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Andrés Báez Moreno, PhD*

Hugo López López, PhD**

BRAIN DRAIN TAX VS. BRAIN GAIN BENEFITS: GENERAL THOUGHTS FROM A SPANISH PERSPECTIVE

One might expect that tax benefits introduced by certain developed countries to attract foreign high-skilled workers would run contrary to taxes aimed at the alleviation or deterrence of so-called brain drain. This article shows, however, that this is not necessarily the case: brain gain benefits might be justified by the existence of home-state brain drain taxes and, at the same time, serve to alleviate international double taxation generated by this type of taxes.

Key words: *Brain drain tax. – Brain gain tax benefits. – High-skilled workers taxation. – Highly mobile individuals taxation. – Inpatriates.*

1. INTRODUCTION

The core of the proposal envisaged by Prof. Bhagwati more than 40 years ago is well known: “(...) the loss to the less developed countries of some of their best-trained citizens can be made up by a tax on emigrants, with the revenues channeled back home through the United Nations.”¹ Since then there has been no shortage of publications complimenting, criticizing and (more frequently) building new models based upon that original idea.² However, the discussion on the very phenomenon of brain

* Associate Professor, Universidad Carlos III de Madrid, abaez@der-pu.uc3m.es.

** Associate Professor, Universidad Pública de Navarra, hugo.lopez@unavarra.es.

¹ Bhagwati (1976, 34–38).

² A good revision in Brauner (2010, 221–268).

drain taxation and the corresponding technical alternatives to articulate it have largely remained academic, inasmuch as no single jurisdiction has seriously implemented legislative measures in this direction. Quite the contrary: the policy of many developed states, and indeed a large part of EU countries, has been to design an entire arsenal of tax incentives to attract talent (*brain gain benefits*). Namely, these countries may accord a beneficial tax treatment for “new residents” postponing the full effect of ordinary residence, thereby limiting personal income taxation on domestic sources of income or even taxing these immigrants at reduced tax rates, all of this aimed at promoting the arrival of high-level professionals (sometimes including even sportspersons).³

We would therefore be facing two tax policies – “brain drain taxes” and “brain drain benefits” – which at first glance are radically opposed. However, and this is the suggestion of this contribution, the legal configuration of the Spanish brain gain benefits might well help to overcome some of the technical difficulties frequently perceived in certain versions of brain drain taxes.

The rest of this article is organized as follows: section 2 briefly exposes the main features of the Spanish tax treatment of highly mobile individuals placing the emphasis on the description of brain gain benefits. Section 3 analyzes the eventual coexistence of these benefits with different versions of brain gain taxes, with a view to detecting a clash or rather a synergy of (tax) policies. Section 4 contains a brief conclusion.

2. SPANISH TAX TREATMENT OF HIGHLY MOBILE INDIVIDUALS AND BRAIN GAIN BENEFITS

In a globalized world, immigration of skilled workers is far from being the matter of migration from developing to developed countries. It is much more a matter of attraction of high-qualified workers wherever they are and of retention of these types of workers, preventing their emigration.

In order to achieve these goals, states implement different kinds of measures. Among these measures, tax policy is one of the most relevant and Spain has set up a number of special tax regimes to deal with this phenomenon: tax rules (incentives and disincentives) to retain talent, on the one hand; and tax rules (incentives) to attract talent.

Regarding the tax measures to retain talent and more specifically, the tax disincentives, Spain has basically set up three exit taxes, which have been very problematic from a EU tax law perspective:⁴ 1) expanded

³ Falcón y Tella (2009).

⁴ On these and other Spanish exit taxes see CJEU, case C-269/09, European Commission v. Kingdom of Spain.

residence for taxpayers who move their residence to a tax haven;⁵ 2) a special timing rule, taxing unrealized income in case of loss of residence;⁶ 3) a specific rule taxing unrealized capital gains on shares with a market value of at least 4,000,000 €.⁷

The previously mentioned tax measures deal with international mobility of workers but they are by no means focused on the phenomenon of brain drain. These measures accent on mere “collection drain”.

Regarding the tax measures to retain talent by granting tax incentives, Spain has set up a special regime for expatriates.⁸ However, the previous tax incentive focuses more on supporting Spanish companies in their process of internationalization than on providing tax incentives to retain talent.

The only tax measure actually related to incentivizing international mobility of (skilled) individuals is the one first introduced in 2004, in Article 93 of the PITA, whose relevance for this contribution recommends a closer examination. Any individual residing in Spain for personal income tax purposes would in principle be taxed on their worldwide income, at a maximum rate of around 45%, depending on the particular region in which the individual is a resident⁹. In very broad terms the special regime consists on an option for inpatriates fulfilling certain requirements to be taxed as non-residents: therefore these individuals may choose between being taxed as ordinary residents, at a progressive rate of up to 45%, on worldwide income, or, if deemed non-residents, at a proportional rate of 24% on Spanish income sources.¹⁰ The regime has been heavily criticized since its inception and this explains to a large extent its successive amendments, the most noteworthy being: 1) the introduction of a maximum threshold of 600,000 euros in 2010 regarding the special tax rate; the limit, certainly explained by the critical situation of Spain since 2009, implied the existence of a dual track tax rate: i.e.

⁵ Art. 8.2 of the Law 35/2006, of 28 November 2006, del Impuesto sobre la Renta de las Personas Físicas y de modificación parcial de las leyes de los Impuestos sobre Sociedades, sobre la Renta de no Residentes y sobre el Patrimonio (Personal Income Tax Act, hereinafter PITA).

⁶ Art. 14.3 of the PITA. This rule is not without EU Law compatibility issues and it has been in fact revised in view of several decisions of the Court of Justice of the European Union considering similar rules of other Member States in breach of the EU freedom of establishment.

⁷ Art. 95 *bis* of the PITA.

⁸ Art. 7 p) of the PITA. For an analysis of this tax incentive, see López López (2015, 94–140).

⁹ The different rates for PITA purposes are derived from the particular Spanish partially decentralized personal income tax system.

¹⁰ This special regime also applies to the Spanish Impuesto sobre el Patrimonio (Capital Tax) whose high minimum exempt amount and low rates makes it practically irrelevant.

24% on source income up to 600,000 euros, and 45% above that figure. 2) in 2015 sportspersons were excluded to this tax regime; this change was the result of an obvious misalignment between the theoretical goal of the benefit – attracting highly-skilled professionals – and its effect in practice – the almost exclusive application to sportspersons, particularly football players.¹¹

Beyond the fact that the special tax regime will in practice preclude the application of the Spanish double tax convention network to residents opting for it,¹² the rule has been harshly criticized from a strict constitutional perspective. Since its seminal Decision of 26 April 1990 (STC 76/1990) the Spanish Constitutional Court has repeatedly made clear that: a) the equality principle imposes the application of the same legal (tax) consequences to comparable factual situations; b) the principle of equality does not prohibit any differential legal treatment but only discriminations that may be considered artificial or unjustified for not being based on objective and reasonable criteria; c) for a different treatment to be in compliance with the constitutional principle of equality, it is not enough that it is objectively and reasonably justified, since the legal consequences of such treatment must be suitable and proportional to the pursued goal.

In a nutshell, according to the Spanish Constitutional Court, just the different (tax) treatment of comparable situations might be considered a violation of the Constitution if that different treatment is either not justified or justified but not proportional. Even if the Spanish Constitutional Court has not yet had the opportunity to rule on the special in-patriate regime, the application of the aforementioned case law should lead to a straightforward conclusion according to the following reasoning. Comparing the situation of an ordinary tax resident earning an income that is comparable (although not identical) to that of a resident in-patriate opting for the application of the special regime, it is obvious that the two taxpayers are treated differently. The former will be taxed on their worldwide income at a progressive tax rate of up to 45%. The latter will be taxed a 24% tax rate on Spanish-source income on the first 600,000 euros. The Spanish-source income exceeding 600,000 will be taxed at a

¹¹ It is with good reason that the special tax regime received, at least before 2010, was called the Beckham Law, being this British football player was one of the first and most prominent beneficiaries of the regime.

¹² In fact, Article 120 of the Reglamento del Impuesto sobre la Renta de las Personas Físicas (PIT regulations hereinafter) allows for the issuing of a certificate of residence for beneficiaries of the special regime. This certificate, however, is not proof of the residence in Spain for double taxation convention purposes, according to the very regulations. Some scholars and practitioners in Spain have been extremely critical of this restriction, not only in regard to Spanish double taxation conventions lacking Article 4(1)2 of the OECD Model Tax Convention. See Falcón y Tella (2010, 49–50).

rate of 45%. Even if the preamble to the law introducing the special inpatriate regime in Spain did not mention its purpose, there is a broad consensus among both tax authorities and scholars that the measure intends to attract high-skilled workers to Spain.¹³ However, it is more than doubtful whether the special tax regime is actually adequate for such attraction, taking into account that the very scope of the measure does not differentiate the workers who might benefit from the special tax regime. The amendment introduced in 2015 – exclusion of sportspersons – merely corrected the initial roughest mistakes of the regime, which, however, remains incapable of objectively defining the criteria referring the high-skilled workers that it theoretically aims to benefit. Finally, and most importantly, the differences in taxation between regular residents and inpatriates opting in for the special regime – which has additionally dragged on for six years – seem too great for them to be considered proportional. The amendment made in 2010 – dual rates for income below and above 600,000 € – does not seem to sufficiently alleviate this lack of proportion, particularly if taking into account that among the 2,000 persons who had enjoyed the regime before 2010, less than 10 percent had incomes above 600,000 €. ¹⁴ This would suggest that especially after 2015, with the exclusion of sportspersons, the regime in practice essentially consists of the application of the reduced rate (24%) on Spanish-source income.

At this point it can only be concluded that Spain lacks a clear policy regarding taxation of cross-border mobile individuals and that the only measure that seems at least to show a more or less clear intention is of questionable constitutionality.

3. BRAIN DRAIN TAXES AND BRAIN GAIN BENEFITS TO THE (MUTUAL) RESCUE

One might expect that brain gain benefits, such as those described for the Spanish tax system, are by definition the opposite of brain drain taxes. Ultimately, both sets of tax measures would serve different and rather contradictive policies, namely to deter the brain drain, for the benefit of developing countries,¹⁵ and to promote it at their expense. However, as we will try to prove, this would only hold true regarding a particular and rather outdated version of brain drain taxes, whereas, in

¹³ See, among others, Álvarez Barbeito, Calderón Carrero (2010, 17–18), Sanz Clavijo (2013); Gorospe Oviedo (2010, 15–48); García Carretero (2015, 93).

¹⁴ Falcón y Tella (2009).

¹⁵ Explicitly recognized as one of the goals of the original Bhagwati tax proposal: Bhagwati, Dellalfar (1973, 95).

their evolved versions, brain gain benefits and brain drain taxes could be rather complementary.

3.1. The Original Bhagwati Proposal and Brain Gain Benefits

In brief, the original Bhagwati brain drain tax proposal implied the imposition of a tax on the income of immigrants, collected by the tax authorities of the developed host state and transferred to the developing home state.¹⁶ It is highly evident that a host-state brain drain tax such as the original proposal by Bhagwati would be difficult to reconcile with the previously described brain gain benefits. Purely from a policy perspective, both measures seem to be rowing in completely different directions. But, beyond this, the coexistence of host-state brain drain taxes and brain gain benefits might well exacerbate the legal problems already suffered by both measures individually.¹⁷ Indeed, both measures are frequently blamed for discriminating regular residents of the host state and new residents after immigration, albeit for different reasons (better treatment of regular residents under host-state brain drain taxes, and better treatment of new residents after immigration under brain gain benefits). It seems apparent that the introduction of a measure (be it a host-state brain drain tax or a brain gain benefit) with a radically opposite purpose to that of the original one (be it again a host-state brain drain tax or a brain gain benefit) would be very unhelpful – actually rather detrimental – in the search of a proper justification or proportion of the described measures. Indeed, it is even harder to justify the different treatment of regular residents of the host state and new residents, whatever it may be, if the opposite policy is promoted at the same time. However, this conclusion proves to be of little value if one takes into account that a host-state brain drain tax has never been implemented, and even if it had been implemented, it is highly unlikely that the jurisdiction would at the same time have passed brain gain benefits. In any case, the proliferation of brain gain benefits is an additional indication of the absolute lack of interest on the part of developed countries in host-state brain drain taxes. However, it would be a huge mistake to extend this incompatibility to any shape of brain drain tax, as we try to demonstrate in the next section.

¹⁶ This was the version maintained in different papers at least until 1976. For a description of the evolution of the original proposal see Brauner (2010, 240–243).

¹⁷ For more on brain gain benefits, see Section 2 of this contribution; for more on the original Bhagwati tax proposal, see Brauner (2010, 242) and the literature referenced in footnote 134.

3.2. “Brain Drain Taxes 2.0” and Brain Gain Benefits

Even among those most committed to taxing the brain drain, it soon became apparent that a host-state brain drain tax was a dead end.¹⁸ This left no other alternative to a brain drain tax than being levied by the sending (home) state, normally in the form of extended or citizenship-based worldwide taxation. The coexistence of these “brain drain taxes 2.0” with brain gain benefits, as those previously described, must be considered in detail.

3.2.1. *Brain drain taxes to the rescue of brain gain benefits*

As indicated above, the enormous tax disparities between original residents and inpatriated residents, generated by brain gain benefits in the form of the Spanish special inpatriate regime, might well prove contrary to Constitutional Law constraints. On the other hand, the alleviation of that disparities might frustrate the very purpose of the measure. However, these benefits would not be in the search of justification and proportionality if they were shaped precisely as a way to alleviate excessive taxation generated by the overlapping of the home-state extended residence– or citizenship-based worldwide taxation and the regular personal income tax of the host state.¹⁹ The degree of this alleviation depends of course on the very benefit and the intensity of the home-state brain drain tax, however, whatever this alleviation might mean in practice, it would provide a constitutional justification for brain gain benefits, and particularly a proportionality that they simply do not have in the absence of a home-state brain drain tax. On the other hand, unless all developed jurisdictions in search of skilled immigrants introduce identical brain gain benefits, the “incentive” would maintain its appeal.

3.2.2. *Brain gain benefits to the rescue of brain drain taxes*

It is quite clear that a home-state brain drain tax, in any of its possible modalities, might generate international juridical double taxation when combined with ordinary residence-based taxation in the host state, assuming that an immigrant will gain residence in the host state immediately upon emigration, according to its domestic law. Although brain gain benefits are not the only way to alleviate this double taxation, as we shall see, they might well serve the purpose of eliminating the most prominent phenomena of double taxation generated by the overlap of

¹⁸ In fact, Bhagwati himself acknowledged that legal restrictions mandated a tax levied by the developing (home) state rather than the developed (host) country. See Brauner (2010, 243).

¹⁹ For the sake of clarity and systematic presentation this excessive taxation will be analyzed in the next section.

national systems induced by brain drain taxes. Different scenarios can be presented regarding this particular issue.

1) In the absence of a double tax convention between the host and the home states.

In this situation the full freedom normally enjoyed by all jurisdictions to define residence criteria will not be limited by a superior rule of law²⁰ and therefore a situation of double tax residence will be consolidated, which involves, in principle, double taxation on worldwide income. A significant part of this double taxation may be alleviated by the unilateral mechanisms (credits) of the home and the host states,²¹ if it exists at all. However, we should not lose sight of the fact that: i) No unilateral mechanism will grant relief for taxes paid in third countries different from the home and the host states. Inasmuch as both countries will tax worldwide income of the migrant, this double taxation will not be relieved. ii) It is very probable that many host (developed) countries will not grant a credit for taxes paid in the home state on the wages gained in the host state. Indeed certain countries will not grant unilateral tax relief for income sourced in their territories, according to their domestic sourcing rules.²² It is obvious that the wages paid to the migrant in the host state will be sourced in that very state whatever its sourcing rules may be. iii) The frequent petty attitude of states in regard to the application of unilateral tax relief may jeopardize the correction of juridical double taxation in this scenario, as both the host and the home states may fear double credits and end up mutually denying it to the taxpayer.

Brain gain benefits, such as those contained in the Spanish system, will help to alleviate double taxation in the following scenarios: i) if the concerned jurisdictions – particularly the home state – do not have a unilateral mechanism to correct international juridical double taxation, or if it exists, it proves not to be applicable. ii) Inasmuch as the special tax regime implies being taxed just on Spanish-source income it prevents income sourced in third countries – different from the home and the host states – of also being taxed twice by the home and the host states, as states of residence (or the state taxing worldwide income based on citizenship). Of course juridical double taxation, generated by source taxation in a third state and residence or citizenship based taxation in the home state, will depend on the existence of treaties between those states

²⁰ Unless the freedom to leave a country, envisaged in certain constitutions and international agreements on human rights, is considered a limit in this context.

²¹ In this regard see Pomp, Oldman (1979, 36–39).

²² Although this restriction to foreign tax credit has at times been presented as exceptional there are several countries where foreign tax credit is not recognized for items of income sourced in the residence state. It is a common statement, for example, that foreign taxes imposed on US-sourced income may not be credited (Choi, Rienstra).

and, perhaps more importantly, domestic mechanisms to correct international juridical double taxation.

2) If a double taxation convention exists between the host and the home states.

One might expect that in the presence of a double taxation convention a “brain drain tax 2.0” would not be possible. In fact, in the current international tax regime tax jurisdiction follows residence²³ and it seems certain that the immigrant would gain residence in the host state upon immigration. Additionally, although the home state may expand its residence criteria to also cover emigrated nationals or residents or even develop citizenship-based worldwide taxation, in the presence of an OECD or UN model patterned double taxation convention, the host state will always be the winner in an eventual double residence conflict between the two states. Indeed, the rules contained in Article 4(2) of both the OECD and UN models will normally lead to this result inasmuch as a) the first tie-break rule in the provision (permanent home available) is largely elective²⁴ – and the immigrant would easily avoid double residence and double taxation altogether; and b) the second tie-break rule – center of vital interests – would lead, at least in our opinion, to decide the residence conflict in favor of the host state.²⁵

In the previous context a home-state brain drain tax would be incompatible with the Convention and the brain gain benefits of the host state would lose their justification and therefore, allegedly, their constitutionality. However, two additional scenarios must be considered.

The first is double taxation conventions containing a provision patterned according to the “saving clause” of the U.S. Model Tax Convention.²⁶ In these treaty circumstances it is obvious that citizenship-based worldwide taxation by the home (sending) state would be in accordance with the corresponding treaty; however, it is also obvious that the overlap of the home-state citizenship-based worldwide taxation and the host-state residence-based taxation might generate double taxation. It is true that – at least according to the current citizenship-based worldwide taxation in the United States – a citizen taxed abroad as a resident may

²³ Brauner (2010, 247).

²⁴ Brauner (2010, 250).

²⁵ For a different position see Brauner (2010, 250). We will later go back to this question.

²⁶ According to this provision in the current Article 1(4) of the U.S. Model Tax Convention (2016) “Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens. Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State.”

claim foreign tax credits, in the U.S., for income taxes paid in the residence (host) state.²⁷ However even if rules similar to the U.S. Foreign Tax Credit were introduced together with citizenship-based worldwide taxation in developing home states, double taxation on income sourced in third countries would persist and brain gain benefits, such as those previously described, would help their elimination at least in regard to worldwide income taxation in both the home and the host states.

The second is double tax conventions with modified tie-break rules. Authors favoring home-state brain drain taxes have claimed a possible variation of tie-break rules contained in Article 4(2) of both the OECD and UN model tax conventions in order to avoid systematic defeats of home (sending) states in double residence conflicts, thereby enabling in practice a home-state brain drain tax based on extended residence of emigrants. The proposal is simply to put the center of vital interests as the tie-break rule before the “permanent home available” criterion, eliminating the elective use of the rule by taxpayers and assuming that during the first years of immigration the center of vital interests remains in the home state.²⁸ In our view this change would not guarantee the systematic triumph of the home state in possible double residence conflicts. Even if the current Commentaries to the 2017 OECD Model Tax Convention seem to give more weight to the personal aspect of the center of vital interests,²⁹ it is important to bear in mind that: i) this interpretation has no basis in the wording of the OECD Model which refers to “...the State with which his personal and economic relations are closer (centre of vital interests)”; ii) the assumption that during the first years of immigration the center of vital interests remains in the home state is also questionable. Indeed, economic relations to the host state would be normally greater than those in the home state; on the other hand, it cannot be assumed lightly that all personal ties can be located in the home state. In any case, conflicts of double residence might persist, even under a change of the tie-break rules in the way suggested. Double taxation will arise in such cases, save for the unlikely event that one of the Contracting States relinquishes its claims, assuming the triumph of the other according to a different tie-break rule (normally habitual abode in the host state). This double taxation may proven to be more problematic than in non-treaty scenario, inasmuch as both contracting states might deny correction of double taxation assuming that the other country is not applying the treaty in a correct manner. In this context, the brain gain benefits would serve as a tool to grant partial – yet relevant – relief for this double taxation.

²⁷ Kirsch (2007, 504–505).

²⁸ Brauner (2010, 250).

²⁹ Article 4 para. 15 of the OECD Model Commentaries states “The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention.”

4. CONCLUSION

The Spanish brain gain benefits special regime, i.e. elective taxation of emigrants in Spain as non-residents during six years after immigration:

- 1) runs contrary to a traditional host-state brain drain tax increasing the many (legal) problems of the latter and exacerbating the constitutional concerns on the former.
- 2) may be a perfect complement to home-state brain drain taxes based on citizenship or extended residence inasmuch as: i) the existence of home-state brain drain taxes might well (constitutionality) justify brain gain benefits; ii) brain gain benefits may partially – yet importantly – correct international double taxation connatural to home state brain-drain taxes.

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