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TAX & EXCHANGE CONTROL **ALERT**

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The tax treatment of retail loyalty programmes decided by the Constitutional Court

On 21 May 2021, in *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* [2021] ZACC 11, the Constitutional Court handed down a judgment on the tax treatment of retail loyalty programmes, specifically in relation to the allowance granted by section 24C of the Income Tax Act 58 of 1962 (Income Tax Act). This judgment is important for any taxpayers that operate loyalty programmes.

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The tax treatment of retail loyalty programmes decided by the Constitutional Court

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On 21 May 2021, in *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* [2021] ZACC 11, the Constitutional Court handed down a judgment on the tax treatment of retail loyalty programmes, specifically in relation to the allowance granted by section 24C of the Income Tax Act 58 of 1962 (Income Tax Act). This judgment is important for any taxpayers that operate loyalty programmes.

Background

The general rule in terms of the Income Tax Act is that a taxpayer will only be able to deduct expenditure in the year of assessment during which the expenditure is actually incurred. Section 24C provides an exception to this general rule, by essentially allowing a taxpayer to defer paying tax on income that accrues to the taxpayer due to a contract in terms of which the taxpayer will incur future expenditure in a subsequent year of assessment.

In *Commissioner for South African Revenue Service v Big G Restaurants (Pty) Ltd* 81 SATC 185, which was upheld by the Constitutional Court, the Supreme Court of Appeal (SCA) commented on the rationale behind section 24C of the Income Tax Act. With reference to the relevant explanatory memorandum that dealt with the introduction of the provision, the SCA observed that the purpose of section 24C (according to the explanatory memorandum) was to deal with instances where a contract provides for advance payment, typically in construction contracts, where one will need upfront finance to perform under the contract - i.e., to purchase building and other materials. In those circumstances, a taxpayer engaged in the construction business could claim a deduction of certain future expenses in the year in which the advance payment is received.

Despite the initial premise behind the introduction of the provision, recent judgments have considered the ambit of the application of section 24C to a myriad of different scenarios. These judgments have developed the meaning and extent of the application of section 24C and the *Clicks v C:SARS* case, which forms the subject of this article, provides further clarification.

Facts

Clicks, the appellant in this matter, runs a loyalty programme for their customers, namely the "*ClubCard programme*" in terms of which participants receive loyalty points upon each qualifying purchase made at Clicks. A qualifying purchase is a purchase that is above the stipulated value threshold at a Clicks store.

The loyalty points may then be redeemed at Clicks Stores as a "*cashback voucher*" allowing the customer to receive a discount on their purchase. While the loyalty points may not be redeemed for cash, they are converted to a rand amount which is deducted from the value of the purchase. Essentially, the appellant returns 2% of the value of all qualifying purchases where a customer presents their ClubCard at checkout while making a qualifying purchase.

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In its income tax return for the 2009 tax year, the appellant included an amount of R58,5 million in its gross income and disclosed it as "*ClubCard deferred income*", whereas the value of the appellant's claim in terms of section 24C, if successful, would be R36,18 million.

In its income tax return for the 2009 tax year, the appellant included an amount of R58,5 million in its gross income and disclosed it as "*ClubCard deferred income*", whereas the value of the appellant's claim in terms of section 24C, if successful, would be R36,18 million.

The appellant claimed the section 24C deduction on the basis that when a customer presents their ClubCard during a purchase, a contract of sale is concluded in terms of which income accrues to the appellant and an obligation to finance future expenditure is incurred by the appellant (i.e. the obligation to sell merchandise at a discounted price proportional to the value of the loyalty points when redeemed).

SARS disallowed the deduction on the basis that the section 24C allowance only applies where the income received and the obligation to incur future expenditure flow from the same contract. In the Commissioner's view, the income accrues to the appellant in terms of the contracts of sale concluded with the customers whereas the obligation to incur future expenditure flows from the ClubCard contracts.

The appellant appealed the Commissioner's decision to the Tax Court which found in favour of the appellant on the basis that the income earned and the obligation to incur future expenditure flowed from the contract of sale.

The Commissioner then appealed the decision of the Tax Court to the Supreme Court of Appeal. The Constitutional Court commented that it appeared that the appellant continued with the argument that the income earned and the obligation to incur future expenditure arose from the same contract being the contract of sale.

The issue before the Supreme Court of Appeal was whether the obligation to incur future expenditure and earn income flowed from the contract of sale as opposed to either the ClubCard contract or the redemption contract. The Supreme Court of Appeal found in favour of the Commissioner and set aside the order granted by the Tax Court on the basis that the income received and the future expenditure sought to be deducted did not arise from the "*same contract*" for purposes of section 24C(2). The appellant thereafter instituted an appeal in the Constitutional Court giving rise to the present case.

Jurisdiction and leave to appeal to the Constitutional Court

Before setting out the crux of the taxpayer's argument and SARS argument, it is worth noting Theron J's finding in relation to the jurisdiction of the Constitutional Court, particularly given that not many tax law cases make their way to the apex court. It is interesting to note that the court granted leave to appeal in this case on the basis that the question of whether or not the appellant should be allowed to claim an allowance in terms of section 24C(2) is a matter of statutory interpretation and one to which the answer was not readily available, as was evidenced by the divergent approaches taken in the Tax Court and the Supreme Court of Appeal. Furthermore, it is trite that the interpretation of statutory provisions is a legal issue.

The court held that the interpretation of section 24C(2) in this matter is not the same question as the question the court dealt with in the *Big G Restaurants (Pty) Ltd V Commissioner for South African Revenue Service* 82 SATC 403 judgment,

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The court also noted that its decision on this matter is an issue of general public importance in that it will have implications for the other retailers who run similar loyalty programmes.

(hereafter *Big G*) and held that it was important to deal with the 'sameness' requirement in the context of inextricably linked contracts.

The court also noted that its decision on this matter is an issue of general public importance in that it will have implications for the other retailers who run similar loyalty programmes.

Taxpayer's argument

The appellant sought to establish that the contracts of sale and the ClubCard contract are inextricably linked. The appellant argued that the two contracts operate together to bring about the income for the appellant as well as the obligation to incur future expenditure. It argued that the ClubCard contract does not give rise to any real obligations as the contract of sale is what triggers and quantifies the obligation to incur future expenditure and that this established an inextricable link between the two contracts.

The Commissioner's argument

The Commissioner argued that in order to establish that the link between the two contracts is 'inextricable', one needs to show that neither contract can stand on its own.

The Commissioner argued that the fact that the ClubCard could be used to acquire points during a purchase made at an affinity partner (i.e. a third-party merchant from which members of the ClubCard programme can earn loyalty points to be redeemed at Clicks stores), demonstrates that the ClubCard contract can operate on its own. The income in this instance will accrue to the affinity partner while the obligation to incur future expenditure will be imposed on Clicks in terms of the ClubCard contract. The Commissioner argued that this breaks the link between the two contracts.

The Commissioner had submitted an alternative argument in the Tax Court to the effect that the appellant's obligation to incur future expenditure was merely a contingent one and that the section 24C allowance should be disallowed for that reason too. This argument was rejected in the Tax Court which held that this argument was not available to SARS as it was not the basis of the disputed assessment and that it had not been pleaded on behalf of SARS. The Commissioner did not raise this argument in the Constitutional Court.

Judgment

The court held that the requirements in terms of section 24C(2) are that a) income accrues to a taxpayer in terms of a contract; (b) there is an obligation on the taxpayer to incur future expenditure which, whether in part or in whole, will be financed by this income; and (c) that the income earned and the obligation to incur future expenditure should flow from the 'same' contract. It was this third requirement that formed the key issue in the present case.

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The court noted that what entitles a customer to a discount following a redemption of their loyalty points is the ClubCard contract. In the event that the appellant refuses to allow the customer to redeem their loyalty points, the customer's cause of action would be rooted in the ClubCard contract.

The last requirement, as was stated by the court in *Big G* (and affirmed in this case), will be met when –

a) the contract in terms of which the income accrues and the contract from which the obligation to incur future expenditure arises are 'literally the same contract' (the same-contract basis); or

b) when the contract in terms of which the income accrues and the contract from which the obligation to incur future expenditure arises are so inextricably linked that they meet the requirement of sameness (sameness basis).

Did the appellant have a claim on either basis?

The same-contract basis

The court noted that what entitles a customer to a discount following a redemption of their loyalty points is the ClubCard contract. In the event that the appellant refuses to allow the customer to redeem their loyalty points, the customer's cause of action would be rooted in the ClubCard contract.

While the court accepted that the contract of sale, in terms of which the income accrues to the appellant, is *closely linked* to the ClubCard contract in that the sale contract triggers the obligation under the ClubCard contract, it held that the ClubCard contract is what gives rise to appellant's obligation to incur future expenditure. This means that the income and the obligation to incur future expenditure do not flow from the same contract and therefore the same-contract requirement was not met and the appellant could not claim a section 24C allowance on this basis.

Sameness basis

The court cited its own judgment in *Big G* in accepting the possibility for two or more contracts to constitute the 'same' contract in terms of section 24C(2). In that case, the court held that the taxpayer must demonstrate that the inextricable link between the two contracts is strong enough to meet the requirement of sameness. In other words, establishing an inextricable link between the two contracts is not the end of the enquiry,

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The court concluded that while an inextricable link had been established between the contract of sale and the ClubCard contract, the appellant failed to demonstrate that the inextricable link between the contracts is such that the two contracts depend on one another for their existence.

as one must ask the further question of whether such inextricable link is so strong that the two contracts may be regarded as the same contract.

The court sought to give content to the sameness test and stated that at the least, the contract in terms of which the income accrues and the contract from which the obligation to incur future expenditure arises must be interdependent in that neither contract should be able to exist without the other. The court held that where it is possible for each of the contracts to be entered into and exist without the other, the sameness requirement will not be met.

The court accepted that a contract of sale in terms of which income accrues to the appellant, triggers and quantifies the appellant's obligation to incur future expenditure but held that the actual obligation to incur future expenditure stems from the ClubCard contract and does not depend on the existence of the contract of sale. It was further noted that the income accrues as a result of the contract of sale regardless of whether the ClubCard contract is in place and that the terms of each contract of sale are the same whether or not the customer is a ClubCard holder or whether or not they present their ClubCard at checkout.

The court concluded that while an inextricable link had been established between the contract of sale and the ClubCard contract, the appellant failed to demonstrate that the inextricable link between the contracts is such that the two contracts depend on one another for their existence. The court noted that the sameness test as outlined in *Big G* may have been misunderstood as the focus of the enquiry should not only be on the inextricable link between the contracts but that one must also be able to demonstrate that the inextricable link is such that the two contracts may be regarded as the same contract and therefore meet the sameness requirement in section 24C.

The court ultimately found that even though an inextricable link had been established, the two contracts are too independent of one another and as such do not satisfy the *sameness* requirement in section 24C as was outlined by the court in *Big G*.

Ultimately, the court held that the appellant could not claim a section 24C allowance on either the same-contract basis or on the sameness basis and on that basis the appeal was dismissed.

Comment

This judgment is an important development of the law as it serves to give content to the sameness requirement in section 24C in the context of inextricably linked contracts as introduced in *Big G*. The court's decision will have implications for all taxpayers who run these types of loyalty programmes.

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