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Submission File

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South African Revenue Service
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BY E-MAIL: policycomments@sars.gov.za

Dear SARS

COMMENTS ON THE DRAFT INTERPRETATION NOTE – VALUE-ADDED TAX CONSEQUENCES OF POINTS-BASED LOYALTY PROGRAMMES

1. We herewith take an opportunity to present our comments on behalf of the South African Institute of Chartered Accountants (SAICA) on the Draft Interpretation Note (IN) providing clarity on the value-added tax (VAT) consequences of points-based loyalty programmes.

COMMENTS

Preamble definitions

2. The Draft IN contains definitions of “redemption partner” and “loyalty partner”. These definitions refer to vendors.
3. The guidance provided in the Draft IN does not make it clear whether the incidence of one or more redemption or loyalty partners in a loyalty programme, who do not have a liability to register for VAT, would preclude that programme (and its stakeholders) from the guidance provided under the Draft IN. The partner may be a resident not in the business of making taxable supplies or may be a non-resident with no liability to register for VAT in South Africa.

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| 4. <u>Submission</u> : Clarity on this matter should be provided in the Draft IN. |
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Paragraph 1

5. We agree that the Draft IN cannot attempt to deal with all forms of loyalty programmes operated in South Africa, but it should address the general VAT principles applicable to the benefits and most common transactions typically associated with loyalty programmes. In this regard, a large number of loyalty programmes operate on a discount basis, which are specifically excluded from the Draft IN.

6. **Submission:** It would be preferable for the Draft IN to clarify the VAT implications of loyalty programmes that operate on a discount basis as well. See our overall comments on this at the end of the submission.

Paragraph 3 – CPA Act and VAT Act application

7. The nature of a loyalty point is determined and analysed in the Draft IN with reference to the Consumer Protection Act No.68 of 2001 ("**CPA**"). Particularly, we note that the definitions of a "loyalty programme" and "loyalty credit or award" in the CPA is relied upon. SARS applies section 35 of the CPA to substantiate that a loyalty point constitutes 'consideration' for a supply made (par 4.3) and that the provisions of section 63 of the CPA need to be considered (par 5.4.1).
8. The VAT Act and the CPA are two separate pieces of legislation dealing with two distinct areas of law. The purpose of the CPA is, amongst others, to protect consumers against unfair marketing and business practices. The purpose of the VAT Act is to provide for taxation on the supply of goods and services, and on the importation of goods and services. The definitions provided in the CPA have been formulated for totally different purposes to that of the VAT Act. Section 1 of the CPA specifically states that the terms contained therein has the meaning for purposes of *that Act*. Consequently, one cannot apply the meaning of terms as defined in the CPA to interpret and apply the VAT Act.
9. Where a term is not defined in the VAT Act, regard should be had to the ordinary meaning of the term and not to the definitions of such term contained in unrelated pieces of legislation. Section 35 of the CPA stipulates specifically that 'Despite any provision in any law, agreement or notice to the contrary for all purposes of this Act [the CPA] loyalty credits or awards are a legal medium of exchange when offered or tendered as consideration for any goods or services offered, or transaction contemplated, in terms of that loyalty programme'. The provisions of section 35 of the CPA are therefore expressly restricted to the CPA.

10. **Submission:** All references to the CPA in substantiating or motivating the interpretation and application of the VAT Act in relation to loyalty programmes should therefore be excluded from the Draft IN.

Paragraph 3 – Value of loyalty points

11. The Draft IN, on page 4, lists the characteristics of a loyalty program. One of these is listed as follows:

"The value of the loyalty points to which the member is entitled is generally small in relation to the original supply of goods or services on which the loyalty points is earned."

12. The term 'small' is not defined in the Draft IN and could lead to interpretation issues. In recent years there had been an increase in the value of the loyalty points in relation to the original supply of goods or services of specifically defined categories of goods or services in a large number of programmes. The value of the loyalty points to which the member is entitled to in relation to the original supply should not have an impact on the VAT implications of a loyalty programme.

13. Submission: We suggest that SARS removes this characteristic from the Draft IN as it may not represent recent changes to a large number of loyalty programmes.

14. From a grammatical perspective, the last “is” in the sentence should be changed to “are”.

Paragraph 4. 1 – Diagram depicting loyalty programme transaction flow

15. We agree with the diagram depicting the transactional flow of a loyalty programme and the transactions as illustrated under this paragraph. However, the diagram does not clarify that a loyalty partner may also be a redemption partner and that these two parties will not always be different suppliers, i.e. points may be earned at Store A, and also redeemed at Store A.

16. Suggestion: We propose that it be clarified in the diagram that a loyalty partner may also be a redemption as discussed above.

Paragraph 4.1 – Use of the label “points fee”

17. SARS identifies payments made by the Loyalty Partner to the Loyalty Partner Operator (LPO) as a supply of money equal to the value of the loyalty points earned as a result of members’ purchases, which will consequently not trigger VAT. If the “points fee” is merely a remittance of money and is not paid in respect of a supply of goods or services supplied by the LPO (i.e. is not “consideration”), use of the term ‘fee’ is misleading as it suggests that the payment is made in exchange for something.

18. Submission: We recommend that reference to the “points fee” in the Draft IN rather be changed to “points cost”. This would then align the description with the contra transaction between the Redemption Partner and the LPO which refers to a “redemption cost” being remitted by the Redemption Partner to the LPO.

Paragraph 4.3

19. With regard to the reference to the CPA under this paragraph, please see our comment above on this matter.

20. We agree that the loyalty points compare with the concept of a “token, voucher or stamp”, and specifically that it comprises a ‘voucher’. However, we note that SARS seems to draw on the principles of section 10(18) and 10(19) of the VAT Act. Section 10(18) and 10(19) of the VAT Act would, however, not find application on the basis that the loyalty point, i.e. the ‘vouchers’ dealt with in the Draft IN are issued to members for no consideration. Sections 10(18) and 10(19) are only applicable in respect of vouchers issued for a consideration. It follows that there is no basis to rely on the principles of section 10(18) and 10(19) for purposes of determining the VAT treatment of point-based loyalty programmes where the points are issued for no consideration.

21. The Draft IN expresses the view that a loyalty point does not represent a discount on a future purchase, but rather constitutes part payment of the purchase price. We are not in agreement with this view. In the context of s10(18) it could be stated that such vouchers cannot be regarded to be a ‘discount’. It is further stipulated in the Explanatory

Memorandum to the Value-Added Tax Bill, 1991, that such vouchers are regarded to be a medium of exchange similar to money. This is in the context of the voucher being issued for a consideration. Where a voucher is issued for no consideration, it cannot be regarded to be a medium of exchange similar to money. The sole purpose of such a voucher is to enable the holder of the voucher to purchase future goods at a discount.

22. In addition, the view that a loyalty point does not represent a discount on a future purchase goes against the view held by the Supreme Court of Appeal in the case of *CSARS v Clicks Retailers* (2019) JOL 46369 (SCA). The SCA considered the nature of loyalty points and the redemption thereof in the context of the Income Tax Act, and specifically whether the redemption of rewards vouchers comprise expenses incurred by the taxpayer as contemplated by section 24C of that Act. The SCA stated that the value of the rewards voucher which is deducted from the overall price of the goods when the customer purchases goods is a discount which is represented by the rewards voucher. According to the SCA, the discount is reflected in the fact that the sales are less than what they would otherwise have been by the amount of the discount.

23. Submission: The findings of the SCA court case should be taken into account in the Draft IN.

24. It is stated at the end of para 4.3 of the Draft IN that *'this note refers to a voucher as contemplated in section 10(20) of the VAT Act'*. However, we note that at para 5.9.1, it is stated that section 10(20) does not apply in the context of loyalty programmes.

25. Submission: These two statements seem to be contradictory and clarity should be provided as to which one is correct.

Paragraph 5.4.1

26. As discussed above, the VAT Act and the CPA are two separate pieces of legislation dealing with two distinct areas of law, and the provisions of the CPA cannot be applied to interpret the VAT treatment of the loyalty programmes under the VAT Act. Section 10(18) does not 'give effect to' section 63 of the CPA as stated in this paragraph. Further, section 63 of the CPA and section 10(18) of the VAT Act deal with 'prepaid' vouchers, which are not applicable to points-based loyalty programmes where the points are issued for no consideration.

27. Submission: We agree that where a loyalty point, as a "voucher", is sold for a consideration, that section 10(18) of the VAT Act can be relied upon to substantiate that the nature of a loyalty point is a 'voucher', but not if there is no consideration. This should be clarified in the Draft IN.

28. The reference to section 63 of the CPA should be excluded as it is not relevant to loyalty points issued for no consideration.

Paragraph 5.4.2

29. We note that the example numbering is incorrect. It currently refers to 'Example 6'.

30. Submission: The example number should be 'Example 5'.

Paragraph 5.5.2

31. We note that the example numbering is incorrect. It currently refers to 'Example 5'.

32. Submission: It should be 'Example 6'.

Paragraph 5.8.1

33. *Value of supply*: The Draft IN seems to apply the deeming principle contained in section 10(20) for purposes of determining the value of the supply made by a redemption partner to a member. We agree that the value of supply made by the redemption partner should include the amount of money received as well as the value of the loyalty points. However, we do not agree that the provisions of section 35 of the CPA can be applied to substantiate this VAT treatment. This is on the basis that the VAT treatment may be adequately addressed under section 10(20) of the VAT Act, which contemplates the issue of a voucher for no consideration.

34. Submission: We accordingly propose that the Draft IN instead refers to section 10(3) of the VAT Act and that SARS acknowledges the application of the section 10(20) deeming principle.

35. *Discount*: SARS recognises that a LPO may structure their loyalty programme in such a way that the benefit to a member is identified as a discount on the supply of future goods or services. It is then specifically stated that the Draft IN will not apply where loyalty points are identified as discounts on future purchase in the relevant agreements.

36. This statement in the Draft IN seems to imply that where a loyalty programme is structured for the loyalty points to constitute a discount, the Draft IN does not apply. However, for the reasons mentioned above, the purpose of a loyalty point issued for no consideration is to enable the holder to purchase future goods or services at a discount.

37. Submission: The Draft IN should deal with the scenario where the loyalty points constitute a discount as a large number of loyalty schemes operate in this manner.

Paragraph 5.9.1

38. It is stated in the Draft IN that the redemption cost paid by the LPO to the redemption partner is not consideration for any supply made by the redemption partners, but is rather merely a transfer of money from the LPO to the redemption partner. The transfer of money will not have any VAT consequences for either party.

39. Whilst we agree that there are no VAT consequences arising for either party in respect of the payment of the redemption cost, we disagree that this is simply because the payment of the redemption costs constitutes the transfer of money.

40. Where a redemption partner accepts the surrender of loyalty points as consideration or part consideration for the supply of goods or services to a member, the loyalty points

evidences an entitlement or right of the redemption partner to claim payment of the monetary value of the loyalty points from the LPO. The loyalty points accordingly constitute a 'debt security' as that term is defined in section 2(2)(iii) of the VAT Act in the hands of the redemption partner. The redemption of the loyalty points with the LPO comprises a 'financial service' as contemplated by section 2(1)(c) and is exempt from VAT under section 12(a). Consequently, the payment of the redemption cost by the LPO to the redemption partner does not have any VAT consequence for either party.

41. The Draft IN contemplates a scenario where there is an arrangement between the LPO and the redemption partner that the money transferred by the LPO to the redemption partner may only be a certain value of the loyalty points accepted as payment for a supply made to a member. For example, only 80% of the value of the loyalty points accepted as payment. In terms of the Draft IN, the value of the redemption cost does not influence the value of the supply made to the member, and the redemption partner will not be entitled to a deduction on the shortfall between the value of the loyalty points accepted as payment and the amount of the redemption cost received from the LPO.

42. We are not in agreement with the VAT consequences of a reduced redemption cost as outlined above. In our view, on the basis that the reduced redemption cost is agreed to between the LPO and the redemption partner in terms of a separate agreement, the value of the reduced amount, i.e. 20% in this scenario, should constitute a taxable fee payable by the redemption partner to the LPO. The redemption partner should then be entitled to an input tax deduction in respect of the VAT incurred on the fee paid to the LPO. In this instance, we agree that the value of supply made by the redemption partner will not be affected by the reduced redemption cost agreed to with the LPO, and the redemption partner will be required to account for VAT on the full value of the supply made to a member.

43. Submission: The VAT consequences of a reduced redemption cost should be reconsidered by SARS and this should be clarified in the Draft IN.

44. It is stated in the Draft IN that section 10(20) does not apply in the context of loyalty programmes.

45. No substantiation is provided for the view that section 10(20) of the VAT Act will never apply to loyalty points in the context of point-based loyalty programmes. The Draft IN simply states that section 10(20) does not apply in the context of point-based loyalty programmes on the basis that the policy intention of section 10(20) envisages that a discount is to be granted to a customer immediately at the point of sale at the retailer, whilst a loyalty point represents the right of a member to a future benefit.

46. Section 10(20) vouchers are issued for no consideration, and can also apply in multiple party loyalty programmes as described in par 4.2.2 of the Draft IN where the objective is to entitle the voucher holder to obtain a discount on a 'future purchase' at another person in that they also represent the right of the voucher holder to a future benefit (discount) upon surrender. It is therefore unclear on what legal basis the Draft IN excludes the application of section 10(20) to loyalty points issued in the context of loyalty programmes.

47. Furthermore, we note that notwithstanding that the Draft IN expressly states that section 10(20) may not be applied in the context of loyalty programmes, at para 5.8.1 the Draft IN nevertheless applies the deeming principle contained in section 10(20) for purposes determining the value of the supply made by a redemption partner to a member. Section 10(20) deems the consideration for a supply to include the monetary value on the voucher. The consideration received by the redemption partner for the supply of goods or services to the member includes both the amount of money received as well as the open market value of the loyalty points. The reliance on the section 10(20) deeming principle seems to contradict the view that section 10(20) may not be applied in the context of loyalty programmes. A further contradiction regarding the applicability of section 10(20) is evident at para 4.4 of the Draft IN, where the Draft IN refers to a voucher as contemplated in section 10(20) of the VAT Act.

48. Despite the statement made in the Draft IN that section 10(20) is not applicable in the context of loyalty programmes, the principles applicable to section 10(20) are applied for purposes of determining the VAT treatment of transactions which occur under a loyalty programme.

49. Submission: The contradictory statements made regarding the application of section 10(20) should be reviewed by SARS.

50. On the basis that section 10(18) and 10(19) cannot apply to loyalty points issued for no consideration, and the view expressed that section 10(20) does not apply to loyalty programmes, it seems that the special valuation and deeming rules applicable to 'tokens, vouchers or stamps' may not be applied at all to loyalty programmes.

51. It follows that an amendment to the VAT Act may be required to provide for the VAT treatment of loyalty programmes. However, the transactions which occur under a loyalty programme where loyalty points are awarded for no consideration to be redeemed by the third party supplier fall within the ambit of section 10(20) of the Act and no amendments to the VAT Act would be necessary to address the VAT treatment of these programmes.

Paragraph 5.9.2

52. The Draft IN stipulates that on the basis that the LPO does not incur any VAT on the payment of the redemption costs, that the LPO is not entitled to any deduction in respect thereof.

53. Submission: It is submitted that section 10(20) of the VAT Act finds application to the extent that a loyalty programme meets the requirements of section 10(20).

54. To the extent that section 10(20) may be applied, the LPO will be entitled to claim an input tax deduction in terms of section 16(3)(i) in respect of the redemption cost paid if it relates to a standard rated supply. This will ensure that the LPO does not bear the VAT cost of operating a loyalty programme.

Overall comments – Types of loyalty programmes

55. Loyalty points that entitle customers/members to future discounts at redemption partners are excluded from the ambit of the Draft IN. Most loyalty programs offer loyalty points which fall into the ambit of this Draft IN but also entitle customers to future discounts on purchases, which remain outside the ambit of this IN and possibly exclude the programme from the Draft IN's guidance in its entirety.
56. For example, the 3-for-2 discounted purchases available to certain members of loyalty programmes through which the member is entitled to discounted purchases and use of their accumulated loyalty points as part consideration for the discounted total.
57. It is unclear whether it is the intention of National Treasury and/or SARS to preclude from the Draft IN's guidance any programmes which contain at least one redemption partner that offers tainted redemption.

58. Submission: Clarity on the treatment of the above-mentioned loyalty programmes by National Treasury and SARS should be provided in the Draft IN.

59. The Note applies to a very narrow set of loyalty programmes which comprise basic loyalty programmes in which the transaction flows are simple. It ignores the majority of loyalty programmes currently operational in South Africa and their associated, often complex, transaction flows to which the guidance in the Draft IN will not universally apply.
60. An interpretation note ought to be issued only if it provides clarity to the sector, however, it is our view that publishing of the Draft IN, in its current format, would only cause further confusion.
61. Furthermore, publishing the Draft IN could result in SARS applying the contents of the Draft IN without taking into account the complexities left unaddressed in the Draft IN. This could result in further inconsistent application of the VAT law in this regard.

62. Submission: If SARS is determined to publish the Draft IN, we suggest that the final IN contain a disclaimer to the effect that the Note merely applies to a limited scope of transactions and that classes of vendors should approach SARS for a binding private ruling in respect of more complex loyalty program structures.

63. We further encourage SARS to refer back to the numerous comments provided in respect of a 2014 publication of the discussion paper as it appears that these comments have not been taken into consideration when drafting this Draft IN.

Should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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