SALES TAX

Sales Taxation of Loyalty and Reward Programs – Navigating the Current Landscape

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The current landscape is akin in many ways to the cloud transaction environment a number of years ago. Generally speaking, the sales tax issue is whether the rewards established through the loyalty program are considered part of the "sales price" and, therefore, are subject to tax when redeemed by a consumer for free or discounted tangible personal property or taxable services. Similar to the cloud arena, there is a dearth of guidance specifically addressing loyalty reward programs. While some states have attempted to deal with the complexities, other states have either not begun to address the issues or have done so on an ad hoc basis through fact-specific cases and rulings. As a result, taxpayers desiring to understand and develop policies regarding the state tax implications of their programs face an uncertain and ever-evolving endeavor.

This is further complicated by the fact that the programs themselves are so diverse. Businesses have different reasons for establishing customer loyalty programs and these reasons will influence elements of the program (such as how rewards can be earned and when they can be redeemed). Not only are there differences between programs offered by competitors, but there are also a number of variations of the program within any one business. For example, customers may be able to earn points through their purchases but also through other activities such as referrals, completing surveys or even having a birthday. Many programs also allow customers to earn points through co-branded credit cards and third-party purchases. Further, the program may be administered by the business, an affiliate or an unrelated third-party. All of these iterations create the sales tax complications that we address today.

Illustrative Examples: Minnesota and Michigan

In states that have not specifically addressed the taxation of loyalty rewards, the nearest paradigm for purposes of analysis is usually the laws and regulations governing coupons, vouchers and discounts. Within this context, retailer coupons are generally considered to be applied as a discount to the sales price (and not taxable consideration), while manufacturer coupons for which the retailer is reimbursed are typically deemed to be consideration (and therefore part of the taxable sales base).

Minnesota is an example of a state that has attempted to address the sales tax consequences of loyalty reward programs within this context. In 1998, the Minnesota Tax Court held in *St. Paul Abrasives* that "incentive items" purchased from a retailer's catalogue in exchange for points accrued from prior purchases were subject to tax.[2] This holding was then reiterated in *Home and Garden Party,* which determined that reward credits provided to potential customers constitute taxable consideration when redeemed for goods.[3] Subsequent to these decisions, the Department promulgated Minn. Rev. Notice No. 03-15 (rev. Nov. 5, 2012), which explained the concept of "taxable scrip" and its application in the context of redeemed rewards: "Generally, if an incentive item is transferred to a customer in exchange for consideration, it is a sale at retail and consequently is subject to tax. Consideration may be in the form of scrip, and it does not matter whether the scrip is purchased or earned by the customer or is given free to the customer." However, Minnesota also had guidance stating that an unreimbursed retailer coupon constituted a discount to the sales tax and was therefore not subject to tax. Minn. R. 8130.0600 (Oct. 2, 2006). It was, quite frankly, hard to square the differing analyses even within a single state.

In June 2015, Minnesota issued Sales Tax Fact Sheet 167, "Coupons, Discounts, Rewards, Rebates, and Other Forms of Payment." The fact sheet explains the sales taxation of eight different types of payments—coupons, discounts, rewards, rebates, trade-ins, gift cards and certificates, scrip and barter. And it provides a level of clarification around loyalty programs that was previously lacking. According to the fact sheet, the value of a reward will be treated as a discount—and therefore will

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[2] *St. Paul Abrasives, Inc., Tri-City Distributing, Inc., Scandia Abrasives & Supplies, Inc.,* and *M & N Supply, Inc. v. Commissioner of Revenue*, Nos. 6814, 6815, 6816 (Minn. Tax Ct. Oct. 12, 1998).

[3] *Home and Garden Party, Inc. v. Comm'r of Revenue*, No. 7924 R (Minn. Tax Ct. Nov. 24, 2008).

not subject to tax—if the reward is not purchased, is not provided in exchange for services, cannot be redeemed for cash, and is not reimbursed by a third party. Examples include store discount cards, punch cards that provide a price reduction after a number of purchases, seller's cash and discounts for opening a store credit card. On the other hand, the value of a reward under a rewards program is *not* a discount—and therefore *is* subject to tax when redeemed—if the reward requires the customer to pay cash or other consideration for the reward, requires the customer to provide services in exchange for the reward, is reimbursed by a third party or can be redeemed for cash. Examples include secret-shopper rewards and credit card points.

Unfortunately, the fact sheet also contains guidance that could be extremely hard to administer for businesses that have loyalty programs through which customers can accumulate points in a variety of ways. The fact sheet provides that if a taxable reward is bundled with a nontaxable reward, the entire reward is taxable unless the seller can provide documentation showing otherwise. So while businesses received certainty related to the taxability of redeemed rewards, the commingling policy will be troubling for business that as a matter of business practice cannot separately identify their points in a manner acceptable to the Department of Revenue.

As demonstrated by a recent case in Michigan, the law related to promotional items and gifts, as well as the "true object" test, may also be utilized for purposes of analyzing loyalty reward programs. This fall, the Michigan Court of Appeals held in *Schoeneckers* that the administrator of an employee rewards program is liable for sales tax on the retail value of the products it provides to its clients' employees when they redeem award points for merchandise.[4] The taxpayer in *Schoeneckers* administered rewards programs for employers and billed its clients based on the number of reward points issued to the clients' employees. The taxpayer purchased the merchandise free of tax, issuing a resale certificate; the employees would then use the reward points to acquire merchandise from the taxpayer. When the taxpayer distributed merchandise to the employees, the taxpayer remitted use tax based on the price it paid for the merchandise. However, the Michigan Department of Treasury argued that the correct measure of the tax was not the taxpayer's cost, but rather the value of the rewards points that the employees gave in exchange for the merchandise—i.e., the gross proceeds received from the taxpayer's clients for the points, which consisted of a payment for the items that could be redeemed and a fee for the administration of the program.

The sales taxation of the transaction was viewed within the context of the "incidental to service" test. Thus, the dispute in *Schoeneckers* boiled down to whether the rewards program in question constituted one transaction or two. In a 2004 Michigan Supreme Court decision, that court held that providing tangible personal property "incidental to service" is not considered a retail sale.[5] Similarly, the taxpayer in *Schoeneckers* argued that its reward program, viewed as a whole, was a service provided to its employer-clients, and the merchandise dispensed to the customers was incidental to that service. Accordingly, it argued that it owed only use tax on the cost for removing the merchandise from its inventory.

The Michigan Court of Appeals disagreed. According to the court, the rewards program involved two individual transactions: the first was the transaction between the taxpayer and its client (which was a nontaxable service transaction), while the second was the transaction between the taxpayer and the client's employees (which was a taxable retail sale). According to the court, the tax in the second transaction is based on the value of the consideration given—*i.e.,* the reward points.

Schoeneckers evidences how fact-specific the inquiries are in this area: had the program been administered in-house and thus involved only one transaction, it is very likely that the taxpayer would have prevailed. As such, this case presents a warning of the potential hazards of trying to draw analogies between the programs at issue in a state's published authorities and a specific company's reward program, even within that state.

Considerations and Conclusion

Just as there is no one-size-fits-all loyalty program, there is not a single solution to the sales tax consequences of such programs. If a taxpayer takes a uniform approach across all states, a taxpayer risks being assessed by states that do not agree with its characterization of the sales tax treatment. Specifically, a taxpayer that offers a loyalty program may decide not to collect any tax when loyalty rewards are redeemed on the basis that the redemption is similar to a retailer's coupon and does not constitute consideration. On the other hand, a company that errs on the side of treating the instrument as taxable consideration risks over-collecting in certain states and thus opening itself up to the risk of a plaintiff's suit. The risk is not theoretical: for example, Whole Foods was

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4 *Schoeneckers, Inc. v. Department of Treasury*, No. 321033 (Mich. Ct. App. Sept. 15, 2015) (unpublished),

5 *Catalina Marketing Sales v. Department of Treasury*, 678 N.W.2d 619 (Mich. 2004).

sued for allegedly overcollecting tax on purchases made with a coupon, in a suit which alleged that Whole Foods incorrectly applied tax to a customer's total purchase amount rather than the net amount due after applying the $15 coupon.[6]

The facts and the law in *Whole Foods* were arguably much simpler than those faced by companies with loyalty and rewards programs; thus, it is imperative that taxpayers understand the facts and circumstances related to their own programs in order to be able to make a determination regarding their state tax obligations. Furthermore, be aware that the program may change to better align with the company's customer incentives. In light of this, it's a good idea to establish clear lines of communication between the tax department and the business unit overseeing the program.

Once the facts are fully understood, a taxpayer should undertake a review of the applicable law in relevant jurisdictions. The starting point for analysis should be the state's definition of the base upon which the tax is imposed. Certain states will have case law that is on point or instructive, and many states have promulgated administrative guidance. If the guidance is less than satisfactory, a taxpayer could always consider seeking ruling from the revenue department in a state where the guidance is unclear and the potential liability could be significant. While a uniform approach to the tax treatment of such programs may be the preferred approach for business and/or logistical reasons, keep in mind that a blanket approach likely means that the company could have some amount of exposure in states that do adopt the coupon framework, for example.

Similar to cloud transactions, states are being forced to address an evolving marketplace of reward programs with antiquated statutes. While cloud transactions and digital goods often seem to be at the forefront of sales and use tax developments, the treatment of loyalty programs will continue to garner more focus as the programs continue to evolve and are increasingly utilized by businesses both large and small, while taxpayers are faced with interpreting and applying unclear and inconsistent guidance.

6 *Wong v. Whole Foods Market Group, Inc*., Dkt. No. 1:15-cv-00848 (N.D. Ill.) (complaint filed January 28, 2015). The case was dismissed on October 14, 2015 as a result of a settlement.