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# **"Tax Expenditures, Charitable Giving, and the Fiscal Future of the European Union"**

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NYU School of Law
Vanderbilt Hall-208
Time: 4:00-5:50pm
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**SCHEDULE FOR 2013 NYU TAX POLICY COLLOQUIUM**

(All sessions meet on Tuesdays from 4-5:50 pm in Vanderbilt 208, NYU Law School)

1. January 22 – David Kamin, NYU Law School, “Are We There Yet?: On a Path to Closing America's Long-Run Deficit.”

2. January 29 – Edward McCaffery, USC Law School, “Bifurcation Blues: The Perils of Leaving Redistribution Aside.”

3. February 5 – Jake Brooks, Georgetown Law School, “Taxation, Risk, and Portfolio Choice: The Treatment of Returns to Risk Under a Normative Income Tax.”

4. **February 12 – Lilian Faulhaber, Boston University School of Law, “Tax Expenditures, Charitable Giving, and the Fiscal Future of the European Union.”**

5. February 26 – Peter Diamond (with Emmanuel Saez), MIT Economics Department, “The Case for a Progressive Tax: From Basic Research to Policy Recommendations.”

6. March 5 – Darien Shanske, University of California at Hastings College of Law, “A Proposal for a New Property Tax Infrastructure.”

7. March 12 – Dhammika Dharmapala, U. of Illinois Law School, “Competitive Neutrality among Debt-Financed Multinational Firms.”

8. March 26 – Sarah Lawsky, University of California at Irvine Law School, “Unknown Probabilities and the Tax Law.”

9. April 2 – Alan Viard, American Enterprise Institute, “Progressive Consumption Taxation: The Choice of Tax Design.”

10. April 9 – Brian Galle, Boston College Law School, “A Nudge is a Price.”

11. April 16 – Leslie Robinson, Tuck Business School, Dartmouth College, “Internal Ownership Structures of Multinational Firms.”

12. April 23 – Larry Bartels, Department of Political Science, Vanderbilt University, “Inequality as a Political Issue in the 2012 Election.”

13. April 30 – Itai Grinberg, Georgetown Law School, “A Governance Structure to Mediate the Battle Over Taxing Offshore Accounts.”

14. May 7 – Raj Chetty, Harvard Economics Department, “Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark.”

Tax Expenditures, Charitable Giving, and the Fiscal Future of the European Union

Lilian V. Faulhaber[†]

*Abstract*

*In the wake of the recent economic crises in Europe, policymakers, academics, and other commentators spoke repeatedly about the fiscal future of the European Union. Had the fact that the twenty-seven Member States of the European Union lacked a harmonized fiscal policy lessened or worsened the impact of the economic crises? Did these crises and the outcry that surrounded them mean that fiscal harmonization was now more or less likely than before? Would Member States forever shy away from fiscal union, or was it even more necessary after the Greek bailout to tie together the taxing and spending policies of the European Union?*

*This Article argues that these current debates have ignored a significant development in the European Union, and that this development means that the budgets of the Member States are already more closely linked than has previously been recognized. This development, which this Article identifies as a "cross-subsidization effect," has emerged out of the tax expenditure jurisprudence of the Court of Justice of the European Union, where the Court struck down revenue-reducing direct tax provisions. By striking down these tax provisions, the Court did more than just require the Member States to amend their tax law. The Court effectively gave Member States a choice: either stop using your tax laws to subsidize your own residents, or extend that subsidy to residents of all the other Member States. Member States that chose the latter option end up subsidizing other Member States, thus linking the budgets of the European Union together.*

*In order to illustrate the cross-subsidization effect, this Article focuses on four recent cases in which the Court considered charitable giving incentives, such as tax exemptions for charitable organizations and deductions for charitable donations. These charitable giving cases illustrate the cross-subsidization effect, and the Member State responses to these cases illustrate both the benefits and the costs of this development. The cross-subsidization effect may offer hope to policymakers interested in pushing the European Union toward greater fiscal harmony in that it suggests that Member States, including those outside the Eurozone, are closer to this goal than has previously been recognized, in that certain elements of their budgets are now interdependent. The Member State responses, however, hold a warning to policymakers. Although the revenue effects of the charitable giving cases are relatively small compared to recent amounts lost and spent in the economic crises, Member States have still pushed back strongly against the cross-subsidization effect that emerged out of these cases. This Article argues that policymakers must consider the Member State responses to this effect, as well as the possible motivations underlying those responses, as they consider their next steps toward European fiscal union.*

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## I. Introduction

In the last several years, the Eurozone countries have seen the downsides of monetary union. As both the financial crisis of 2008 and beyond and the associated Greek debt crisis have shown, harmonized monetary policy can have a negative impact on the economies of states bound together by one currency. Prior to these crises, the creation of the Eurozone was one of the great successes of the European Union, and joining this monetary union was one of the great appeals of acceding to the Union.[1] Now, debates over the monetary union have focused less on its successes and more on the likelihood of its continued existence.[2]

Behind the events unfolding in the monetary sphere, however, debates continued over fiscal union, pursuant to which the taxing and spending powers of Member States would be harmonized.[3] These debates took several different guises. In one form, commentators argued over whether the lack of fiscal harmonization had contributed to the fallout from the financial crises.[4] Elsewhere, policymakers and politicians argued over the Commission's recent proposal for a harmonized corporate tax base.[5] Yet another form of this debate took place in academic circles, with commentators questioning whether the last several years of case law will eventually force the Member States to accept greater fiscal harmonization.[6]

This Article enters these debates over the fiscal future of the European Union and argues that the Member States of the European Union are in certain ways closer to fiscal union than has previously been acknowledged – but that they have also revealed their unwillingness to fully accept this state of affairs. This Article makes this argument by focusing on the tax expenditure jurisprudence of the Court of Justice of the European Union (the "CJEU" or the "Court"). Although direct taxation is not subject to EU-level control, the direct tax systems of the twenty-seven Member States have been subject to the "negative harmonization" of the Court.[7] Positive harmonization occurs when the executive and legislative arms of the European Union – the Commission, the Council of the European Union, and the European Parliament – pass harmonizing legislation in a specific area. Negative harmonization, in contrast, occurs when the

1 *But see* Protocol No. 25 on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland (1992), annexed to the Treaty establishing the European Community (stating that the United Kingdom would retain its own currency separate from the euro).

2 *See, e.g.*, Floyd Norris, *Euro Survives, but Future Is in Doubt*, NY TIMES (October 25, 2012); Michael Heise, *Why the Euro Will Survive*, WALL ST. JOURNAL (January 6, 2011); Lionel Barber, *Can the Euro survive?*, FINANCIAL TIMES (October 29, 2010).

3 This Article differentiates these fiscal debates from debates over the currency and exchange control powers associated with monetary policy.

4 *See, e.g.*, Austan Goolsbee, *A Fiscal Union Won't Fix the Euro Crisis*, WALL ST. JOURNAL (May 29, 2012); Derek Thompson, *Fiscal Union Cannot Save the Euro*, THE ATLANTIC (Nov. 28, 2011); Wolfgang Münchau, *Fiscal union is crucial to the euro's survival*, FINANCIAL TIMES (Nov. 14, 2010).

5 *See, e.g.*, European Parliament, *Press Release: Corporate taxation: Parliament pushes for a compulsory common base* (Apr. 19, 2012).

6 *See, e.g.*, Servaas Van Thiel, *The Direct Income Tax Case Law of the European Court of Jusice: Past Trends and Future Developments*, 62 TAX L. REV. 143 (2008); Peter J. Wattel, *Commentary: Judicial Restraint and Three Trends in the ECJ's Direct Tax Case Law*, 62 TAX L. REV. 205, 207 (2008).

7 *See, e.g.*, Alexandre Sayde, *One Law, Two Competitions: An Enquiry into the Contradictions of Free Movement Law*, 13 CAMBRIDGE Y.B. EUR. LEGAL STUD. 365 (2011) (cited in Michael J. Graetz and Alvin C. Warren, Jr., *Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility*, 112 YALE L.J. 1118, n.20 (2012)); Ruth Mason, *U.S. Tax Treaty Policy and the European Court of Justice* , 59 TAX L. REV. 65, 91 (2005) (highlighting the limits of "negative harmonization by the ECJ, since the ECJ merely has the power to invalidate provisions . . . that violate EC law and cannot replace them with positive measures").

judicial arm – the CJEU – strikes down Member State legislation, thereby achieving a form of harmonization by eliminating differences. In the direct tax arena, very little positive harmonization has taken place because any legislative act at the EU level requires the unanimous consent of all twenty-seven Member States. Each Member State thus retains veto power over any supranational fiscal legislation. Starting in the 1980s, however, the CJEU entered into the direct tax arena, and there have since been hundreds of direct tax cases, many of which have struck down Member State tax provisions and thus contributed to negative harmonization.

The Court's opinions in four cases decided between 2006 and 2011 brought particular attention to this negative harmonization. In these cases, which this Article refers to collectively as the "charitable giving cases," the Court required Member States to change tax provisions meant to create incentives for both charitable giving and charitable activity. These cases addressed two general scenarios involving non-resident charitable organizations. In the first scenario, addressed in Walter Stauffer and Missionswerk, a charitable organization attempts to qualify for tax exemption or reduced rates in a country other than its country of residence. Exemption or reduced rates are granted to charitable organizations that are resident in the country in question, but they are not permitted to non-resident charitable organizations. In the second scenario, addressed in Persche and Commission v. Austria, a resident donor attempts to take a deduction for a donation to a non-resident charitable organization. Deductions are permitted for donations to resident charitable organizations, but they are not permitted for donations to non-resident charitable organizations.

This Article uses the charitable giving cases to illustrate the unrecognized impact of the CJEU's tax expenditure jurisprudence. Tax expenditures are certain revenue-reducing tax provisions that are economically equivalent to government spending. This Article argues that the many cases addressing these provisions have gradually established what this Article refers to as the "cross-subsidization effect." This term highlights that Member States that choose to subsidize select taxpayers or activities through their tax systems must now extend that subsidy to similarly situated taxpayers or activities throughout the European Union. The Member States must thus effectively subsidize the economics of the other Member States housing those beneficiary taxpayers or activities. In the context of the charitable giving cases, this means that Member States that choose to provide tax incentives for charitable giving – including tax exemption for charitable organization and tax deductions for charitable donations – must extend those subsidies to charitable organizations throughout the European Union.

This Article does not limit itself to charitable giving. Instead, this Article uses the charitable giving cases as an illustration of the broader development that is the cross-subsidization effect. These cases are particularly useful illustrations of the cross-subsidization effect because, as will be shown later in this Article, the provisions in question are more likely than others to be accepted as spending equivalents, and Member States have responded forcefully to the Court's decisions in these cases. Moreover, due to their impact on the charitable sector, the charitable giving cases have received a significant amount of attention in the literature, but discussions of these cases have not articulated the broader development that they highlight.

This Article is also not limiting itself to a study of ECJ jurisprudence. It is instead arguing that this jurisprudence has effects on European politics and economics well beyond the court system. While much has been written about the Court's role in negatively harmonizing the tax systems of Member States by striking down tax provisions, the cross-subsidization effect is more than just the elimination of laws. Instead, Member States must choose between eliminating laws – or subsidizing each other by way of tax expenditures. This cross-subsidization effect thus means that the Member States are more closely bound in fiscal terms than has previously been acknowledged. The budgets of Member States are now dependent on each other, even when the Member States in question are not members of the Eurozone.

And yet, despite the fiscal closeness created by the Court's negative harmonization, many Member States have rejected the cross-subsidization effect. Their responses to the Court's decision in the charitable giving cases illustrate that the cross-subsidization effect is not enough to create full harmonization. Instead, Member States have responded to cases creating this effect in a variety of ways. While some expanded their charitable giving provisions to organizations across the European Union, some ignored the charitable giving cases for several years, some modified their laws in name only, some went to the other extreme and expanded their tax incentives worldwide, and one eliminated its charitable giving incentives entirely.

This Article argues that both the cross-subsidization effect and Member State responses provide guidance for policymakers considering the future of European fiscal union. In recent years, both before and after the financial crisis, many policymakers have discussed and debated fiscal harmonization of the European Union. None of these discussions, however, have acknowledged either the cross-subsidization effect or Member State responses to the cross-subsidization effect. This Article argues that both are necessary to discussions of fiscal union, since the former shows that the European Union as a whole has moved toward fiscal linkage and is thus closer in certain ways to fiscal union than has previously been understood, while the latter reveals that Member States are still not unanimously embracing any form of fiscal harmonization. While their varied responses to the charitable giving cases are partly due to the specific subject matter and their disparate cultures of giving, these responses also hold a warning for attempts to move toward greater fiscal harmonization in the future.

This Article makes three primary contributions to the literature. First, it introduces the cross-subsidization effect and illustrates how this has developed by way of the Court's tax expenditure cases. The cross-subsidization effect has evolved throughout the last several decades of the Court's direct tax jurisprudence, but it has not yet been identified as such. Second, it places the four charitable giving cases in the European Union in the larger context of the future of the European Union. Although these cases have received attention from European commentators,[8] this commentary has generally not considered what these cases mean for the future of the European Union as a whole. In the United States, these cases have received limited attention thus far, with commentators focusing primarily on their role as a potential model for changes to the treatment of charitable donations in the Internal Revenue Code.[9]

Third, it places these cases in the context of debates over the future of the European Union. This Article concludes that the charitable giving cases contribute to these debates – but that they do so inconsistently. In that these cases are weakening Member State sovereignty and

[8] *See, e.g.,* Ineke A. Koele, *How Will International Philanthropy be Freed from Landlocked Tax Barriers?*, EUROPEAN TAXATION, September 2010, 409; Sigrid J.C. Hemels, *What if Gulbenkian had been Persche: taxing charitable giving in Europe*; Theodore Georgopoulos, *Can Tax Authorities Scrutinise the Ideas of Foreign Charities? The ECJ's Persche Judgment and Lessons from US Tax Law*, EUROPEAN LAW JOURNAL, Volume 16, No. 4, 458-476 (July 2010). There have been only a few American articles that have mentioned the charitable giving cases, and these have not placed the cases in the broader context of EU harmonization. *See* Charles R. Ostertag, *Comment: We're Starting To Share Well with Others: Cross-Border Giving Lessons from the Court of Justice of the European Union*, 20 TUL. J. INT'L AND COMP. L. 255.

[9] *See* Khrista McCarden, *The Charitable Hunger Games: Are the Laws in Your Favor?* (unpublished manuscript).

tying together the budgets of individual Member States, they are paving the way for future fiscal harmonization. In that these cases are also leading Member States to reform their tax incentives for charitable giving along a very wide spectrum, however, they are also highlighting that negative harmonization is very different from positive harmonization. They – and the cross-subsidization effect that they illustrate – are thus revealing the many hurdles that the move toward full fiscal harmonization still faces.

Readers should note that the significance of the charitable giving cases does not lie in their revenue effects. Although the financial effect of these cases may be significant to the charitable sector, the amount of money that is likely to shift between Member States as a result of these cases is relatively minimal, particularly when compared with recent explicit subsidization requirements such as the European bailout of Greece.[10] The significance of these cases instead lies in what they represent. The Court has been developing the cross-subsidization effect over the last several decades, and the budgets of the Member States both within and without the Eurozone have thus gradually been becoming more and more closely linked. Furthermore, the fact that some Member States have so strongly rejected this effect in the context of charitable giving, where they are unlikely to lose a significant amount of revenue, suggests that this push-back will only strengthen in areas where more money is at stake.

This Article proceeds in four parts. Part II introduces the cross-subsidization effect by way of the four charitable giving cases. This Part also illustrates the robust history of this effect over the past several decades. Part III then introduces arguments for why policymakers may interpret the cross-subsidization effect as boding well for the future of fiscal harmonization. Part IV, however, points to the Member State responses to the cross-subsidization effect to provide policymakers with warnings about the likelihood of Member State rejection of fiscal harmonization. Part V concludes with suggestions as to how to build on the cross-subsidization effect to create a more fiscally unified Europe.

## II. The Charitable Giving Cases and the Cross-Subsidization Effect

In the past several decades, the executive and legislative institutions of the European Union have been granted competency over an increasing number of areas. As the EU has increased in size and Member States have grown more comfortable with its role, the Member States have ceded more power to both the Commission, which acts as the EU executive arm, and the legislative arm (comprised of the Council of the European Union and the European Parliament). In ceding power, the Member States have moved away from requiring a unanimous vote of all twenty-seven Member States for legislation and have instead permitted legislation in many areas to be approved by majority or "qualified majority" voting.

Direct taxation[11] is one of the few areas over which Member States retain individual veto power. Despite the fact that Member States have attempted to retain control over their fiscal

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[10] *See* International Monetary Fund, Press Release 12/85, *IMF Executive Board Approves €28 Billion Arrangement Under Extended Fund Facility for Greece* (March 15, 2012).

[11] In the European Union, the term direct taxation refers to taxation of individuals and corporations. It is contrasted with indirect taxation, which refers to taxation of goods and is exemplified by the Value Added Tax (VAT). Note that the VAT could be seen as itself creating a cross-subsidization effect, in that Member States that may previously have had systems that collected more VAT revenue lost revenue to the other Member States when they agreed to the harmonized VAT. This cross-subsidization effect does not raise the same issues discussed in this

policies, however, they have gradually lost this control at the hands of the CJEU. This Part introduces readers to the Court's direct tax jurisprudence in Section A, explaining why many commentators have described the Court as the engine of "negative integration." Section B focuses on the four charitable giving cases that the Court has recently decided, and Section C builds on these cases to introduce readers to the cross-subsidization effect. Section C also outlines the history of this effect, which the Court has developed through its decades-long tax expenditure jurisprudence.

A. Direct Taxation in the European Union

The European Union has come a long way since its start as a coal and steel community in 1956. With a shared monetary policy among the Eurozone countries,[12] borders eliminated between the twenty-seven Member States,[13] and the concept of EU citizenship enshrined in the founding treaties,[14] the current EU has in many ways lived up to its early goal of becoming an "ever-closer union."[15] One of the areas that has not been part of this push toward unification, however, has been direct taxation. Instead, as the Member States have eliminated legislative hurdles to harmonization in other fields, direct taxation has been one of the last holdouts.[16] Under Article 115 TFEU,[17] no direct tax legislation may be passed at the EU level without the unanimous consent of all twenty-seven Member States.[18] In other words, each Member State retains veto power over any proposed direct tax measure. The principle of subsidiarity also prevents tax legislation at the EU level if it would be more appropriate at the Member State level.[19]

Because of the ability of each Member State to block any move toward fiscal harmonization, the direct tax measures that have gained unanimous approval have done little to lead to fiscal union. The main legislative acts thus far approved under Article 115 TFEU and its predecessors have been six directives, which do not have immediate effect in the Member States

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Article, however, because Member States agreed to the harmonized VAT, rather than having it imposed on them by the Court of Justice of the European Union.

12 The current seventeen members of the Eurozone are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

13 *See, e.g.*, Schengen Agreement of 1995.

14 *See* Art. 20(1) TFEU (stating that "[e]very citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect").

15 *See* Preamble, EEC Treaty ("determined to lay the foundations of an ever closer union among the peoples of Europe…").

16 Note that indirect tax policy has long been one of the areas of EU law that *has* been harmonized. *See* Art. 113 TFEU.

17 Whenever possible, this article will refer to the Articles of the Treaty on the Functioning of the European Union. However, readers should note that the founding treaties of the European Communities and the European Union have gone through several stages of renumbering, and many of the Articles mentioned herein have themselves had different numbers throughout the history of the European Union. References to Article 115 TFEU thus also encapsulate references to Article 97 EC and its predecessors, all of which required unanimous consent for legislative regulation of direct taxation.

18 Art. 115 TFEU.

19 *See* Ruth Mason, *Common Markets, Common Tax Problems*, 8 FLA. TAX REV. 599, 602 (2007) (stating that "the principle of "subsidiarity," which forbids action at the EU level except when the policy objective cannot be achieved at the state level, also suggests that the Member States will remain the principal actors for tax matters").

of the EU.[20] Instead, directives set out ultimate policy objectives for Member States to achieve, but Member States are free to achieve these objectives as they see fit.[21] While these directives do signal that Member States share certain goals in the direct tax arena, they also highlight that fiscal policy is still far from unified across the twenty-seven Member States.[22] And yet, despite this limited legislative authority in the direct tax arena, the Member States have embarked on a form of fiscal harmonization. This harmonization has been sparked not by the legislative arm of the European Union, but rather by the judicial arm.

The Court of Justice of the European Communities has jurisdiction over cases that challenge Member State acts as violations of the treaties of the European Union. As the CJEU often writes, "although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law."[23] Although Article 115 TFEU requires the unanimous consent of the Member States for any EU-wide measure regulating direct taxation, all Member State laws may be challenged before the CJEU for violating the fundamental freedoms of the European Union. These fundamental freedoms include the so-called "four freedoms" of movement of goods, labor, capital and services, as well as the freedom of establishment.[24] For the first several decades of the Court's jurisprudence, no cases challenged any direct tax measures as violations of the fundamental freedoms, and many observers assumed that the unanimity requirement of Article 115 TFEU meant that direct tax cases were not within the jurisdiction of the CJEU. In 1986, the CJEU upset this understanding when it decided Avoir Fiscal, which struck down a French tax credit that was permitted only to companies resident in France.[25] As one commentator has noted, the effect of Avoir Fiscal "can be likened to the opening of Pandora's Box."[26]

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[20] *See* Rita de la Feria and Clemens Faust, *Closer to an Internal Market? The Economic Effects of EU Tax Jurisprudence*, Oxford University Centre for Business Taxation WP 11/12, 13 ("At present there are six EU legislative instruments on direct taxes"). These directives are the Mutual Assistance Directive for the Recovery of Taxes (Council Directive 76/308/EEC), the Mutual Assistance Directive for the Exchange of Information (Council Directive 77/799/EEC), the Merger Directive (Council Directive 90/434/EEC), the Parent-Subsidiary Directive (Council Directive 90/435/EEC), the Savings Directive (Council Directive 2003/48/EC), and the Interest-Royalties Directive (Council Directive 2003/49/EC). *Id.* at n.51.

[21] Art. 249 TFEU ("A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.").

[22] Another development in the direct tax area, which is not a legislative enactment but still took place based on a recommendation from the Commission, is the Code of Conduct for Business Taxation (the "Code of Conduct"). Council, Conclusions of the EcoFin Council Meeting on 1 December 1997 concerning taxation policy, 98/C, 2/01. Although the Code of Conduct is not binding on Member States, its mandate that Member States remove any forms of harmful tax competition has been widely respected. Tracy A. Kaye, *The Gentle Art of Corporate Seduction: Tax Incentives in the United States and the European Union*, 57 KAN. L. REV. 93, 109 (2008) ("The Code is not binding on the Member States, but those adopting it agree to reduce any existing tax measures that constitute harmful competition and to refrain from instituting any similar measures in the future.").

[23] *E.g.*, Centro di Musicologia Walter Stauffer v. Finanzamt München für Körperschaften, C-386/04, ¶15 (September 14, 2006); Commission v. Austria, C-10/10 (June 16, 2011).

[24] *See, e.g.,* Ruth Mason and Michael S. Knoll, *What Is Tax Discrimination?*, 112 YALE L.J. 1014, 1025 (2012); Michael J. Graetz and Alvin C. Warren, Jr., *Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility*, 112 YALE L.J. 1118, 1120-21 (2012) (stating that "[t]hese freedoms of movement were intended to create an economic market relatively/free of internal barriers, as well as greater social and political union within Europe.").

[25] Commission v. France, 270/83, 1986 E.C.R. 273 (Jan. 28, 1986). *See, e.g.*, Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 TAX L. REV. 131, 166 (2001) ("Beginning in the 1980's, the European Court of Justice has interpreted these various rights to provide protection against income tax discrimination among member states. The first such case was Commission v. France, in which France's denial of

After 1986, the number of direct tax cases before the CJEU blossomed from zero to hundreds over the last decade.[27] Now, direct tax cases constitute almost 2% of the CJEU's caseload, with tax cases in general making up approximately 10% of the Court's cases.[28] Many commentators have discussed this increased role of the Court in direct taxation, reaching a wide variety of conclusions. Most commentators agree that the court's activity in this field has limited the ability of Member States to shape their tax systems,[29] and the discussion within that agreement has focused on everything from whether the Court has a cohesive view of taxation[30] to the Court's oscillation between harmonization and Member State sovereignty[31] to whether the Court's encroachment into this field is a positive or a negative development.[32] Among both those who criticize the Court's entry into the direct tax arena and those who support it, there is general agreement that an apt description of the effect of the Court's decisions is "negative harmonization." This term captures the fact that, while the Court is eliminating aspects of Member State tax regimes, the legislative arm of the EU still lacks the authority to positively harmonize those regimes. The CJEU's direct tax jurisprudence is thus hollowing out individual Member State tax regimes, but no EU-level entity yet has the ability to replace the provisions that the Court removes.

When the Court decides direct tax cases, it generally follows a multi-part analysis pursuant to which restrictive provisions are only permitted if justified.[33] This analysis is sometimes referred to as the proportionality analysis, in which the Court considers whether the restriction on free movement is proportionate to a permissible goal. Permissible justifications include "reasons of public policy, public security or public health,"[34] as well as "preserving the fiscal cohesion" of a Member State's tax system.[35] The availability of administrative remedies

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integration credits to the French branch of a foreign insurance company that held shares of French companies was held to violate the freedom of establishment.").

26 Feria and Faust, *supra* note 20, at 15.

27 *See* CJEU Cases in the Area of Direct Taxation, *available at* http://ec.europa.eu/taxation_customs/common/infringements/case_law/index_en.htm (last visited October 22, 2012).

28 *See* Philipp Genschel and Markus Jachtenfuchs, *How the European Union constrains the state: Multilevel governance of taxation*, 50 EUROPEAN JOURNAL OF POLITICAL RESEARCH 293, 301-02 (2011) ("the relative share of direct taxes grew from less than 10 per cent of all tax cases (1988-1997) to almost 25 per cent (1998-2007)"); Mason and Knoll, *supra* note 24, at 1018 ("…tax cases constitute about 10% of the CJEU's caseload").

29 *See, e.g.,* Genschel and Jachtenfuchs, *supra* note 28, at 297 ("while Member States continue to levy taxes, EU institutions increasingly shape them").

30 Graetz and Warren, *supra* note 24, at 1120-21; Mason and Knoll, *supra* note 24, at 1014.

31 *See* Wattel, *supra* note 6, at 205 (perceiving "a cyclical pattern [from] hesitance in the beginning (until 1994), followed by outright activism (1995-2004) [to] a return to judicial restraint and a certain deference to the fiscal sovereignty of the Member States (since 2005)"); Suzanne Kingston, *The Boundaries of Sovereignty: The ECJ's Controversial Role Applying Internal Market Law to Direct Tax Measures*, CAMBRIDGE Y.B. EUR. LEGAL STUD., Volume 9, 2006-2007, pg. 287, 297-303 (charting "the three 'eras' in the Court's jurisprudence applying the fundamental freedoms to national direct tax rules").

32 *Compare* Van Thiel, *supra* note 6, *with* Wattel, *supra* note 6, at 207 ("I…generally welcome the court's recent restraint, as I feel the court was overplaying its hand (its competence and its possibilities) in its activist years and had given us an intractable ball of unacceptably inconsistent case law, as the court was regularly backing out – without saying so – of consequences of its previous vigorous case law.").

33 *See, e.g.,* Tracy A. Kaye, *Direct Taxation in the European Union: From Maastricht to Lisbon*, 35 FORDHAM INT'L L.J. 1231 (2012); Ruth Mason, PRIMER ON DIRECT TAXATION [hereinafter " Mason Primer"].

34 Mason Primer, *supra* note 33, at 93 (internal quotations omitted).

35 Bachmann v. Belgium, C-204/90 (Jan. 28, 1992). For more on justifications that are permitted in certain limited circumstances, see Mason Primer, *supra* note 33, at 101-108. Note that even permitted justifications can

or offsetting tax advantages are among the justifications that have been found not to be permissible.[36] Notably, one justification that the Court consistently rejects in direct tax cases is the protection of Member State revenue.[37] Thus, although one of the primary reasons that Member States have retained control over fiscal policy is so that they can protect their tax bases, the CJEU has declared that this very protection is not sufficient justification for discriminatory or restrictive domestic tax provisions.

If the Court finds that the Member State tax provision in question impermissibly violates the fundamental freedoms, then Member States are required to eliminate or amend similar tax provisions to ensure that they do not discriminate based on residence or seat of establishment. Some Member States may respond by eliminating the tax provision entirely, while others may extend the beneficial treatment of the provision to non-resident taxpayers or restrict the negative treatment that previously applied only to non-resident taxpayers.

From 1986 onwards, the CJEU has applied its direct tax analysis to all kinds of Member State tax provisions, including rate differentials,[38] loss consolidation,[39] and anti-avoidance rules.[40] In 2006, the Court's direct tax jurisprudence considered another type of provision: incentives for charitable giving. Section B discusses the four cases that this Article refers to as the CJEU's "charitable giving cases," which address the legitimacy of restrictions on incentives for charitable giving.

B. The Charitable Giving Cases of the CJEU

Due to historical, religious, and cultural differences between the individual Member States, the charitable sectors within the European Union are extremely varied. The tax treatment of charitable organizations and charitable donations also varies by Member States. In some Member States, charitable giving incentives take a form similar to that provided in the United States: charitable organizations are exempt from income, property, estate, and other taxes, while donations to these organizations are deductible from income and estate taxes. Member States with these incentives vary in terms of their limitations, but the general shape of the incentives remains similar.[41] Other Member States, however, retain charitable giving incentives in their tax systems, but they operate differently from the exemptions and deductions that may be familiar to

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only support narrowly tailored Member State provisions; the fact that a justification has been accepted by the CJEU in the past does not guarantee that it will be accepted in a particular case.

36 Mason Primer, *supra* note 33, at 108-114.

37 *See, e.g.,* Commission v. Austria, C-10/10, ¶40 ("it is settled case-law that the need to prevent the reduction of tax revenues is neither among the objectives stated in Article 58 EC nor an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty").

38 *See, e.g.*, CLT-UFA S.A., C-253/03 (Feb. 23, 2006).

39 *See, e.g.*, Marks and Spencer, C-446/03 (Dec. 13, 2005).

40 *See, e.g.*, Cadbury Schweppes, C-196/04 (Sept. 12, 2006).

41 *See, e.g.*, Antoine Vaccaro, Chris Olivier & Edith Bruder, *France*, 21 in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) ("the deductibility rates of charitable giving in France have increased from 1995 to 2006. For donations to organizations of general interest, the deductibility evolved from 40% of the gift with a maximum of 5% of the income in 1995, to 60% with a maximum of 20% of the income in 2003, and to 66% of the gift in 2005. For charitable giving to organizations specialized in social care, the deductibility rate increased from 50% of the donation with a maximum of 1040 French Francs (€158) in 1995, to 66% with a maximum of €414 in 2003, and to 75% with a maximum of €470 in 2005"). The definition of qualifying charitable organizations also varies by Member State, although most Member States have overlapping definitions.

readers. In the United Kingdom, for example, the most popular charitable giving incentive is Gift Aid, pursuant to which donations to charitable organizations are not deductible to donors, but instead are grossed up in the hands of the recipient organizations.[42] In Italy and Spain, in contrast, after individuals calculate their personal income tax liability, they can choose on their tax returns to allocate a set portion to the Catholic Church or other qualifying organizations.[43] Hungary had a similar rule until recently, pursuant to which taxpayers could designate a charitable organization to receive 1% of their tax owed.[44]

Despite these differences, one similarity amongst the tax treatment of charitable giving and charitable organizations is that, until 2006, the majority of Member States limited their charitable giving incentives to charitable organizations located within their individual borders. Under this limitation, the only charitable organizations that were exempt from income or property tax were domestic organizations, and the only charitable donations that qualified for tax deductions were those to domestic organizations. This limitation, commonly known as the "landlocked"[45] or "water's edge"[46] principle, was not limited to Member States of the European Union. It has been common amongst the many countries worldwide that offer charitable giving incentives in their tax systems, including the United States.[47] Although commentators have

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42 *See* HM Revenue and Customs, Giving to Charity through Gift Aid. *See also* Cathy Pharaoh, *United Kingdom*, 74 in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) ("Tax repaid to charities on giving through Gift Aid – the most popular tax-effective method in the UK which accounts for 90% of all giving – is worth around £850 million: tax repaid to donors is around £200 million").

43 *See* Giuiliana Gemelli, *Italy*, 45 in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) (describing the cinque per mille: Cinque per mille: government allocation of .5% of personal income tax → in 2006, this was €395 million. "This represents direct contributions from individuals who are free to give their personal share of taxes to their favorite NPO or research institution."); Marta Ray García, *Spain*, 58, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) ("The amount of household giving indirectly raised under the 0.7% of the Tax on Individual Income ruling (0.52% until fiscal year 2006) is published every year. This differential subsidization mechanism allows individuals to voluntarily devote 0.7% of their total tax liability…to charitable purposes. In their tax statement, taxpayers can choose to devote that amount to either the Catholic Church…, to NGOs active in social action and cooperation…, to match it and share it among the two with no additional cost…, or to mark neither of the two options, thus leaving the amount to the State for general purposes.").

44 *See* David Moore, *The Fiscal Framework for Corporate Philanthropy in CEE and NIS*, INT'L J. OF NOT-FOR-PROFIT L., Vol. 6, Issue 2 (Feb. 2004) ("One of the more innovative tax incentives in the region in recent years has become known as the '1% Law.' Pioneered in Hungary in 1996, the 1% Law allows private individuals to designate 1% of their tax liability to an NGO and 1% to a church. To be entitled to receive 1% contributions, a foundation or association must carry out public benefit activities. State museums and other state cultural institutions are also eligible recipients. Hungary's 1% Law, through which $15.76 million was designated for NGOs in 2001 alone, has served as a model for similar tax designation legislation now enacted in Slovakia, Lithuania, and most recently, Poland.").

45 Koele, *supra* note 8, at 409.

46 David Pozen, *Remapping the Charitable Deduction* 39 CONN. L. REV. 531 (2006).

47 *See* 26 U.S.C. § 170. Note that this limitation is less onerous in practice in the United States because the United States allows "friends of" organizations, which are U.S. charitable organizations that are "friends of" established non-U.S. organizations. *See* Rev. Rul. 63-252, 1963-2 C.B. 101 (Jan. 1, 1963). The "friends of" exception, however, still requires non-U.S. charities to establish a U.S. charitable organization, while U.S. charities do not need to create a separate conduit organization.

For sources questioning the wisdom of the continued water's edge limitation, see *See* Eric M. Zolt, *Tax Deductions for Charitable Contributions: Domestic Activities, Foreign Activities, or None of the Above*, 63 HASTINGS L.J. 361 (2012); Pozen, *supra* note 46; Harvey P. Dale, *Foreign Charities*, 48 TAX L. REV. 655 (1995).

discussed the pros and cons of this limitation in recent years, Member States did not appear set to shift away from this restriction prior to 2006.

The CJEU addressed this state of affairs in 2006, when it decided its first charitable giving case. In Walter Stauffer,[48] the court considered whether Germany could limit its charitable tax exemption to domestic non-profit organizations. Under the German tax provisions in question, Italian foundations such as the Centro di Musicologia Walter Stauffer were not exempt from taxation on any income earned in Germany because they, as foreign institutions, were only subject to limited tax liability in Germany.[49] The CJEU held that this restriction on tax exemption to domestic non-profits violated the free movement of capital.[50]

This finding was striking in its effect from the perspective of Member States. Limiting tax exemptions to domestic charitable organizations was hardly unique to Germany, but after Walter Stauffer, Germany and all other Member States that had limited tax exemption to domestic non-profits were presented with two options. They could either exempt all non-profits from the twenty-seven Member States from tax, or they could deny tax exemption to all non-profits, including domestic organizations that had previously had tax-exempt status. Member States thus had lost the ability to limit their exemption regime to their domestic charitable sectors.

Walter Stauffer dealt with a non-resident charitable organization that was prohibited from taking advantage of a charitable tax exemption that would be permitted for a resident charitable organization. In 2009, the Court considered a different scenario: whether a resident donor could be prevented from taking a charitable deduction just because the donee was a non-resident charitable organization. Persche dealt with Germany's charitable tax deduction. As with many other Member States, Germany limited the deduction for charitable donations to donations that were given to domestic charitable organizations.[51] In 2003, Mr. Persche, a German tax adviser with a second home in Portugal, donated "a gift in kind of bed linen and towels, and also Zimmer frames and toy cars for children" to the Centro Popular de Lagoa in Portugal, a retirement home with an attached children's home near Persche's Portugal residence.[52] Persche valued this donation at €18,180, and he deducted this amount from his German income taxes.[53] In order to substantiate this deduction, Persche provided a receipt showing that Centro Popular was "registered as a private social solidarity body with the General Directorate of Social Services and that it was accordingly entitled to all exemptions and tax benefits conferred by Portuguese law on bodies recognised as charitable";[54] the CJEU accepted that this certificate was "sufficient under Portuguese law to entitle him to a deduction for tax purposes."[55]

The German tax authorities, however, disallowed the deduction, both because Centro Popular was not a German charitable organization and because the receipt provided by Persche was not in a form required by German law for substantiating documentation.[56] The CJEU was

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48 Walter Stauffer, C-386/04.
49 Walter Stauffer, C-386/04. The income in question was rental income from property owned in Germany.
50 Walter Stauffer, C-386/04.
51 Hein Persche v. Finanzamt Lüdenscheid, C-318/07, Opinion of Advocate General Mengozzi, ¶10 (October 14, 2008); Hein Persche v. Finanzamt Lüdenscheid, C-318/07, ¶6 (January 27, 2009).
52 Persche, C-318/07, Mengozzi Opinion, ¶16; Persche, C-318/07, ¶¶2, 12. For American readers, Zimmer frames are the British term for walkers.
53 Persche, C-318/07, Mengozzi Opinion, ¶16; Persche, C-318/07, ¶12.
54 Persche, C-318/07, Mengozzi Opinion, ¶17.
55 Persche, C-318/07, ¶13.
56 Persche, C-318/07, Mengozzi Opinion, ¶19.

thus presented with two primary questions after a German court sent the case to the European court for a preliminary ruling. First, do the donations in question fall within the treaty prohibition on free movement of capital? If so, does a residency restriction on deductions for such donations constitute an impermissible restriction on free movement of capital?[57]

The CJEU held that charitable donations, including in-kind gifts, did fall under the treaty guarantee of the free movement of capital[58] and that restricting charitable deductions to domestic recipients was an impermissible restriction on the free movement of capital.[59] The CJEU thus disallowed absolute territorial restrictions on charitable deductions; resident donors must be able to receive a deduction if they could show that the foreign recipient organization would have been permitted to receive deductible donations had it been a domestic organization.

The Persche holding is significant because of both its limitations and its wide-ranging impact. In terms of limitations, the CJEU placed the burden on taxpayers to provide evidence that a donation to the foreign charitable organization would qualify for a tax deduction were that donation made to a domestic organization. In other words, Member States were permitted to limit their deduction to donations to qualified organizations, but nationality could not be one of the qualifications for a deduction.[60] Furthermore, placing the burden on taxpayers allows Member States to continue to treat donations to domestic and foreign organizations differently, if only in terms of the hurdles faced by taxpayers. So long as the Member State does not categorically refuse to allow deductions for any donations to foreign organizations,[61] Member States may still require taxpayers to acquire all necessary substantiation and reject such documentation if it does not comport with Member State requirements.[62] As will be seen in Part

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[57] Note that the Advocate General presented these as three questions, with the third question being whether Member States are obligated to obtain assistance from another Member State to determine if a charitable organization meets the latter Member State's requirements. The Grand Chamber combined the second and third questions into one.

[58] Persche, C-318/07, ¶30 ("the answer to the first question referred is that, where a taxpayer claims, in a Member State, the deduction for tax purposes of gifts to bodies established and recognised as charitable in another Member State, such gifts come within the compass of the provisions of the Treaty relating to the free movement of capital, even if they are made in kind in the form of everyday consumer goods").

[59] Persche, C-318/07.

[60] *See, e.g.*, Persche, C-318/07, ¶47 ("it is permissible for a Member State, as part of its legislation relating to the deduction for tax purposes of gifts, to apply a difference in treatment between national bodies recognised as charitable and those established in other Member States if the latter bodies pursue objectives other than those advocated by its own legislation"); Persche, C-318/07, ¶48 ("it is not a requirement under Community law for Member States automatically to confer on foreign bodies recognised as having charitable status in their Member State of origin the same status in their own territory….In those circumstances, they are free to define the interests of the general public that they wish to promote by granting benefits to associations and bodies which pursue objects linked to such interests in a disinterested manner and comply with the requirements relating to the implementation of those objects.").

[61] Persche, C-318/07, ¶72 ("Article 56 EC precludes legislation of a Member State by virtue of which, as regards gifts made to bodies recognised as having charitable status, the benefit of a deduction for tax purposes is allowed only in respect of gifts made to bodies established in that Member State, without any possibility for the taxpayer to show that a gift made to a body established in another Member State satisfies the requirements imposed by that legislation for the grant of such a benefit.").

[62] *See* Persche, C-318/07, ¶54 ("Nothing would prevent the tax authorities concerned from requiring the taxpayer to provide such proof as they may consider necessary in order to determine whether the conditions for deducting expenses provided for in the legislation at issue have been met and, consequently, whether to allow the deduction requested"); Persche, C-318/07, ¶70 ("As regards charitable bodies in a non-member country, it must be added that it is, as a rule, legitimate for the Member State of taxation to refuse to grant such a tax advantage if, in

IV, this limitation may have created enough of a loophole to permit some Member States to avoid, at least in the short term, the actual holding of Persche. However, the number and speed of Member State responses suggests that Member States themselves do not believe that this substantiation requirement is sufficient to undo the effect of the Court's holding in Persche.[63] Furthermore, the Commission's responses to Member State laws also reveal the limits of this apparent loophole.[64]

In terms of wide-ranging impact, the effect of Persche was to require most Member States to make fundamental changes to the tax incentives they provided for charitable giving. After Persche, the Member States that provided charitable giving incentives in the form of deductions had two choices. They could either eliminate their incentive for charitable giving entirely, meaning that donors would not benefit from the incentive regardless of the residence of the recipient organization, or they could extend the incentive to apply to donations to charitable organizations in other Member States that met the requirements – other than residency – for qualified recipients of charitable organizations.[65] As will be discussed in Part IV, the Member States responded to this requirement in a variety of ways.

Persche was not the CJEU's last word on charitable giving or non-profit institutions. In 2011, the Court decided both Missionswerk and Commission v. Austria. In Missionswerk,[66] the CJEU extended the Walter Stauffer holding beyond personal and corporate income tax regimes. Under Belgian law, beneficiaries of bequests were required to pay succession duties at a rate of up to 80%.[67] This marginal rate was reduced to 7% if the beneficiary was a non-profit organization, but only if the organization was either in Belgium or in the benefactor's actual place of work or residence.[68] Mme Renardie had bequeathed a gift to Missionswerk, a religious organization Germany, and Belgium taxed this gift at a marginal rate of 80% because the benefactor had neither lived nor worked in Germany.[69] The CJEU held that this restriction on the reduced rate for succession duties violated Article 63 TFEU.[70] After Missionswerk, Member States thus face the same decision in the estate tax realm that they faced after Walter Stauffer and Persche in the income tax realm. They must either eliminate charitable tax incentives entirely, or they must extend them to otherwise qualifying organizations in other Member States.

The most recent charitable giving case was also decided in 2011. Although Commission v. Austria was not about a charitable deduction *per se*, because Austria had not implemented

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particular, because that non-member country is not under any international obligation to provide information, it proves impossible to obtain the necessary information from that country").

63 To the extent that this substantiation requirement does limit the effect of Persche, it may be that it makes it harder for smaller charitable organizations to benefit from cross-border giving, since larger charitable organizations may be able to apply for charitable status in the Member States from which they are likely to receive donations, while smaller charitable organizations will have to rely on donors to provide substantiation to their countries of residence.

64 See *infra* Part IV.

65 Although some commentators incorrectly interpreted Persche as requiring the latter choice, see Karla W. Simon, *International Non-Governmental Organizations and Non-Profit Organizations*, 44 INT'L LAW. 399 (2010) ("This decision is an important one for all of Europe, holding as it does that cross-border donations within Europe must be made deductible under domestic law"), the CJEU only required that Member States not discriminate based on residence, so they had the option described here.

66 Missionswerk Werner Heukelbach eV v. Etat Belge, C-25/10 (10 February 2011).

67 Missionswerk, C-25/10.

68 Missionswerk, C-25/10.

69 Missionswerk, C-25/10.

70 Missionswerk, C-25/10.

such a deduction until 2009, it focused on what was effectively a deduction for charitable giving. Under a portion of its income tax, Austria provided that certain gifts could be deducted as "operating expenses," and these gifts included gifts out of operating capital to educational institutions that were established in Austria.[71] The Commission in 2005 challenged this limitation, first in two letters of formal notice and then in a reasoned opinion.[72] In 2010, the Commission brought this case before the CJEU, and the Court decided that Austria had violated the free movement of capital provisions under both the founding treaties and the EEA Agreement by limiting its deduction to recipients established in Austria.[73] The fact that the Court reached this holding by applying both the treaties and the EEA Agreement means that the deduction in question must be extended to all EFTA member states.[74] The charitable sectors that can benefit from the charitable giving cases thus now include those throughout the European Free Trade Association as well as the European Union. In other words, Member States in the EU must not only extend their charitable giving incentives to the other twenty-six Member States of the Union, but they must also extend them to Iceland, Lichtenstein, Norway, and Switzerland.

C. The Cross-Subsidization Effect

Upon first reading, it may appear that the charitable giving cases are no different than the Court's earlier direct tax cases referenced in Section A. In many ways, this is correct. The Court applied the analysis that it generally uses in direct tax cases. The Court found, as it has in many other direct tax cases, that the provisions in question were impermissible restrictions on free movement. And this finding led the Court to hold that Member States must either eliminate these restrictive provisions or extend them to similarly situated beneficiaries in other Member States.

While these cases were decided consistently with previous direct tax jurisprudence,[75] however, their result highlights a larger development in the CJEU. Because the charitable tax incentives in question are tax expenditures, requiring states to either eliminate them or extend them throughout the EU compels Member States to subsidize one another's charitable sectors – or deny support from their own domestic charitable sectors. This illustrates that the Court has, with these and previous tax expenditure cases, established a cross-subsidization effect. The first of the following subsections introduces the cross-subsidization effect and the second subsection provides background on its development.

i. Tax Expenditures and Spending

The charitable giving provisions at issue in the cases described above illustrate the cross-subsidization effect because they are an example of a specific type of direct tax provisions. They are tax expenditures, and, as such, they are economically equivalent to direct expenditures, or

71 Commission v. Austria, C-10/10, ¶¶5-8.
72 Commission v. Austria, C-10/10, ¶¶7-14.
73 Commission v. Austria, C-10/10, ¶44.
74 *See* Commission v. Austria, C-10/10, ¶2 (quoting Article 40 of the EEA Agreement as preventing "restrictions between the Contracting Parties on the movement of capital belonging to persons resident in [EU] Member States or [EFTA] States…").
75 The decisions in these cases may strike American readers as familiar, since state-level charitable giving incentives in the United States are also not constitutionally permitted to differentiate between domestic and out-of-state charities. *See* Camps Newfound/Owatonna v. Harrison, 520 U.S. 564 (1997).

subsidies. Unlike revenue-raising tax provisions, which collect money from taxpayers, tax expenditures are revenue-reducing tax provisions. Tax expenditures include exclusions, deductions, and credits,[76] and taxpayers who benefit from tax expenditures owe less money to the government than they would in the absence of such provisions.[77] Surrey, who introduced the concept of tax expenditures, defined them as foregone income; tax expenditures are deviations from a so-called normal income tax, and the government that provides such provisions loses revenue that it otherwise would have raised.[78] As explained more recently by Fleming and Peroni: "when a taxpayer-favorable feature of income tax law is used to provide a subsidy or incentive for a discrete income source or taxpayer group, the effect is the same as a direct cash payment from the government to the beneficiaries."[79]

Tax expenditures are thus part of a direct tax system, but they can be thought of as subsidies from the government.[80] If a government provides a tax expenditure that reduces taxpayer revenue by $1 million, that has the same effect on government revenue as a direct subsidy of $1 million. Although courts do not always accept this economic equivalence as equal to legal equivalence,[81] the effect of tax expenditures is seen by economists as fundamentally similar to direct expenditures.[82] Although the term "tax expenditure" originated in the United States, where "tax expenditure analysis" is now an accepted – if controversial[83] – part of the annual budget process,[84] the concept of tax expenditures as foregone revenue is understood within the European Union as well. In fact, the concept of tax expenditures has been described as a "simple, intuitively obvious idea,"[85] and the idea that foregone revenue is equivalent to a subsidy has been adopted by international organizations in many areas beyond pure tax policy.[86]

Readers should note that the concept of the cross-subsidization effect does not require acceptance of tax expenditure analysis or the tax expenditure budget, nor does it depend on how

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76 Joint Comm. on Taxation, A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (2008).

77 *Id.*

78 Stanley S. Surrey, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973).

79 J. Clifton Fleming, Jr. and Robert J. Peroni, *Can Tax Expenditure Analysis Be Divorced from a Normative Tax Base?: A Critique of the "New Paradign" and Its Denouement*, 30 VA. TAX REV. 135, 137-38 (2010).

80 Surrey referred to expenditures and deductions as "upside-down subsidies" because their value increased as a taxpayer's tax rate increased. Surrey, *supra* note 78.

81 *See* Arizona Christian School Tuition Organization v. Winn, 131 S.Ct. 1436 (2011). *See also* Mason, *supra* note 19, at 625 ("Subsidies and tax incentives highlight the advantages and disadvantages of tax competition. In the United States, the states are permitted to use their tax systems to compete for business, investment, and residents, as long as they do not discriminate against interstate commerce. But whether tax incentives constitute unconstitutional discrimination is unclear.").

82 *See, e.g.,* Arizona Christian School Tuition Organization v. Winn, 131 S.Ct. 1436, 1450 (2011) (Kagan, J., dissenting).

83 Fleming and Peroni, *supra* note 79, at 140-41 ("Although some commentators have regarded the validity of TEA as obvious, the general tone of the literature in the United States has been disparaging. One of the most prominent criticisms came in 2005 when the Office of Management and Budget stated that 'the [Bush] Administration believes that the concept of "tax expenditure" is of questionable analytic value.'").

84 *Id.* at 139 ("TEA has been a significant component of U.S. tax policy debates since it was introduced by Stanley Surrey in 1967 and each year both the U.S. Treasury Department and the Staff of the Joint Committee on Taxation of the U.S. Congress produce separate tax expenditure budgets listing all federal income tax provisions that fall under the tax expenditure rubric.").

85 *Id.* at 136.

86 *See* Warren, *supra* note 25, at 143-144 (discussing the historical treatment of tax subsidies in the General Agreement on Tariffs and Trade (GATT) and adding that "the Uruguay Round yielded a new Subsidies Code, which defines a subsidy as a "financial contribution by a government or any public body" including forgone revenue, such as a tax credit, that confers a benefit").

broadly one defines tax expenditures.[87] Instead, this Article uses the language of tax expenditures to illustrate the cross-subsidization effect only to the extent that the cross-subsidization effect exists because the revenue-reducing tax provisions challenged before the Court are economically equivalent to subsidies. This Article does not enter into the debate over how to define tax expenditures, nor does it require readers to accept any specific view of tax expenditures. Instead, it merely highlights that, by requiring Member States to extend tax expenditures to non-resident beneficiaries, the effect of the Court's holdings in certain cases has been to require Member States to subsidize non-resident beneficiaries and thus their Member States of residence.

This idea is perhaps most clearly exemplified in the charitable deduction, which is often presented as a key example of a tax expenditure. This is because the definition of a tax expenditure is more than just a revenue-reducing tax provision, and it is the distinction between the former and the latter that has produced much of the controversy around tax expenditures.[88] Surrey defined a tax expenditure as a revenue-reducing tax provision that would not be found in a so-called "normative income tax base," although the lack of any clear definition of such a normative base has prompted significant criticism.[89] Many tax provisions that reduce revenue are thus arguably not tax expenditures if they are merely ensuring the accurate calculation of income.[90] With few exceptions,[91] however, charitable deductions are seen as clearly tax expenditures; under a normal income tax, however that is defined, there would be no incentive for charitable giving, and they are thus essentially a replacement for a direct subsidy to charitable organizations.[92]

This discussion of charitable giving incentives as tax expenditures focuses specifically on charitable deductions, such as those discussed in <u>Persche</u> and <u>Austria</u>, simply because these are the least likely to trigger debates about what does and does not constitute a tax expenditure. Charitable deductions are generally accepted as tax expenditures by governments, commentators, and taxpayers alike.[93] Furthermore, it should be noted that this Article does not use "subsidy" as a normative term; it aims to stay out of the "vortex" of discussions over what is and is not a tax expenditure.[94] Instead, this term is meant to be a purely descriptive term. Because this Article is

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87 As will be shown in subsection II.C.ii, the incidence of the cross-subsidization effect does depend on how one defines tax expenditures, but the concept as a whole does not.

88 *See generally* Fleming and Peroni, *supra* note 79.

89 *See id.* at 142 ("The strongest attacks, however, have focused on the TEA baseline. For example, one prominent tax scholar has recently asserted that 'where tax expenditure analysis went off the rails ... was not in its aim of identifying "special" provisions ... but in its means of doing so, through the identification of a supposedly canonical, yet in practice under-theorized... definition of the "normative income tax base."'") (citing Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 199 (2004)).

90 *See id.* (stating by way of example that "the section 162 deduction for business expenses is not a tax expenditure, even though it benefits taxpayers by reducing their taxable income, because the deduction is a normative element in the definition of the base of a net income tax.").

91 *See, e.g.,* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346 (1972).

92 *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

93 *See, e.g.,* Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 Tax L. Rev. 283 (2011) (stating that the author believes "that Congress intends the charitable deduction to provide a subsidy even for charities that benefit individuals in high marginal brackets").

94 Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. DAVIS L. REV. 79, 81, 103 (1980) (cited in Fleming and Peroni, *supra* note 79, at 142). *Cf. generally* Halperin, *supra* note 93 (contrasting provisions that are "consistent with proper measurement of income" with subsidies); Boris I. Bittker

not focused on the purposes of the charitable deduction domestically, as is much of the literature that debates the degree to which revenue-reducing provisions are "subsidies," its use of the term "subsidy" is merely meant to show that governments are foregoing revenue to support charitable organizations, and not to argue as to whether or not this support is the role of the government generally. The tax exemption in Walter Stauffer and the lower estate tax rate in Missionswerk may also be considered tax expenditures,[95] but the charitable deduction is in many ways the clearest illustration.[96]

The economic equivalence of tax expenditures and direct expenditures thus provides one reason that Member States limited their charitable deductions and other charitable giving incentives to domestic taxpayers. Since these provisions are economically equivalent to direct subsidies, many countries chose not to extend these subsidies beyond their own domestic charitable sectors. And it is because these provisions are equivalent to subsidies that the Court's holdings in the charitable giving cases are fundamentally different from its holdings in cases addressing provisions that are not tax expenditures. The effect of these cases has been to place a much more onerous obligation on Member States than has previously been acknowledged.

After the charitable giving cases discussed above, Member States may no longer limit this subsidy to their domestic charitable sector. Instead, they are now required either to stop subsidizing their own charitable sector entirely or to subsidize the charitable sectors of other Member States. This is what this Article refers to as the *cross-subsidization effect*. When the Court decides a case about tax expenditures and holds that the tax expenditure in question is impermissibly restrictive or discriminatory, the Court is not just requiring Member States to harmonize their tax systems piece-by-piece. Instead, this harmonization of tax provisions that are economically equivalent to subsidies has the effect of requiring Member States to subsidize one another. The Court has thus created a network of cross-subsidization across the European Union.

And yet the Court has not taken the same approach to direct subsidies in the European Union. Although a full analysis of this counterfactual is beyond the scope of this Article, had the tax incentives challenged in the charitable giving cases been direct payments to charitable organizations, the Court likely would not have required that they either be eliminated or extended to organizations in Member States. This is because such direct payments would have to be challenged under the state aid rubric. "State aid" is the term used in the European Union for direct subsidies from Member States to specific domestic industries,[97] and the Court has decided dozens of cases dealing with state aid since its creation.[98] Under Article 107 TFEU,

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and George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299, 357 (1976) (using the term "hidden subsidy" pejoratively).

95 For debates on the U.S. about whether tax exemption is a tax expenditure, see Halperin, *supra* note 93; Hansmann, *supra* note 92; Bittker and Rahdert, *supra* note 94.

96 Note that this Article is not attempting to conflate the many charitable giving incentives with the charitable deduction but is instead focusing primarily on the latter as an example. *See* Hansmann, *supra* note 92, at 56 (stating that "the charitable deduction and the exemption raise different issues, and it would be quite conceivable for the tax system to embrace one without the other"); Bittker and Rahdert, *supra* note 94, at 306 (referring to the fact that the exemption of nonprofit organizations and the charitable deduction are "quite separate issues [that] are often confused.").

97 Kaye, *supra* note 22, at 100 ("In general, state aid is financial support given by a government to a certain business sector, enterprise, or geographic region through either direct or indirect transfer of resources.").

98 The Code of Conduct discourages tax provisions that may have the effect of state aid. Kaye, *supra* note 22, at 110 ("Article J of the Code of Conduct urged the Commission to strictly apply the state aid rules to those measures that were deemed to be harmful.").

"any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition" is impermissible state aid, unless the aid falls within a list of numbered exceptions.[99] Although state aid is generally thought of as focusing on competition – or, in American terms, antitrust –in that the relevant treaty provisions focus on state aid that distorts competition, Article 107 TFEU applies by its terms to state aid "in any form whatsoever."[100] The CJEU has interpreted this to mean that tax provisions that are equivalent to state aid may be considered state aid for purposes of Article 107;[101] in 1998, the Commission confirmed that, at least in the context of business taxation, tax expenditures may function as state aid.[102]

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[99] Art. 107 TFEU (ex Art. 87 TEC). Permitted exceptions include: "(a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned; (b) aid to make good the damage caused by natural disasters or exceptional occurrences; (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point." Art. 107(2) TFEU. Other forms of state aid that may possibly be exceptions include: "(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation; (b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State; (c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest; (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest; (e) such other categories of aid as may be specified by decision of the Council on a proposal from the Commission." Art. 107(3) TFEU. The prohibition on state aid extends throughout the European Economic Area and European Free Trade Area through EEA Agreement Article 61. Peter Ørebech, *The Art of Subsidizing Fuel-Free Electricity Under the European Economic Area Agreement as Illustrated by Norway's Reversion Instrument*, 86 CHI.-KENT L. REV. 109, 109-11 (2011).

[100] Art. 107(1) TFEU. For a list of the many different forms of state aid that have been recognized as such, see Christopher H. Bovis, *The Application of State Aid Rules to the European Union Transport Sectors*, 11 COLUM. J. EUR. L. 557, 574 (2005). *See also* Michael Reynolds, Sarah Macrory & Michelle Chowdhury, *EU Competition Policy in the Financial Crisis: Extraordinary Measures*, 33 FORDHAM INT'L L.J. 1670, 1674-75 (2010) ("The Commission has historically adopted a broad interpretation of the notion of 'state resources.' Aid can include 'grants, loans at a low rate of interest, deferment of tax liabilities, schemes of aid financed by compulsory contributions by all traders including those who do not benefit and in general, any gratuitous advantage such as a state guarantee of a firm's debt.'").

[101] Kaye, *supra* note 22, at 101 ("Although tax incentives were not the initial focus of the state aid restrictions, the European Court of Justice (ECJ) made it clear in dictum in Italy v. Commission that Article 87 applies to aid in any form."). Mason, *supra* note 19, at 627. Hanno E. Kube, *Competence Conflicts and Solutions: National Tax Exemptions and Transnational Controls*, 9 COLUM. J. EUR. L. 79, 92 (2002) (citing Banco Exterior de Espana SA v. Valencia, C-387/92, 1994 E.C.R. I-877; see also Commission v. Germany, 70/72, 1973 E.C.R. 813).

[102] Kube, *supra* note 101, at 95 (referring to the "1998 Commission guidelines on the application of Article 87 EC to direct business taxation measures (which are generally considered compatible with the prior and also the most recent jurisdiction of the European Courts)[, which] solidified to some extent the application of Article 87 I EC to tax subsidies"). In order to qualify as state aid, tax provisions must not be generally applicable. Reynolds, Macrory & Chowdhury, *supra* note 100, at 1675 ("General measures open to all comparable market players, such as guarantees for all retail bank deposits or open market operations and standing facilities entered into with or provided by central banks, are not selective and do not constitute state aid."). Instead, they must be "specific" or "selective." Kaye, *supra* note 22, at 102 ("The tax measure must also be specific or selective and not a part of the general overall tax system. n62 The ECJ has clarified that tax measures are specific if they differentiate between enterprises that are in legally and factually comparable situations.").

While many direct tax provisions have been struck down by the CJEU as impermissible state aids,[103] the charitable giving cases were not brought as state aid cases. Furthermore, had the Commission or other Member States challenged the charitable exemptions and deductions in these cases as state aids, there are several reasons that the cross-subsidization effect would not have been the result. First, it is unlikely that the Court would even have considered the charitable giving provisions to be state aid. State aid is focused on domestic industries and competition, and the broad charitable sector is not analogous to other industries considered in state aid cases.[104] Second, if the Court found that the provisions in question were potentially anti-competitive state aid, they very likely would fall under one of the exceptions provided in Article 107 TFEU, meaning that any restriction on this state aid would not violate the treaty protections.[105] Third, even if the Court fully considered the case and struck down the charitable giving incentive as impermissible state aid, the likely response of the challenged Member State, based on other state aid cases, would not be to initiate its own cross-subsidization effect. The majority of state aid cases result in the state aid being eliminated, rather than extended to recipients throughout the European Union; as will be shown in Part IV, the opposite was true in the wake of the charitable giving cases. Finally, in the unlikely event that the Court considered a charitable tax incentive to be impermissible state aid that was not exempt under the treaties and the Member State explicitly extended it to all other Member States, the result would still be different from the cross-subsidization effect in that this result would not be as hidden from political debate as the cross-subsidization effect has been. One of the criticisms of tax expenditures in general is that they allow spending to remain less politically salient than were the spending conducted through direct appropriations.[106] Similarly, one of the striking aspects of the cross-subsidization effect is that, since it has not been created by state aid cases that would have highlighted its existence, the fact that the Court is pushing Member States to subsidize each other has achieved much less attention.

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[103] Mason, *supra* note 19, at 627 ("Indeed, there have been many successful challenges by the Commission of tax provisions under the, prohibition on state aids."). For the history of the Commission's enforcement of state aid provisions beginning in the 1960s and 1970s and accelerating in 1998, see Kaye, *supra* note 22, at 102-04; Kube, *supra* note 101, at 90-91. Member States have also complied with the Commission's demands that tax provisions be eliminated or amended and thus avoided having to defend these provisions before the CJEU. One prime example of a tax provision that the Commission found to be incompatible with the internal market was Ireland's 10% corporate tax rate, which it ended up changing to comply with the Commission's demands. *See* European Commission Press Release IP/98/691/B, *Commission Addresses Recommendations to Ireland Regarding Corporate Tax* (July 1998). For more on Ireland's corporate tax rate as impermissible state aid, see Jennifer A. McHugh, *Balancing Reputation and Foreign Investment Incentives: Ireland's Second Attempt at Combating the Abuse of Irish Registered Non-Resident Companies*, 26 BROOKLYN J. INT'L L. 1207, 1214 (2001); Julia R. Blue, *The Celtic Tiger Roars Defiantly: Corporation Tax in Ireland and Competition within the European Union*, 10 DUKE J. COMP. AND INT'L L. 443, 460-61 (2000).

[104] *See, e.g.*, Italy v. Commission, C-6/97 (striking down state aid to Italian trucking industry).

[105] Depending on the recipient organization, charitable giving incentives would likely fall under Art. 107(2)(a) ("aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned"); Art. 107(2)(b) ("aid to make good the damage caused by natural disasters or exceptional occurrences"); Art. 107(3)(a) ("aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation"); or Art. 107(3)(d) ("aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest").

[106] Deborah H. Schenk, *Exploiting the Salience Bias in Designing Taxes*, 28 YALE J. ON REG. 253 (2011); David Gamage and Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011).

Despite the fact that the Court has decided cases dealing with both revenue-raising tax provisions and tax expenditures for several decades, the literature seems not to have highlighted the reason that tax expenditure cases are in fact very different from other direct tax cases. When the Court rules on cases dealing with revenue-*raising* tax provisions, a decision striking down the Member State provision in question will require the Member State to either eliminate the provision or require all taxpayers, including domestic taxpayers, to pay more in taxes. This outcome of course affects Member State budgets, but it does not link them together in the way that the cross-subsidization effect does. When the Court instead rules on cases dealing with tax expenditures, a decision striking down the Member State provision does more than just require Member States to align specific tax provisions. It also requires Member States to either stop subsidizing their own residents or start subsidizing the resident of other Member States.

This distinction can be illustrated by a series of earlier cases in which the Court considered anti-avoidance rules, which are revenue-raising provisions.[107] When the Court strikes down these rules, the result is in some ways similar to the cross-subsidization effect. Member State A, which previously had an anti-avoidance rule that required Resident Taxpayer to pay taxes on an investment in Member State B, can now no longer raise revenue by taxing Resident Taxpayer's investment. Member State B is now likely to raise more revenue by appealing to more taxpayers resident in Member State A. The difference between this result and the cross-subsidization effect, however, is that, after the anti-avoidance cases, Member State A is not explicitly subsidizing its own resident taxpayer to invest in Member State B, nor is it explicitly subsidizing a resident of Member State B. Any revenue lost as a result of the anti-avoidance cases is lost not because Member State A made a policy choice to *retain* a distortionary tax provision for policy reasons. Instead, any loss of revenue occurs because Member State A lost a distortionary tax provision. The cross-subsidization effect thus effectively penalizes Member States for making policy through their tax codes: if they choose to provide a tax benefit for certain behavior, such as giving to charity, they will be forced to subsidize other Member States. In contrast, any cross-subsidization that arises out of cases striking down revenue-raising provisions occurs against the political will of the Member State. The cross-subsidization effect thus attaches to the Member State's policy decision to encourage certain behaviors, rather than just the Court's decision to strike down a revenue-raising provision.

Readers should note that, although the term "cross-subsidization" suggests equal subsidization across Member States, that is likely more of an ideal than a reality. Instead, it is likely that some Member States are net exporters of charitable giving – meaning that they end up subsidizing more cross-border charitable giving than their domestic organizations receive – while other Member States are net importers of charitable giving – meaning that their charitable organizations receive more out-of-state charitable donations than the government foregoes in tax expenditures for cross-border giving. "Cross-subsidization" does not mean to imply that the CJEU is expected Member States to subsidize each other equally, but rather that the CJEU has created a requirement that subsidies from one Member State be extended to the other twenty-six Member States and vice-versa.

ii. The History and Incidence of the Cross-Subsidization Effect

[107] *See* Lilian V. Faulhaber, *Sovereignty, Integration, and Tax Avoidance in the European Union: Striking the Proper Balance*, 48 COLUM. J. TRANSNAT'L L.117 (2010).

This Article has chosen to introduce cross-subsidization by way of the incentives for charitable giving both because of the timing of the cases, all of which were decided fairly recently, and because such incentives are particularly well-suited to illustrating the cross-subsidization effect. Charitable giving incentives are intended to distort behavior;[108] an entire literature has been written about their function as a subsidy;[109] and they are fairly common both throughout the European Union and beyond.[110]

The charitable giving cases thus exemplify the cross-subsidization effect, but are they the only examples of this effect? This Article argues that, no, the cross-subsidization effect has evolved out of the Court's jurisprudence over the last several decades. This subsection argues that three elements of the charitable giving cases were necessary for their contribution to the cross-subsidization effect, and that these three elements existed in several earlier CJEU cases as well. The cross-subsidization effect is thus not limited to the charitable sector, and the larger ramifications of the cross-subsidization effect discussed in Parts III and IV should also not be dismissed as limited to this sector. The three factors necessary for a direct tax case to contribute to the effect are: (1) that the tax provision in question is economically equivalent to a subsidy in that it represents both foregone government revenue and a policy-motivated deviation from a normal income tax, (2) that beneficiaries of the provision can be found beyond the territory of the previous territorial limitation, and (3) that the CJEU strikes down a territorial limitation that restricted the benefits of the provision based on residence. The charitable giving cases had all of these. The charitable giving incentives, particularly the charitable deduction, are tax expenditures; beneficiary charitable organizations exist throughout the European Union; and, finally, these provisions were limited by territoriality, which the Court struck down.

This subsection considers whether any other CJEU cases meet all three of these requirements. The first is in many ways the hardest requirement to meet, since the provision in question must be more than merely revenue-reducing. The Court has been considering revenue-reducing tax provisions for as long as the Court has been deciding direct tax cases. The first direct tax case, <u>Avoir Fiscal</u>, was in fact a case about a tax provision that reduced revenue,[111] and the Court's jurisprudence in this area has continued to grow. This fact should not strike readers as surprising. Since the majority of direct tax cases that arrive before the CJEU are preliminary rulings from national courts, and since the cases in the courts below are brought by individual or corporate taxpayers, it makes perfect sense that these cases are generally challenging tax treatment that the taxpayers see as unfavorable.[112] Most tax cases focus on one of two fact patterns: the taxpayer is either challenging the application of a revenue-raising tax provision or arguing that a revenue-reducing tax provision should apply to that same taxpayer. It is in the latter group of cases that the CJEU has had the opportunity to consider revenue-reducing tax provisions.

As outlined above, however, the mere fact that a provision reduces government revenue is not sufficient for that provision to qualify as a tax expenditure.[113] Therefore, not all cases considering revenue-reducing tax provisions can be seen as creating a cross-subsidization effect.

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108 *See* Joint Comm. on Taxation, *supra* note 76 (categorizing charitable deductions as the types of tax expenditures "intended to subsidize or induce behavior").

109 *See, e.g.*, Halperin, *supra* note 93.

110 *See supra* notes 41-47 and accompanying text.

111 The provision in question was France's credit to offset the double taxation of dividends.

112 Alvin C. Warren, Jr. and Michael J. Graetz, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 YALE L.J. 1186 (2006).

113 *See supra* Part II.C.i.

Only those that consider provisions that are equivalent to direct subsidies can be seen in such a light. Since this Article is introducing the cross-subsidization effect, it is wary of overstating its incidence. This subsection thus defines tax expenditures narrowly. Some readers may find that the cross-subsidization effect is more common than is suggested in this Article, which only serves to strengthen the Article's arguments about the importance of identifying the development.

In order to apply the narrowest definition of tax expenditures possible, this Article accepts for argument's sake that many cases in which the Court considered revenue-reducing tax provisions did not in fact address tax expenditures. These cases include those in which the CJEU considered provisions that are essentially refunds of taxes already paid,[114] shareholder credits or deductions for tax paid at the corporate level on distributed profits itself,[115] provisions necessary for accurate measurement of income,[116] provisions that apply a lower rate to certain taxpayers or

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114 Biehl I, C-175/88 (holding that Luxembourg's limit on refunds for overpaid taxes to full-time residents was inconsistent with the Treaty freedoms); Commerzbank, C-330/91 (holding that the UK's limit on interest on tax refunds to resident taxpayers was inconsistent with the Treaty freedoms); Biehl II, C-151/94 (same holding as Biehl I).

115 Avoir Fiscal, C-270/83 (holding that France's limit on the shareholder tax credit on dividends to resident taxpayers was inconsistent with the Treaty freedoms); Manninen, C-319/02 (holding that Finland's limit on the imputation credit to dividends from companies resident in Finland was inconsistent with the Treaty freedoms); Meilicke, C-292/04 (holding that Germany's limit on the shareholder tax credit to dividends from companies established in Germany was inconsistent with the Treaty freedoms).

116 It should be noted that there are significant debates over what provisions are necessary for accurate measurement of income. See articles on business deductions as income measurement, not tax expenditure. *See* Fleming and Peroni, *supra* note 79, at 142 (stating by way of example that "the section 162 deduction for business expenses is not a tax expenditure, even though it benefits taxpayers by reducing their taxable income, because the deduction is a normative element in the definition of the base of a net income tax."). Imperial Chemical Industries, C-264/96 (holding that, except in cases where all or almost all of the subsidiaries are foreign, the UK's limit on group relief to holding companies with a majority of subsidiaries resident in the UK was inconsistent with the Treaty freedoms); X and Y, C-200/98 (holding that Sweden's limit on the deduction for intragroup transfers to groups where the Swedish parent owns at least 90% was inconsistent with the Treaty freedoms); De Groot, C-385/00 (holding that the Dutch limit on personal restrictions to resident taxpayers was inconsistent with the Treaty freedoms); Bosal Holdings, C-168/01 (holding that the Dutch limit on the deduction for financing costs related to holding a subsidiary to situations where the subsidiary's profits were taxable in the Netherlands was inconsistent with the Treaty freedoms); Gerritse, C-234/01 (holding that the limit on the deduction for business expenses to German residents was inconsistent with the Treaty freedoms); Mertens, C-431/01 (holding that Belgium's restriction on loss carryforwards for a Belgian resident who earned income in Germany was inconsistent with the Treaty freedoms); Wallentin, C-169/03 (holding that Sweden's limit on the standard deduction to resident taxpayers was, in the circumstances before the Court, inconsistent with the Treaty freedoms); Keller Holding, C-471/04 (holding that Germany's restriction on the deduction for financing costs by a parent company to acquire a subsidiary for costs related to dividends from a non-resident indirect subsidiary was inconsistent with the Treaty freedoms); Lakebrink, C-182/06 (holding that Luxembourg's restriction on the deduction for negative rental income for nonresidents who make the majority of their income in Luxembourg was inconsistent with the Treaty freedoms); Deutsche Shell, C-293/06 (holding that Germany's restriction on currency losses for a permanent establishment outside of Germany was inconsistent with the Treaty freedoms); Renneberg, C-527/06 (holding that the Dutch restriction on the deduction for negative rental income for nonresidents who make the majority of their income in the Netherlands was inconsistent with the Treaty freedoms); Busley and Cibrian Fernandez, C-35/08 (holding that Germany's limit on the deduction for rental losses to property situated in Germany was inconsistent with the Treaty freedoms); Gielen, C-440/08 (holding that the differential treatment of residents and non-residents in the context of the deduction for self-employed taxpayers was inconsistent with the Treaty freedoms); and SIAT, C-318/10 (holding that Belgium's restriction on the deduction for business expenses for entities not established in Belgium that are not subject to taxation in their home state was inconsistent with the Treaty freedoms).

transactions,[117] and provisions encouraging the purchase of or contribution to insurance and other savings vehicles.[118]

Even setting aside all the cases in which the Court considered the above types of revenue-reducing tax provisions, several cases still remain in which the Court established the cross-subsidization effect. In these cases, the Court considered narrowly tailored deductions, exclusions, and credits that are intended to create an incentive for a certain type of activity. The types of provisions that the CJEU has considered include those meant to encourage home ownership, education, and targeted forms of business investment, as well as a few provisions that apply even more narrowly. Early in the Court's consideration of such provisions, the CJEU allowed the territorial limits on these provisions to stand.[119] By the mid-1990s, however, the Court had started to hold that the Member States' restriction of these provisions to residents or domestic activity was inconsistent with the Treaty freedoms. As these holdings increased, they gradually created the cross-subsidization effect that reached its apex in the charitable giving cases.

The provisions meant to encourage home ownership included interest rate subsidies for housing construction,[120] capital gains exemptions for reinvestment in owner-occupied housing,[121] accelerated depreciation for real property,[122] and provisions explicitly described as "subsidies" for owner-occupied housing.[123] All of these provisions were limited to property situated in the

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117 Asscher, C-107/94 (holding that the higher rate imposed by the Netherlands on nonresident taxpayers was inconsistent with the Treaty freedoms); Royal Bank of Scotland, C-311/97 (holding that the higher rate imposed by Greece on foreign banks was inconsistent with the Treaty freedoms); and Zurstrassen, C-87/99 (holding that Luxembourg's restriction on the ability of nonresident married couples to take advantage of joint assessment of income was inconsistent with the Treaty freedoms).

118 Wielockx, C-80/94 (holding that the Dutch limit on the deduction for self-employed pension reserves to residents was inconsistent with the Treaty freedoms); Danner, C-136/00 (holding that Finland's limit on the deduction for contributions to voluntary pension insurance contracts to contracts offered by Finnish insurers was inconsistent with the Treaty freedoms); Skandia and Ramstedt, C-422/01 (holding that Sweden's limit on the deduction for premiums paid by employers to insurance policies to those policies issued by insurers established in Sweden was inconsistent with the Treaty freedoms); Commission v. Denmark, C-150/04 (holding that Denmark's limit on deductions and exemptions for payments to life insurance and pensions to pension institutions established in Denmark was inconsistent with the Treaty freedoms); Commission v. Belgium, C-522/04 (holding that Belgium's limit on deductions for employers' pension and life insurance contributions to contributions to companies and funds established in Belgium was inconsistent with the Treaty freedoms); Uwe Rüffler, C-544/07 (holding that Poland's restriction on the deduction for health insurance contributions for a German national attempting to deduct contributions to German insurance was inconsistent with the Treaty freedoms); Krzysztof Filipiak, C-314/08 (holding that Poland's limit on the deduction for social security contributions to contributions paid in Poland was inconsistent with the Treaty freedoms).

119 *See* Bachmann, C-204/90 (holding that Belgium's limit on the deduction for insurance premium to insurers established in Belgium was justified by the need for fiscal cohesion); Commission v. Belgium, C-300/90 (same holding as in Bachmann); Werner, C-112/91 (holding that Germany's limit on the deduction for expenses to resident taxpayers was, in the specific circumstances, a purely national issue and thus did not implicate the Treaty freedoms); Schumacker, C-279/93 (holding that Germany's limit on the deduction for expenses to resident taxpayers was generally consistent with the Treaty freedoms, unless the non-resident earned all or nearly all income in Germany).

120 Svensson-Gustavsson, C-484/93.

121 Commission v. Portugal, C-345/05; Commission v. Sweden, C-104/06.

122 Busley and Cibrian Fernandez, C-35/08.

123 Commission v. Germany, C-152/05. Note that this list, as with the rest of this discussion of revenue-reducing tax provisions, focuses solely on income taxes throughout the European Union. The CJEU has also considered cases dealing with incentives for home ownership in other tax systems. *See* Eckelkamp, C-11/07 (holding that Belgium's limit on the inheritance tax deduction of the amount of mortgage debt from the value of an estate to resident decedents was inconsistent with the Treaty freedoms); Commission v. Greece, C-155/09 (holding

Member State providing the tax benefit. The reason for this limitation was that the Member States aimed to encourage residents to buy domestic real property, thereby likely paying more in taxes to the Member State in the long term, becoming a more entrenched member of the local community, and supporting the domestic construction industry. The CJEU struck down the territorial limits in all of these provisions, thereby forcing Member States to make the same choice they ended up facing after the charitable giving cases: they could either stop subsidizing home ownership for domestic purchasers, or they would have to subsidize home ownership by their own taxpayers across the European Union and beyond.

The same type of result was reached in cases dealing with tax incentives for education. These incentives have included deductions for educational expenses by professionals,[124] deductions for private school fees,[125] deductions for payments to state educational institutions,[126] and exemptions for income received for teaching.[127] All of these provisions were limited to educational institutions within the Member State providing the tax benefit, and this limitation can be seen as an effort by the Member States to subsidize their own educational sectors. The CJEU struck down these limitations, and Member States were again faced with the choice of either not subsidizing their own institutions (or their own citizens who wanted to receive education) or subsidizing educational institutions across the European Union.

Another set of tax expenditures that the Court has considered has been incentives for investment. These incentives have included deductions and credits for research and development expenses,[128] accelerated depreciation,[129] and credits for the acquisition of assets.[130] The Court heard cases in which these incentives were limited to expenses incurred in the Member State providing the incentive or to assets that were remained in the relevant Member State. As with the cases discussed above, these territorial limits were at the heart of the incentive the Member State intended to create. These provisions were intended to encourage domestic investment vis-à-vis foreign investment, and they can thus be seen as subsidies to domestic industries. After the CJEU struck down the territorial limits in these provisions, Member States were yet again left to choose between no longer subsidizing their domestic industries at all or extending their subsidies to foreign investment.

Even defining tax expenditures narrowly, the CJEU has thus decided several cases that meet the first requirement for the cross-subsidization effect, in areas such as home ownership, education, and investment. Do these cases all meet the second and third requirements, however? In order to contribute to the cross-subsidization effect, there must be likely beneficiaries, whether direct or indirect, of the tax expenditure outside the previous territorial limitation. In some cases that appear to contribute to the cross-subsidization effect, it is extremely unlikely that the original Member State will end up foregoing a significant amount of revenue because of the type

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that Greece's limit on the transfer tax exemption for first purchases of real property to Greek residents and buyers of Greek origin was inconsistent with the Treaty freedoms); Commission v. Belgium, C-250/08 (holding that the Flemish Region's limit on the offset of property registration duties to purchases of property in the Flemish Region was inconsistent with the Treaty freedoms).

[124] Bent Vestergaard, C-55/98 (Danish rebuttable presumption that educational expenses in foreign tourist resorts were not deductible).

[125] Schwarz and Gootjes-Schwarz, C-76/05; Commission v. Germany, C-318/05.

[126] Zanotti, C-56/09.

[127] Jundt, C-281/06.

[128] Baxter, C-254/97; Laboratoires Fournier, C-39/04; Commission v. Spain, C-248/06 (opinion currently available only in French or Spanish).

[129] Jobra, C-330/07 (Austrian "investment growth premium" for assets used within Austria).

[130] Weidert and Paulus, C-242/03; Tankreederei I, C-287/10; Waypoint Aviation, C-9/11.

of benefit in question. In the home ownership cases, for example, it is unlikely that the Member States providing the tax expenditures will subsidize many first home purchases in other Member States because of the physical hurdles to such a situation. A homeowner in another Member State is likely to become a resident taxpayer in that latter Member State, meaning that the first Member State will no longer have taxing jurisdiction.[131] Thus, some tax expenditures are innately limited to resident beneficiaries. Some of the cases addressing incentives for education and investment may, however, meet the second requirement. Educational incentives may benefit educations institutions outside the Member State in question or non-resident students studying within the Member State, while investment incentives likely benefit non-resident research and development providers, as well as suppliers of certain property.

The final inquiry for those cases that meet the first and second criteria is whether the Court struck down a territorial limitation on the benefit of the tax expenditure. Although the Court has been much more willing in recent years to find such limitations inconsistent with the Treaty freedoms, there have still been several cases in which the CJEU allowed a tax expenditure to be limited territorially. Cases that arguably met the first and second requirements but that have wholly or partly upheld such limitations include those considering deductions for alimony payments[132] and deductions for artistic and athletic expenses.[133] But since the Court struck down territorial limitations in the educational and investment incentive cases that also provided non-resident beneficiaries, this subsection concludes that the charitable giving cases are not unprecedented. Instead the cross-subsidization effect has existed before – and, as shown by the three requirements for its existence, the Court can continue to establish it in future tax expenditure cases.

This discussion is not meant to suggest that the cross-subsidization effect is arising out of all direct tax cases decided by the Court, or even out of all tax expenditure cases that the Court decides. It is instead intended to show that the cross-subsidization effect is not limited to the charitable giving cases. The fact that the cross-subsidization effect is not limited to the four charitable giving cases argues in favor of its importance. In the following two Parts, this Article will use the charitable giving cases and Member State responses to them as an illustration for a larger discussion of what academics, commentators, and policymakers can learn from both the cross-subsidization effect and the Member State reactions to it.

## III. Moving toward Fiscal Harmonization?

This Part III argues that the cross-subsidization effect should be included in discussions about the future of European fiscal policy. In the wake of the economic crisis, much has been said about the economic linkages between members of the Eurozone. What has received less attention, however, is the fact that the cross-subsidization effect means that the budgets of all twenty-seven Member States, regardless of their monetary policies, are also bound together.

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[131] Another example can be seen in Conijn, where the Court struck down Germany's territorial limitation on the deductibility of the cost of tax advice. Conijn, C-346/04. The restriction that was struck down was not, however, a restriction on the residence of the tax advisor but instead the restriction on the residence of the taxpayer. The beneficiaries are thus likely to remain German tax advisors, and the impact of this decision is unlikely to lead to cross-subsidization of foreign tax bars.

[132] Schempp, C-403/03.

[133] Centro Equestre de Lezíria Grande, C-345/04 (upholding the German requirement that these expenses be linked to income earned in Germany).

This Part discusses the many ways that the cross-subsidization effect undermines Member State sovereignty while also tying together Member State fiscal systems.

A. Threats to Sovereignty

As with all encroachments by the CJEU into an area over which Member States believed they had retained veto power, the cross-subsidization effect represents a threat to Member State sovereignty. Putting aside academic debates over the most appropriate definition of sovereignty, direct taxation is generally accepted as one of the powers of the state most closely tied to sovereignty.[134] Without the ability to raise revenue, the thinking goes, a state is unable to exercise any of the other trappings of sovereignty.

The cross-subsidization effect represents an even greater threat to classic conceptions of Member State sovereignty than have previous obligations imposed by the CJEU in the direct tax area. Whereas cases addressing revenue-raising tax provisions weakened the abilities of Member States to raise revenue as they saw fit, the impact of these cases on Member State spending decisions was only indirect. Although it may seem highly probable that a Member State that has, for example, lost its ability to prevent all but the most egregious tax evasion will respond to the likely loss of revenue by cutting its spending, the Court did not require such spending cuts. With the cross-subsidization effect, the Court is inserting itself directly in Member State decisions about the use of revenue.

Some Member States made it clear in response to the Persche decision that they were opposed to this encroachment on their sovereignty. The United Kingdom was one of the most outspoken Member States in the wake of Persche. After first suggesting that the revenue authority would not change its tax provisions unless a donor brought a case against it,[135] the UK then argued that the changes that it made in the Finance Act 2010 were making it harder to prevent tax avoidance and tax evasion[136] and necessitated a cap on tax relief due to the resulting revenue losses.[137] And, given the increased international attention on the interaction between terrorist financing and charitable organizations after September 11, 2001, several Member States

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[134] *See, e.g.*, McCulloch v. Maryland, 17 U.S. 316 (1819).

[135] *See* David Ainsworth, *Finance: Tax ruling 'will be ignored,'* Third Sector, 2009 WLNR 2598660 (Feb. 10, 2009) (suggesting that the UK will fight the Persche decision and won't accept it until a UK donor brings HMRC to court).

[136] *Compare* Clive Cutbill et al., *Income Tax Cap – Update and Frequently Asked Questions*, Mondaq Blog, 2012 WLNR 9202463 (May 2, 2012) ("Public comments from the highest level of Government have additionally referred to high-income UK tax payers making gifts to organisations which they set up abroad and then fraudulently misusing those funds for non-charitable purposes.") *with* Clive Cutbill et al., *Income Tax Cap – Update and Frequently Asked Questions*, Mondaq Blog, 2012 WLNR 9202463 (May 2, 2012) ("the Treasury has indicated that fears of foreign abuse are not the motivation for the proposed cap."). *See also* Alana Lowe-Petraske, *Are the New Charities Provision in the Finance Act 2010 Fit for Purpose?*, Mondaq, 2010 WLNR 14691512 (July 19, 2010) ("We are told that the change to the definition of what constitutes a 'charity' [in Finance Act 2010] has been introduced in order to address the problems of tax fraud and 'sham charities,' thought to be likely to increase following the extension of UK reliefs to European organisations."); Sigrid J.C. Hemels, *Are we in need of a European Charity? How to remove fiscal barriers to cross-border charitable giving in Europe*, 19 ("According to an article in the Guardian of April 2012, the UK treasury and the Revenue and Customs have complained that EU law is inhibiting their ability to regulate bogus charities, based in Member States, that are being used as vehicles to avoid paying tax.").

[137] *See* Cutbill et al., *supra* note 136 ("There have been suggestions for 'Treasury sources' that the introduction of the cap was motivated by the extension of charitable reliefs to eligible organisations in the EU, Norway and Iceland following the Hein Persche line of cases at the European Court of Justice.").

complained that Persche were limiting their ability to ensure that charitable organizations were actually doing what they claimed.[138]

B. Revenue Losses

This threat to sovereignty would possibly not be as concerning to Member States if the cross-subsidization effect in fact required equal subsidization, with each Member State allowing the same amount in deductions that its domestic charitable organizations receive in contributions from abroad. Instead, since different Member States have very different levels of giving,[139] it is extremely unlikely that each Member State will be subsidizing the other Member States to the same degree that it is being subsidized by them. Imagine that, in the wake of Persche and the resulting changes to Member State A's tax legislation, Member State A taxpayers donate € 500,000 to charities in Member States B and C. It is unlikely that Member State A's charitable organizations will receive exactly € 500,000 in donations from taxpayers in Member States B and C. Instead, it is likely that at least one of these Member States will be a net exporter of charitable giving, while one or more of these Member States will be a net importer. If it turns out that Member State A taxpayers give € 250,000 each to Member State B and C charitable organizations, Member State B taxpayers give € 250,000 only to Member State A charitable organizations, and Member State C taxpayers make no charitable donations at all, then Member State A is a net exporter (with the entire charitable surplus going to Member State C), Member State B is neutral, and Member State C is a net importer (with the entire charitable deficit arising with Member State A).

Furthermore, the differences in tax rates in Member States may mean that, even if they are not net importers or net exporters in terms of absolute amounts donated, the subsidies themselves may be different. Return to Member State A and Member State B, the charitable organizations of both of which received € 250,000 from taxpayers in the other Member State. If Member State A has a flat tax rate of 10%, while Member State B has a flat tax rate of 50%, Member State A is only foregoing €25,000 in revenue to Member State B, while Member State B is foregoing €125,000 in revenue to Member State A.

In other words, the fact that some Member States will benefit much more than others from this requirement – and that others will end up paying much more than others – means that the cross-subsidization effect is requiring the net exporters to subsidize other Member States, and it is allowing net importers to siphon money from those net exporters to their own charitable sectors. Although the revenue implications of the charitable giving cases may not be significant compared to the amounts at stake in the Greek bailout or the recent financial crisis, the broader cross-subsidization effect of the CJEU's jurisprudence may have larger revenue implications. Furthermore, even small revenue losses or gains are significant when they are imposed on Member States by the judicial arm of a supranational body that allegedly has no authority to bind the budgets of Member States.

As will be mentioned in Part IV, some Member States appear to have foreseen this effect when they drafted their revised charitable giving provisions. Those countries that were motivated by reciprocity or benefit concerns may have been most concerned about becoming net exporters. So too may the recent debates over bailouts and the economic crisis have made

[138] Ainsworth, *supra* note 135.
[139] *See infra* Part IV.

potential net exporters warier of providing yet more funding to the countries that they believed most likely to become net importers.[140]

Interestingly, among the debates over cross-border giving in other states, much of the focus has been on third-world countries as the recipients.[141] The argument in favor of this extension has thus been focused on a moral imperative of the wealthier donor countries to aid impoverished recipient countries.[142] The requirement to cross-subsidize within the EU or the EFTA countries, however, does not necessarily have the same moral weight of a decision to extend funding to other countries within Europe. Member States may thus be less willing to lose revenue to support one another's charitable sectors, particularly in light of recent debates over intra-EU payments.

C. Ever-Greater Negative Fiscal Harmonization

The cross-subsidization effect thus strips Member States of even more fiscal sovereignty and will likely lead to a loss of revenue in many Member States. These two effects of the requirement mean that one major reason that the cross-subsidization effect matters for both the EU and the international community as a whole is that it has created a greater level of fiscal linkage than has heretofore been recognized. No longer is the negative harmonization of the CJEU just focused on harmonizing specific tax provisions. Now, Member States must both harmonize their tax provisions and subsidize one another through their tax systems.

After the charitable giving cases, when one Member State's charitable sector solicits and receives donations from taxpayers in other Member States, those latter Member States end up foregoing revenue in order to support the former Member State's charitable sector. This is particularly striking in the context of charitable deductions. Since one justification for charitable giving incentives is that charitable organizations relieve states from providing services,[143] the decision to require Member States to subsidize one another's charitable sectors can be seen as requiring them to subsidize one another's replacement service-providers. To understand this argument, imagine that Member State D provides five different services to its citizens and residents, and Member State E provides five different services to its own citizens and residents. Member State D has a national election, where one of the major debates is over whether the state can afford to provide these five services. Member State E also has a national election, where the major debate is the same. In Member State D, the election is won by the party that promises to cut these services; in Member State E, the election is won by the party that promises to keep these services. After the election, Member State D thus no longer provides the services, while Member State E does provide the services. When the charitable sector in Member State D steps up to provide these services, any deduction allowed by Member State E for donations from its taxpayers to Member State D charitable organizations will be a subsidization of Member State

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140 *See, e.g.*, International Monetary Fund, Press Release 12/85, *IMF Executive Board Approves €28 Billion Arrangement Under Extended Fund Facility for Greece* (March 15, 2012); International Monetary Fund, Press Release 10/187, *IMF Executive Board Approves €30 Billion Stand-By Arrangement for Greece* (May 9, 2010).

141 Zolt, *supra* note 47.

142 *Id.* (describing one argument in favor of eliminating the geographic limit on charitable deductions by stating that "[f]or a wealthy country, there is a moral obligation to provide financial and other support for famine and poverty relief.").

143 *See* Persche, C-318/07, Mengozzi Opinion, ¶57; Persche, C-318/07, ¶42, ("The German, Spanish and French Governments add that if a Member State abstains from levying certain tax revenue by exempting gifts made for the benefit of charitable bodies established in that State, that is because such bodies absolve that Member State of certain charitable tasks which it would otherwise have to fulfil itself using tax revenues.").

D's charitable sector. In other words, Member State E will be foregoing revenue to replace the services that Member State D has chosen *not* to spend its own revenue in providing.

Thus, while Member State D saves money by not providing services, this fiscal decision to limit spending ends up affecting the budget of Member State E. Prior to the cross-subsidization effect, Member State E would not necessarily have chosen to provide its own revenue to essentially replace Member State D's services. Due to the cross-subsidization effect, Member State E has no choice if it retains its charitable giving incentive.

The example above may appear extreme, and it assumes that the charitable sector will automatically leap into any vacuum created by a cut in state funding. Although it is worth questioning whether such an assumption is true, the above example is mainly a thought experiment to illustrate the budgetary linkage created by the cross-subsidization effect. This linkage can also be understood with a less extreme example that does not require the same assumptions. Although they did not give rise to tax deductions in many Member States, it is likely that there were at least some cross-border donations taking place prior to the charitable giving cases.[144] Imagine that Member State F was and is a net exporter of charity, while Member State G was and is a net importer of charity (and that the EU is only made up of those two Member States). Before the cases were decided, Member State F was not subsidizing Member State G's charitable sector at all. After the cases were decided, even if nothing other than the required legislative changes took place, Member State F suddenly was subsidizing Member State G's charitable sector. Member State F's revenue thus went down, and it did so merely because of its own taxpayers' decisions about charitable giving.

Now assume that Member State F taxpayers are not somehow immune to the price elasticity of giving models that show that a deduction makes taxpayers willing to give more to charity than they were before.[145] In other words, assume that Member State F taxpayers increase their cross-border giving once they learn that donations to Member State G are now deductible from taxation. (Note that, given the publicity surrounding many of the legislative changes discussed above, it is possible that taxpayers in the EU are likely to distort their behavior even more than they otherwise would have.[146]) This change would mean that Member State F would forego even more revenue than before – and Member State G's charitable sector would benefit from this increase in giving. Thus, while Member State F's revenue decreases, Member State G's charitable sector increases in size. This increase in Member State G's charitable sector could, of course, just lead to greater salaries for those working in the sector or greater administrative costs, but it may also lead to an increase in services, which may in turn relieve Member State G of some of its responsibilities, thus increasing Member State G's revenue. Again, the end result is that a decrease in Member State F's revenue is linked to (if not directly caused by) an increase in Member State G's revenue.

Even if the final step in that chain does not take place, and Member State G does not experience a reduction in spending, it is still striking that the beneficiary of Member State F's reduction in revenue is the charitable sector of another Member State. The cross-subsidization

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[144] If nothing else, Hein Persche himself clearly engaged in at least one instance of cross-border giving prior to the decision in Persche.

[145] *See, e.g.*, Gerald Auten et al., *The Distribution of Charitable Giving, Income and Taxes: An Analysis of Panel Data*, 92 AM. ECON. REV. 371, 380-81 (2002); William C. Randolph, *Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions*, 103 J. POL. ECON. 709, 724 (1995).

[146] This statement suggests that the charitable deduction for cross-border giving has become hypersalient. *See* Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307 (2012); Yair Listokin and Jacob Goldin, *Tax Expenditure Salience* (unpublished manuscript).

effect thus links the purse strings of Member States together more closely, with the charitable giving cases meaning that the charitable sectors of some Member State benefit at the expense of the government revenues of other Member States.

The cross-subsidization effect is thus fundamentally different from just requiring Member States to harmonize their tax rules. They have ended up subsidizing one another's charitable sectors, thereby linking their budgets and moving toward a form of fiscal unity that has thus far gone unmentioned. While the debates over the future of the euro and the future of the EU as a whole go on in multiple media outlets, most commentators seem not to have noticed that the CJEU has recently required a whole new level of fiscal unity among the Member States – and that, as will be shown in Part IV, the Member States have generally acted on this requirement.[147]

For years, commentators both inside and outside of the EU have criticized the lack of fiscal union that coexisted with the partial monetary union of the Eurozone. These critiques have become louder in recent years for several reasons. First, the CJEU's entry into the direct tax arena has led many commentators to demand either an end to the Court's direct tax jurisprudence[148] or a move toward positive legislative harmonization.[149] These demands have been based on a view of the Court as the engine of negative harmonization,[150] pursuant to which Member States have slowly lost their ability to tax their citizens and prevent tax avoidance without receiving any offsetting increase in taxing authority.[151]

A second reason for the increased calls for fiscal harmonization has been the Greek debt crisis. As the Member States realized the downsides of monetary union, some commentators argued that, had there been a unified fiscal system throughout Europe, it would have been easier for Europe as a whole to respond to the crisis. Instead, Member States retained their authority over their spending and taxing decisions, even while the other Member States remained on the hook for the results of those decisions.

The responses to the financial crisis within and beyond the European Union were immediate. Some commentators blamed individual countries. Others blamed the European Union as a whole, or at least the Eurozone and the ECB. Some commentators predicted an end to the euro.[152] And many commentators called for a fiscal union to match the monetary union that had contributed to the economic crisis.[153]

This call for a fiscal union was not new, but it was injected with greater urgency in the wake of the economic crisis. For years, commentators had been calling for a fiscal union,

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147 Although commentators have occasionally discussed the subsidization inherent in tax expenditures and a loss of state sovereignty, they have done so in the context of *limits* on Member State tax expenditures, rather than requirements that they be extended. *See* Kube, *supra* note 101, at 105 (stating that since "it is possible to subsidize by taxing…, transnational state aid control leads to restrictions on national tax sovereignty" in the context of state aid limitations on tax expenditures).

148 *See* Mason, *supra* note 19, at 608 (referring to the possibility of "abandon[ing] judicial review of state taxes altogether. This could be accomplished in Europe by stripping the ECJ of its jurisdiction to review income tax cases. A suggestion to do just that was made during recent negotiations over the European Constitution").

149 *See* Van Thiel, *supra* note 6.

150 *See* Mason, *supra* note 19, at 608 (2007) (referring to the "the important pro-integration role played by the Court of Justice in taxation" and pointing out that "most of the progress in removing tax barriers to cross-border trade and investment has resulted from tax cases brought in national courts by private litigants and referred to the ECJ for preliminary ruling").

151 *See, e.g.* Suzanne Kingston, *supra* note 31, at 287.

152 *See, e.g.*, Gerald O'Driscoll, *Opinion: How the Euro Will End*, WALL ST. JOURNAL (June 12, 2012).

153 *See, e.g.*, Reuters, *Debt crisis: Eurozone fiscal union needed, says JP Morgan*, THE TELEGRAPH (June 10, 2012).

claiming that this was necessary for the EU to live up to its claim of being a single market. These discussions started early in the history of the EU, when indirect taxes were harmonized, but they gained more strength with the introduction of the euro. As the EU headed toward monetary union, some commentators argued that the logical next step was fiscal union, while others argued that monetary union was inappropriate in the absence of fiscal union.

And yet, amongst all this discussion of the need for fiscal harmonization, there has been little discussion of the recent development that has created a different type of fiscal unity – the cross-subsidization effect. By linking the Member State's budgets, the CJEU has done more than negatively harmonize taxation. It has also created a situation in which one Member State's budget is reduced to support the charitable sector of another. While this fiscal unity is not fiscal union, it may be yet another factor pushing Member States toward fiscal union. And it may be a different type of factor pushing toward fiscal union in that Member States are now not just losing their ability to tax – they are also losing their ability to control their own revenue streams. Furthermore, this fiscal linkage applies to all twenty-seven Member States, and not just to those in the Eurozone.

The cross-subsidization effect thus represents a new type of negative harmonization. Prior to this development, the tax systems of the Member States were being hollowed out in that Member States were being required to amend their revenue codes. The cases contributing to the cross-subsidization effect do compel Member States to amend their revenue codes, but they also require them to forego income in order to underwrite other Member States. This is more than just negative harmonization; it is positive subsidization. While this development may not immediately push Member States toward fiscal harmonization, it must be acknowledged in the debates over the future of the EU. Although many of these debates acknowledge the Court's role in setting the groundwork for future harmonization, they must also consider that the Court has recently made legislative harmonization even more attractive by taking away yet another fiscal tool that Member States had previously thought they could control.

This effect has implications well beyond the jurisprudence of the CJEU. As Member States have rejected proposals to subject fiscal policy to qualified majority voting,[154] and as proposals for limited fiscal harmonization have been hailed as major steps away from the fiscal atomization that currently exists,[155] observers are understandably led to believe that the budgets of the Member States are not linked together, particularly when those Member States are not members of the Eurozone. And yet the cross-subsidization effect reveals that the CJEU has been pushing Member State budgets closer together through its tax expenditure jurisprudence. Now, when one Member State decides to use its tax code to encourage certain behaviors, it must subsidize those behaviors throughout the EU. This effect in turns mean that other Member States may no longer have to forego as much revenue to subsidize certain behaviors – or that they will continue to forego revenue, but will now be using it to subsidize behaviors of non-residents. Although the revenue implications of this effect may be relatively small, the political implications are much more significant. Thanks to the cross-subsidization effect, the Member States of the European Union have not retained as much control over their budgets as the treaties

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[154] *See* Tracy A. Kaye, *Essay: Direct Taxation in the European Union: From Maastricht to Lisbon*, 35 Fordham Int'l L.J. 1231, 1231-32 (2012) (stating that "[a]lthough the European Commission . . . recommended qualified majority voting with respect to certain corporate tax matters at the 2003-2004 Intergovernmental Conference, Ireland and the United Kingdom were vehemently opposed to such a change in the unanimity requirement for direct taxes").

[155] European Commission, COM/2011/121, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) (March 16, 2011).

of the European Union would suggest. Moreover, this budgetary linkage is likely to affect different Member States very differently, with some seeing revenue gains or losses and others experiencing less of an impact. The Member States have thus been pushed toward fiscal harmonization by the Court, but, as the following Part will show, at least some of them have pushed back strongly.

## IV. Moving away from a European Charitable Sector?

The preceding Part III argued that the cross-subsidization effect has linked Member State budgets in a way that has not previously been acknowledged. This does not, however, mean that this judicial development has paved a smooth road to fiscal harmonization. As this Part will show, although most Member States have responded to the charitable giving cases by modifying their charitable giving incentives, their responses to the cross-subsidization effect reveal significant hurdles to future harmonization. Moreover, along with raising concerns for future positive harmonization, the varied Member State responses also suggest the weaknesses of negative harmonization in general.

Member States were not unaware that the Court's decisions in the charitable giving cases could lead them to subsidize one another's charitable sectors. As Austria argued in Commission v. Austria, "[a]n extension of…deductibility to institutions established in Member States other than the Republic of Austria…would have the consequence that part of the gifts in question…would benefit institutions which pursue objectives that are not in the public interest of the Republic of Austria, which would reduce correspondingly the means of institutions established in that Member State."[156] Also, even before these cases were being argued, the Commission had been actively pursuing those Member States who had limits on their charitable giving incentives.[157]

The Member States thus had fair warning and, in the wake of both the Court's rulings in the charitable giving cases and the Commission's efforts to end discriminatory tax incentives for charitable giving, the majority of Member States amended their tax codes. Most of these changes allowed donations to foreign charities to qualify for tax incentives, so long as those charities are resident in other Member States,[158] but the Member States vary widely in the speed

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156 Commission v. Austria, C-10/10, ¶20.

157 This was true even before the charitable giving cases. *See* Oonagh B. Breen, *EU Regulation of Charitable Organizations: The Politics of Legally Enabling Civil Society*, 10 INT'L J. OF NOT-FOR-PROFIT L. 50, 71 (June 2008) ("Before and particularly since the decision in Stauffer, the Commission has actively encouraged complaints regarding alleged Member State discrimination against foreign charities in the area of tax exemption"). The Commission increased its challenges in the wake of the Walter Stauffer decision, and, by 2008, the Commission had opened multiple investigations against Member States for discriminatory tax provisions that limited the beneficiaries based on the residence of the recipient charitable organization. *Id.* at 72 ("Since the decision in Stauffer, the Commission has begun action against the UK, Ireland, and now Belgium to end their discrimination against foreign charities in the area of direct tax; Commission Press Release, IP/06/964 (10 July 2006) (United Kingdom); Commission Press Release, IP/06/1408 (Ireland and Poland); Commission Press Release, IP/06/1879 (Belgium).

158 *See* Koele, *supra* note 8, at 413 ("As a result of the Commission's activity, 12 Member States have resolved elements of their landlocked legislation referring to cross-border philanthropy: Poland, Slovenia, the Netherlands, Denmark, the Czech Republic, Luxembourg, Bulgaria, Latvia, Greece, Belgium, Germany and France."); Ostertag, *supra* note 8, at 270 (after Persche, "most countries in the EU have changed their laws to allow donors to claim deductions for gifts to qualifying foreign organizations that reside in other Member States within the EU"); Ostertag, *supra* note 8, at n. 98 ("These countries include Austria, Bulgaria, Belgium, [*sic*] the Czech Republic, Denmark,

and impact of these amendments. Furthermore, not all Member States have yet amended their tax incentives, and some have chosen to abolish tax incentives for charitable giving entirely rather than extend such incentives to charitable organizations across the EU.

The amendments made by Member States in response to the charitable giving cases can be divided in as many ways as there are Member States. This Part separates them out according to two metrics. Section A places them along a spectrum from contractive to expansive. Next, Section B discusses the possible motivations for the different types of amendments. Finally, Section C discusses the impact of these amendments on both the future of fiscal harmonization and the concept of negative harmonization in general.

A. The Spectrum of Amendments

Member State amendments to their charitable deductions can be broken into two main categories: expansive changes, in which Member States expended their tax incentives to apply to more donations, and contractive changes, in which Member States contracted their tax incentives such that they applied to fewer (if any) donations. The majority of changes thus far have been expansive changes, meaning that most Member States have decided in favor of subsidizing foreign non-profits rather than eliminating tax incentives for charitable giving altogether, but there have also been some contractive changes.

This Section charts Member State charitable tax incentives post-Persche along a spectrum from contractive to expansive. The most contractive provisions are those that eliminate the charitable giving incentive entirely, while the most expansive provisions are those that apply to donations to any qualifying organization, regardless of residence. In between are deductions for donations to EU Member States, member states of the European Economic Area (EEA), members of the European Free Trade Association (EFTA), and other states as defined by treaty provisions or other agreements. This Section does not offer possible explanations for this spectrum of amendments; that task is left for the following Section B, which considers possible motivations for the variety of changes.

i. Contractive responses

The most contractive response to the charitable giving cases has been the complete elimination of tax incentives for giving. One country that took this approach is Hungary, which no longer provides any tax incentives for charitable giving in the wake of Persche.[159] The next-most-contractive response has been the ostensible expansion of tax incentives to non-resident organizations while retaining a restrictive definition of "qualifying organizations" that has the probable effect of limiting tax incentives geographically. Two countries that appear to have taken this approach are France and Germany. Prior to legislation at the end of 2009, France limited its charitable deductions to donations made to domestic charitable organizations, and it further required that the activities of such organizations either take place in France or benefit French citizens.[160] In 2009, in response to the CJEU decisions discussed above,[161] France's law

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Estonia, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, the Netherlands, Poland, Slovenia, and the United Kingdom.").

[159] *See* Koele, *supra* note 8, at 414.

[160] National Report on Taxation of Charities in France, 15, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at*

was changed to eliminate this residence requirement and extend the deduction to the other twenty-six Member States, as well as member states of the European Economic Area (EEA) that had mutual assistance agreements with France, but the requirement that the activities take place in France or benefit France remains.[162] As others have pointed out, it is likely that this requirement that the organization's activities or benefits be located in France will be challenged by the Commission.[163] If this requirement does stand, then France gets the benefit of appearing to be expansive in its response to Persche while still effectively limiting its subsidization of other charitable sectors. A similar situation exists in Germany, where the previous version of the charitable deduction challenged in Persche required that activities be "suitable for upholding Germany's international reputation."[164] After Persche, Germany did change its charitable deduction to encompass charitable organizations anywhere in the world, but only so long as they support German permanent residents or benefit Germany's reputation.[165] Although some commentators have argued that this limitation is not in fact contractive since all charity benefits Germany's reputation,[166] others have declared this new limitation "more subversive than an across-the-board lack of incentives" because, under the new requirement, Hein Persche would not be permitted a deduction for his donation to Centro Popular.[167]

Depending on how their definitions of qualifying organizations are interpreted, France and Germany may thus not have charitable giving incentives that are as expansive as they first appear. If it does turn out that France retains its activity/benefit limit and Germany's reputational requirement must be read narrowly, then neither France nor Germany appears to have charitable giving incentives that are sufficiently cross-subsidizing to pass muster under Persche. The Commission will likely challenge these limitations if such narrow readings are upheld by the French and German domestic revenue authorities.

ii. Expansive responses

Among the expansive responses, the spectrum varies depending on the number of countries whose charitable organizations may receive deductible donations. The least expansive

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http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013) [hereinafter "EATLP Report – France"].

161 France's change in law was also spurred by its national court deciding cases in light of the charitable giving cases.

162 EATLP Report – France, *supra* note 160, at 15.

163 *Id*.

164 Steffen Lampert and Heike Jochum, National Report on Taxation of Charities in Germany, 10, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013).

165 Ostertag, *supra* note 8, at 271. *See also* Koele, *supra* note 8, at 414 (stating that the German legislature "amended the general requirement for philanthropic organizations. Art. 51(2) of the Fiscal Code (*Abgabenordnung*) provides for the general requirement that an organization…carrying out the promotion of tax-privileged purposes abroad shall either further individuals resident or domiciled in Germany or shall – among other things – make a possible contribution to the reputation of the Federal Republic of Germany abroad.").

166 *See* Koele, *supra* note 8, at 414 ("In the author's opinion, it would be unlikely that a philanthropic organization would be viewed as not contributing to the reputation of the Federal Republic of Germany since Germany is, like all of us, part of a globalized world. Any purpose that serves the pluralism of German society, in its broadest sense [sic] would have a positive impact on that society."). Although this idealized view of the world is appealing, it seems unlikely that Germany would add a restriction on the benefits provided by a charitable organization if that restriction had no actual restrictive effect.

167 Ostertag, *supra* note 8, at 271.

approach permits deductions only for donations to Member State organizations. Although this approach appears to be the one envisioned by the CJEU in Persche and its predecessors, no Member States appear to have this limitation. This is at least partly due to the fact that, in Commission v. Austria, the CJEU expanded the cross-subsidization effect to include the three countries that join the EU Member States to make up the European Economic Area ("EEA").[168]

Many EU Member States have included the EEA and EFTA countries as beneficiaries of their charitable giving incentives. The degree to which charitable organizations in these countries can benefit from deductible donations, however, varies widely across the Member States. Some Member States, such as Austria and the United Kingdom, have extended their charitable deductions to organizations in the EU and all countries in the EEA – so long as those countries have sufficient mutual assistance agreements with the Member State in question.[169] The effect of this requirement is to exclude Liechtenstein, which does not yet have a sufficient mutual assistance or information-sharing agreement.

The next degree of expansiveness adds Liechtenstein to the list, meaning that charitable organizations in all three members of the EEA may receive deductible donations. Member

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[168] The EEA Agreement was signed in 1992 and the EEA was established in 1994. Currently, the EEA consists of the EU Member States, Iceland, Liechtenstein, and Norway, and the Agreement provides the latter three members with the benefits of the EU's internal market while requiring them to adopt related EU legislation. The European Free Trade Association (EFTA) predates the EEA. It was established by the Stockholm Convention in 1960, and its current members are Iceland, Liechtenstein, Norway, and Switzerland. While the former three members are members of the internal market by way of EEA membership, Switzerland's involvement in the internal market takes place through bilateral agreements with the EU. Austria extended the cross-subsidization effect to the EEA countries because the CJEU decided the case under both the TFEU and the EEA Agreement and found that Austria's geographic restriction was a violation of both.

[169] In the United Kingdom, Finance Act 2010 changed the definition of charitable organizations such that qualifying organizations were no longer limited to the UK. Mark Bowler Smith, National Report on Taxation of Charities in the United Kingdom, 5, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013). As of now, however, this extension is only to EU Member State organizations and organizations in EEA member states with "sufficient information exchange and collection of tax arrangements are in place to ensure the reliefs can be administered properly." Cutbill et al., *supra* note 136 ("Following the introduction of Finance Act 2010, eligible organisations in the EU, Norway and Iceland may receive donations from UK taxpayers which are relieved under Gift Aid and other charitable tax reliefs"); *See* Koele, *supra* note 8, at 415; Lowe-Petraske, *supra* note 136 (UK donors may be able to receive a tax break for donating to foreign charities if the foreign recipient organization is "Established for purposes that would be charitable in the UK; If required by law, registered with the local charities regulator; Managed by 'fit and proper persons.'"). As of now, this includes Iceland and Norway, but not yet Liechtenstein. Smith, *supra* note 169, at 5 ("Presumably, Lichtenstein, the remaining EEA member country, will join Iceland and Norway when HMRC are satisfied that sufficient information exchange and collection of tax arrangements are in place to ensure the reliefs can be administered properly"). Since the UK requires registration of foreign charities, some have predicted that its amendment is likely to face the scrutiny of the Dutch legislation as well. *See* Koele, *supra* note 8, at 415 ("the UK probably has the same problem with the Commission as the Netherlands since it requires a preliminary registration of all foreign charities."). *See* Christoph Urtz, National Report on Taxation of Charities in Austria, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013) for expansiveness of Austrian charitable giving incentives.

If France's activity/benefit limitation is not allowed to stand, so too does France's claimed expansion extend its charitable tax relief to donations to qualifying charitable organizations in other Member States and the EEA so long as the relevant EEA state has signed a bilateral treaty with France for mutual assistance with regards to tax fraud or tax evasion. *See* Koele, *supra* note 8, at 414 and n. 27. See supra notes 161-63 and accompanying text for an explanation of why this may only be "claimed."

States that have taken this approach include Belgium,[170] Denmark,[171] and Poland.[172] One more step in the direction of expansiveness is to allow deductions for donations to organizations in selected countries beyond the EEA. Member States that have taken this approach include Ireland, the Netherlands, and Sweden.[173] Sweden may arguably have made the most expansive change in that it created a tax incentive for charitable giving that did not previously exist. Prior to 2012, Sweden was one of the few countries that did not provide any charitable tax benefit whatsoever[174]; as of January 1, 2012, Sweden now permits a 25% deduction for qualified

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170 Edoardo Traversa and Barbara Vintras, National Report on Taxation of Charities in Belgium, 6, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013). Belgium, which was the target of Commission investigations as early as 2002, ultimately amended its relevant tax legislation to allow tax deductions for donations to qualifying organizations in other Member States as well as qualifying organizations in the EEA. *See* Koele, *supra* note 8, at 414. This change went into effect in 2010.

171 Søren Friis Hansen and Jacob Graff Nielsen, National Report on Taxation of Charities in Denmark, 5, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013).

172 Alicja Majdańska, National Report on Taxation of Charities in Poland, 26, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013).

173 In Ireland, donations to qualifying organizations within the EU and EFTA may be deductible. *See* http://www.revenue.ie/en/personal/charities.html. Note that while some commentators seem to think that Ireland does not have a charitable deduction, see Bartlett, The Benefit and Burden, the Revenue Office quite clearly advertises its deduction and the fact that this is permitted for organizations throughout the EU and EFTA.

Both the Netherlands and Sweden go further, and they extend the deduction to countries with which they have mutual assistance agreements. The Netherlands allows deductions for donations to organizations in the Kingdom of the Netherlands, the European Union, and "designated countries," a term that is defined to include countries that have mutual assistance agreements with the Netherlands. Sigrid J.C. Hemels, National Report on Taxation of Charities in the Netherlands, 5, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013). Furthermore, even countries that do not qualify as designated countries may receive deductible donations if they share certain information with Dutch authorities on an annual basis. Hemels, *supra* note 173, at 6. The Netherlands responded even more expansively than either Belgium or France and permitted charitable organizations in any country in the world to register as qualifying charitable organizations. *See* Koele, *supra* note 8, at 413. Note that this announcement in November 2008 came after the Netherlands became "the first country in the world to make gifts to foreign charities fully deductible for Dutch resident individual and corporate donors and provide for an equivalent exemption for gift and inheritance tax" in January 2008. *See* Koele, *supra* note 8, at 413. This expansive change, however, was met with criticism by the Commission, which issued a formal request implying that the registration process for foreign charitable organizations was itself discriminatory. Koele, *supra* note 8, at 413. This formal request, filed by the Commission in March 2010, has been roundly criticized by commentators, who note that both foreign and domestic organizations are required to register under Dutch law. Koele, *supra* note 8, at 414 ("In the author's opinion, this seems to be a flawed initiative of the Commission, since there is no discriminatory treatment between foreign and domestic charities in this regard under Dutch tax laws.").

174 Hemels, *supra* note 136, at n.10 ("Until 2012 no gift deduction was possible in Sweden…"); Ostertag, *supra* note 8, at 270 ("Sweden remains an outlier by providing no tax benefits for charitable giving"). Note that this is a change from Sweden's historic willingness to provide incentives for charitable giving. *See* Richard Arvidsson, National Report on Taxation of Charities in Sweden, 1, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013) (""The first type of legal entity to be granted tax relief was the foundation, which obtained some relief as early as 1810. This was followed by the non-profit association, which did not obtain their first privileges until 1942.").

charitable giving.[175] This incentive applies to donations to organizations within the EEA as well as within any countries with which Sweden has a mutual assistance agreement.[176]

Finally, the most expansive response to the charitable giving cases would be for a Member State to extend its charitable giving incentives to organizations worldwide. This approach is, unsurprisingly, not the most popular among Member States since it requires the subsidization of the charitable sectors of the most countries. Some countries, however, have such provisions, including Italy and, ostensibly, Germany.[177] Italy's charitable giving incentive, however, is quite limited in its benefit,[178] and it applied worldwide even before Persche,[179] and Germany's deduction continues to be restricted by the reputational requirement.[180] The Member States that have chosen the most facially expansive charitable tax incentives may thus not in practice end up foregoing as much revenue as it may at first appear.

B. Possible Motivations

The Member States have thus responded to the charitable tax incentive cases with a wide variety of tax provisions. At one extreme, at least one Member State has eliminated its charitable deduction entirely. At the other extreme, a few Member States have eliminated geography as a factor entirely, thus extending their deductions to worldwide charitable organizations. The majority of Member States, however, have extended their charitable tax incentives slightly beyond the limits of the European Union. Some have stayed within the lines of the EEA or EFTA, while others have focused more on the existence of mutual assistance agreements or other affiliations. This Section posits some possible motivations behind the many different approaches.

i. Benefit

One possible explanation for the provision chosen by a Member State lies in the idea that charitable organization benefit Member States by relieving the government of some of its responsibility.[181] Countries that are motivated by this view of the charitable sector may provide charitable deductions only if the charities that are benefiting from these deductions[182] are in turn relieving that country's government of providing services. This benefit theory was offered by various Member State governments in defending their residence-based charitable tax incentives before the CJEU, and it may partly explain why some countries have chosen more restrictive

175 Hemels, *supra* note 136, at n.10 ("…but as of 2012 individuals can claim a tax reduction of 25% on the value of donations to certain charities").

176 Arvidsson, *supra* note 174, at 12.

177 Fabrizio Amatucci, National Report on Taxation of Charities in Italy, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013); Lampert and Jochum, *supra* note 164.

178 Amatucci, *supra* note 177.

179 Zolt, *supra* note 47 (stating that Poland and South Africa also "allow charitable deductions without regard to where the funds are used").

180 *See supra* notes 164-67 and accompanying text.

181 *See supra* note 143 and accompanying text (describing Germany's argument in Persche that charitable organizations should only receive tax benefits if they provided services that the government would otherwise have to provide).

182 For more on charitable organizations benefiting from charitable deductions, see Faulhaber, *supra* note 146.

responses to the CJEU's charitable giving cases.[183] Countries such as Hungary, France, and Germany have expressed their fealty to the benefit theory by refusing to extend their charitable deductions to charitable organizations that are not, in fact, relieving them of their state responsibilities. Hungary has done this by eliminating the deduction entirely, but the French and German responses are even clearer in their expression of the benefit theory. By limiting their deduction to organizations with activities in France or those institutions that improve Germany's reputation, France and Germany may be making their deductions even more benefit-based than the residence-based deductions that were struck down by the CJEU.

ii. Reciprocity

While the Member States that chose more expansive responses to the charitable giving cases do not appear as wedded to the benefit theory, their different approaches reveal their own motivations. Some countries may have been motivated by reciprocity, pursuant to which Country H only provides deductions to countries that allow deductions for donations to Country H charitable organizations. This approach, which underlies portions of the international tax system as a whole,[184] is not unprecedented in the charitable tax incentive context; in Germany, inheritance and gift tax provisions exempt bequests to foreign institutions only if they reside in a state that also exempts donations to German institutions.[185] Although the reciprocity requirement does not appear to have been made quite as explicit in many Member State charitable deductions, it does underlie both the cross-subsidization effect itself and the provisions of those Member States who refused to extend their charitable deductions to certain countries that very clearly do not provide reciprocal deductions.

As envisioned in <u>Persche</u> and its predecessors, the cross-subsidization effect embodies reciprocity because it requires all Member States to extend their deductions to one another's charitable organizations – or not to provide deductions at all. For any Member States that chose to extend their deductions just within the EU – or within the EEA, after all three EEA member states themselves extended their deductions – this choice may have been partly based on reciprocity. In choosing not to extend their deductions further, therefore, countries such as Belgium, Denmark, and Poland may have been particularly motivated by concerns about reciprocity in that they extended their deductions just to those countries that were required to have reciprocal donations – and no further. In contrast, countries such as Ireland, which extended their donations to EFTA, and therefore included Switzerland in the mix, appear to be less concerned about reciprocity.[186]

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183 This motivation can also be explained by the practice of governments to focus more on the utility of their citizens than that of non-citizens. *See* Zolt, *supra* note 47 ("Despite calls from moral philosophers advocating greater cosmopolitan responsibilities, tax and spending policies in the U.S. are driven by the gains to its citizens and residents not to foreign beneficiaries. We give greater weight to the utilities of our citizens and residents and discount the utilities of foreigners.").

184 Warren, *supra* note 25, at 135 ("Three principles generally are invoked in defense of the particular division of the income tax base that has long been the international norm: reciprocity, nondiscrimination, and neutrality. The principle of reciprocity is manifest in the mutual reduction of source-country withholding taxes on investment income to the same level in the tax treaties.").

185 Lampert and Jochum, *supra* note 164, at 14.

186 This is because Switzerland is one of the neighboring countries to the EU that still limits its deductions to donations to domestic organizations. As a member of the EFTA who is not a member of either the EEA or the EU, Switzerland is not bound to follow the CJEU's jurisprudence, and it has thus chosen to keep its domestic limit on charitable deductions, regardless of the changes occurring with its neighbors. Madeleine Simonek, National Report

iii. Information-sharing

A further motivation that underlies the provisions of many Member States is a concern about information sharing. Many Member States, including Austria, France, the Netherlands, Sweden, and the United Kingdom, have conditioned their extension of charitable giving incentives on the recipient organization's country having signed an information-sharing agreement with the Member State. Required information-sharing agreements apply well beyond the charitable sector; they generally require provisions for the sharing of information in many contexts beyond giving, including tax evasion and tax fraud.[187] Since EU Member States have information-sharing agreements with one another, these conditions only apply to states beyond the EU. Some countries, such as Austria, the Netherlands, and the UK, have refused to extend their donations to all of the EEA until Liechtenstein proves itself willing to share information to their satisfaction.[188] Others, such as Sweden, have extended their deductions to the entire EEA, but they require information-sharing agreements of any further recipient states.

This focus on information sharing has many causes. First, there has been a focus on charitable organizations as possible recipients of terrorist funding and laundered money since September 11, 2001.[189] In the wake of the terrorist attacks in the United States, the U.S. raised the spectre of terrorist organizations posing as charitable organizations to benefit from tax incentives.[190] The United States thus initiated its own investigations into suspicious charitable organizations, and international organizations emphasized the importance of similar investigations worldwide.[191] The Commission followed suit in 2005, issuing a communication raising the possibility that offshore organizations claiming to be charitable entities may instead be sheltering terrorist money from taxation.[192] Although the Commission received criticism for the fact that its first entrée into regulation of the charitable was based on distrust,[193] this recent history could provide on explanation for the concern of some Member States with information sharing.

Second, even if there is no concern about laundered money or terrorist financing, Member States are justifiably concerned that taxpayers trying to avoid taxation may invent cross-border giving as a way to reduce their tax bill. In many jurisdictions, there have been numerous examples of taxpayers attempting to reduce their taxes by claiming a deduction for a payment that was not in fact made for charitable purposes.[194] When <u>Persche</u> was argued, Member States

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on Taxation of Charities in Switzerland, 10, from the Rotterdam Conference of the European Association of Tax Law Professors (June 2012), *available at* http://www.eatlp.org/uploads/public/Reports%20Rotterdam/ (last visited January 11, 2013) (noting that this "has been subject to criticism among Swiss scholars.").

[187] *See supra* note 169 (describing the level of information sharing required under various Member State laws).

[188] *See supra* note 169-72 and accompanying text (listing the Member States that had extended their charitable tax incentives to Liechtenstein – and those that had not).

[189] *See* Oonagh B. Breen, *Through the Looking Glass: European Perspectives on Non-Profit Vulnerability, Legitimacy and Regulation*, 36 BROOK. J. INT'L L. 947 (2010).

[190] *See* U.S. Department of the Treasury, Anti-Terrorist Financing Guidelines: Best Practices for U.S.-Based Charities (2002).

[191] Breen, *supra* note 189.

[192] Commission Communication to the Council, the European Parliament and the European Economic and Social Committee of 28 November 2005 - The prevention of and fight against terrorism financing through enhanced national level coordination and greater transparency of the non-profit sector [COM(2005) 620 final - Official Journal C 122 of 23 May 2006].

[193] Breen, *supra* note 189.

[194] *See, e.g.,* <u>Free Fertility Foundation v. Commissioner</u>, 135 T.C. No. 2 (July 7, 2010).

were understandably concerned that cross-border giving would create more opportunities for taxpayers attempting to use charitable giving incentives to avoid taxes.[195] The CJEU acknowledged these concerns and permitted Member States to require the taxpayer to show that the foreign recipient organization was a qualifying charitable organization.[196] It appears from the changes implemented by some Member States, however, that concerns remain about substantiation, and this may also explain the need for information-sharing provisions with any recipient country.

Third, this requirement builds on the recent focus in the international tax system on the need for greater information-sharing. As highlighted by Grinberg,[197] the international tax system is currently choosing between two models to ensure taxation of offshore income: the information-sharing model and the anonymous withholding model.[198] While some countries have chosen the latter model, recent developments outside the charitable giving context suggest that the EU has opted for the former model.[199] The Member States that have decided to emphasize the need for information-sharing agreements in their expanded charitable giving incentives add greater support to the argument that the EU is heading toward this choice.[200]

Finally, and building on the reason above, this information-sharing requirement may be a political tool to encourage trading partners such as Liechtenstein and Switzerland to move toward greater information sharing. Member States, as well as other trading partners such as the United States, have long been pushing for greater transparency from some smaller non-Member States in the European Union.[201] These demands have been increasing in recent years,[202] and some Member States may see the expansion of their charitable giving incentives as an opportunity to increase the pressure on countries that still do not have information-sharing agreements. Member States now have the carrot of subsidizing the other country's charitable sector to offer in exchange for greater transparency, and making this trade-off explicit may be another explanation for the focus on information-sharing.

A focus on the exchange of information thus likely motivates the changes made by many Member States, and it may also explain why the majority of Member States did not just open their charitable deductions to worldwide giving. As many of the recently changed provisions now read, however, Member States may be on track for worldwide deductions if the current holdouts are willing to sign satisfactory information sharing agreements.[203]

iv. Balance of charitable giving

Another partial explanation as to why different Member States chose different degrees of cross-subsidization may lie in the question of whether the Member State in question will be a net exporter or net importer of charitable giving. As discussed previously in Part III, it is unlikely that each Member State will subsidize other Member States to the exact same degree that its

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195 *See* Persche, C-318/07.
196 Persche, C-318/07.
197 Itai Grinberg, *The Battle over Taxing Offshore Accounts*, 60 UCLA L. REV. ____ (2012).
198 *Id*.
199 *Id*.
200 *Id*.
201 *See, e.g.*, U.S. Treasury Dept., *Joint Statement from the United States and Switzerland Regarding a Framework for Cooperation to Facilitate the Implementation of FATCA* (June 21, 2012).
202 *See* U.S. Dept. of Justice, *Press Release: Justice Department and IRS Announce Results of UBS Settlement and Unprecedented Response in Voluntary Tax Disclosure Program* (November 17, 2009).
203 *See supra* notes 173-76 and accompanying text (referring to Sweden's reforms).

charitable organizations receive cross-border donations. There will therefore likely be net exporters and net importers of charitable giving. Based on how recently Member States have opened themselves up to deductible cross-border giving, it is not yet possible to predict accurately which Member States will fall into each category.

It is, however, possible to see significant differences in the cultures of giving in various Member States. Multiple studies have been conducted on the different levels of giving throughout the European Union. While these studies have not provided equivalent data on all twenty-seven Member States, their findings hint at some possible motivations for the spectrum of charitable giving amendments. A simplified summary of the differences between Member State giving is that Nordic countries other than Finland generally donate more, in terms of the number of households that donate, whereas Southern European and former Eastern European countries donate less.[204] Yet this simplification does not capture the fact that individual Member States have very different approaches to giving, and these differences even affect how they define giving and charity and how they collect data about the charitable sector. In a recent study of charitable giving in twelve Member States,[205] Wiepking emphasized the difficulty of comparing data across Member States, since each Member State had its own separate definitions and approaches to data collection.[206] The data from some of these Member States, however, can highlight the very broad differences in approaches to charitable giving.

Although Member States reported data from different years, the euro value of donations in the countries that participated in the study ranged from €80 million, in Hungary, to approximately €10.55 billion, in the United Kingdom.[207] Per capita amount donated ranged from

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204 Pamala Wiepking and René Bekkers, *Explaining differences in charitable giving in Europe*, 185.

205 THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009).

206 *Id*.

207 These numbers are estimates given that many countries in the Wiepking report reported multiple statistics over multiple years. Out of the countries that reported the gross donations provided to charity, this number increased along the following spectrum: Hungary (€80.5M), Klára Czike and Éva Kuti, *Hungary*, 29, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) (stating that total revenues for secular nonprofits, including faith-based charities from individual donations totaled 20,2017.1 million HUF in 2006; this Article converted at the spot rate of exchange for December 31, 2006); Belgium (€97.9M), Lesley Hustinx and Caroline Gijselikckx, *Belgium*, 11, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) (stating that "Belgian households deducted about 97.9 million euros from taxes. In the same year, corporations residing in Belgium deducted some 17,3 million euros from taxes"); Spain (€135M - €330M), *compare* García, *supra* note 43, at 58 (stating that in 2005, "[d]eclared donations totaled €330,000,000") *with* García, *supra* note 43, at 60 (stating that "direct household donations amounted to €135,462,305 in 2005"); Austria (€ 295M), Florian Bittner and Michaela Neumayr, *Austria*, 10, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) (stating that "estimated total income [from?] donations was about 295 million euros in 2008"); Ireland (€450M), Geraldine Prizeman and Andrew O'Regan, *Ireland*, 37, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) (citing a study conducted in 2005 to conclude that "a total of €450 million was donated to charity in Ireland"); The Netherlands (€1.9B), Pamala Wiepking, *The Netherlands,* 48, in THE STATE OF GIVING RESEARCH IN EUROPE: HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) ("[I]n 2005, the total amount donated to charitable causes was 1.9 billion euros"); France (€2.2B), Vaccaro, Olivier & Bruder, *supra* note 41, at 20 (stating that "[u]ndeclared donations are evaluated for 2006 at €650 million, compared with €1,575 million declared for the same year"); Germany (€2.8B), *compare* Burkhard Wilke, *Germany*, 25, in THE STATE OF GIVING RESEARCH IN EUROPE:

€42 donated per adult, in Austria,[208] to an average individual contribution in Ireland that was estimated to be as high as €465.[209] Other data focus on the percentage of households that donate, with the Netherlands topping the list and Hungary lagging behind.[210] Along with varying in terms of the amount donated, Member States also differ in terms of the recipients that receive the most donations. In some Member States, including Hungary, Ireland, and the Netherlands, religious organizations received the most charitable donations,[211] while other Member States did not report religious organizations as being the largest recipients.[212] The specific areas that received donations varied by country as well.[213]

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HOUSEHOLD DONATIONS TO CHARITABLE ORGANIZATIONS IN TWELVE EUROPEAN COUNTRIES, Pamala Wiepking, ed. (Pallas Publications, 2009) ("It can thus be estimated in 2008 the sum collected by all the social charitable organizations amounted to 2,45 billion euros") *with* Wilke, *supra* note 207, at 25 ("[i]n 2005, [a limited number of] German households deducted a total of 3.1 billion euros from taxes[, and the 2008] estimations on the overall annual donation amount in Germany are between 3 and 5 billion euros"); Italy (€4B), Gemelli, *supra* note 43, at 45 (estimating the 2005 individual donations to non-profit organizations, including the Catholic Church); and the United Kingdom (€10.55B), Pharaoh, *supra* note 42, at 73 (stating that the "Individual Giving Survey currently estimates UK Giving at about £9.5 billion"; this was then converted at the spot rate of exchange for December 31, 2009).

It should be noted that this data is only being used for illustrative purposes because the information in each statistic is so different that it is impossible to compare. In some countries, for instance, revenue seems to be limited to individual donations, while it is not clear whether this same limit applies to other countries' data. Some countries also include donations to religious organizations, while others do not. Other countries extrapolated from their tax data, while others instead used revenue reported by charitable organizations.

208 *See* Bittner and Neumayr, *supra* note 207, at 10.

209 These data are even less comparable than the overall amount donated, given that different countries report different amounts, including the average amount donated per donor, per adult (with age of adulthood varying) or per adult. Numbers reported include Austria's amount donated per donor (€65.3), Bittner and Neumayr, *supra* note 207, at 10; Ireland's average individual contribution (€120 - €465), *compare* Prizeman and O'Regan, *supra* note 207, at 36 (stating that "the average monthly donation per individual was €9.97) *with* Prizeman and O'Regan, *supra* note 207, at 37 (stating that "[t]he average weekly contribution per individual was €8.94); Spain's average declared donation per donor (€184), García, *supra* note 43, at 58; France's average donation (€305), Vaccaro, Olivier & Bruder, *supra* note 41, at 23 (referring to either the average declared donation per household or the average total donation per household); and the United Kingdom's average annual giving (€359.08 - € 419.60), Pharaoh, *supra* note 42, at 73 (stating that average month giving estimates from different individual giving surveys places average monthly giving at either £26.53 or £31.00 for 2009. These values were converted at the spot rate for December 31, 2009).

210 *See* Wiepking and Bekkers, *supra* note 204, at186. The order of percentage of households giving, from highest to lowest, is: The Netherlands, Sweden, Norway, the United Kingdom, Austria, Denmark, Germany, Ireland, Slovenia, the United States, Belgium, France, Finland, Luxembourg, Spain, Israel, Poland, Italy, Greece, and Hungary.

211 *See* Czike and Kuti, *supra* note 207, at 29 ("Most donors and the largest amount of donations are attracted by churches"); Prizeman and O'Regan, *supra* note 207, at 37 ("Church dues were the single greatest recipient of contributions); Wiepking, *The Netherlands, supra* note 207, at 48 ("Religious organizations…received the most money"). Note that many of the donations to religious organizations were given by those donees other recipient organizations.

212 *See* Pharaoh, *supra* note 42, at 74-75 (stating that, among the causes supported in 2006 and 2007, religious causes received 16% of donations, while medical research received 17%).

213 Donors in Austria focus on "children, natural disaster relief, and animals," Bittner and Neumayr, *supra* note 207, at 10 (internal quotations removed); donors in Belgium focus on "development cooperation [and] social services," Hustinx and Gijselikckx, *supra* note 207, at 13 (internal quotations removed); donors in Hungary favor "education, health care, and social care," Czike and Kuti, *supra* note 207, at 29; donors in Ireland donors favor international development and social service organizations, Prizeman and O'Regan, *supra* note 207, at 38; and donors in the UK give primarily to health-related causes, with religion and "children/young people" being the next-most-popular recipients, Pharaoh, *supra* note 42, at 74.

While the above data do not provide information about the percentage of giving donated to foreign charitable organizations or the percentage of giving received from foreign donors, they do highlight that the Member State that responded most contractively (Hungary) also reported the smallest amount of gross charitable donations, while the Member State that provided the largest amount (United Kingdom) also had one of the more expansive responses.[214] Thus, although Member State's responses do not match up directly with their donations prior to the charitable giving cases,[215] it is possible that a Member State's expected role as a net importer or exporter may have played a part in the design of its charitable giving incentives. It is possible that net exporters would be more willing to choose a more expansive amendment, based on a history of encouraging charitable giving, but it is also possible that net exporters may instead have chosen a more contractive option given that they are likely to lose more revenue from an expansive change. So too could net importers see the benefit of both a more restrictive approach (since they have less of a history of giving) and a more expansive approach (since such a change would likely not lead to as much revenue loss). Another possibility is that countries that believed they were unlikely to be either net importers or net exporters may have responded more expansively if they believed a generous provision was unlikely to have any ultimate effect on their revenue. Although this Article cannot predict how net exporters and net importers would respond to their position, it is worth considering that Member States' predictions of their position may have played a role in what degree of expansion they chose.

These predictions may also have been fueled by recent political debates over the future of the EU. In the wake of the Greek debt crisis, tensions between Member States flared, with Germany, France, and others expressing disproval with the policies of Greece, Portugal, and other countries that were most in need of support from the rest of the European Union. After months of highly publicized debates between these groups of countries, with net exporters of bailout money refusing to assist the net importers unless the latter group agreed to adopt extreme austerity measures, it is possible that the net bailout exporters feared that they would also become net exporters of charitable giving. This fear may have been based only on partially correct assumptions. While many of the countries with the lowest level of donations by percentage of the population are also the countries that were closest to economic collapse,[216] the net exporters of the bailout are not themselves much more likely to be net exporters of charitable donations.[217] Regardless, it may have been enough to encourage some countries, such as France and Germany, to adopt more contractive provisions than they otherwise would have.

### C. The Limits of Negative Harmonization

The Member State responses to the cross-subsidization effect complicate the lessons drawn in Part III. While this Article argued that one result of the requirement is that the budgets of Member States are more closely linked than has been previously recognized, the responses of the Member States also reveal that the cross-subsidization effect is not itself enough to push

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[214] *See supra* notes 159 and 169 and accompanying text (setting out the responses of Hungary and the United Kingdom).

[215] France and Germany, for example, were both some of the most generous Member States in terms of reported donations, but they also have some of the most contractive responses to the cross-subsidization effect.

[216] *See* Charities Aid Foundation, World Giving Index 2011, Table 13 (listing Greece, Portugal, and Spain as the countries with the lowest percentage of their populations donating money).

[217] *See id.* (listing France as having a smaller percentage of the population donating to charities than Italy).

toward full positive harmonization. Instead, the Member State responses to the cross-subsidization effect have themselves provided a hint of the level of fiscal harmonization with which they are comfortable. Recall that the CJEU left Member States with a choice: they could either eliminate their charitable giving incentives entirely or extend them to other Member States. Although a few Member States chose to either explicitly or effectively choose the former option, most chose the latter option. This suggests that Member States are willing to accept a level of fiscal harmonization that may not have previously been expected.

The degree to which Member States were willing to expand their charitable giving incentives, however, is also instructive for future debates over the EU. The countries that appear the most resistant – including Hungary, France, and Germany – may hold a warning for European politicians or bureaucrats who hope for an easy transition to fiscal union. The fact that France and Germany chose to modify their charitable giving incentives in such a way that they appeared to comply with the CJEU's demands but likely still restrict the tax provisions in question also implies both respect and disrespect for EU law. This decision also suggests that these two countries whose politicians were the most outspoken about the downsides of bailing out Greece may now be unwilling to engage in any more harmonization that could require them to subsidize the other countries of the European Union.

At the other extreme, the countries that chose to extend their charitable giving incentives not just within the EU or the EEA but instead worldwide hint at a very different view of the fiscal future of the EU. These Member States may foresee a union that extends beyond the confines of the European Union, perhaps including states in the European Economic Area or those that have been willing to sign information-sharing agreements with the Member States of the EU. By extending the benefit of the cross-subsidization effect to countries beyond the confines of the EU, these Member States suggest that next step in fiscal union may not be limited to the current twenty-seven Member States.

Another way of reading this generally expansive approach, of course, is as a warning that Member States are opposed to EU-wide fiscal union. Member States that have amended their laws in the wake of the charitable giving cases have done so in either a restrictive way (eliminating their incentives entirely or severely limiting the recipient organizations who qualify for such incentives) or an expansive way that goes beyond the confines of the EU. In other words, they appear to have been motivated by every possible consideration *other than* the fiscal harmonization of the twenty-seven Member States. If Member States consider the community of countries who should benefit from their subsidization to include either no other Member States or many more Member States than the EU twenty-seven, this could be seen as a more global view of the future fiscal union. It could, however, also be seen as a rejection of the EU entirely in the fiscal arena.

If the latter reading is the correct one, then the cross-subsidization effect appears to have pushed Member States to the brink of *needing* a fiscal union, as they lose all fiscal tools they previously deemed within their sovereign power, while at the same time highlighting their overall unwillingness to take the next step. If the former reading is correct, then the cross-subsidization effect has both pushed Member States closer to needing a fiscal union *and* highlighted that they are more prone to sign on to a broader fiscal union than one that is limited to the current Member States of the European Union. Either way, the CJEU's requirement has removed yet another area that was deemed sacrosanct from Member State control while also showing that Member States view their future fiscal union as something more or less than the European Union as it currently exists.

Furthermore, the Member States' responses to the CJEU's cross-subsidization effect as exemplified in the charitable giving cases hints at the issues that they will most concern them as they head toward fiscal union. While some Member States seem most concerned about ensuring that an expansive approach to cross-border subsidization does not lead to tax avoidance, others seem much more concerned with ensuring that the burden of cross-border subsidization is shared equitably. Member States that appeared motivated by concerns about the benefit principle, reciprocity, and the balance of charitable giving fall into the latter category, while those that were more motivated by information-sharing concerns fall into the former category. While Member State responses to one set of CJEU cases cannot, of course, definitively predict future action in other contexts, the fact that concerns about equitable sharing of any fiscal burden and tax evasion seem to have been the primary motivating factors in these Member State responses may hint at the concerns that Member States will bring to any broader proposals for fiscal reform.

The responses to the cross-subsidization effect are thus instructive for larger debates about fiscal harmonization. They are also instructive as to the limitations of the concept of negative harmonization. While academics often discuss the CJEU's role as the engine of integration,[218] the wide variety of charitable giving incentives that currently exist in the European Union highlight that Member States are still the brakes. The negative harmonization achieved by the CJEU in the charitable giving cases thus could only go so far; Member States still had the right and ability to change their laws as they saw fit, and they did so in a wide variety of ways. Negative harmonization can thus only push Member States so far toward positive integration.

## V. Conclusion

There are currently multiple proposals for various degrees of fiscal harmonization in the European Union. From politicians and the popular press, there have been general cries for either complete fiscal harmonization or complete monetary and fiscal separation. From the Commission and the Parliament, there have been actual legislative proposals for a harmonized corporate tax base and a European Foundation Statute.[219] And from Member States, there have been calls for both greater harmonization and greater independence.

This Article argues that these proposals, as well as general debates over the fiscal future of the European Union, have ignored the fact that, due to the CJEU's tax expenditure jurisprudence, the budgets of all twenty-seven Member States are more closely linked than previously understood. Debates over fiscal harmonization must thus consider the lessons to be learned from both the cross-subsidization effect and the charitable giving cases that exemplify this effect. Although general discussions over the future of EU-wide fiscal policy take it as a given that there is no fiscal harmonization at all, this is not true. As the CJEU has created the cross-subsidization effect by way of cases considering tax expenditures, it has linked together Member State budgets in a way that has heretofore gone unnoticed. Member States are now not only losing control over their revenue codes, but they are being required to subsidize the industries and non-profit sectors of other Member States and members of the European Free

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[218] *See, e.g.*, J. H. H. Weiler, *Journey to an Unknown Destination: A Retrospective and Prospective of the European Court of Justice in the Arena of Political Integration*, 31 J. COMMON MKT. STUD. 417, 426-427 (1993).

[219] Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM 2011/121 (Mar. 11, 2011); Commission Press Release IP/12/112, Promoting projects that benefit society at large: the European Foundation Statute (Feb. 8, 2012).

Trade Association. This budgetary linkage may make Member States even more open to legislative harmonization of their fiscal policies. However, given the varied responses to this development, the cross-subsidization effect also holds a warning for Europe's fiscal future. Even though the revenue implications of the cross-subsidization effect are relatively minor compared to the recent bailout of Greece and the amounts lost during the economic crisis, the Member States have responded to this development in very different ways, with some of the largest and most politically powerful pushing back against it. Their responses have highlighted the limits of negative harmonization, while also providing suggestions as to what level of fiscal harmonization various Member States will accept and the concerns that will motivate them as they consider proposals for the future of the European Union.