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AN ANALYSIS OF THE EMPLOYEES' TAX IMPLICATIONS OF LOYALTY POINTS AWARDED TO EMPLOYEES IN SOUTH AFRICA

by

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STUDY LEADER: Mr T.L. Steyn

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ABSTRACT

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by

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Since the introduction of frequent flyer miles (e.g. Voyager miles) in South Africa, the concept has evolved in a number of ways. Currently, loyalty programmes are widely used in the consumer industry. Despite the fact that these programmes have been in place for several years, the South African Revenue Service (hereafter referred to as SARS) has failed to issue any legislation or guidance with regard to the treatment of these miles from an employees' tax perspective.

The fringe benefit implications of frequent flyer miles have been the topic of research both in South Africa and abroad. However, little research has been identified on the tax implications of loyalty programmes. This study re-examined past studies and literature identified on frequent flyer miles and analysed the impact these have on loyalty points earned on personal and corporate credit cards from an employees' tax perspective. The study also extended past research and investigated loyalty points awarded to employees as an incentive from an employees' tax perspective.

The study had three specific objectives. The first objective was to analyse past research studies, court cases and other literature in order to establish the theoretical construct of this study. Secondly, it compared the treatment of frequent flyer miles earned by, or

awarded to, employees in South Africa to the treatment of these in Australia and Canada. The third objective was to analyse the employees' tax implications of loyalty points earned by, or awarded to, employees in specific *scenarios*. These *scenarios* were limited to loyalty points earned by employers on corporate credit cards and which are awarded to employees for personal use; loyalty points earned on personal credit cards as a result of business expenditure incurred by employees; and loyalty points awarded to an employee, as part of a loyalty programme operated by the employer, as an incentive.

The concluding argument of this study was that loyalty points earned on corporate or personal credit cards, which are used for the benefit of employees, may be considered not to be taxable and that consequently, no employees' tax obligation will arise. However, this argument is plagued by uncertainties and it is questionable as to whether this view will be supported by the South African courts and SARS. In the *scenario* where loyalty points are awarded as an incentive to employees, it may clearly be argued that these should be taxable with the result that an employees' tax obligation will arise. However, the nature and value of the benefit, as well as the point at which the tax event occurs, may create inequities and is therefore uncertain. All these uncertainties highlight the need for guidance in this area from SARS.

Keywords:

Employees' tax
Fringe benefits
Loyalty programmes
Frequent flyer miles
Loyalty points
Taxable benefits

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OPSOMMING

’N ONDERSOEK NA DIE WERKNEMERSBELASTINGIMPLIKASIES VAN LOJALITEITSPUNTE TOEGEKEN AAN WERKNEMERS IN SUID-AFRIKA

deur

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GRAAD: MAGISTER COMMERCII IN BELASTING

Sedert gereelde vlugmyle (bv. *Voyager miles*) in Suid-Afrika in plek gestel is, het hierdie konsep in verskeie vorms ontwikkel. Vandag word lojaliteitsprogramme algemeen in die verbruikersbedryf gebruik. Ten spyte van die feit dat hierdie programme vir baie jare reeds in plek is, het die Suid-Afrikaanse Inkomstediens (hierna verwys na as SAID) steeds geen wetgewing of leiding uitgereik oor die hantering van hierdie myle uit ’n werknemersbelastingsoogpunt nie.

Alhoewel die byvoordeelimplikasies van gereelde vlugmyle die onderwerp was van navorsing in Suid-Afrika sowel as oorsee is min navorsing geïdentifiseer oor die belastingimplikasies van lojaliteitsprogramme. Hierdie studie heroorweeg bestaande studies en literatuur oor gereelde vlugmyle en analiseer die impak daarvan op lojaliteitspunte verdien op persoonlike en sakekredietkaarte uit ’n werknemersbelastingsoogpunt. Die studie sal ook bestaande navorsing uitbrei deur lojaliteitspunte, wat as ’n aansporing aan werknemers gegee word, uit ’n werknemersbelastingsoogpunt te analiseer.

Die studie het drie spesifieke oogmerke. In die eerste plek is dit om bestaande navorsingstudies, hofsake en ander literatuur te analiseer om ’n teoretiese basis te vestig.

Tweedens is dit om die belastinghantering van gereelde vlugmyle verdien deur of toegeken aan werknemers in Suid-Afrika te vergelyk met die hantering hiervan in Australië en Kanada. Die derde oogmerk is om die werknemersbelastingimplikasies van lojaliteitspunte toegeken aan of verdien deur werknemers in spesifieke *scenario's* krities te analiseer. Hierdie *scenario's* is beperk tot lojaliteitspunte verdien deur werkgewers op sakekredietkaarte en toegeken aan werknemers vir persoonlike gebruik; lojaliteitspunte verdien deur werknemers weens sake-uitgawes aangegaan op persoonlike kredietkaarte; en lojaliteitspunte, wat deel vorm van 'n lojaliteitsprogram wat deur die werkgewer bedryf word, gegee aan werknemers as 'n aansporingsbonus.

Volgens die studie se bevindinge kan daar aangevoer word dat lojaliteitspunte verdien op sake- en persoonlike kredietkaarte vir werknemers se persoonlike gebruik nie belasbaar is nie en gevolglik geen werknemersbelastingverpligting teweeg bring nie. Nietemin gaan hierdie siening gepaard met baie onsekerhede en word bevraagteken of dit deur die Suid-Afrikaanse howe en SAID ondersteun sal word. In die *scenario* waar lojaliteitspunte aan werknemers as 'n aansporing gegee word, kan dit duidelik aangevoer word dat hierdie voordeel belasbaar is en dus 'n werknemersbelastingverpligting teweegbring. Daar is egter onsekerheid oor die tydstip waarop die voordeel belas moet word, asook die aard en waarde van die belasbare byvoordeel. Hierdie onsekerhede onderstreep die behoefte aan leiding op hierdie onderwerp vanaf SAID.

Sleutelwoorde:

Belasbare byvoordeel	*Byvoordele*
Gereelde vlugmyle	*Lojaliteitsprogramme*
Lojaliteitspunte	*Werknemerbelasting*

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The following table sets out abbreviations which will be used throughout this study.

Abbreviation	Meaning
IASB	International Accounting Services Board
IFRIC 13	International Financial Reporting Interpretations Committee 13 -– Customer Loyalty Programmes
SARS	South African Revenue Service
The Consumer Act	Consumer Protection Act, 6 of 2008
The Fourth Schedule	Fourth Schedule to the Income Tax Act, 58 of1962
The Income Tax Act	Income Tax Act, 58 of 1962
The Seventh Schedule	Seventh Schedule to the Income Tax Act, 58 of 1962

AN ANALYSIS OF THE EMPLOYEES' TAX IMPLICATIONS OF LOYALTY POINTS AWARDED TO EMPLOYEES IN SOUTH AFRICA

CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

Long after frequent flyer miles (e.g. Voyager miles) were first introduced in South Africa, the South African Revenue Service (hereafter referred to as SARS) has failed to issue any legislation or guidance with regard to the treatment of these miles from an employees' tax perspective.

Subsequent to the introduction of frequent flyer miles years ago, this concept has evolved in a number of ways. Currently, loyalty programmes are widely used in the consumer industry. A loyalty programme can broadly be defined as a programme whereby free points are accumulated by customers when repeatedly purchasing the products, or using the services of a company (Liu, 2007:20). In turn, these loyalty points may be redeemed for a variety of commodities including goods, services or a discount upon the customer's next purchase.

The taxable (fringe) benefit implications of frequent flyer miles, earned as a result of business flights paid for by the employer and used by the employee for private purposes, has been the topic of many research projects and articles both in South Africa and abroad. In his study, Andoh (2008:58) argues that Voyager miles do not constitute a taxable benefit as the South African Airways is not an associated institution as defined in the Seventh Schedule to the Income Tax Act 58 of 1962 (hereafter referred to as the Income Tax Act) in relation to the employers of his study. Clegg (2002:34-35), in turn, argues that no taxable benefit arises in terms of the Seventh Schedule to the Income Tax Act (hereafter referred to as the Seventh Schedule) on Voyager miles as there is arguably no taxable event or cost to the employer.

Although research has been conducted on the fringe benefit implications of frequent flyer miles, it would appear that, at present, little or no research has been conducted on the employees' tax implications of the various ways in which employees benefit from loyalty programmes. Regardless of the fact that no formal studies have been identified on the tax implications of loyalty programmes, various literature has been identified which may contribute towards a study in this area. These include the recent *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS,* 2009 JDR 0743 (WCC) (71 SATC 249) case (including the court *a quo case* (court of first instance) *XYZ (Pty) Ltd v Commissioner for SARS,* 2008 *Case number 12244*, unpublished (Tax Court of South Africa)), which dealt with the provision of timeshare points to sales staff; and the accounting interpretation guideline, IFRIC 13 – Customer Loyalty Programmes (hereafter referred to as IFRIC 13), which requires companies to place a fair value on loyalty points earned by their customers (IASB, 2009:2577).

1.2 PROBLEM STATEMENT

The lack of research conducted on loyalty programmes from a South African employees' tax perspective leaves the question as to whether an employees' tax obligation arises where loyalty points are awarded to, or earned by, employees, unanswered.

Unlike countries such as Canada, Denmark and Sweden, which provide guidance with regard to the fringe benefit implications of frequent flyer miles, the Income Tax Act contains no such guidance (Andoh, 2008:4). Clegg (2002:33) suggests that the taxation of Voyager miles has not been attacked by SARS due to the fact that the Seventh Schedule is not equipped to do so. For the purposes of this study, it will be assumed that frequent flyer miles are similar to loyalty points and thus a parallel argument may be drawn between this statement for frequent flyer miles and loyalty programmes.

Even where employers do consider a taxable benefit to arise as a result of the aforementioned award to an employee, uncertainty exists around:

- the timing of the tax event;
- whether the points or the services/goods for which points may be redeemed should be considered as the taxable benefit (i.e. the nature of the taxable benefit);

- the value of such benefit;
- the impact that the recent *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* case and the court *a quo* case, *XYZ (Pty) Ltd v Commissioner for SARS,* may have on loyalty programmes; and
- the impact that the IFRIC 13 may have on the employees' tax implications of loyalty programmes.

1.3 PURPOSE STATEMENT

The main purpose of this study is to analyse the employees' tax implications with regard to loyalty points earned by, or awarded to, employees in terms of the Seventh Schedule and paragraph (c) of the definition of gross income in section 1 of the Income Tax Act and to compare the tax treatment thereof to the practices in Australia and Canada from a South African point of view.

1.4 RESEARCH OBJECTIVES

A literature review will be conducted in this study which will aim to achieve the following specific research objectives:

- to analyse research studies, court cases and other literature in order to establish the theoretical construct of this study;
- to compare the tax treatment of frequent flyer miles earned by, or awarded to, employees in South Africa to the tax treatment thereof in Australia and Canada; and
- to analyse the employees' tax implications with regard to loyalty points earned by, or awarded to, employees in terms of the Seventh Schedule and paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act, using the theoretical construct as a basis.

1.5 IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

The study will make the following academic contribution:

- it will re-examine previous studies and articles that have been written on the fringe benefit implications of frequent flyer miles and analyse the impact these have on loyalty points earned on corporate or personal credit cards which are used by the employee for personal benefit;
- it will consider previous research that has been conducted on the fringe benefit implications of frequent flyer miles and extend it to the employees' tax implications of loyalty programmes operated by the employer where points are provided to employees as an incentive; and
- it will make a unique contribution by investigating the impact which *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS*, *XYZ (Pty) Ltd v Commissioner for SARS* and IFRIC 13 has on the employees' tax treatment with regard to loyalty points.

The practical benefit of the study for employers awarding loyalty points to employees is that it will provide insight into whether these points are taxable, the timing of the taxation event and the value of such taxable benefit.

1.6 DELIMITATIONS OF THE STUDY

This study will be performed with the following delimitations:

- the study will be limited to the following *scenarios*:
  - loyalty points earned on corporate credit cards or personal credit cards as a result of business expenditure incurred which are awarded/used for the employee's personal purposes; and
  - loyalty points, which form part of the employer's loyalty programme, awarded to employees as an incentive;
- the corporate tax, value-added tax and personal income tax implications of loyalty points provided under the various *scenarios* noted above will not be investigated in this study;

- the study will be limited to the investigation of whether loyalty points awarded to employees falls within paragraph (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act;
- the study will be limited to loyalty programmes where loyalty points may be redeemed for goods or services; and
- the comparison of international practices will be limited to Australia and Canada.

1.7 ASSUMPTIONS OF THE STUDY

This study will be conducted on the basis of the following assumptions:

- frequent flyer miles earned on frequent flyer programmes are similar to loyalty points earned on loyalty programmes;
- the timeshare points referred to in *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS* were accounted for in terms of IFRIC 13;
- loyalty points earned on corporate credit cards accrue to the employer;
- employees referred to in the study are natural persons who are in the current employment of the employer. Therefore, it will be assumed that an employer-employee relationship exists as referred to in the Fourth Schedule to the Income Tax Act (hereafter referred to as the Fourth Schedule);
- the employers referred to in this study are companies; and
- loyalty points are not provided by any person by arrangement with the employer as referred to in paragraph 2(*a*) of the Seventh Schedule.

1.8 DESCRIPTION OF ENQUIRY STRATEGY AND BROAD RESEARCH DESIGN

To establish the theoretical construct of this non-empirical study, the enquiry strategy and broad research design of this study will be based on the literature review method (Mouton, 2001:179). Searches will be performed for local and international studies on this topic, as well as the related topic, namely frequent flyer programmes.

According to Mouton (2001:180), a study based on a literature review method has certain limitations: it can only summarise and organise existing literature; it cannot validate existing or create new empirical insights; and empirical studies will still have to be performed to test new insights.

The above-mentioned strategy and design are considered appropriate for this study due to the following reasons:

- the field of this study, namely taxation, lends itself to this research strategy and design; and
- a literature review method lends itself to the focus of this study and increases the depth of understanding on the chosen subject.

1.9 DEFINITION OF KEY TERMS

The study will use a number of key terms including loyalty programme, loyalty points, taxable benefit, fringe benefit, gross income, employer, and employee. These terms will be used throughout this study, in particular in the literature review in Chapter 2. The definition of all key terms used in this study will be considered below.

Associated institution

According to paragraph 1 in the Seventh Schedule, an associated institution means:

- in the case of the employer being a company, any other company which are managed or controlled directly or indirectly by substantially the same persons; or
- any company managed or controlled directly or indirectly by the employer, who is not a company, or by a partnership of which the employer is a partner; or
- a fund established for the sole or main benefit of employees or former employees and any company which is an associated institution as defined in the first two points above. It excludes any fund established by a trade union or industrial council or a postgraduate research fund.

For the purposes of this study, it will be assumed that the employers mentioned in this study are companies. Therefore, the term “associated institution” will be defined in line with

the Seventh Schedule as, in relation to any single employer, any other company managed or controlled directly or indirectly by substantially the same persons.

Employer

The term “employer” is defined both in the Fourth Schedule and the Seventh Schedule.

Paragraph 1 in the Fourth Schedule defines employer to mean any person who pays or is liable to pay (this excludes any person who does not act as a principal, but includes any person who acts in a fiduciary capacity or as a trustee in an insolvent estate, an executer of a benefit fund, pension fund, pension preservation fund, provident fund, provident preservation fund, retirement annuity fund or any other fund) any amount by way of remuneration to any person. It also includes any person responsible for the payment of any amount by way of remuneration to any person under the provisions of any law or out of public funds or out of funds voted by Parliament or a provincial council.

In turn, paragraph 1 in the Seventh Schedule defines employer to mean any person defined as an employer in the Fourth Schedule, including a company and the State.

For the purposes of this study, it will be assumed that the employers mentioned in this study are companies. As the Seventh Schedule refers to the definition of employer in the Fourth Schedule and specifically includes a company, for the purposes of this study, the term “employer” will be defined in line with the Fourth Schedule as any person who pays or is liable to pay to any person any amount by way of remuneration.

Employee

The term “employee” is defined both in the Fourth Schedule and Seventh Schedule.

Paragraph 1 in the Fourth Schedule defines the term “employee”; to mean:

- any person (who is not a company) receiving any remuneration or to who any remuneration accrues; or
- any person who receives or to whom any remuneration accrues as a result of services rendered to a labour broker; or
- a labour broker; or

- any person declared as an employee by the Minister of Finance in the Gazette; or
- any personal services provider; or
- any director of a private company not included in the first point above.

According to paragraph 1 of the Seventh Schedule an employee is defined as a person who is defined as an employee in the Fourth Schedule. It excludes a person who has retired before 1 March 1992 as a result of superannuation, ill-health or other infirmity. It includes, in relation to any company, any director (past or present) and any person previously employed by such company, if such person is or was the sole or controlling shareholder of such company. It also includes retired employees or a person who has, after his retirement, been released by his employer from an obligation arising before the employee's retirement or to pay an amount owing by the employee to the employer before retirement.

For the purposes of this study, the assumption is made that the employees referred to in this study are employees in the current employment of a company and thus the inclusions and exclusions in the definition of employee in the Seventh Schedule will not find application here. Therefore, for the purposes of this study, the term "employee" will be defined in line with the Fourth Schedule as any person who receives any remuneration or to whom remuneration accrues.

Employees' tax

For the purposes of this study, remuneration will be defined in line with paragraph 1 of the Fourth Schedule as: "… the tax required to be deducted or withheld by an employer in terms of paragraph 2 from remuneration paid or payable to an employee …".

Fringe benefit

For the purposes of this study, the term "fringe benefit" will be used interchangeably with "taxable benefit" and will bear the same meaning.

Gross income

For the purposes of this study, the term "gross income" will be defined in line with section 1 of the Income Tax Act as:

- the total amount, in cash or otherwise, received by or accrued to a resident; or
- in the case of a non-resident, the total amount received by or accrued to such person from a source within or deemed within South Africa.

The above amount excludes receipts or accruals of a capital nature.

Paragraph *(c)* of the definition of gross income specifically includes any amount received or accrued in respect of services rendered or to be rendered; or any amount received or accrued in respect of, or by virtue of, any employment or the holding of any office. This paragraph will not apply to any benefit to which paragraph *(i)* of the definition of gross income in section 1 of the Income Tax Act applies.

Paragraph *(i)* of the definition of gross income furthermore specifically includes the cash equivalent of any benefit or advantage granted in respect of employment or to the holder of any office which is a taxable benefit as defined in the Seventh Schedule.

Loyalty programmes

Liu (2007:20) defines a "loyalty programme" as a programme whereby free points are accumulated by customers when repeatedly purchasing the products or using the services of a company.

Section 1 of the Consumer Protection Act 6 of 2008 (hereafter referred to as the Consumer Act) defines loyalty programmes as "… any arrangement or scheme in the ordinary course of business, in terms of which a supplier of goods or services … offers or grants to a consumer any loyalty credit or award in connection with a transaction or an agreement …".

A slight extension of the definition by Liu provides an appropriate definition of loyalty programmes in the context of this study. Therefore, for the purposes of this study, "loyalty programmes" will be defined as a programme whereby free points are accumulated by customers when purchasing the products or using the services of a company which, in turn, may be redeemed for a variety of commodities including goods, services or a discount upon the customer's next purchase (Liu, 2007:20).

Loyalty points

Section 1 of the Consumer Act defines the terms “loyalty credit” or “award” as, in terms of a loyalty programme:

- a benefit which accrues to a customer; or
- a right to goods, services or other benefits; or
- a point, credit, etc. which entitles the holder to claim goods, services or other benefits.

The International Accounting Standards Board (2009:2576) (hereafter referred to as the IASB) states that credits, also referred to as points, are used to incentivise customers by granting these credits to the customer when purchasing the goods or services of a company. These credits may then be redeemed for awards such as free or discounted goods or services.

A combination of the above two definitions provides an appropriate definition of loyalty points in the context of this study. Therefore, for the purposes of this study, “loyalty points” will be defined as credits or points that form part of a company’s loyalty programme, which are awarded to customers or employees and which may be redeemed for free or discounted goods or services.

Remuneration

For the purposes of this study, “remuneration” will be defined in line with paragraph 1 of the Fourth Schedule as: any amount of income which is paid or is payable to any person in cash or otherwise and whether or not in respect of services rendered. It also includes any amount referred to in paragraph (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act.

Taxable benefit

For the purposes of this study, the term “taxable benefit” will be defined in line with paragraph 1 of the Seventh Schedule as a taxable benefit envisaged in paragraph 2 of the said Schedule, but excluding:

- any benefit which is exempt from normal tax in terms of section 10 of the Income Tax Act; or
- any benefit provided by a benefit fund relating to medical services, dental and similar services, hospital services, nursing services and medicines; or
- any lump sum payable by a benefit fund, pension fund, pension preservation fund, provident fund or provident preservation fund which is a benefit referred to in the definition of "benefit fund" in section 1 of the Income Tax Act or the proviso to paragraph *(c)* of the definition of "pension fund" in that section or in paragraph *(a)* of the definition of "provident fund" in that section; or
- any benefit received by or accrued to a person stationed outside South Africa as contemplated in section 9(1)(e) of the Income Tax Act.

1.10 CHAPTER OVERVIEW

Chapter 1 introduced the focal points of the study. It set out the background, problem statement, purpose statement, research objectives and certain delimitations and assumptions of the study. It also highlighted the importance of the study, detailed the broad research design and enquiry strategy, and provided definitions of key terms that will be used throughout the study. Lastly, this paragraph provides and overview of the chapters contained in this study.

In setting the theoretical construct of this study, Chapter 2 provides an analysis of five areas related to loyalty programmes from an employees' tax perspective. Firstly, an analysis of the elements of employees' tax and taxable benefits in terms of relevant legislation, case law and other literature identified on this matter is performed. Secondly, the literature review is extended to provide an analysis of IFRIC 13 and the impact it may have on loyalty programmes from an employees' tax perspective. Thirdly, an analysis is provided of *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS* which dealt with the provision of timeshare points to employees. Fourthly, this section provides an analysis of the subject of frequent flyer miles, an area which is closely related to loyalty programmes. Finally, the tax treatment of loyalty programmes is analysed from an Australian and Canadian perspective.

Chapter 3 firstly provides a comparison between the principles identified from a South African perspective and those identified from an Australian and Canadian perspective. Secondly, the theoretical construct identified in Chapter 2 is applied against the different *scenarios* noted in Chapter 1.

Chapter 4 summarises and conclude on the findings of this study.

CHAPTER 2: A REVIEW OF LITERATURE RELATING TO LOYALTY PROGRAMMES AND FREQUENT FLYER PROGRAMMES

2.1 INTRODUCTION

The purpose of this chapter is to analyse previous research studies, court cases and other literature in order to establish the theoretical construct of this study. In establishing the theoretical construct of a tax-related study, local legislation and case law are important sources. International judicature, articles, research projects and papers may supplement these sources, especially where local legislation is silent on a specific matter.

2.2 THE ELEMENTS OF EMPLOYEES' TAX AND TAXABLE BENEFITS

2.2.1 Introduction

Employees' tax is the amount of tax that should be withheld from an employee's taxable earnings by his or her employer on a monthly basis (paragraph 1 of the Fourth Schedule). This tax is payable to SARS within seven days following the end of each month in which it was withheld (paragraph 2(1) of the Fourth Schedule). The amount of employees' tax withheld during a tax year is set off against an individual's personal income tax liability upon assessment.

The following paragraphs provide an analysis of the elements that need to be present for an employees' tax obligation to arise in the hands of an employer and for a taxable benefit to arise in the hands of an employee. It also provides an analysis of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. This analysis is performed by way of a review of existing literature, legislation and case law.

2.2.2 Elements of employees' tax

For an employees' tax obligation to arise, three elements need to be present, namely "remuneration", "employer" and "employee". Where one of these elements are not present,

employees' tax should not be withheld (SARS, 2010:3; paragraph 1 of the Fourth Schedule).

The elements "employer" and "employee" are defined in both the Seventh Schedule and the Fourth Schedule. The terms as defined in the Seventh Schedule are wider and more complex than in the Fourth Schedule and would therefore include more elements (De Koker, 2010:20-4). For the purposes of this study, an employee is defined as any person who receives remuneration or to whom remuneration accrues. In turn, an employer is any person who pays or is liable to pay to any person any amount by way of remuneration (paragraph 1 of the Fourth Schedule). The common factor in these elements is "remuneration". Thus, for the purposes of this study, an employees' tax obligation essentially hinges on whether loyalty points provided to employees under the specific *scenarios* may be seen as remuneration as defined in the Fourth Schedule.

Remuneration, as defined paragraph 1 of the Fourth Schedule, can be divided into a general inclusion and specific inclusions (De Koker, 2010:20-2). Subparagraphs (*a*) and (*b*) of the definition of remuneration in the Fourth Schedule specifically includes amounts to be included under paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act. Paragraph (*i*) of the said definition essentially deals with taxable benefits under the Seventh Schedule. The following paragraphs provide an analysis of the elements that need to be present for a taxable benefit to arise in terms of paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act.

2.2.3 Elements of a taxable benefit

Paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act includes the cash equivalent of any benefit or advantage granted in respect of employment, being a taxable benefit as defined in the Seventh Schedule. The important elements that need to be present to meet the requirements of paragraph (*i*) of the said definition are thus "cash equivalent", "benefit or advantage", "a benefit or advantage provided in respect of employment" and a "taxable benefit".

Meyerowitz (2007:9-16) states that the benefits or advantages referred to in paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act are the taxable benefits referred to in the Seventh Schedule. Broadly speaking, the Seventh Schedule defines and quantifies benefits (i.e. determines the cash equivalent) and imposes an employees' tax withholding obligation in respect thereof.

A taxable benefit is a benefit granted in terms of paragraph 2 of the Seventh Schedule (paragraph 1 of the Seventh Schedule). This paragraph deems a taxable benefit to be granted by an employer to an employee in respect of the employee's employment if, as a benefit or advantage of or by virtue of such employment or as reward for services rendered or to be rendered, certain in-kind benefits are provided by an employer to an employee. Meyerowitz (2007:3-18) states that the meaning of "by virtue of" as referred to in paragraph 2 of the Seventh Schedule should be determined with reference to *Millin v Commission for Inland Revenue*, 1928 AD 207 (3 SATC 170). This case held "by virtue of" to be equivalent to "for" in as much as it relates to services or work to be done. In *Commissioner for Inland Revenue v McNeil*, 1959 (1) SA 481 (A) (22 SATC 374) it was held that "in respect of" provides a grammatical link between two items. Thus, for a taxable benefit to arise the benefit provided must be linked to an employee's employment with the employer or it should be provided as a reward for services rendered.

Paragraphs 2(*a*) to 2(*j*) of the Seventh Schedule specifically include certain types of benefits as taxable benefits. As this study is limited to the loyalty points redeemed for goods and services, the following paragraphs of the Seventh Schedule are relevant:

- paragraph 2(*a*) - any asset (other than money) acquired by an employee from an employer, associated institution or from any person by arrangement with the employer for either no consideration or a consideration less than the value of the asset ; and
- paragraph 2 (*e)* - any service which has been rendered to the employee (whether by the employer or by some other person) at the expense of the employer and utilised for his private or domestic purposes for no consideration or for a consideration less than the value of such benefit.

The cash equivalent (or taxable value) of the taxable benefits noted under paragraph 2 of the Seventh Schedule is determined in paragraphs 5 to 13 of the said Schedule. The cash equivalent is the difference between the value of the benefit and the consideration paid by the employee (Meyerowitz, 2007:9-18).

Paragraph 5(2) of the Seventh Schedule states that the value of an asset acquired at less than actual value shall be the market value thereof at the time of acquisition. Where the asset is moveable property acquired by the employer in order to dispose of it to the employee, the cash equivalent of the taxable benefit is the cost thereof to the employer. Where the asset was held by the employer as trading stock, the cash equivalent is the lower of cost or market value. The market value or cost of the asset shall be reduced by any consideration paid by the employee (paragraph 5(1) of the Seventh Schedule).

In terms of paragraph 10 of the Seventh Schedule, the cash equivalent of free or cheap services provided to an employee is the cost thereof to the employer less any consideration paid by the employee.

To reduce instances of tax avoidance, the concept of associated institution has been introduced by the legislator (Clegg, 2005:6). In terms of paragraph 4 of the Seventh Schedule, any benefit granted to an employee by an associated institution in relation to the employer, which would, if provided directly by the employer, constitute a taxable benefit under paragraph 2 of the said Schedule, would be deemed to be granted directly by the employer. An associated institution is any other company directly or indirectly managed or controlled by substantially the same persons (paragraph 1 of the Seventh Schedule). According to Clegg (2005:6), SARS will follow a pragmatic approach in applying this provision. Control will generally be seen as control by a board of directors as opposed to shareholding or ownership in a company. Where the board of directors of two companies are thus essentially the same, control as envisaged in the said definition will exist.

Following the analysis of the elements of a taxable benefit, the following paragraphs provide an analysis of the elements of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act.

2.2.4 Paragraph (*c*) of the definition of gross income

Paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act will apply where any amount was received or accrued in respect of services rendered or to be rendered or where any amount was received or accrued in respect of, or by virtue of, any employment. Furthermore, where paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act applies to any benefit or advantage, it will be excluded from paragraph (*c*) of the said definition.

Terms such as “amount”, “received”, “accrued”, “in respect of services rendered” and “by virtue of employment” are not defined in the Income Tax Act. Various court cases have dealt with the meaning of these terms.

Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd, 1945 AD 301 (13 SATC 21) confirmed that “amount” means something which has monetary value. *Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Ltd,* 1990 (2) SA 353 (A) (52 SATC 9) confirmed the principle that “amount” means “… every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value …” Wiliams (2009:82) supports these interpretations. Case law relating to the valuation of an amount and, in particular, the decision in *Commissioner for South African Revenue Service v Brummeria Renaissance (Pty) Ltd and Others,* 2007 (6) SA 601 (SCA) (69 SATC 205) will be discussed in Chapter 3.

In *Geldenhuys v Commissioner for Inland Revenue*, 1947 (3) SA 256 (C) (14 SATC 419), it was held that the term “received by” means “… received by the taxpayer on his own behalf for his own benefit …” Williams (2009:84) supports this interpretation. O*chberg v Commissioner for Inland Revenue*, 1933 CPD 256 (6 SATC 1) laid down the principle that there is no accrual unless the right to the payment of an amount is unconditional. Muller (2009:19) supports this interpretation and based on O*chberg v Commissioner for Inland Revenue* stated that “accrued to” means that a person is unconditionally entitled to an amount.

In *Stevens v Commissioner for South African Revenue Service*, 2007 (2) SA 554 (SCA) (69 SATC 1), it was held that there is no material difference between the expressions "in respect of" and "by virtue of" in paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. These terms connoted a causal relationship between the amount received and the taxpayer's services or employment.

Stander v Commissioner for Inland Revenue, 1997 (3) SA 617 (C) (59 SATC 212) dealt with the term "in respect of services rendered". In this case, the court held that the fact that the appellant's employment was a sine qua non (a condition without which) of the receipt of the award sought to be taxed, was not sufficient to provide the necessary causal link between the services which he rendered to his employer and his obtaining the award. Those services did not constitute the *causa causans* (proximate or actual effective cause or direct and immediate cause) of the award he received.

With reference to *Commissioner for Inland Revenue v Crown Mines*, 1923 AD 21, it was held in *De Villiers v Commissioner for Inland Revenue,* 1929 AD 227 (4 SATC 86) that the term "in respect of" means that there must be a causal relationship between the services rendered and the remuneration received or accrued. Thus, there must be a direct or causal connection between services rendered and the award received by the employee (Klue, 2005:2).

Klue (2005:2) notes that "in respect of" or "by virtue of employment" is a factual question, answered by looking at the specific circumstances.

2.2.5 Summary

The above paragraphs provided an overview of the elements of employees' tax and paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act.

For an employees' tax obligation to arise, three elements, as defined in the Fourth Schedule, need to be present. These are "employer", "employee" and "remuneration". Specifically included in the definition of remuneration in the Fourth Schedule is amounts which fall within paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the

Income Tax Act. For the purposes of this study, the elements “employer” and “employee” will be assumed to be present. Thus, for an employees’ tax obligation to arise for the purposes of this study, it has to be shown that the element of “remuneration” is present.

Paragraph (*i*) of the said definition includes in-kind benefits (i.e. taxable benefits) provided to employees which are linked to the employee’s employment or as a reward for services rendered. These are specifically dealt with in the Seventh Schedule. The Seventh Schedule includes a host of benefits including goods and services provided by an employer to an employee and also provides specific methods to value these goods.

For amounts to fall within the provisions of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act there should be a direct causal link between the benefit received by the employee on the one hand and the services rendered by the employee on the other.

Despite the fact that the area of Voyager miles has been identified for review by the Minister of Finance in 1998, no guidance has been provided by SARS with regard to this matter (Clegg, 2002:33). It can also be seen from the above analysis that the Income Tax Act contains no specific legislation which addresses loyalty points provided in any manner by an employer to an employee.

The above elements are further discussed in the context of loyalty points in Chapter 3 of this study. The following section provides an analysis of the impact which IFRIC 13 may have on the tax treatment of loyalty programmes.

2.3 AN ANALYSIS OF THE IMPACT OF IFRIC 13 ON EMPLOYEES’ TAX

2.3.1 Introduction

Customer loyalty programmes are widespread across the consumer industry. The International Financial Reporting Standards, commonly known as the IFRS statements, are adopted by many companies in South Africa as their financial reporting standards. However, these statements do not provide specific guidance with regard to the treatment

of customer loyalty programmes (IASB, 2009:2582). IFRIC 13 is an accounting interpretation guideline, which was initially issued in 2007 by the IASB, and gives guidance on the valuation of loyalty points provided as part of loyalty programmes (South African Institute of Chartered Accountants, 2010:1). The following paragraph provides an overview of the guidelines contained in IFRIC 13.

2.3.2 Overview of IFRIC 13

IFRIC 13 requires companies to place a fair value on loyalty points earned by its customers (IASB, 2009:2577). According to the IASB (2009:2577), a sale transaction should be split between the award credit (loyalty point) component and other components of the sale, such as services or goods. The portion allocated to the award credits should reflect the fair value of the credits to the customer and not the cost thereof to the entity. The amount for which the award credits can be sold will equate to the fair value thereof. If the fair value cannot be determined, it should be estimated. The revenue relating to the award credits should be recognised when the entity fulfils its obligations connected to the award credits (IASB, 2009:2579, 2583).

2.3.3 An analysis of the impact which IFRIC 13 may have on the employees' tax treatment of loyalty points

From a technical perspective, IFRIC 13 may be useful when attempting to value loyalty points provided to employees. However, when considering the different *scenarios* which fall under review in this study, IFRIC 13 will probably only be applied by companies who operate a loyalty programme. It will not be applied in the *scenario* where loyalty points, which are earned by the employee or employer on credit cards, are provided by a third party and where the loyalty programme is not operated by the employer itself. Chapter 3 further explores the impact which IFRIC 13 may have on loyalty points provided by an employer to the employee.

It is also important to emphasise that IFRIC 13 requires companies to value loyalty points at their fair value and not in terms of the cost thereof to the company. This requirement suggests that the fair value of a loyalty point is not necessarily a reflection of the cost

thereof to the company. This is an important factor to consider in view of the valuation methods prescribed by the Seventh Schedule.

2.3.4 Summary

These paragraphs provided an overview of IFRIC 13. In essence, IFRIC 13 only applies to companies which operate a loyalty programme and will most likely not apply to the *scenario* where the employer or employee (as the loyalty programme member) accumulates loyalty points as a result of business expenditure incurred. IFRIC 13 requires companies to defer a portion of income received from customers until such time that the customer redeems the points or credits earned. This portion should be equal to the fair value of the loyalty points and not the cost thereof to the company.

Thus, in the context of employees' tax and the Seventh Schedule, IFRIC 13 may provide guidance in determining the fair value on loyalty points provided, as part of a loyalty programme operated by the employer, to its employees. Whether, in terms of the Seventh Schedule, it is required to put a market value on points is further investigated in Chapter 3.

In the paragraphs that follow, an analysis is performed of *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS*, which dealt with timeshare points provided by an employer to its employees.

2.4 AN ANALYSIS OF *VACATION EXCHANGES INTERNATIONAL (PTY) LTD V COMMISSIONER FOR SARS* AND *XYZ (PTY) LTD V COMMISSIONER FOR SARS*

2.4.1 Introduction

The recent *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* case and the *XYZ (Pty) Ltd v Commissioner for SARS* case dealt with the provision of timeshare points in respect of timeshare properties to sales staff. As such, these cases may provide insight with regard to the treatment of loyalty points in South Africa.

XYZ (Pty) Ltd v Commissioner for SARS focused on two points: firstly, whether the provision of holiday benefits to employees had a nil taxable value in the hands of the employees; secondly, it centred on the point that SARS was required by law to re-determine the cash equivalent of the benefit upon assessment of the employees' personal taxes. The appeal case, *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS,* provided clarity with regard to which party had the obligation to pay tax when the value of a taxable benefit was determined incorrectly by the employer (PricewaterhouseCoopers, Date unknown:1).

The background facts of *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS* are essentially the same and are briefly discussed in the paragraph below. This is followed by an analysis of the principles laid down in these cases.

2.4.2 Background to *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS*

The appellant (i.e. Vacation Exchanges International (Pty) Ltd or XYZ (Pty) Ltd) operated as a timeshare exchange company. Developers sold timeshares in their resorts to the appellant. Members of the appellant's timeshare scheme received occupational rights with the appellant in exchange for an annual membership fee. Members were allowed to "space-bank" these rights and, in return, received timeshare points. These points could be used by members to buy rights of occupation in another holiday resort at any stage within three years. Members who "space-banked" their rights did not pay anything for the timeshare points and ceased to have any interest in their existing right of occupation.

Holiday timeshare exchanges were made by members via a call centre operated by the appellant. The appellant took the view that call centre employees who were knowledgeable about the affiliated resorts and the exchange system offered by the appellant were essential to its business. To this end, each call centre member received 17 000 timeshare points each year for "resort education". Employees forfeited their points if they were not used within one year. The appellant's employees were allowed to utilise

their points at their resort of choice, but had no obligation to do so. Members always took precedence with regard to the availability of holiday accommodation.

Employees paid for their own transport, meals and any amenities enjoyed at the holiday resorts. Following their visit to the resort, employees were required to complete an evaluation form and financial penalties were imposed for any failure to do so. Certain restrictions were placed on the use of these points including the fact that employees were not allowed to transfer, sell, cede or dispose of his or her points in any way. With these factors taken into account, the appellant determined that the cash equivalent of the aforementioned benefit was nil in accordance with the Seventh Schedule.

2.4.3 An analysis of the principles laid down in *XYZ (Pty) Ltd v Commissioner for SARS*

The appellant's primary ground of appeal was that the company did not provide employees with accommodation, but instead provided them with timeshare points. These points were argued to represent the acquisition of a conditional right by the employees, which are "property of any nature" in terms of paragraph 2(*a*) of the Seventh Schedule. The appellant claimed that the points should be valued in accordance with paragraph 5 of the Seventh Schedule at the market value. By virtue of the conditions attached to the points, the appellant argued that the points have a market value of nil. The appellant further asserted that the points/conditional rights constituted "moveable property", which was acquired in order to dispose of to the employee or were "trading stock" as referred to in paragraph 5 of the Seventh Schedule. In terms of paragraph 5 of the said Schedule, moveable property should be valued at cost, and trading stock at the lower of cost or market value. In either case, the conditional rights were argued to have no ascertainable value and thus the cash equivalent of the rights was nil.

In an alternative analysis, the appellant submitted that the taxable benefit arose in terms of paragraph 2(*a*) of the said Schedule and that the asset acquired by the employee was a right of occupation, which was held by the appellant as trading stock. Accordingly, in terms of paragraph 5 of the Seventh Schedule, the appellant argued that the right of occupation should be valued at the lower of market value and cost. The appellant argued that there

was no cost to the company for units that would, if not used by its employees or members, otherwise be vacant. It appears that the court agreed with the appellant's contention that the cost was nil.

The court held that there was no merit in the appellant's submission that it provided timeshare points to the employees instead of residential accommodation in terms of paragraph 2(*d*) of the Seventh Schedule. The court stated that the points were merely a mechanism by which the timeshare exchange policy was administered. The fact that the employees had the option to utilise the points did not causally distance the accommodation from the point's allocation.

When considering loyalty points, it appears that many argue that the services or goods for which points may be redeemed, as opposed to the loyalty points itself, constitutes the taxable benefit (Clegg, 2002:34). This argument is supported by Czerny, Forsyth and McCaughey (2008:5) who state that, according to the authors' knowledge, no country has ever attempted to tax the awarding of loyalty points. Whether the points or the goods/services they are redeemed for are seen as the taxable benefit has a significant impact on the valuation thereof. For example, assets provided to employees should be valued at cost or market value, depending on the circumstances (paragraph 5(2) of the Seventh Schedule). Free or cheap services should be valued at the cost to the employer (paragraph 10(1) of the Seventh Schedule), whereas holiday accommodation, which is not hired by the employer, should be valued at the prevailing rate at which the accommodation would normally be let to a third party (paragraph 9(4)(*b*) of the Seventh Schedule).

Loyalty programmes have become strategically imperative for companies and more and more companies regard loyalty programmes as an essential tool to their business rather than a nice-to-have. During the past few years, loyalty points have become a commodity with which the recipient can buy almost any product or service. In certain programmes, rewards are even earned in the form of cash (Finweek, 2010:40). Section 35 of the Consumer Act states that "… despite any provision in any law, agreement or notice to the contrary, for all purposes of this Act, loyalty credits or awards are a legal medium of exchange …". The effective date of this section of the Consumer Act is yet to be announced. However, the weight given to loyalty points by the Consumer Act as a legal

medium of exchange raises the question as to whether the court was correct in holding that the timeshare points were merely an administrative mechanism and that the points in themselves were not the benefit provided to employees.

While considering whether loyalty points may be seen as the taxable benefit, one should also consider whether it may be regarded as an asset as defined in the Seventh Schedule. The term "asset", as referred to in paragraph 2(*a*) of the Seventh Schedule, refers to any goods, commodity or property of any nature. None of these terms are defined in the Income Tax Act. The Concise Oxford English Dictionary defines "goods" as "… merchandise or possessions …" (Soanes & Stevenson, 2006:613). In turn, it defines "commodity" as "… a useful or valuable thing …" (Soanes & Stevenson, 2006:288). "Property" is defined as "… a thing or things belonging to someone …" (Soanes & Stevenson, 2006:1151). When considering all these factors together with section 35 of the Consumer Act as a support, it may be argued that the points itself may be considered as goods, a commodity or even property of any nature as envisaged in the Seventh Schedule. It is unfortunate that the court did not investigate this matter further as it would have provided useful guidance in the area of loyalty programmes. Based on the aforementioned factors, there may be a strong argument that the loyalty points in themselves and not the goods or services for which they may be redeemed, constitute the taxable benefit.

In both analyses noted above, the appellant argued that the timeshare points should be valued at market value or, alternatively, at cost, which were both argued to be nil. However, by arguing that there was no cost attached to the benefit as the resorts would be vacant if not used by a client or employees, it appears as if the appellant argued that there was no opportunity cost in providing the benefit. According to Clegg (2002:35), the term "cost", as used in the Seventh Schedule, does not mean opportunity cost from an economic perspective. Thus, should the court have investigated this argument further, it may have come to the conclusion that, although indirectly, there may, in fact, be a cost in providing the accommodation to employees (i.e. the amount initially paid to developers to acquire the right of accommodation).

In supporting his argument that the cash equivalent of the acquisition of an asset by employees was nil, the appellant relied on the finding in *Stander v Commissioner for Inland Revenue*. In this case, the Commissioner sought to tax an overseas trip won by the taxpayer. The court held that, by having gone on the trip, the taxpayer had not received any property which has a monetary value. However, this view was overturned in *Commissioner for SARS v Brummeria Renaissance (Pty) Ltd and Others*, where the court held that whether a receipt or accrual has monetary value is the primary question and whether it can be turned into money is but one way of determining whether this is the case. Put differently, if a receipt or accrual cannot be turned into money, it does not mean that it does not have monetary value. The judge in the *XYZ (Pty) Ltd v Commissioner for SARS* relied on *Commissioner for SARS v Brummeria Renaissance (Pty) Ltd and Others* and held that the fact that the right to accommodation cannot be alienated does not negate the value. Accordingly, this ground of appeal by the appellant was overturned by the court.

In his argument that the market value was nil, it appears that the appellant did not consider the impact which IFRIC 13 may have on the timeshare points. IFRIC 13 requires companies to allocate a fair value to loyalty points. The application of IRFIC 13 by the applicant is an area which was not investigated by the court. However, it may have provided further grounds in dismissing the argument that the market value was nil.

In its final conclusion, the court held that paragraph 9(4)(*a*) of the Seventh Schedule relating to holiday accommodation was applicable. This paragraph states that the value of the taxable benefit should, in any case other than rental by the employer, be calculated at the prevailing rate per day at which the holiday accommodation would normally be let. The court held that, in terms of the said paragraph, a notional value should be placed on the rental value of the accommodation in question.

Finally, the court held that paragraph 3(2) of the Seventh Schedule provided an alternative, though not an exclusive remedy, to the Commissioner. The said paragraph states that the Commissioner may re-determine the cash equivalent upon the employee's assessment of normal tax. The appeal case focused primarily on this point. The decision made in the appeal case will be investigated in the following paragraph.

2.4.4 An analysis of the principles laid down in *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS*

Vacation Exchanges International (Pty) Ltd v Commissioner for SARS focused on the same two points as *XYZ (Pty) Ltd v Commissioner for SARS*. The court pointed out that the case may successfully be appealed on either of the two points.

The court firstly dealt with the second point (i.e. the person liable for tax). The court in *XYZ (Pty) Ltd v Commissioner for SARS* held that paragraph 3(2) was not an exclusive remedy to the Commissioner. In a technical analysis, the court overturned this decision of the court a quo and held that the said paragraph does not confer a discretion upon the Commissioner to apply this paragraph (PricewaterhouseCoopers, Date unknown:2). Thus, the Commissioner could not hold the appellant liable for incorrectly determining the taxable value and was required to assess the employee upon assessment.

The court further commented that, once the aforementioned analysis was adopted, there was no need to explore any of the remaining issues (i.e. the cost of the taxable benefit). Therefore, although *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* provided valuable insight into the interaction between the Fourth and Seventh Schedules, it does not provide additional insight into achieving the objectives of this study. *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* will therefore not be considered in any further detail.

2.4.5 Summary

This chapter provided an analysis of *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* and *XYZ (Pty) Ltd v Commissioner for SARS*. The *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* case provided clarity with regard to which party has the obligation to pay tax when the taxable value of a taxable benefit was determined incorrectly by the employer. As stated, *Vacation Exchanges International (Pty) Ltd v Commissioner for SARS* does not provide much insight into achieving the objectives of the study and as such was only briefly analysed to illustrate the point.

In *XYZ (Pty) Ltd v Commissioner for SARS*, the appellant argued the taxable benefit to be the timeshare points (as opposed to holiday accommodation), which fell within paragraph 2(*a*) of the Seventh Schedule. The court dismissed this argument, saying that the points were merely an administrative mechanism and that the employees' choice to use points did not causally distance the accommodation from the allocation of points. There are, however, factors which suggest that the appellant was correct in his argument.

In an alternative analysis, the appellant argued that the taxable benefit was the right of occupation in terms of paragraph 2(*a*) of the Seventh Schedule. In all its analyses, the appellant argued that the taxable value of the benefit provided was nil. In an examination of case law pertaining to the monetary value of an amount, the court held that the fact that the conditional right cannot be alienated by employees does not mean that it does not have a monetary value and, accordingly, this argument was overturned by the court.

The court finally held that the benefit provided to employees was holiday accommodation in terms of paragraph 2(*d*) of the Seventh Schedule, which had to be valued in terms of paragraph 9(4)(*a*) of the said Schedule.

An analysis of the literature reviewed on frequent flyer miles is performed in the following paragraphs.

2.5 AN ANALYSIS OF FREQUENT FLYER MILES

2.5.1 Introduction

The topic of past research and articles has been limited to the fringe benefit implications of frequent flyer miles. For the purposes of this study, frequent flyer miles are assumed to be closely associated with loyalty points earned as a result of business expenditure incurred on private or corporate credit cards. An analysis of past studies and articles related to frequent flyer miles is thus relevant in this instance.

In his article, Clegg (2002:33) distinguishes between two *scenarios* when considering Voyager miles (frequent flyer miles), namely:

- where Voyager miles accrue to the employer; and
- where the employee is the Voyager member and accumulates miles as a result of business flights in his/her personal capacity.

Chapter 2.5.2 provides an analysis of the first *scenario* followed by a similar analysis in Chapter 2.5.3 of the second *scenario*.

2.5.2 Voyager miles accruing to an employer

The first *scenario* refers to instances where frequent flyer miles accrue to the employer and the miles are used to provide a free ticket/free flight to the employee for private use. In this *scenario*, Clegg (2002:35) asserts that the flight provided to the employee falls into paragraph 2(*e*) of the Seventh Schedule, but that it is doubtful as to what value should be placed on the flight under paragraph 10(1)(*b*) of the Seventh Schedule.

In terms of the classification of a taxable benefit according to its nature in terms of paragraph 2 of the Seventh Schedule, many writers, including Clegg (2002:34-35), argue the taxable benefit to be the goods or services for which the points/miles may be redeemed. In *XYZ (Pty) Ltd v Commissioner for SARS*, the court rejected the appellant's argument that the taxable benefit was the timeshare points and held the taxable benefit to be holiday accommodation. It should be noted that the facts and circumstances in *XYZ (Pty) Ltd v Commissioner for SARS* are different from the frequent flyer miles accruing to an employer as loyalty points in this instances are provided by a third party and not by the employer as was the case in *XYZ (Pty) Ltd v Commissioner for SARS*. A further investigation into the nature of the taxable benefit (i.e. whether the taxable benefit is the miles or free flight) is thus warranted.

It is accepted that the employer may use the accrued frequent flyer miles either for the benefit of its employees or to fund subsequent business flights. Furthermore, the miles are allocated to the employer's membership with the airline and cannot be used by employees. As the miles are a medium which belongs to the employer, and which is, in turn, used to provide tickets/free flights to employees, it is considered correct to argue that the employer in this instance provides the employee with a service in terms of paragraph 2(*e*) of the

Seventh Schedule. As such, this service should be valued in accordance with paragraph 10(1) of the said Schedule at the cost thereof to the employer.

Clegg (2002:35) states that the term “cost” is not defined in the Income Tax Act. He continues to mention that cost is envisaged to mean an outgoing or disbursement by the employer and does not extend to an opportunity cost. The Concise Oxford English Dictionary defines the verb “cost” as “…the payment of (a specified sum) in order to be bought or obtained …”. In turn, it defines the noun “cost” as “… the amount that something costs …” or “… the effort or loss necessary …” (Soanes & Stevenson, 2006:323).

When considering whether there is, in fact, a cost for the employer in accumulating loyalty points, Brooks (2004:299) suggests that prices of air tickets are likely to be inflated in order to subsidise free flights redeemed from frequent flyer miles. Clegg (2002:34) echoes this possibility. Thus, when incurring an expense for a business flight, the employer is likely to be indirectly incurring a cost in acquiring frequent flyer miles. By contrast, when paying for a business flight, the same price is paid whether the purchase is made by a member of the frequent flyer programme or a person who is not a member (Clegg, 2002:34). This suggests that there is either no cost involved in acquiring the loyalty points or that both members and non-members indirectly subsidise (i.e. carries the cost) these frequent flyer miles.

Consideration may also be given to whether the cost of frequent flyer miles may be determined according to their fair value/market value. When considering whether there is a market value attached to the frequent flyer miles or free flights provided to employees, Andoh (2008:26) states that additional Voyager miles may be purchased by the member at a specific cost. The market value may thus be determined according to the number of points redeemed for the benefit of the employee and the cost thereof in the open market (Brooks, 2004:301). Despite this argument, IFRIC 13 requires loyalty points to be valued at the fair market value and not in terms of the cost thereof to the company. This requirement, in addition to the fact that the Seventh Schedule differentiates between valuing benefits at the cost and at the market value thereof, suggests that the fair value of loyalty points does not necessarily equate to the cost thereof. It is thus questionable as to

whether it is appropriate to determine the cost of frequent flyer miles in terms of the Seventh Schedule with reference to the market value thereof.

Brooks (2004:299,300) states that there is a strong case for taxing frequent flyer miles; however, the difficulty in valuing these may be an argument not to do so. Similarly, Clegg (2002:35) mentions that attributing a part of the cost of a normal business flight ticket to the free ticket would be "arbitrary and capricious" and not within the scope of SARS' powers in terms of the Income Tax Act. It is thus arguable that, due to the administrative difficulties as discussed, no cost can be attributed to frequent flyer miles earned by the employer and, subsequently, no cost can be placed on the free flight provided to employees following the redemption of the flyer miles.

The question which follows from the argument that the employer provides employees with a free flight as opposed to miles, is whether the miles earned by the employer constitute gross income as defined in section 1 of the Income Tax Act in the hands of the employer. One important element of the said definition is that an amount should be received by a taxpayer. In *Geldenhuys v Commissioner for Inland Revenue* "received by" was held to mean "… received by the taxpayer on his own behalf for his own benefit …". The fact that employers may use Voyager miles as they choose may well suggest that the miles earned by the employer may, in fact, constitute gross income as defined in section 1 of the Income Tax Act. However, this is an aspect which will not be further explored in this study. As such, this is an area identified for future research.

2.5.3 Voyager miles accruing to an employee

The second *scenario* referred to by Clegg (2002:33) refers to instances where the employee is the Voyager member and accumulates miles as a result of business flights in their personal capacity.

Paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act includes the cash equivalent of any benefit or advantage granted in respect of employment, being a taxable benefit as defined in the Seventh Schedule. Thus, for a taxable benefit to arise, the

benefit provided must be linked to an employee's employment with the employer or it should be provided as a reward for services rendered.

Where frequent flyer miles are earned by an employee as a result of business expenditure incurred, Clegg (2002:34) argues that the direct and immediate cause of earning a free ticket is the employee's act of converting the miles into the free ticket. Clegg (2002:34) asserts that where an employee earns miles as a result of business-paid travel, a more direct nexus (connection) exists between his/her employment and the miles earned. In turn, however, he asks whether, if the earning of miles is dependent on the employee's registration of the flight, this is not the *causa causans* (direct and immediate cause) of the event as opposed to the employee's employment. Consequently, he argues that there is no taxable event. Jones (date unknown:2) argues that an employee usually becomes a member of the frequent flyer programme independently of his or her employment and that this is not a condition of employment. Legally, therefore, the miles accrue directly from the airline and not the employer, which leads to no taxable benefit arising in the hands of the employee, despite the fact that the accrual of the miles was triggered by an employer-paid business flight. These arguments are supported by case law in Australia, on the one hand, but opposed by case law in Canada, on the other hand. This case law is discussed below.

Clegg (2002:34) further states that, even if there had been a taxable event, these miles could only fall within paragraph 2(*e*) of the Seventh Schedule, which deals with free or cheap services paid for by the employer. Clegg (2002:34) favours the argument that a taxable benefit may arise when the flight which earned the miles are taken as opposed to when accumulated miles are redeemed for a flight (although he states that inequities are created when miles are not used). The reason stated for this argument is that, in the latter event, the employee is merely using a contractual relationship between himself and the airline (Clegg 2002:34). Czerny *et al.* (2008:5) disagree with this statement by saying that it is nonsensical to consider the taxable event to be the awarding of loyalty points or frequent flyer miles. Should the latter event be seen as the taxable event, Clegg (2002:34) further highlights the difficulty in tracking miles earned as a result of business flights versus miles earned as a result of private flights taken. Whichever event is seen as the taxable event, Clegg (2003:34) argues that it would be impossible to attach a cost to the free tickets as required by paragraph 10(1)(*b*) of the Seventh Schedule. The fact that the same

price is paid for a flight, whether it is registered to earn Voyager miles or not, is noted as one of the reasons for this argument. For these, and the same administrative difficulties discussed in relation to Voyager miles accruing to the employer, it may be argued that Clegg is correct in stating that no cost can be attributed to the free tickets or frequent flyer miles earned by an employee as the result of business costs incurred.

Although Andoh (2008:33) also concludes that there is no taxable benefit, he argues that miles earned as a result of business flights used for private purposes is unlikely to be taxed as the miles are not provided by the employer or an associated institution as defined in the Seventh Schedule. Jones (Date unknown:1) follows a similar argument to that presented by Andoh in claiming that, as the miles are not provided by the employer, no taxable benefit arises. In most instances, there is no connection between the employer and the third party providing the frequent flyer miles. To this end, the third party will not meet the definition of an associated institution as envisaged in the Seventh Schedule.

A third entity is mentioned in paragraph 2(*a*) of the Seventh Schedule. This paragraph includes assets provided by "… any person by arrangement with the employer …". Andoh (2008:32) states that frequent flyer miles are not provided by a third party by arrangement with the employer. For the purposes of this study, it will also be assumed not to be provided by any person by such arrangement. Thus, it may be argued that neither the employer nor an associated institution or a third party by arrangement with the employer is providing the frequent flyer miles to the employee. Thus, it appears that Andoh and Jones are correct in arguing that these miles fall outside the Seventh Schedule.

From his study it can be seen that Andoh has only briefly considered paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. As paragraph (*c*) of the said definition is included in the definition of remuneration as defined in the Fourth Schedule, it will impose an obligation to withhold employees' tax on the employer should it meet the requirements of this paragraph. Paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act includes any amount received or accrued in respect of services rendered or to be rendered or any amount received or accrued in respect of, or by virtue of, any employment.

The courts have held the term “amount” to mean every form of property earned whether corporeal or incorporeal, which has a monetary value. The court in *XYZ (Pty) Ltd v Commissioner for SARS* (relying on *Commissioner for SARS v Brummeria Renaissance (Pty) Ltd and Others*) held that, if a receipt or accrual cannot be turned into money, it does not mean that it does not have monetary value and that the fact that the right to accommodation cannot be alienated does not negate the value.

Andoh (2008:26) notes that additional frequent flyer miles may be purchased by the member from the airline. As such, it may be argued that a monetary value may be placed on frequent flyer miles. In line with this argument and the decisions made by the courts, it may be considered that the miles/free flights do constitute an amount as envisaged in paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. From an international perspective, it is interesting to note that, due to difficulties experienced by employees in valuing this benefit (i.e. determining an amount), the Canada Revenue Agency has issued a note of guidance stating that employees will no longer be required to include free flights, earned from the redemption of frequent flyer miles accumulated as a result of business costs incurred, in their taxable income (subject to certain requirements).

Furthermore, for an amount to fall within paragraph (*c*) of gross income in section 1 of the Income Tax Act, the courts held that there must be a direct causal link between the services rendered, on the one hand, and a receipt of a benefit, on the other hand. Whether the fact that the miles accrue to the employees in their personal capacity sufficiently distances itself from the receipt thereof is a question of fact. Paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act is very similar in meaning, both requiring a link between services rendered and the benefit received. As stated earlier, Jones argues that no taxable benefit arises as miles legally accrue to an employee as a result of his/her membership with the frequent flyer programme (Jones, Date unknown:2). The argument posed by Jones, in addition to Clegg’s (2002:34) view that the direct and immediate cause of the free flight may be the employee’s decision to register the flight, may be equally applied in arguing that there is no direct causal link between services rendered and the receipt of the miles for the purposes of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. As discussed in the following sections, the Australian court has held in *Payne v Australia (Commissioner of Taxation),* (1996), 66

F.C.R. 299, 96 A.T.C. 4407 (F.C.A.) that there is an insufficient nexus between the points earned and the taxpayer's employment as the employer was not party to the agreement between the taxpayer and the airline. By contrast, the Canadian court held in *John Giffen and Fred Mommersteeg v Her Majesty The Queen*, 1995 CarswellNat 597, [1995] 2 C.T.C. 2767, 9 C.C.P.B. 149, (96 D.T.C. 1011) that the free travel was a benefit of employment and "… where a benefit is received by reason of employment it is of no consequence that some other condition unconnected with employment must also be met …". However, guidance was subsequently issued in Canada stating that the benefit will no longer be considered taxable. This may provide support for the view that the benefit falls outside paragraph (*c*) (and paragraph (*i*)) of the definition of gross income in section 1 of the Income Tax Act.

The accumulation of frequent flyer miles by employees, as a result of business expenditure incurred, is yet to be tested in South African courts. The lack of local judicature or guidance provided by SARS with regard to an area which has already been considered in foreign jurisdictions as early as 1995 confirms Clegg's (2002:33) view that the taxation of Voyager miles has not been attacked by SARS due to the fact that the Seventh Schedule is not equipped to do so. Consequently, although there is a strong argument that miles earned by employees as a result of business-paid flights falls outside paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act, uncertainty exists as to whether this view will be supported either by the South African courts or SARS.

From the above discussion it appears that Clegg, Andoh and Jones have not considered whether the taxable benefit is, in fact, the Voyager miles, as opposed to the free flight/ticket for which it may be redeemed. There may well be an argument that it is, in fact, the frequent flyer miles which is possibly the taxable benefit. However, whichever argument is taken, one would end up with the same uncertainties around the cost of the benefit, the benefit falling outside the scope of the Seventh Schedule and paragraph (*c*) of the definition of gross income in the Income Tax Act as discussed above.

It is commonly known that, although an amount or benefit received by a taxpayer may not necessarily be subject to employees' tax, it may still be taxable in the individual's hands on

the premises that it constitutes gross income as defined in section 1 of the Income Tax Act. It appears that Clegg, Jones and Andoh have only considered these miles from an employees' tax perspective and not whether these miles may constitute gross income in the hands of the recipient (i.e. whether there is a personal income tax implication for the recipient). The personal income tax implication of loyalty points will not be explored in this study. As such, this is an area which has been identified for further research.

2.5.4 Summary

This section has provided an investigation into the fringe benefit implications of frequent flyer miles earned as a result of employer-paid business flights, by employees as members of a frequent flyer programme, or by an employer as a member of such a programme.

When considering the first *scenario* (frequent flyer miles accrued to an employer and used for the personal benefit of employees), it appears that most argue for the taxable benefit to be the free flight/ticket provided to employees and the taxable value thereof to be the cost to the employer. However, it appears that the most-favoured argument is that, due to the administrative difficulties involved in assigning a cost to the benefit and without sufficient guidance by SARS, the taxable value is nil.

When considering the second *scenario* (frequent flyer miles accrued to an employee as a result of business expenditure incurred), it appears that there are two alternative arguments that this benefit falls outside the Seventh Schedule. Firstly, there is an insufficient link between an employees' employment and the receipt of the miles. This argument is, however, contradicted by foreign case law. Alternatively, it may be argued that the benefit is not provided by the employer or an associated institution. Even in the event that a taxable benefit is considered to arise, it appears that, due to the same administrative difficulties in allocating a cost to such benefit noted in relation to frequent flyer miles accruing to an employer, it is argued that a nil taxable benefit arises. These factors all provide a strong argument that the benefit resulting from frequent flyer miles, which accrued to an employee as a result of business expenditure incurred, is outside the ambit of the Seventh Schedule or has a nil taxable benefit.

Whether the benefit will fall within paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act is also uncertain. There may be a strong argument that this benefit does indeed fall outside paragraph (*c*) of the said definition. This is supported by *Payne v Australia (Commissioner of Taxation)*. However, it is contradicted by *John Giffen and Fred Mommersteeg v Her Majesty The Queen*, where the court held that the free tickets were to be included in the taxpayer's income. However, the Canada Revenue Agency subsequently issued a note of guidance which stated that, under certain circumstances, it will be deemed that no benefit arises in this instance. Whether the view that the benefit will fall outside the ambit of paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act will be supported by the South African courts or SARS is thus uncertain.

An analysis of the tax treatment of loyalty points from an international perspective is performed in the following paragraphs.

2.6 AN ANALYSIS OF THE TAX TREATMENT OF LOYALTY POINTS FROM AN INTERNATIONAL PERSPECTIVE

2.6.1 Introduction

According to Czerny *et al.* (2008:9), many countries have attempted to tax loyalty points, but with little success. Brooks (2004:297) notes perceived administrative and political pressures as factors leading to the abandonment by tax authorities in attempting to tax frequent flyer miles. In Switzerland, for example, frequent flyer awards used to fall within the fringe benefit laws, but due to problems relating to the valuation of these awards, it was exempt from tax (Czerny *et al.*, 2008:9). The tax treatment of loyalty points in Australia and Canada is investigated in the following paragraphs. Two important tax cases in these countries, which dealt with this subject, will also be investigated. An analysis which compares South Africa and other countries is not the main objective of this study. Consequently, as part of an explorative investigation on loyalty programmes, Australia and Canada have been identified as countries which may provide more insight into this topic.

2.6.2 Australia

Australia is one of few countries which provide detailed guidance as to the tax treatment of frequent flyer miles and awards in similar loyalty programmes. Initially, the Australian Taxation Office issued Tax Ruling TR93/2 in which employees were required to include free flights earned as a result of business travel in their income (Brooks, 2004:297). Following the *Payne v Australia (Commissioner of Taxation)* case, this ruling was withdrawn and replaced with Taxation Ruling 1999/6 and Taxation Determination 1999/34. More recently, the Australian Taxation Office has issued the Practice Statement Law Administration 2004/4 (General Administration) which has provided further guidance with regard to this matter.

In *Payne v Australia (Commissioner of Taxation)*, the taxpayer became a member of a loyalty programme without the employer's knowledge. The points earned were non-transferrable and could not be redeemed for cash. The taxpayer earned points as a result of employer-paid business trips. These points were redeemed for airline tickets for family members of the taxpayer. The court found that the points were not convertible into cash (i.e. it is not money or money's worth) and, accordingly, was not income. Furthermore, it was held that there was an insufficient nexus between the points earned and the taxpayer's employment as the employer was not party to the agreement between the taxpayer and the airline. Accordingly, there was no fringe benefit.

The guidance provided in Tax Ruling 1999/6 is limited to the tax implications of free flights (including flight upgrades, accommodation, and car rental attached to the free flight) earned from consumer loyalty programmes. Another important limitation that has been noted is that this ruling is based on loyalty programmes where membership is restricted to natural persons (such as employees) (Australian Taxation Office, 1999:1-2). The tax implications addressed are twofold. Firstly, it addresses whether there is a fringe benefit tax liability for employers and, secondly, whether the employee is assessable for income tax (Australian Taxation Office, 1999:2). Although this study is limited to the employees' tax implications with regard to loyalty points, the income tax implications for the individual (both in Australia and Canada) are briefly considered as this provides further insight into possible areas for further research.

In Taxation Ruling 1999/6, the Australian Taxation Office (1999:4) provides that flight rewards are not subject to fringe benefit tax as it results from a personal contractual relationship. It goes on to state that "… flight rewards received by employees from employer-paid expenditure are not assessable income …". However, the following exceptions apply:

- where the award received is connected with an employee's employment and the employer and employee have a family relationship; and
- where a flight reward, which resulted from business expenditure, is provided to an employee by an arrangement for the purposes of the Fringe Benefits Tax Assessment Act 1986 (this is further dealt with in Practice Statement Law Administration 2004/4 (General Administration)).

Flight rewards received by individuals as a result of business expenditure are not assessable, except where the individual renders the service on the basis that he or she will receive a flight reward or where the obtaining of these benefits results in a business activity (Australian Taxation Office, 1999:3).

Practice Statement Law Administration 2004/4 (General Administration) (Australian Taxation Office, 2004:3) states that rewards accumulated under consumer loyalty programmes will be taxable where:

- the reward is received as part of an income earning activity; and
- a business relationship exists between the reward provider and the recipient; and
- the benefit can be converted directly or indirectly into money's worth or the recipient is carrying on a business, and, in terms of the Income Tax Assessment Act 1936, the non-cash benefit should be included in the taxpayer's assessable income.

As noted above, Taxation Ruling 1999/6 states that a reward received by an employee under a loyalty programme may be a fringe benefit if there is an arrangement between the employer and employee. Practice Statement Law Administration 2004/4 (General Administration) (Australian Taxation Office, 2004:3) expands upon this issue by stating

that a fringe benefit may arise where the reward has a "… sufficient and material connection to employment …", that is, it takes on the character of being received in respect of employment. This statement is explained by means of an example where an arrangement exists between an employer and employee where the employee incurs business costs on the employee's credit card and which are subsequently reimbursed by the employer. By doing this, the employee earns loyalty points which may be used for a substantial personal benefit. This arrangement may give rise to fringe benefit tax (Australian Taxation Office, 2004:4). This example is differentiated from the instance where expenses are incurred for legitimate business reasons on behalf of the employer. This will not give rise to a fringe benefit tax (Australian Taxation Office, 2004:4). Another example is provided where the employer and employee may enter into an arrangement where the employee renders services and an entitlement to a reward arises in substitution for income. In this case, an income tax liability may arise.

Taxation Ruling 1999/6 also provides guidance with regard to the valuation of flight rewards (Australian Taxation Office, 1999:4). Flight rewards are required to be valued at the fair market value thereof. In the case of free tickets, a valuation method based on a percentage of the full published fare is suggested. The percentage will depend on whether it is an international or domestic flight and whether it is an economy or business class ticket. The prescribed percentage ranges between 35% and 70%. Although it is accepted that this is a starting point for the valuation of flight rewards, employers are due to experience some elements of difficulty in applying this valuation method. Airlines determine a range of prices depending on the demand for their flights. Thus, you will find a wide range of prices for the same flight depending on factors such as the day on which the flight is booked (Brooke, 2004:300).

2.6.3 Canada

In Canada, the stance taken with regard to the taxation of loyalty points is much simpler than that in Australia. The Canada Revenue Agency has always taken the position that the fair market value of tickets received following the redemption of points that have accumulated from business travel should be included in an employee's income (Brooks, 2004:297-298). This is supported by the decision in *John Giffen and Fred Mommersteeg v*

Her Majesty The Queen where taxpayers earned frequent flyer awards in the form of free airline tickets as a result of travelling for business. The tickets were eventually used by the taxpayers' family members. In this case, it was held that the tickets were to be included in the taxpayers' income. It was held that the value to be attached to these tickets was to be the price which the taxpayers would have been paid for a ticket to travel on the same flight, in the same class and subject to the same restrictions as those applicable to the reward tickets. Attempting to value these reward tickets appears to be easier said than done and there are various difficulties in valuing these tickets even with the guidance noted by the court.

In the past, where employers did not control the points accumulated under a loyalty programme, the responsibility was placed on the employee to determine and include the fair market value of the benefit received or enjoyed in his or her income (Canada Revenue Agency, 2009:2). However, in 2009, the Canada Revenue Agency (2009:2) stated that employees have experienced significant difficulties in valuing these points, as well as in tracking and distinguishing between points earned as a result of employer-paid business travel and points earned from personal use of credit cards. Thus, with effect from 2009, the Canada Revenue Agency (2009:2) no longer requires these benefits to be included in the employees' income provided that:

- the points cannot be converted into cash; or
- there is no indication that the plan or arrangement is an alternate form of remuneration; or
- the plan or arrangement is not for tax avoidance purposes.

Where the employer controls points and uses the points to provide a benefit to employees, the fair market value of the benefits received should still be included on an employees' T4 slip (tax certificate) (Canada Revenue Agency, 2009:2). An example of where an employer controls the points is where loyalty points are earned by an employer as a result of business expenditure incurred on a corporate credit card and the points are redeemed for the benefit of employees (Canada Revenue Agency, 2010:1). In addition, points redeemable for air travel or other rewards need to be disclosed by an employee when filing his or her taxes irrespective of the value of such benefit (Warren, 2007:1).

2.6.4 Summary

Australia does not subject flight rewards to fringe benefit tax and assessable income unless:

- the award is connected with the employee's employment and there is a family relationship between the employer and employee and it forms part of an arrangement between the employer and employee; or
- where it forms part of an income earning activity and a business relationship exists between the reward provider and the recipient, and the rewards can be converted into money's worth or, where the recipient is carrying on a business, the non-cash benefit should be included in the taxpayer's assessable income.

In Canada, where the employer controls the loyalty points, they should be included in the employee's income. Where the loyalty points are not controlled by the employer, no such benefit needs to be included in the employee's income provided that the following factors are present:

- the points cannot be converted into cash; or
- there is no indication that the plan or arrangement is an alternate form of remuneration; or
- the plan or arrangement is not for tax avoidance purposes.

2.7 CONCLUSION

The purpose of this chapter was to review literature in order to establish the theoretical construct of this study. In achieving this objective, various sources of literature were consulted. This included legislation, case law and other literature around the elements of employees' tax and taxable benefits, IFRIC 13, the case of *XYZ (Pty) Ltd v Commissioner for SARS*, literature on frequent flyer miles and guidance offered in Australia and Canada with regard to the tax treatment of loyalty points.

In summary, three elements, as defined in the Fourth Schedule, need to be present for an employees' tax obligation to arise. These are employer, employee and remuneration. The

common factor in these elements is the element of remuneration as defined in the Fourth Schedule which, in turn, includes paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act. The decisions in various court cases provide guidance with regard to the interpretation of these two paragraphs. Paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act includes taxable benefits provided to employees, which are linked to the employee's employment or as a reward for services rendered. In turn, paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act includes amounts where there is a direct causal link between the benefit received by the employee, on the one hand, and the services rendered by the employee, on the other hand. Where an amount falls within the provisions of paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act, it is excluded from the provisions of paragraph (*c*) of the same definition.

IFRIC 13 provides guidance with regard to the treatment of loyalty programmes from an accounting perspective. IFRIC 13 will most probably not apply to the *scenario* where the employer or employee (as the loyalty programme member) accumulates loyalty points as a result of business expenditure incurred. IFRIC 13 requires companies to defer a portion of income received from customers until such time that the customer redeems the points or credits earned. This portion should be equal to the fair value of the points and not the cost thereof to the company. The differentiation made by IFRIC 13 between the cost and fair value of loyalty points highlights the difference in meaning between these terms.

The court dealt with the provision of timeshare points to employees in *XYZ (Pty) Ltd v Commissioner for SARS*. In this case, the appellant argued for the taxable benefit to be the timeshare points provided to the employees as opposed to the holiday accommodation. Although the court overturned this argument, there are factors which suggest that the appellant may have been correct in his argument. The appellant furthermore argued that the taxable value of the benefit was nil. In overturning this argument, the court held, inter alia, that the fact that a conditional right cannot be alienated does not mean that it does not have a monetary value.

In an analysis of the fringe benefit implications of frequent flyer miles, two *scenarios* were identified. In the first *scenario*, where frequent flyer miles accrue to the employer and are

used for the personal benefit of employees, most writers argue for the taxable benefit to be the free flight/ticket provided to employees and the taxable value thereof to be the cost to the employer. However, most argue that, due to the administrative difficulties involved in assigning a cost to the benefit and without sufficient guidance by SARS, the taxable value is nil. In the second *scenario*, where frequent flyer miles accrue to an employee as a result of business expenditure incurred, there are two alternative arguments that this benefit falls outside the Seventh Schedule. Firstly, there is an insufficient link between the employees' employment and the receipt of the miles. This is both supported and contradicted by foreign case law. Alternatively, it may be argued that the benefit is not provided by the employer or an associated institution. Even in the event that a taxable benefit is considered to arise, it appears that, due to the same administrative difficulties in allocating a cost to such benefit noted in relation to frequent flyer miles accruing to the employer, it is argued that a nil taxable benefit arises. These factors all provide a strong argument that the benefit resulting from frequent flyer miles, which accrued to an employee as a result of business expenditure incurred, either falls outside the Seventh Schedule or have a nil taxable benefit. Furthermore, there may also be a strong argument that this benefit falls outside the provisions of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. However, it is uncertain as to whether this view will be supported by the South African courts or SARS.

In analysing the tax treatment of loyalty points from an international perspective, it can be seen that both Australia and Canada have specific guidance with regard to the area of frequent flyer miles and loyalty points. Where loyalty points/frequent flyer miles are earned by an employee as a result of business expenditure incurred, this benefit is not considered to be taxable in Australia and Canada. Where loyalty points/frequent flyer miles are earned by an employer and provided to employees for personal use, the benefit is considered to be taxable in Canada. Australia does not provide any guidance in this regard.

In the following chapter, an analysis of the tax treatment of loyalty points from a South African perspective is performed. This analysis is performed by comparing the tax treatment of frequent flyer miles in South Africa to that of Canada and Australia and by applying the principles established in chapter 2 to the various *scenarios* related to loyalty programmes.

CHAPTER 3: AN ANALYSIS OF THE TAX TREATMENT OF LOYALTY POINTS FROM A SOUTH AFRICAN PERSPECTIVE

3.1 INTRODUCTION

In Chapter 2, a literature review was undertaken in order to establish the theoretical construct of this study. In Chapter 3, the principles identified in the literature review are firstly compared to the practices of Australia and Canada from a South African point of view. Secondly, these principles are applied to analyse the employees' tax implications with regard to loyalty points earned by, or awarded to, employees in terms of the Seventh Schedule and paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. This is achieved by an application of the principles identified in the literature review to the specific *scenarios* related to loyalty programmes.

3.2 FREQUENT FLYER MILES: A COMPARISON BETWEEN SOUTH AFRICA, CANADA AND AUSTRALIA

From the literature review undertaken in Chapter 2, it can be seen that neither South Africa nor Australia nor Canada have any specific legislation which addresses the tax treatment of loyalty points earned under loyalty programmes. The Australian Taxation Office and Canada Revenue Agency have offered specific guidance with regard to the areas of loyalty programmes and frequent flyer miles (Australian Taxation Office, 1999:1-11, Australian Taxation Office, 2004:1-6; Canada Revenue Agency, 2009:1-2; Canada Revenue Agency, 2010:1). These specifically relate to the treatment of free flights or other rewards received by employees following the redemption of miles/loyalty points accumulated as a result of business expenses incurred. SARS has not offered specific guidance with regard to this topic.

Literature in all three countries differentiates between the following two *scenarios*:

- loyalty points/frequent flyer miles earned as a result of business expenditure incurred where the employer is the member of the loyalty programme; and

- loyalty points/frequent flyer miles earned as a result of business expenditure incurred where the employee is the member of the loyalty programme.

Whereas Taxation Ruling 1999/6, issued by the Australian Taxation Office, appears to address flight rewards received under loyalty programmes only, Practice Statement Law Administration 2004/4 (General Administration) (also issued by the Australian Taxation Office) addresses rewards received under loyalty programmes more broadly. The guidance offered by the Canada Revenue Agency addresses loyalty points received under loyalty and other similar programmes. Furthermore, the guidance offered by the Australian Taxation Office only addresses the instance where the employee is the member of the loyalty programme, whereas Canada also addresses the instance where the employer is the member of the loyalty programme.

When considering whether the loyalty points themselves or the goods or services for which the points may be redeemed are considered to be the possible taxable benefit, it appears that in South Africa, most researchers consider this to be the rewards under the loyalty programme, such as goods or services. This is echoed by both Australia and Canada.

Whether loyalty points are earned by the employer or the employee, as described above, has an important bearing on whether it is taxable. In South Africa, most writers argue, that, in the *scenario* where the employer is the member of the frequent flyer mile programme, even where the benefit is considered to be taxable in terms of the Seventh Schedule, it is so difficult to determine the taxable value, that it is considered not to be taxable. From a Canadian perspective, where the employer is the member of the loyalty programme, the reward provided to the employee will be considered to be taxable. Australia, in turn, is silent with regard to this *scenario*.

As regards the *scenario* where the employee is the member of the frequent flyer programme, it appears that, in South Africa, various arguments are followed which essentially arrive at the same conclusion that no taxable benefit arises in terms of the Seventh Schedule. There is a strong argument that the miles fall outside paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. However, whether this will be supported by the South African courts or SARS is uncertain. In Canada, where the

employee, as the member of such a programme, accumulates points as a result of employer-paid business expenditure, no taxable benefit arises. Similarly, Australia does not consider any fringe benefit tax (or assessable income) to arise in this instance.

It should be noted that the guidance offered by both Australia and Canada has certain exceptions, where the reward would be considered to be taxable.

In terms of the valuation of any taxable benefit which arises, most writers in South Africa consider the cost of the taxable benefit to be so difficult to determine, that the value thereof is nil. Both in Australia and Canada, the taxable value (if considered taxable) should be determined with reference to the fair market value of the reward received by the employee.

The lack of guidance offered by SARS from a South African income tax perspective is highlighted in view of the guidance offered by Australia and Canada.

The comparison described above, may be summarised in the following table.

Table 1: Comparison between South Africa, Australia and Canada

Principle	South Africa	Australia	Canada
Specific legislation with regard to loyalty programmes	No	No	No
Guidance offered by local revenue authority with regard to loyalty programmes	No	Yes	Yes
Guidance with regard to frequent flyer miles and similar loyalty programmes	n/a	Yes	Yes
Guidance with regard to employer membership and employee membership	n/a	Guidance only offered with regard to employee membership	Yes
Loyalty points/frequent flyer miles or rewards considered to be taxable	Most argue reward is a taxable event	Reward	Reward

Principle	South Africa	Australia	Canada
Rewards received by employees as a result of business expenditure where *employer* is a member of loyalty programme considered to be taxable	Most argue that a taxable benefit arises, but at a nil value	Not addressed	Yes
Rewards received by employees as a result of business expenditure where *employee* is a member of loyalty programme considered to be taxable	Strong argument that it falls outside the Seventh Schedule and paragraph (i) of the definition of gross income	Generally no	Generally no
Valuation of reward	Different opinions – most argue that a nil taxable benefit arises or no taxable event at all	Fair market value of reward (if considered taxable)	Fair market value of reward (if considered taxable)

3.3 LOYALTY POINTS EARNED ON CORPORATE CREDIT CARDS

The *scenario* where loyalty points are earned by the employer on corporate credit cards and awarded to employees for personal use will now be investigated. For the purposes of this study, it is assumed that loyalty points earned on corporate credit cards may be likened to frequent flyer miles earned by an employer who is a member of the frequent flyer programme. The principles discussed in Chapter 2, relating to frequent flyer miles earned by the employer, will thus also be applicable to loyalty points earned by employers on corporate credit cards.

Similar to frequent flyer miles, loyalty points earned by employers and used to provide employees with a benefit for personal use may be argued to fall within the Seventh Schedule as the receipt of the benefit is linked to the employee's employment in terms of paragraph (*i*) of the Seventh Schedule to the Income Tax Act (Clegg, 2002:34). Paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act excludes amounts which are included by way of paragraph (*i*) of the said definition. As the benefit provided to employees is considered to fall within the Seventh Schedule (i.e. paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act), it is considered that paragraph (*c*) of the said definition will not apply to the same benefit.

The taxable benefit which arises may be argued to be the rewards for which the points are redeemed as opposed to the points themselves. This is due to the fact that the points are accumulated in the employer's capacity as a member of the loyalty programme. As a result, the employer may redeem loyalty points at will, which includes the option of redeeming them for a host of rewards for use by the business or for the benefit of employees. This study is limited to loyalty points which may be redeemed for goods or services. Consequently, the taxable benefit falls into the ambit of paragraphs 2(*a*) (goods) and 2(*e*) (services) of the Seventh Schedule and should be valued in terms of paragraphs 5(2) and 10(1) of the said Schedule respectively.

Paragraph 5(2) of the Seventh Schedule regulates the valuation of assets in terms of paragraph 2(*a*) of that Schedule. Paragraph 5(2) of the Seventh Schedule caters for three circumstances, namely:

- where the asset is acquired by the employee from the employer; and
- where the asset (which is movable property and has not been used by the employer before) has been acquired by the employer with the intention of disposing thereof to the employee; and
- where the asset is acquired by the employee and such asset is held by the employer as trading stock.

As noted by Clegg (2002:33), the Seventh Schedule does not adequately deal with loyalty points/frequent flyer miles. It is not clear as to which of the three above-mentioned instances noted in paragraph 5(2) of the Seventh Schedule will best suit goods provided to employees for personal use as a result of loyalty points redeemed by the employer. The first circumstance catered for in paragraph 5(2) of the Seventh Schedule implies that some time should have passed between the acquisition of the asset and the disposal thereof to the employee. The valuation method thereof (i.e. at market value) also implies that the asset should have been used by the employer for some time. This valuation method is unlikely to be applicable to goods provided to employees following the redemption of loyalty points by the employer. It is doubtful as to whether goods redeemed will be recognised by the employer as trading stock as there was no direct expense incurred in acquiring these points and the employer is unlikely to acquire loyalty points with the intention of reselling them at a profit. When following the chain of events in the transaction

(i.e. loyalty points are redeemed for goods and services which are then provided to employees), it appears likely that the goods provided to employees will fall within the second circumstance provided for in paragraph 5(2) of the Seventh Schedule (i.e. acquired in order to dispose thereof to the employee) and, as such, should be valued at the cost thereof to the employer.

Paragraph 10(1)(*b*) of the Seventh Schedule regulates the valuation of services in terms of paragraph 2(*e*) of this Schedule. As stated earlier, in terms of this paragraph, services provided to employees should be valued at the cost to the employer in rendering such services to employees or having such services rendered.

The difficulty in determining the cost of free flights related to frequent flyer miles was discussed earlier in this study. The term “cost” refers to an outgoing expenditure as opposed to a notional cost determined with reference to the market value of the reward (Clegg, 2002:35). In addition, it is likely that the employer is funding the loyalty programme and thus indirectly incurring a cost in providing the employees with these rewards (Brooks, 2004:299). However, various writers argue that a nil taxable benefit arises as a result of the administrative difficulty involved in allocating a cost to frequent flyer miles.

Guidance may be sought from Canada where the Canada Revenue Agency requires this benefit to be valued at the fair market value (Canada Revenue Agency, 2009:2). Whereas the difficulty in valuing flight tickets include various factors such as the class of the ticket, the time it was purchased and so forth, assigning a market value to goods or services (other than flights) may be much simpler depending on the nature of these. Employers may simply enquire what these goods or services sell for on the open market, thus arriving at the market value thereof. Alternatively, as noted by Andoh (2008:26), additional frequent flyer miles may be purchased by the member and, as such, a value may be placed on each mile redeemed. One may thus consider putting a notional value on the goods or services with reference to the number of points used during redemption and the price at which it may be purchased with the operator of the loyalty programme.

However, whether the Canadian principle of using market value may be applied in South Africa is arguable. The differentiation in paragraph 5(2) of the Seventh Schedule between

cost and market value highlights the fact that there is a difference between the two terms. As such, where the Seventh Schedule expressly refers to valuing a benefit with reference to the cost thereof, it remains questionable as to whether assigning a market value to the goods and services is appropriate and would accurately reflect the actual cost to the employer. All of these factors strengthen the argument that the value of the taxable benefit cannot be determined due to the administrative difficulty involved. It is especially in this area where guidance is needed from SARS or the South African courts.

It should again be noted that, should the taxable benefit need to be valued at market value in terms of paragraph 2(*a*) of the Seventh Schedule, this stance will significantly change as there are many options available to an employer to attribute a market value to the goods/services provided to employees.

As mentioned above, due to the fact that the benefit resulting from loyalty points earned on corporate credit cards and used for the personal benefit of employees is considered to fall within paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act, it will be excluded from paragraph (*c*) of this definition. Even if the taxable value may be nil under the Seventh Schedule, it could be argued that paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act cannot be invoked as recourse since these two paragraphs are mutually exclusive.

Once more, SARS' lack of guidance in the area of loyalty programmes is highlighted by the above-mentioned uncertainties. These uncertainties will continue to exist until such time that SARS or a South African court provides the South African taxpayer with clarity on this matter.

3.4 LOYALTY POINTS EARNED ON PERSONAL CREDIT CARDS

The *scenario* where loyalty points are earned by an employee on a personal credit card as a result of business expenditure incurred will now be investigated. For the purposes of this study, it is assumed that loyalty points earned by employees on personal credit cards as a result of business expenditure incurred, may be likened to frequent flyer miles earned by employees in their capacity as a member of the frequent flyer programme. As such, the

principles discussed relating to frequent flyer miles earned by an employee in Chapter 2, will also be applicable to loyalty points earned by employees on personal credit cards.

For an amount to fall within paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act, it should be shown that a benefit provided to an employee is linked to his/her employment or it should be provided as a reward for services rendered.

As was noted earlier in this study, no guidance or legislation exists in South Africa with regard to the treatment of loyalty points earned as a result of business expenditure incurred on personal credit cards from a tax perspective. Guidance may thus be sought from international judicature. However, the decisions made in *Payne v Australia (Commissioner of Taxation)* and *Fred Mommersteeg v Her Majesty The Queen* provided conflicting decisions on essentially the same set of facts. It was held in the Australian case that the free flight was not taxable, whereas in the Canadian case it was held that it was. However, the Canada Revenue Agency has subsequently released guidance stating that, due to the difficulties involved for employees in valuing and tracking loyalty points earned by them as a result of employer-paid business expenses, it will no longer be considered to be taxable (Canada Revenue Agency, 2009:2). This may provide support for the argument that the benefit falls outside paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act.

In discussing frequent flyer miles earned by employees, Clegg (2002:34) used the argument that the direct cause of the accumulation of miles is the employees' election to register the flight to earn miles, to support his view that no taxable benefit arises. Similarly, Jones (Date unknown:2) argues that miles accrue directly from the airline and not the employer, which means that no taxable benefit arises. These arguments may be replicated where loyalty points are earned by employees on personal credit cards, as a result of business expenditure incurred, to argue that there is an insufficient link between employees' employment and the receipt of loyalty points. Consequently, the loyalty points earned by employees as a result of business expenditure incurred may be argued to fall outside paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act (i.e. the Seventh Schedule). It is, however, uncertain as to whether this opinion will be supported by the South African courts and SARS.

An alternative argument that this benefit falls outside the Seventh Schedule relates to whether the benefit is provided by an employer or an associated institution as defined in the Seventh Schedule. In general, the Seventh Schedule includes benefits provided to an employee by an employer or an associated institution in relation to the employer. Andoh (2008:33) argued that no taxable benefit arises as the frequent flyer miles are generally not provided by an associated institution. In addition, loyalty points are clearly not provided by the employer where the loyalty points are earned by employees on personal credit cards (Jones, Date unknown:2). It is interesting to note that, where the taxable benefit is considered to fall within paragraph 2(*a*) of the Seventh Schedule, consideration should be given to whether the asset will be seen to be provided by any person (the company operating the loyalty programme) by arrangement with the employer. Andoh (2008:32) argued that this is not the case with Voyager miles. Whether such an arrangement is however present where loyalty points are earned by employees on personal credit cards, need to be established with the facts and circumstances at hand. For the purposes of this study, it is assumed that the benefit was not provided by a person by arrangement with his employer. To this end, there is an argument that loyalty points earned as a result of business expenditure incurred on personal credit cards are not provided by the employer or an associated institution and, as such, may fall outside the ambit of the Seventh Schedule.

In the event that this benefit is considered to be within the ambit of the Seventh Schedule, there may be an argument that the loyalty points, as opposed to the goods/services for which they are redeemed, constitute a taxable benefit. However, whichever argument is taken, one would end up with the same uncertainties around the valuation of the benefit which are discussed below.

Clegg's (2002:33) argument that the taxation of frequent flyer are not provided for in the Seventh Schedule is particularly highlighted where loyalty points are earned by employees on personal credit cards. Where the benefit (loyalty points or goods) is argued to fall within the ambit of paragraph 2(*a*) of the Seventh Schedule, it should be valued in terms of paragraph 5(2) of this Schedule depending on whether the asset was previously owned by the employer or not or is held by the employer as trading stock. Where the benefit is a

service which falls within the provisions of paragraph 2(*e*) of the Seventh Schedule, it should be valued at cost in terms of paragraph 10 of this Schedule.

The three circumstances which paragraph 5(2) of the Seventh Schedule caters for were discussed earlier in this study. These include instances where the asset is owned by the employer and provided to the employee, where the asset is purchased with the intention of disposing thereof to the employee and where the asset consists of trading stock. These areas clearly do not fit the instance where loyalty points or goods are provided by a third party (the company operating the loyalty programme) to the employee and have not been owned by the employer at any point. This may further support the argument that the loyalty points or goods/services fall outside the ambit of Seventh Schedule.

In the case of services, and in the event where loyalty points or goods are argued to be valued at cost, the same administrative difficulties in determining the cost for frequent flyer miles earned by the employer are once again present. Should an argument be successful that the benefit needs to be valued at market value in terms of paragraph 5(2) of the Seventh Schedule, this stance will significantly change. This is due to the fact that, generally, it should be simple to put a fair value on the points, goods or services in relation to the value thereof in the open market.

In the case where it is argued that the loyalty points/goods/services fall outside the ambit of the Seventh Schedule, consideration should still be given to the provisions of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. The provisions of this paragraph will apply if the amount is received or accrued in respect of services rendered or in respect of, or by virtue of, any employment. These terms have been interpreted by the courts and, in essence, an amount means every form of property earned, whether corporeal or incorporeal, which has a monetary value. As with frequent flyer miles, the loyalty points/goods/services are likely to constitute an amount, thus satisfying the requirement that there should be an amount for the purposes of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act.

“In respect of” and “by virtue of” means that, where there is a direct link between the services rendered by an employee and the receipt of a benefit, the benefit will fall within

the paragraph (c) of the definition of gross income in section 1 of the Income Tax Act. Although most writers in South Africa have not specifically expressed a view with regard to the impact of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act on loyalty points, the interpretation by the courts as to the meaning of the terms used in paragraphs (*c*) and (*i*) of this definition are very similar. As such, the arguments noted earlier to show the insufficient link for the purposes of paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act may equally be applied to paragraph (*c*) of the said definition to show the lack of a direct link between the services rendered by an employee and the receipt of the loyalty points/goods/services. As with paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act, it is, however, uncertain as to whether these arguments will be accepted by the South African courts and SARS.

Loyalty points earned by employees on personal credit cards as a result of business-paid expenditure may thus be argued to fall outside the Seventh Schedule (either by arguing that there is no direct link between employees' employment and the receipt of loyalty points or by arguing that the loyalty points are not provided by the employer or associated institution). Whether this benefit falls outside paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act is uncertain. However, there may be a strong argument that it does indeed fall outside the said paragraph. If South Africa follows the lead of Australia and Canada (as well as other countries, such as Switzerland) with regard to the treatment of this benefit, this benefit will not be taxable in South Africa. These uncertainties showcase the need for guidance from the South African courts or SARS.

3.5 LOYALTY POINTS AWARDED TO EMPLOYEES AS AN INCENTIVE

Loyalty points, which form part of a loyalty programme operated by the employer, may be provided to employees as an incentive to, for example, reward excellent service. Although this has not been addressed in past research, guidance may be sought from the principles established in the *XYZ (Pty) Ltd v Commissioner for SARS* case.

In *XYZ (Pty) Ltd v Commissioner for SARS*, the court held the benefit to be covered by the provisions of the Seventh Schedule. Furthermore, the court held that the taxable benefit was the holiday accommodation as opposed to the timeshare points provided to

employees. However, there are factors which contribute to an argument that the taxable benefit is, in fact, the loyalty points. Although this argument may appear to be superfluous, it does have a significant impact on the timing of the tax event and the valuation thereof.

Where the taxable benefit is argued to be the loyalty points provided to employees, these will most probably constitute an asset in terms of the provisions of paragraph 2(*a*) of the Seventh Schedule. In terms of paragraph 5(2) of the Seventh Schedule, these should be valued at market value or where the asset is moveable property which has been acquired by the employer to be disposed of to the employee at cost or where the asset consists of trading stock at the lower market value or cost.

In view of IFRIC 13, which requires employers to defer income relating to loyalty points (as opposed to recognising it as trading stock), it is unlikely that points will be considered as trading stock in terms of the Seventh Schedule. As such, the valuation provisions relating to trading stock will not be considered (IASB, 2009:2579, 2583).

Where the loyalty points are argued to be valued at market value, IFRIC 13 clearly provides a solution as this accounting guideline requires companies to assign a fair value to loyalty points provided to customers (IASB, 2009:2577). Generally, there are various restrictions attached to loyalty points. These include lapsing after a certain period and that points are non-transferrable. In *XYZ (Pty) Ltd v Commissioner for SARS*, the appellant argued that these factors are indicative that timeshare points cannot be turned into money and that no taxable benefit arises. This argument, however, was trumped in *XYZ (Pty) Ltd v Commissioner for SARS*, where the court held that, if a receipt or accrual cannot be turned into money, it does not mean that it does not have a monetary value. Therefore, possible restrictions attached to loyalty points cannot be used as an argument that it has no value.

Where it is argued that the loyalty point should be valued at cost, consideration should again be given to IFRIC 13. IFRIC 13 clearly states that the points should be valued at fair value and not in terms of the cost thereof to the employer (IASB, 2009:2577). This implies that, from an accounting, administrative and good governance perspective, it should be possible for companies to determine the cost of loyalty points.

An additional concern which may be raised from the argument that the loyalty points constitute the taxable benefit is the timing of the taxable event. Clegg (2002:34) states that, when an employee makes use of a free flight, he/she is merely exercising a contractual right between him/herself and the airline. Therefore, the taxable event is the earning of miles. In addressing the same, Czerny *et al.* (2008:5) state that it is nonsensical to consider the taxable event to be the awarding of loyalty points or frequent flyer miles. Whether the taxable event is considered to be the earning or redemption of loyalty points is thus a moot point. It should be noted, however, that it may be argued that inequities may be created where the taxable event is considered to arise as and when the points are awarded to the employee. This is due to the fact that the employee may never actually utilise the points awarded by the employer and, as such, will be taxed on something which has never brought him/her any value in a personal capacity (Clegg, 2002:34).

Where the taxable benefit is argued to be the goods or services for which the points are redeemed (as supported by the decision in *XYZ (Pty) Ltd v Commissioner for SARS*), one should again look at the valuation paragraphs 5(2) and 10(1) of the Seventh Schedule. As described above, where the reward constitutes goods falling within the provisions of paragraph 2(*a*) of the Seventh Schedule, it has to be valued at market value where the asset was previously owned by the employer, or cost where the asset is moveable property and it was purchased to provide to the employee, or the lower of cost or market value where it constitutes trading stock.

In the case of goods, these will, in most instances, form part of the employer's normal trading stock and, as such, should be valued at the lower of cost or market value. This should not be a difficult task for the employer since, from an accounting perspective, the cost of trading stock and the realisable value thereof are usually closely monitored by companies. The market value of goods may be established with reference to the value thereof in the open market.

Alternatively, where the reward constitutes a service falling within the provisions of paragraph 2(*e*) of the Seventh Schedule, it should be valued at the cost to the employer. Assigning a cost to a service rendered may admittedly be more difficult. However, should the rendering of such services be part of the employer's business, it should, once again,

be possible from an accounting perspective. Even in the event that a third party provides the services to the employee on behalf of the employer, a cost will be involved for the employer which should be easily determinable.

The fact that the court in *XYZ (Pty) Ltd v Commissioner for SARS* held that the holiday accommodation was the taxable benefit implies that the taxable event arises at the point where the loyalty points are redeemed for goods and services and not when the points were awarded. This view is supported by Czerny *et al.* (2008:5) and may lead to a more equitable solution whereby employees will be taxed on the benefit actually used for personal purposes. This is in contrast to where the taxable benefit is argued to be the loyalty points and the employee is possibly taxed when the points are awarded irrespective of whether these are used for personal purposes or not.

As can be seen from the above arguments, it is not a matter of whether the benefit provided to employees should be taxable, but it is a question as to the nature, valuation and timing of the taxable benefit. As little literature exists on loyalty points, which form part of an employer's loyalty programme, provided to employees as an incentive, it is an area which has been identified for further research in future.

3.6 CONCLUSION

This chapter provided a comparison of the treatment of frequent flyer miles between South Africa, Canada and Australia. The lack of guidance provided with regard to this matter by SARS in South Africa, as opposed to the guidance offered by the revenue authorities in Australia and Canada, was highlighted by this comparison. Rewards received by employees as a result of business expenditure incurred, where the employer is a member of the loyalty programme, are considered to be taxable in Canada. By contrast, where the employee is the member of the loyalty programme, neither Canada nor Australia consider the reward to be taxable. There are, however, certain exceptions to these principles.

In addition, an analysis of loyalty points earned by an employer on corporate credit cards which are awarded to an employee and used for private purposes was performed in this chapter. In summary, it may be argued that benefits (such as goods or services) received

under this arrangement falls within the ambit of the Seventh Schedule (i.e. paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act). The taxable value which arises may be argued to be the cost thereof to the employer. However, although there should be a cost for the employer in earning these loyalty points which are used to provide a benefit to employees, many writers argue that the administrative difficulties involved in determining this cost means that the taxable value is nil. It may be argued that the cost may be determined with reference to the market value of the goods or services. However, it is questionable as to whether this is correct since it is clear that the market value may not necessarily equate to the cost thereof to the employer. Paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act excludes amounts included in terms of paragraph (*i*) of the same definition. As the benefit is considered to fall within the ambit of Seventh Schedule, although at a nil value, it may be argued that it is excluded from paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. Consequently, the element of remuneration, as required for an employees' tax withholding obligation to arise, is not present. As such, it may be argued that no employees' tax obligation arises where loyalty pints are earned by an employer on corporate credit cards and used to provide a benefit to employees.

This chapter also provided an analysis of loyalty points earned as a result of business expenditure incurred on personal credit cards which are also used by an employee for private purposes. There is an argument that there is an insufficient link between the employees' employment and the receipt of the loyalty points or, alternatively, that the loyalty points are not provided by an associated institution, thus causing the benefit to fall outside the ambit of the Seventh Schedule. Even where the loyalty points are considered to be within the ambit of the Seventh Schedule, the same uncertainties around the cost of this benefit, as noted for corporate credit cards, is present, thus leading to an argument that a nil taxable benefit arises. Furthermore, there is a strong argument that the benefit falls outside the ambit of paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. However, there are uncertainties attached to this argument. Thus, where loyalty points are earned by employees on personal credit cards as a result of business expenditure incurred, there are strong arguments that the benefit is not taxable and that hence, no employees' tax obligation arises. However, it is uncertain as to whether these arguments will be accepted by the South African courts and SARS.

The provision of loyalty points to employees as an incentive, which forms part of a loyalty programme operated by the employer, was also analysed in this chapter. The benefit received by employees is likely to be covered by the provisions of the Seventh Schedule. Whether the taxable benefit is the loyalty points or the goods or services for which the loyalty points may be redeemed is arguable. Where the taxable benefit is argued to be the loyalty points, these should be valued at cost or market value depending on whether it is considered as an asset disposed of to the employee or an asset acquired by the employer to be disposed of to the employee. However, by regarding the tax event as the point where the points are provided to employees, inequities may be created as the employee may be taxed on a benefit which has not yet offered him/her any personal benefit. Where the goods or services are argued to be the taxable benefit, these should also be valued at cost in the case of services and the lower of cost or market value in the case of goods (on the basis that the goods are considered to be trading stock). The argument that the taxable benefit is the goods or services may lead to a more equitable solution as employees are only taxed on something which has afforded them personal value. It is considered that it should be plausible for the employer to allocate a cost or market value to these goods or services or, alternatively, the loyalty points. On this basis, an employees' tax obligation is likely to arise in the hands of the employer when loyalty points are provided to employees as an incentive.

All the uncertainties highlighted in this section showcase the need for guidance with regard to the fringe benefit implications of loyalty points by SARS.

CHAPTER 4: CONCLUSION

4.1 INTRODUCTION

The research objectives of this study were set out as follows:

- to analyse research studies, court cases and other literature in order to establish the theoretical construct of this study;
- to compare the tax treatment of frequent flyer miles earned by, or awarded to, employees in South Africa to the treatment thereof in Australia and Canada; and
- to analyse the employees' tax implications with regard to loyalty points earned by, or awarded to, employees in terms of the Seventh Schedule and paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act, using the theoretical construct as a basis.

In achieving the first objective of this study, a review was undertaken in chapter 2 with regard to legislation, case law and other literature on the principles of employees' tax. This review was extended to other literature pertaining to frequent flyer miles and loyalty programmes. Finally, an analysis was performed of the tax treatment of loyalty programmes from an Australian and Canadian perspective.

In achieving the second and third objectives of this study, a comparison between the principles identified from a South African tax perspective against those identified from an international perspective was made in chapter 3. This comparison was followed by the application of the principles identified in the literature review to the specific *scenarios* of loyalty programmes.

4.2 SUMMARY: LOYALTY POINTS EARNED ON CORPORATE CREDIT CARDS

The *scenario* where loyalty points are earned on corporate credit cards by the employer and awarded to employees for personal use is assumed to be similar to frequent flyer miles where the miles are earned and used by employers to provide employees with a flight for private use.

From a Canadian perspective, rewards offered in this instance are considered to be taxable at the market value in the hands of the employee. From a South African perspective, the Income Tax Act does not specifically deal with this matter, neither does SARS provide any guidance with regard to the issue.

Where loyalty points are earned by an employer and redeemed for the benefit of employees, the rewards are considered to be covered by the provisions of the Seventh Schedule as there is a link between the receipt of the benefit and the employee's employment. It is considered correct to argue for the taxable benefit to be the goods or services received by employees as opposed to the loyalty points. As such, these goods and services will be included in paragraphs 2(*a*) and 2(*e*) of the Seventh Schedule and should be valued in terms of paragraph 5(2) and 10(1) of the same Schedule.

Paragraph 5(2) of the Seventh Schedule caters for three circumstances namely where the asset is acquired by the employee from the employer, where the asset moveable property acquired by the employer to dispose of to the employee and where the asset is held by the employer as trading stock. The goods are likely to be considered assets acquired by the employer to be disposed of to the employee. Accordingly, the goods should be valued at cost. Similarly, the services will also be valued at cost in terms of paragraph 10(1) of the Seventh Schedule.

Although the same price is likely to be paid for purchases on corporate credit cards by members of the loyalty programme as non-members, previous research indicates that it is likely that the employer incurs some form of cost in earning loyalty points. However, the administrative difficulty involved in determining this cost has caused many writers to argue that a nil taxable benefit arises. Lead may be sought from the guidance provided in this area by the Canada Revenue Agency, which requires this benefit to be valued at the fair market value (Canada Revenue Agency, 2009:2). However, the Seventh Schedule makes a clear distinction between cost and market value and, accordingly, it may be argued that it is inappropriate to value the goods or services with reference to the market value thereof as this may be much higher than the actual cost thereof to the employer.

As the benefit described is included in the Seventh Schedule, albeit at a nil value, it may be argued that it will be excluded from paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act. As the element of remuneration is not satisfied, it may be argued that no employees' tax withholding obligation in terms of the Fourth Schedule will arise.

The lack of guidance from SARS, especially in view of the guidance provided by international revenue authorities, is highlighted by the above valuation uncertainties. These uncertainties are likely to continue until such time that this matter is addressed in court or when SARS provides guidance in this area.

4.3 SUMMARY: LOYALTY POINTS EARNED ON PERSONAL CREDIT CARDS

It is assumed that loyalty points are earned by an employee on a personal credit card as a result of business expenditure incurred may be likened to frequent flyer miles earned by employees as a result of business-paid expenditure.

From an Australian and Canadian perspective, loyalty points/frequent flyer miles earned in this instance is not considered to be taxable. It is interesting to note that, the Canada Revenue Agency's view has always been that this benefit received is taxable, however, due to difficulties involved in tracking and valuing these points, this view has been abandoned.

From a South African perspective, it may be argued loyalty points, earned by employees on personal credit cards as a result of business expenditure incurred, fall outside the ambit of the Seventh Schedule as there is an insufficient link between the services rendered by an employee and the receipt of loyalty points. This stance is, however, contradicted by Canadian case law and it is thus uncertain as to whether this view will be supported by the South African courts and SARS. Alternatively, this benefit may be argued to fall outside the ambit of the Seventh Schedule as the loyalty points are not provided by the employer or an associated institution as defined in the said Schedule. Even in the event that it is successfully argued to be included in the Seventh Schedule, the same administrative difficulties involved in valuing the benefit as noted for loyalty points earned using corporate

credit cards will hold for loyalty points earned as a result of business expenditure incurred on personal credit cards. Therefore, the taxable value may be argued to be nil.

Despite the fact that loyalty points earned as a result of business expenditure incurred on personal credit cards may be argued to fall outside the ambit of the Seventh Schedule, paragraph (*c*) of the definition of gross income in section 1 of the Income Tax Act still needs to be considered. An amount will fall within the ambit of this paragraph if the amount is received or accrued in respect of services rendered or by virtue of employment. The interpretation of the meaning of paragraphs (*c*) and (*i*) of the definition of gross income in section 1 of the Income Tax Act is similar. Therefore, as with paragraph (*i*) of the definition of gross income in section 1 of the Income Tax Act, although this is contradicted by Canadian case law, there is a strong argument that loyalty points earned by employees on personal credit cards fall outside paragraph (*c*) of the said definition.

Thus, there are strong arguments that the loyalty points earned by employees on personal credit cards, as a result of business expenditure incurred, falls outside the ambit of both paragraphs (*c*) and (*i*) of the definition gross income in section 1 of the Income Tax Act. Therefore, it fails to meet the requirements of remuneration as defined in the Fourth Schedule and hence no employees' tax obligation arises. It is, however, uncertain as to whether these arguments will be supported by the South African court or SARS.

4.4 SUMMARY: LOYALTY POINTS AWARDED TO EMPLOYEES AS AN INCENTIVE

Loyalty points which form part of a loyalty programme, operated by the employer, and which are awarded to employees as an incentive have not been the subject of past research. However, guidance may be sought from the *XYZ (Pty) Ltd v Commissioner for SARS* case.

The benefit of loyalty points, which forms part of a loyalty programme operated by the employer, provided to employees as an incentive is likely to be covered by the provisions of the Seventh Schedule as it is clearly linked to an employee's services. However, the nature of the taxable benefit is arguable. On the one hand, the taxable benefit may be

argued to be the loyalty points while, on the other hand, it may be argued to be the goods or services for which the points may be redeemed.

Where the taxable benefit is considered to be the loyalty points, it is likely to be included under paragraph 2(*a*) of the Seventh Schedule. In terms of paragraph 5(2) of the Seventh Schedule, it should be valued at cost or market value depending on whether it will be seen as assets disposed of to the employee, assets purchased to be disposed of to the employee or trading stock. The market value of these loyalty points may be determined with reference to IFRIC 13 and the cost may be determined with reference to an employer's accounting records. However, the taxation of loyalty points at the time of provision to employees may lead to inequities whereby the employee will be taxed on something which has not yet offered him/her any personal benefit at that point.

When arguing that the taxable benefit is the goods or services for which the loyalty points are redeemed, these will be covered by the provisions of paragraphs 2(*a*) and 2(*e*) of the Seventh Schedule. In the case of goods, these are likely to be considered as trading stock, which should be valued in terms of paragraph 5(2) of the Seventh Schedule at the lower of cost or market value. Both the cost and market value should be determinable with reference to the employer's accounting records. Services will be valued in terms of paragraph 10(1) of the Seventh Schedule at the cost thereof to the employer. Similarly, this should be determinable with reference to the employer's accounting records. The taxation of the goods or services as opposed to the loyalty points will lead to a more equitable solution whereby the employee will be taxed on something which has brought him/her personal value.

The element of remuneration as required by the Fourth Schedule for an employees' tax obligation to arise is thus present where loyalty points are provided to employees as an incentive under a loyalty programme operated by the employer. Consequently, although there is uncertainty about the taxable amount, the nature and timing of the taxable benefit, an employees' tax withholding obligation will arise.

4.5 CONCLUSION

The fringe benefit implications of the various *scenarios* of loyalty points may be inferred from the application of the view of past researchers, legislation and international practice. However, in all the *scenarios* which were investigated as part of this study, the lack of guidance from SARS and local judicature was highlighted.

The lack of guidance from SARS and local judicature was particularly highlighted in the comparison of the tax treatment of loyalty points provided to employees between South Africa, Australia and Canada. While there is no guidance in South Africa with regard to loyalty points earned by, or provided to, employees as a result of business expenditure incurred, both Australia and Canada have issued guidance in this area. Where loyalty points/frequent flyer miles are earned by an employee as a result of business-paid expenditure, these are not considered to be taxable in Australia and Canada. Where the loyalty points/frequent flyer miles are earned by the employer and used for the personal benefit of the employee, it is considered to be taxable in Canada. There is no guidance provided in this regard by the Australian Taxation Office.

From a South African perspective, it may be argued that loyalty points earned as a result of business expenditure incurred on corporate or personal credit cards, which are used for the benefit of employees, may not be taxable (and no employees' tax withholding obligation will arise). However, it is questionable as to whether this view may be supported by the South African court and SARS. Where loyalty points are provided as an incentive to employees, it may clearly be argued to be taxable (and an employees' tax withholding obligation will arise). However, the nature, whether it should be valued at cost or market value and the point at which the tax event occurs is uncertain.

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