countries is of the essence. The general rule contained in Article 11 of the USMITC says "*Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State*". Article 11 in the OECD Model similarly says *"Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."* So, after reading the general rule in both models, **the essential question as to where does interest income arise**, for example, in a cross-border loan situation, remains unanswered under the USMITC unless each party resorts to its own domestic legislation to source interest income. This would take the parties, U.S. and Panama, to potentially contradictory interpretations deriving from different internal sourcing rules on interest income that may also render an eventual treaty unfruitful with respect to harmonization of interest income taxation. As said, according to Panamanian rules, interest deriving from funds borrowed by a U.S. corporation and then "economically used" in Panama would be sourced in Panama albeit the same interest would be sourced in the U.S. under federal income tax law. According to Panama's rules, in such hypothetical situation and under the current language of the USMITC, Panama would automatically interpret that it is the source-State hence the State called to define under internal law whether the beneficial owner of the interest is a U.S. resident or not. On the other hand, being the borrower a U.S. person, the U.S. would regard itself as the source-State called to define under internal law whether the *"beneficial owner"* (under the USMITC) of the interest is a Panamanian resident or not. A taxpayer could find itself trapped between two different interpretations as to who the beneficial owner or the person being paid the interest is. International double taxation may arise in such situation. On the other hand, international double non-taxation may also arise (only under the USMITC as it provides for exclusive taxing rights) if each country deems the other as the country of residence of the beneficial owner. So the issue of source of interest income itself would have to be expressly addressed by the parties [Panama and the U.S.] if the USMITC and/or the OECD Model were used, as most probably would, in a negotiation of a treaty to avoid double income taxation between Panama and the U.S.

The parties need to keep in mind that the USMITC allocates exclusive taxing rights to the country of residence of the ultimate beneficial owner of the interest income whilst the OECD Model provides for a shared right to tax the same interest income. Neither the term *"beneficial owner"* nor the term *"payment of interest"* are defined in the USMITC and the OECD Model, respectively, but it is intended that way[x] however. These broad terms are intentionally left for definition through the domestic law of the country which current U.S. and OECD policy[xi] assume to be "the State of source", that is, the State of the subject under obligation to pay the interest.

Needless to say, if Panama and the U.S. do not reach under a negotiated treaty a common understanding on which is the "State of source" of interest income, the term "beneficial owner" would then remain undefined and inconvenient unilateral interpretations will follow more likely than not.

The term interest is nonetheless defined in both the USMITC and the OECD Model to facilitate characterization of income.

5.2 Dividend income – the issue of source in Article 10.

Article 10 of the USMITC and Article 10 of the OECD Model, **although do not address the issue of source itself**, provide rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. Article 10 in both models permits the full taxation of the dividend by the State of residence [xii] of the beneficial owner and provides for a limited source-State right to tax the same dividend to a maximum of 15%; despite under current federal income tax law the U.S. affords preference to the paying-State with respect to taxation of dividends in full [insofar as the U.S. foreign tax credit is not available against U.S. federal income tax on U.S. source dividend income]. Again, in both models, the payor-State is assumed to be the State that under current U.S. and OECD current policy is considered to be the source State of the dividend: the State of residence of the dividend paying corporation.

Differently, the Panamanian conception of source of a dividend is linked to the territorial business profits from which the dividend derive, not to whom the paying entity is. However, since Panama just enacted new legislation providing for taxation of both Panamanian (10%) and foreign (5%) source dividend income, the particular Panamanian conception of source becomes relevant only for withholding rate purposes and no dividends will remain untaxed when deriving from foreign source, regardless of who the beneficial owner is. However, it would be in the interest of both parties to expressly state in the treaty under which circumstances a dividend is to be considered as paid by a company resident in a Contracting State, in order to avoid unilateral interpretations under domestic laws of the term "payment".

The term dividend is also defined in the USMITC and the OECD Model to facilitate characterization of income.

5.3 *Royalty income – the issue of source in Article 12*.

Article 12 in both the USMITC and the OECD Model reads *"Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State".* Because the source rationale of article 12 for allocating the right to tax royalties is not expressed in either of the two model conventions, even though the phrase ***"arising in a Contracting State"*** is used, the source purports to be ascertained under the domestic tax laws of the signatory countries. That is, each signatory country is expected to source the royalty income under its domestic rules [determine where income "arises"] and likewise define under internal law the term "beneficial owner". So, potentially, this article may lead to interpretative conflict with respect to the source of royalty income as does article 11 on interest income under the USMITC. However, Panama and the U.S. follow substantially the same criterion to source royalty income. That is, both countries pay attention to the use of the licensed right(s) within their respective territories for sourcing royalty income domestically as indicated in 4.3 above. As noted, when the source rules are substantially the same they harmonize naturally although the potential international double taxation remains when one or both of the countries tax their residents on their world wide income.

Nevertheless, provided that Article 12 in both model conventions do not contain an explanation as to where does royalty income arise, it would be advisable to include a provision addressing the matter expressly in the treaty itself to reconcile minor differences that might exist between the respective internal legislations of Panama and the U.S.

6. Conclusions and recommendations.

Instances of unrelieved double or multiple international income taxation may arise as a direct consequence of the same income being sourced domestically in two or more jurisdictions. In such cases, normally, the foreign tax credit or the exemption on foreign income are not available for relief of the double income taxation, so treaty law may come into play to harmonize clashes among sourcing rules.

Panama's territorial income tax system does not insulate Panamanian source income from international double taxation since other countries may not share the same sourcing rules and/or characterization rules. Treaty law would come to alleviate instances of international double taxation on income that Panama regards as deriving from Panamanian source under its internal law but that other countries do likewise source locally.

In an eventual negotiation between Panama and the U.S. to enter into a treaty to avoid international double taxation, specific care must be afforded to the issue of source as the domestic sourcing rules of both countries differ in some instances and coincide in others. Not paying due attention to the domestic sourcing rules of both countries during negotiation could render some provisions of a future treaty unfruitful due to contradictory interpretations of the same provision under internal laws.

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[i] "Based on this policy, Panama's cabinet-level commission is designing a strategy for entering into tax treaties, determining the parameters for the negotiating team, and identifying potential key jurisdictions to begin negotiations before the end of 2009." See "Panama: On track toward international fiscal transparency", by Luis E. Ocando and Alfredo Apéstegui, Tax Notes Int'l, Sept 28, 2009, p. 1121.

[ii] Political and macroeconomic considerations are neither the aim nor part of the analysis in this article.

[iii] In the United States, the Office of Tax Policy (a division of the U.S. Treasury Department) handles tax treaty negotiations with assistance from IRS personnel. The negotiators are generally from the Office of International Tax Counsel and the Office of Tax Analysis (International) See "U.S. International Agreements: Understanding the Process" by Ernest R. Larkins, Ph.D., Tax Notes Int'l, July 1, 1996, p. 60.

[iv] See "Taxation of Individual Income, Eighth Edition, J.Martin Burke and Michael K. Friel", page 24: "Certainly, the most basic question confronted in our federal income tax system is "What is income"? The answer to that question is not simple. One cannot merely rely on common usage, nor will one find much solace in the definitions of economists. Rather, the answer is found in an examination of the interplay of congressional purpose, administrative goals, accounting concepts and public policy as defined by the Congress, the courts and the Treasury…"

[v] See "Introduction to United States International Taxation, Fifth Edition, Paul R. McDaniel, Hugh J. Ault and James R. Repetti", page 39.

[vi] See "Introduction to United States International Taxation, Fifth Edition, Paul R. McDaniel, Hugh J. Ault and James R. Repetti", page 39.

[vii] See "Fundamentals of international Taxation, Second Edition, Boris. I. Bittker & Lawrence Lokken", page 70-7.

[viii] Panamanian Law 49 of September 17, 2009, although imposing income taxation on dividends and distributions paid by Panamanian entities [engaged in commercial and/or industrial activities in Panama] when deriving income from domestic sources and/or foreign sources, the new law does not affect the traditional territorial conception of source in Panamanian income tax law. However, such newly enacted piece of legislation does subject to income tax distributions paid by domestic Panamanian legal entities regardless of the source [in the Panamanian sense] from which such distributions derive. So, from a practical point of view, and in anticipation to treaty negotiations with OECD countries, Panama's income taxation on profits distributions [by entities engaged in a Panamanian commercial or industrial activity] is now imposed via withholding on all distributions paid by a Panamanian entity regardless of the source from which such distributions derive. Distributions out of foreign source profit are subject to 5% withholding and distributions out of domestic source are subject to 10% withholding.

[ix] U.S. treaties typically do not provide source rules for interest and dividend income but often do so for royalties.
[x] See "Unites States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006", page 39.

[xi] See "Model Tax Convention (Condensed Version) — ISBN 978-92-64-04818-8 – © OECD 2008", page177.

[xii] See "Unites States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006", page 32.