When loyalty comes for a price !!!!

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(*Published on https://www.taxsutra.com/[1] on 25.08.2021)*

In commercial world, when smart companies realize that customer loyalty is the most powerful and sustaining sales and marketing tool , they invent umpteen ways and models to canvas the customers in to it. The ever growing customer loyalty programs have become a business in itself with more players at different stages to initiate, co-ordinate, deliver and ensure effective implementation of it. The increase in the number of players has created multi faceted tax dimensions to each limb of the transaction. This has posed various challenges for the players involved and also for tax authorities. The main cause of the challenge was the differing perception and understanding of the nature of transaction on the side of the players *vis a vis* the revenue authorities.

The tax implications of different aspects of loyalty schemes have been subject to judicial scrutiny from 1990s. Loyalty schemes are operated through different models. The earlier models of loyalty schemes involved only two parties - *ie, a supplier of goods or services and their customers*. For example, a supermarket which grants loyalty points to their customers, wherein the points could be redeemed on making future purchases from same supplier. But gradually the operation of scheme involved more parties. For example, a supermarket would engage a third party to manage the distribution and redemption of points to the customers. Such third party would be responsible for paying the redemption partners whose goods and services are supplied on redemption by the customers. The three limbs of the transaction are given below:

(i) *The contractual agreement between a participating partner (one who promises and grants loyalty points to customers) and loyalty program provider (third party who manages the scheme)*

(ii) *The right of a member (customer) of the program to redeem the points earned by them as per the conditions prescribed.*

(iii) *The contractual arrangement between the loyalty program provider and redemption partner.*

When the nature of transactions brought in more players, each limb had to be examined separately for its tax implications. Various courts across jurisdictions have dealt with the issue on several occasions. The latest judicial precedent available on the point is Judgment of the Federal Court of Appeal, Canada in the matter of *Canadian Imperial Bank of Commerce Vs. Her Majesty the Queen 2021 FCA 10*[2]. The focal point of dispute was the nature of transaction between a loyalty service provider, Aeroplan Inc and participating partner, Canadian Imperial Bank of Commerce (hereinafter referred to as CIBC) The *'Aeroplan program'* is the loyalty rewards program operated by *Air Canada's* subsidiary *Aeroplan Inc.* CIBC had entered in to agreement with *Aeroplan* wherein "*Aeroplan miles"* were supplied to the customers of CIBC credit cards. Such points were redeemed by

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[1] https://www.taxsutra.com/news/global-idt-chronicles-when-loyalty-comes-price

[2] https://decisions.fca-caf.gc.ca/fca-caf/decisions/en/491777/1/document.do

the customers from *Aeroplan* either for travel on flights or through purchase of merchandise offered by the suppliers having tie up with *Aeroplan*. As part of the arrangement *Aeroplan* would provide a list of its members to CIBC and promote CIBC's credit cards.

CIBC, being a financial service provider, was exempted from GST in respect of value generated from rendering financial services. For the supply made by Aeroplan, invoices were raised on CIBC with GST. A refund claim was filed in respect of GST paid on invoices of Aeroplan on ground that the Supply of *Aeroplan miles* to CIBC are to be treated as *supply of gift certificate*, which constituted an exempted activity under the Canadian GST. The claim for refund was rejected by the Revenue on the ground that the nature of supply provided by Aeroplan to CIBC was marketing and promotional service which are taxable and not transaction *in gift certificate* as claimed by CIBC.

The matter, reached in appeal before the Tax Court of Canada and it was held that Aeroplan was providing single supply of marketing and promotional services for increased use of CIBC credit cards and hence the transaction is liable for GST and hence CIBC was not eligible for refund. The tax court also addressed the issue whether Aeromiles are gift certificates and held that Aeroplan Miles do not have attributes similar to money, Aeroplan Miles are not gift certificates for the purposes of the Act

The matter was taken in further appeal before the Federal Court. The Federal Court gave a split verdict, with majority in favor of Revenue and upholding the Judgment of the Tax Court classifying the activity as marketing and promotional service. The majority view was based on clauses of agreement which categorically provided for responsibility of Aeroplan to provide CIBC with information and list relating to Aeroplan members, allow CIBC to place insertions in four mailings to Aeroplan members, mention of CIBC cards in Aeroplan bulletins to customers, providing space for display of CIBC credit card at lounges and Aircanada counters, providing space for advertising of the cards at airport bridge poster locations etc. The agreement provided that consideration in form *of 'referral fee'* was payable to Aeroplan. Reliance was also placed on the description in invoice that the amount is payable towards "*Participation of CIBC in the Aeroplan Program* . Since payment of consideration is linked to obligation of Aeroplan to promote business of CIBC, the nature of supply is promotional and marketing services.

The majority refrained from addressing the issue whether Aeroplan miles are *gift certificates* or not observing that this aspect has more relevance to persons who are redeeming it and since they are not party to the transaction, it is not relevant to examine.

The dissenting view favors the assesee and holds that the predominant element that gives commercial efficacy to the transaction is right to allocate miles. If CIBC is not able to receive Aeroplan miles, the access to customer information or advertising opportunities serves no purpose. The fact that CIBC uses its property, Aeroplan miles to make money does not mean they are providing marketing service. Aeroplan miles are in the nature of *gift certificates*.

If CIBC chooses to prefer further appeal, the matter will be decided by the Supreme Court of Canada. If no appeal is preferred or Supreme court does not leave grant to the appeal the majority ruling of the Federal court of appeal would continue to bind the issue.

While tracing the roots of judicial scrutiny further , we have prominent decision of ECJ in the matter of *Kuwait Petroleum*[3] which rules the field for more than a decade. The case dealt with the nature of transaction when coupons received by persons on filling fuel from a petrol pump was redeemed at later point of time. ECJ did not favor the argument of the assesee that the price of petrol originally sold included the price of product for which coupons were granted. It was held that the buyers are liable to pay tax when the coupons are redeemed irrespective of whether price of such commodities were originally collected when coupons were issued. The judgment invited criticism as it resulted in taxing the value of redeemed goods twice- once included in value of petrol originally purchased and for the second time at the value when the vouchers were redeemed. Post *Kuwait Petroleum*, though commercial world adopted different models to circumvent the Judgment of ECJ, the judicial favor was always in direction of upholding the ratio in *Kuwait Petroleum*[4].

Another important aspect of loyalty schemes were addressed in the matter of *Loyalty Management*[5]. The situation involved, the Participating retailers, loyalty scheme manager, redeeming enterprises and customers. The Loyalty manager was paid amounts by participating retailers for issuing loyalty points to customers. The loyalty manager in turn paid amounts to the redeeming enterprises for goods and services redeemed by customers using accumulated points. HMRC denied VAT credit on amounts paid to redeeming enterprises on ground that the customers are actually purchasing the commodities and that role of loyalty manager is only to pay consideration on behalf of third party. The Supreme Court held that the economic reality was that *Loyalty Management* was clearly receiving a service from the redeemers in return for the payment it made, and so it could recover as input tax the VAT on the payment it made. Another interesting case from UK on the issue is in the matter of *Marriot Rewards LLC*[6] wherein the issue was similar *to Loyalty Management case* where payments made by assesee, the loyalty scheme manager to participating hotels were payments made in consideration for suppliers to the assesee and hence eligible for input tax credit or alternatively "third party consideration" paid, for supplies made by the Participating Hotels to customers who redeemed points under the Program. The Upper tribunal allowed the assesee to claim input tax credits for the tax included in the cost of redemption rooms. In UK, further guidance is available in form of guidance note issued by HMRC which among other things clarifies that the Payments made by a business to a third party reward supplier usually represent third party consideration for supplies made by the reward supplier to the collector[7].

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[3] *C-48/97 Kuwait Petroleum (GB) Ltd v Customs and Excise Commissioners EU: C:1999:203.*

[4] *Tesco Plc v Customs and Excise Commissioners [2003] EWCA Civ 1367; Total UK Ltd v Customs and Excise Commissioners [2007] EWCA Civ 987*

[5] *HMRC v Aimia Coalition Loyalty UK Ltd [2013] UKSC 15*

[6] *Marriot Rewards LLC Vs. HMRC* http://www.bailii.org/uk/cases/UKUT/TCC/2018/129.pdf

[7] https://www.gov.uk/guidance/business-promotions-and-vat-notice-7007

Coming to other jurisdictions, the Australian Tax Office has issued ruling[8] which deals with various aspect of loyalty programs. It is clarified that the points given by the reward operator to customer is consideration for a supply by the operator to the program partner of those points.

The litigation history of indirect tax in India would show that, there are not many precedents available on the aspects of loyalty programs. During the pre GST scenario, in the matter of *Sodexo Coupons* , the Supreme Court has held vouchers are merely *"payment instruments"* and not 'goods' and they become taxable only when they are redeemed[9]. After GST was introduced, there are few interesting Advance Rulings on some aspects of loyalty programs.

In the matter of *Loyalty Solutions and Research Pvt., Ltd., Ruling dated 23-10-2018*[10], an application was preferred by Loyalty program manager in respect of fee retained by them in respect of points not redeemed by the customers. The arrangement has three parties , the partner , their customer and the Loyalty program manager. The Loyalty program manager was issuing loyalty points to customers charging a fee to partner. In cases when customers are not redeeming such points with in the fixed time period, the loyalty manager was free to retain the fee collected on issuance of such points. The Applicant contended that the nature of transaction when points were issued was supply of actionable claim. The AARA ruled that the nature of transaction for which consideration was received by the applicant from the partner was management of loyalty scheme. The transaction never had the character of supply of loyalty points and hence exclusion cannot be claimed on ground that they were supplying actionable claims. Whenever customers redeem the points it is their liability to honour the claim of customers. However when there can be no claims by the end-customers after the expiry of validity period, these are no more actionable claims. These stand lapsed at the end of the Customers and applicant treat the redeemed money as revenue which can never be described as any claim against anyone.

Another interesting ruling by the Appellate Authority of Advance Ruling , Tamilnadu, in the matter of *Kalyan Jewellers India Ltd* [11] dealt with GST liability of Pre paid Gift vouchers issued by applicant to their customers and time of supply of such Gift vouchers. It has been ruled that, voucher is only an instrument of consideration and not goods or services, and hence same is not classifiable separately but only the supply associated with the voucher is classifiable according to the nature of the goods or services supplied in exchange of the voucher earlier issued to the customer. When a voucher is issued, though it is just a means of advance payment of consideration for a future supply, subsection (4) of section 12 and 13 determine the time of supply of the of the underlying good(s) or service(s). Therefore GST would be levied on the underlying goods/service at the time of redemption and not when the vouchers are supplied.

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[8] https://iknow.cch.com.au/document/atagUio1997840sl343471631/gstr-2012-1-gst-loyalty-programs

[9] *Sodexo Coupons* – ***2015-TIOL-293-SC-MISC***

[10] https://taxguru.in/goods-and-service-tax/gst-amount-forfeited-non-redemption-payback-points.html

[11] https://taxguru.in/goods-and-service-tax/time-supply-gift-vouchers-gift-cards-gst.html

Conclusion :

Since the scope of loyalty schemes are ever evolving and expanding, it is difficult to converge the different views to a common point. Deciding the taxability, even in future would depend on various factors as terms of agreement, the commercial reality of the transaction and how far the same can be aligned with principles of Value Added Taxation.