



## Tax deduction of customer loyalty scheme costs

Customer loyalty schemes are widely used. In the absence of specific tax legislation that deals with these schemes, the deductibility of the costs associated with a scheme must be determined in accordance with the general provisions governing the deductibility of expenditure, including section 24C. The tax court recently ruled in case 13988 that the taxpayer was allowed to claim a deduction under section 24C for its obligations relating to vouchers issued in terms of its customer loyalty programme. This article provides a brief review of the matters considered in this case.

Customer loyalty schemes are widely used, especially by retail businesses. In the absence of provisions that specifically deal with these schemes, the deductibility of costs associated with such a scheme should be determined by applying the provisions that generally deal with the deductibility of expenditure to the terms of the particular scheme. In November 2018 the tax court ruled on the application of section 24C of the Income Tax Act to a customer loyalty programme (Case 13988). This article provides a brief overview and analysis of the case.

### Facts of the case

The taxpayer operates a retail business where it sells health and pharmacy, beauty, fragrance, toiletries, baby, men's, electrical and household merchandise. It conducts a loyalty programme in terms of which points are awarded to participating customers (members) who present their loyalty card when making a purchase. A number of points are earned for each purchase (referred to as the *first purchase*). If a specified number of points have been earned during a set period, the customer qualifies for a voucher with a monetary value (approximately 2% of the customer's spend). This voucher cannot be redeemed for cash, but may be used as payment against the retail price of goods in a future purchase (referred to as the *second purchase*).

### Dispute

The taxpayer claimed a deduction for the value of loyalty points that it expected to be converted into free or discounted purchases in future under section 24C.

SARS disallowed the deduction on the basis that the obligations under the loyalty programme do not stem from the same contract as the first purchase from which the income was earned against which the taxpayer claimed the allowance under section 24C. The taxpayer did not earn any income from the loyalty programme contract against which the allowance could be claimed.

The taxpayer contended that it was artificial to regard the obligations in respect of the vouchers to arise from a contract other than the first purchase given how closely and inextricably the loyalty contract and first purchase were connected.

### Judgment and analysis

Section 24C allows a deduction of future expenditure where the income of a taxpayer included an amount received in terms of a contract and the Commissioner is satisfied that such amount will be utilised to finance future expenditure against the performance of the taxpayer's obligations under such contract. In assessing the case, the tax court considered a number of cases where the courts reinforced the principle that the income and obligations to incur expenditure had to arise from the same contract.

Nuku J concluded that SARS' view that the taxpayer did not incur a concomitant obligation to incur future expenditure when the first purchase occurred (from which the taxpayer earned income) was not factually correct. Instead, in his view, upon conclusion of the first purchase, the taxpayer became aware of the obligation to the customer based on the points granted as a result of that transaction. The first purchase transaction incorporated the terms of the loyalty programme. It was held that the obligations in terms of the loyalty programme arose from first purchase, the same contract from which it also earned income, and that the taxpayer was entitled to the allowance in terms of section 24C.

It appears as if counsel for SARS also argued that the obligations of the taxpayer were only contingent obligations as a second purchase was required to determine the expenditure to be incurred with certainty. The court did not consider this contention as it was not the basis on which SARS disallowed the deduction or included in the Rule 31 statement. It is submitted that it this may nevertheless be a relevant consideration for taxpayers to take into account in determining the deductibility of costs associated with customer loyalty schemes.