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In this article, the authors examine the legal basis for treating digital services taxes as deductible expenses for Irish corporation tax purposes.

The delayed implementation of pillar 1 of the OECD's global tax reform deal means many multinational groups will continue to incur digital services taxes — at least in the short term. Helpfully, Irish Revenue recently published guidance accepting that DSTs may sometimes be deductible for Irish corporation tax purposes.[1]

This article explores the legal basis for treating DSTs as deductible expenses for corporation tax purposes, focusing by way of example on the DSTs levied by France and the United Kingdom.

DSTs

Overview

DSTs are generally levied on gross revenues generated from the provision of specific digital services to users in a territory, irrespective of the tax residence of the digital service provider. They present several challenges for taxpayers. For instance, they can be structured differently across jurisdictions, and the introducing jurisdiction will likely argue that its DST is not a covered tax for tax treaty purposes.

U.K. and French Regimes

The table outlines the key features of the DSTs in the United Kingdom and France.

The Legal Basis for Deducting DSTs in Ireland

Overview

For taxpayers operating in Ireland that incur DST costs, the fact that a particular DST might not qualify for relief under a double taxation treaty does not necessarily mean no relief is available for the tax cost incurred. Depending on the taxpayer's circumstances and the DST's structure, the cost incurred may be deductible as a trading expense for corporation tax purposes.[2]

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[1] Irish Revenue, "Tax and Duty Manual: Part 04-06-03" (Sept. 2022).

[2] In Ireland, when a company is carrying on a trade such as the operation of online platforms or marketplaces or the provision of online advertising services, when calculating its taxable profits, the company is entitled to a deduction for all expenses wholly and exclusively incurred for conducting that trade. Trading profits in Ireland are taxable at 12.5 percent. When a company is not carrying on a trade, it might still be able to claim a deduction for expenses incurred in earning its taxable income when calculating its corporation tax liability. Non-trading income is taxable in Ireland at 25 percent.

U.K. and French DSTs

	United Kingdom	France
In-scope services	Social media services, search engines, and online marketplaces	Digital intermediation (marketplaces, networking services, and targeted advertising), data transmission services, and advertising placement services
Taxable base	Total group revenues derived from U.K. users attributable to in-scope services	Gross revenues derived from the relevant services when accessed through a French terminal and when user participation is essential to generating value
Revenue threshold	Worldwide revenues from in-scope services exceed £500 million and over £25 million is derived from U.K. users	Worldwide revenues from in-scope services exceed €750 million and over €25 million is derived from French users
Rate	2%	3%

To qualify as a deductible trading expense, the DST must be incurred wholly and exclusively for the taxpayer's trade and must not be an income tax.[3] It also should not be a creditable tax that can be offset against the taxpayer's corporation tax liability under Irish law.

Wholly and Exclusively for the Trade

Case Law

For an expense to be wholly and exclusively incurred for a trade, one U.K. court said it must be incurred "for the purposes of earning the profits" of the trade.[4] The Irish Supreme Court has upheld that approach.[5]

In determining whether a tax expense is incurred wholly and exclusively for the trade, courts have tended to draw a distinction between taxes on profits and other taxes.

The House of Lords has held that the U.K. branch of an Irish company was not entitled to deduct Irish income tax as an expense for U.K. income tax purposes.[6] The court held that the income tax could not be treated as a deductible expense in computing trade profits because it was levied on profits after they had been earned. As such, the court held that the tax could not logically be incurred "for the purposes of earning" those profits.[7] In particular, the House of Lords said taxes such as income tax, corporation profits tax, and excess profits tax are not wholly and exclusively laid out for purposes of a company's trade. It continued, "Taxes such as these are not paid for the purpose of earning the profits of the trade: they are the application of those profits when made and not the less so that they are exacted by a dominion or foreign government."

By way of contrast, the U.K. Court of Appeal considered the tax deductibility of an Argentine substitute tax.[8] Foreign companies doing business in Argentina were required to pay the annual substitute tax of 1 percent of the value of the company's capital irrespective of whether the company earned any profits in a given year. In holding for the taxpayer that the substitute tax was a deductible trading expense, the court was influenced by the fact that the tax was paid to ensure the company could continue trading during the next and succeeding years:

> The tax is not . . . a tax which is of the same character as Income Tax or Excess Profits Tax; it is not a tax which can only be measured and the liability to which can only be ascertained after the profits position of the Company has been finally determined. . . . Payment of that tax is not . . . an application of the Company's

[3] Section 81(2) of the Taxes Consolidation Act 1997.

[4] *Strong v. Woodfield*, [1906] AC 448. *See also Smith's Potato Estates Ltd. v. Inspector*, (1948) 30 TC 267. U.K. case law is persuasive, but not binding, authority in Ireland.

[5] *MacAonghusa v. Ringmahon Co.*, [2001] 2 IR 507.

[6] *IRC v. Dowdall O'Mahoney & Co. Ltd.*, [1952] AC 401.

[7] *See also Smith's Potato Estates*, (1948) 30 TC 267.

[8] *Harrods (Buenos Aires) Ltd. v. Inspector*, 41 TC 450.

> profits, nor . . . a payment . . . to be made out of the earned profits of the Company, for it is not a tax the liability to which depends upon the Company having earned any profits. It is a liability which the Company has exposed itself to, or undertaken, in order that it may be able to carry on its business in . . . [Argentina]. And so it is . . . a payment wholly and exclusively made for the purposes of the Company's trade.

Given the foregoing, when applying the wholly and exclusively test in the context of a DST, all the facts and circumstances surrounding incurring the tax must be considered together with the manner in which the relevant DST is levied. To satisfy the test, the taxpayer must be able to demonstrate a purposive nexus between incurring the relevant DST and earning profits in its trade.

In light of the scope and application of the U.K. and French DSTs, it is likely that an Irish taxpayer would be considered to have incurred the taxes wholly and exclusively for its trade. Even so, that must be confirmed case by case.

HMRC Guidance

HM Revenue & Customs has published guidance[9] supporting the deductibility of DSTs in the United Kingdom, which is based on the case law above, noting in particular:

> The availability of any deduction will depend on the particular facts and circumstances of the business. However, it should be noted that a company's DST expense is directly related to the earning of its revenues and is a legal obligation of performing that trade. Therefore, in most cases it is likely the expense will have been incurred wholly and exclusively for the purposes of the trade.

There is no reason in principle why the same approach should not be equally applicable in an Irish tax context.

[9] HM Revenue & Customs, "DST47100 — UK CT Deductibility of DST," Digital Services Tax Manual (last updated June 14, 2021).

TAC Determinations

The Irish Tax Appeals Commission (TAC) issued determinations in 2018[10] and 2019[11] on whether foreign taxes may be deductible as a trading expense for corporation tax purposes.[12]

In the 2018 determination, the TAC said foreign withholding tax incurred on royalty income (which was a trading receipt in the circumstances) could not be treated as a deducible expense for corporation tax purposes.

The taxpayer sought to treat the excess foreign tax that could not be relieved under Ireland's tax credit rules as a deductible expense. The TAC held that because the taxpayer had accepted that the tax in question was a tax on income — that is, a profits tax — for claiming credit relief, it could not treat the tax as a deductible expense in computing trading profits.

In the 2019 determination, the TAC found that foreign withholding tax incurred on dividend income (also a trading receipt in the circumstances) could be treated as a deductible expense for corporation tax purposes.

The TAC rejected Irish Revenue's suggestion that a tax on income cannot be treated as a deductible expense as a general principle of Irish tax law, saying no general principle specifically denies a deduction for taxes that "are not calculated after the ascertainment of profit." Applying the case law above, the TAC determined that the taxpayer paid the withholding tax to enable it to carry on and earn profits in its proprietary trading trade.

Those different TAC determinations led to uncertainty regarding the scope of deductibility of foreign taxes for corporation tax purposes.

A 'Tax on Income'

In response to the TAC determinations, Ireland amended its tax code in Finance Act 2019 to specifically deny a deduction for any taxes on income. That change effectively gave Irish

[10] TAC Determination 02TACD2018.

[11] TAC Determination 08TACD2019.

[12] Determinations of the Tax Appeal Commission do not have strict precedential authority. However, the TAC can (and, in practice, often does) have regard to prior determinations when adjudicating on subsequent appeals raising common or related issues.

Revenue's position as expressed in the 2018 and 2019 determinations a statutory footing.

The Irish tax code does not define the term "income" for corporation tax purposes; however, it defines "profits" as "income and chargeable gains." Thus, the statute envisages that income is, for tax code purposes, a net-of-expense concept — that is, profit.

Courts have considered the nature of taxes on income on many occasions. In one case, the House of Lords highlighted that a tax on income can apply only after a taxpayer's profits have been ascertained:

> The profit upon which the income tax is charged is what is left after you have paid all the necessary expenses to earn that profit. Profit is a plain English word; that is what is charged with income tax. . . . The income tax is a charge upon the profits; the thing which is taxed is the profit that is made, and you must ascertain what is the profit that is made before you deduct the tax.[13]

In another case, the House of Lords highlighted that income tax "is imposed in respect of the annual profits or gains arising or accruing to any person from any trade . . . to tax not receipts but profits properly so called."[14]

That approach was also articulated by the U.K. Privy Council:

> Some attempt was made in argument to support . . . [a tax on gross receipts] on the ground that it is analogous to an income tax, which has always been regarded as the typical example of a direct tax; but there are marked distinctions between a tax on gross revenue and a tax on income, which for taxation purposes means gains and profits. There may be considerable gross revenues, but no income taxable by an income tax in the accepted sense.[15]

As noted above, the U.K. Court of Appeal took the position in one case that a tax on income is a tax that "can only be measured and the liability to which can only be ascertained after the profits position of the Company has been finally determined."

Although U.K. case law is only of persuasive (and not binding) authority in Ireland, in our view it represents a correct interpretation of the law as it applies in Ireland. Accordingly, a tax on income should be construed as referring only to a tax levied on a company's profits — that is, the amount arising by reference to the net residue of a taxpayer's earnings after deducting relevant expenses — that have been earned and computed. By extension, a tax that is not levied on profits and is computed without regard to whether the taxpayer makes a profit is unlikely to constitute a tax on income under the Irish tax code.

That conclusion is reflected in Irish Revenue's recently published guidance (of course, a separate analysis would be required to determine the nature of the relevant DST under a tax treaty).

Irish Revenue Guidance

The new Irish Revenue guidance accepts that when incurred wholly and exclusively for the purposes of a trade, the Austrian, French, Italian, Kenyan, Turkish, Spanish, and U.K. DSTs, as well as India's equalization levy, may be deductible expenses for corporation tax purposes.

The obvious question is why some jurisdictions are not listed. Our understanding is that Irish Revenue had simply not yet been asked to consider those DSTs before it released the guidance. Accordingly, the list should not be viewed as representing Irish Revenue's position after having assessed all existing DSTs. Rather, we believe the list will continue to grow as different DSTs are considered, especially given the confirmation in the guidance that Irish Revenue will consider the deductibility of other DSTs individually.

Conclusion

We believe that when analyzed in light of the foregoing, a company's DST expense must surely be considered a legal obligation directly related to earning revenue and therefore as incurred wholly and exclusively for the company's trade. Irish Revenue's guidance requires that the matter be considered case by case, which will require

[13] *Ashton Gas Co. v. AG*, [1906] AC 10.

[14] *The Gresham Life Assurance Society v. Surveyor of Taxes*, [1892] AC 309. *See also Duple Motor Bodies Ltd. v. Inland Revenue*, [1961] 1 WLR 739.

[15] *King v. Caledonian Collieries Ltd.*, [1928] A.C. 358.

analyzing the nature of the taxpayer's business, as well as the structure of the relevant DST and the circumstances in which it is incurred.

With implementation of the OECD's pillar 1 proposal remaining unclear, it is likely that DSTs will become more prevalent — at least in the short term.[16] As such, the Irish Revenue guidance provides some welcome clarity on a topic that is likely to become increasingly relevant in the coming years. ■

[16] *See* Nana Ama Sarfo, "Shifting Goal Posts in Digital Taxation," *Tax Notes Int'l*, Aug. 8, 2022, p. 651.