

# **An analysis of the income tax treatment of gift card transactions by South African suppliers**

**IV Mkhomazi**



**[orcid.org/0000-0003-0282-214X](https://orcid.org/0000-0003-0282-214X)**

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Supervisor: Prof P van der Zwan

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Student number: 36012017

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## **ABSTRACT**

Gift cards are popularly used in businesses especially in the retail sector. This widespread business practice has become popular worldwide and is continuing to grow. Gift cards are increasingly used as a marketing strategy and a promotional tool by businesses in order to increase sales and grow profits. This strategy strengthens customer loyalty, enhances brand awareness, and retains customers. Non-redemption of gift cards is a notable part of the retail sales economy and has a significant impact on the company's profits in the long term. Customers also prefer gift cards because they reduce the dead weight loss of unwanted gifts.

There are no specific income tax rules, tax provisions or tax guidelines that currently address the income tax implications of gift cards in South Africa. It is thus uncertain what the correct income tax treatment of gift cards is, and this could potentially result in inconsistencies for different taxpayers in South Africa. The main objective of this study was to analyse the South African income tax legislation to determine what the areas of uncertainty are in the current legislation on the income tax treatment of gift cards in the hands of suppliers and how these uncertainties have been dealt with in the United States of America (USA). There are hardly any countries that provide guidance on the income tax treatment of gift cards, the USA was selected because it is one of the few that do. This study employed a qualitative research approach and largely followed an interpretive research method and doctrinal research methodology.

The findings of this study indicate that gift cards are generally classified into two categories, viz. closed-loop and open-loop gift cards. They have varying features and characteristics; however, their transaction process is fairly similar. The South African income tax legislation has been found lacking in the following aspects with regard to the income taxation of gift cards; the issue of the taxability of the proceeds from issuing gift cards, specifically the timing of inclusion in gross income; the issue of how non-redemption should be treated for income tax purposes; and the issue of the deductibility of costs to fulfil the gift cards. Guidance on the income tax treatment of gift cards in the USA was analysed in order to draw lessons on the uncertainties identified in the South African income tax legislation on gift cards transactions.

**Key terms:** Gift cards, gross income, sale of gift cards, CPA, income tax on gift cards, deductions, South Africa

## **LIST OF ABBREVIATIONS**

CFR:	Code of Federal Regulations
Commissioner:	The Commissioner of the South African Revenue Services (SARS)
CPA:	Consumer Protection Act 68 of 2008
GAAP:	Generally Accepted Accounting Principles
IFRS 15:	International Financial Reporting Standards 15
IN:	Interpretation Note
IRC:	Internal Revenue Code
IRS:	Internal Revenue Services
ITA:	The South African Income Tax Act 58 of 1962
SARS:	South African Revenue Services
UK:	The United Kingdom
USA:	United States of America

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# CHAPTER 1 INTRODUCTION

## 1.1 Introduction and background

### 1.1.1 Background to study

Gift cards were incepted in the United States of America (hereafter referred to as "USA") in the mid-1990s (Diamond, 2011:975) with early adopters Mobil Oil Company (Offenberg, 2007:227) and Blockbuster Video (Odell, 2012:26) and have since become popular. This industry is becoming a truly worldwide market (Groine, 2009:10). Well established in the USA and now receiving a great deal of attention globally, the sale of gift cards has become a ubiquitous business practice in consumer market industries, especially the retail industry (Fitzpatrick & Suttora, 2011). The meaning of the term gift card is defined in the Merriam-Webster online dictionary as "a card entitling the recipient to receive goods or services of a specified value from the issuer" (Merriam-Webster Inc., 2021). Gift cards are also known worldwide as gift certificates or gift vouchers.

Gift cards have evolved from the twentieth century when they were used as paper gift certificates (Horne & Bendle, 2016:155). The paper gift certificates performed similar functions to a gift card that is used today (Offenberg, 2007:228). Modern day gift cards are in plastic form and are identifiable by a magnetic strip at the back of the card or a unique barcode (Offenberg, 2007:229). These cards are attached to an account where the value of the card is kept and as such a customer can pre-purchase credit, the value of which is stored on the card to use in future (Norvell & Horky, 2017:250). With the rapid growth of technology, many retailers have now adopted e-gifting. Electronic gift cards are commonly known as e-gift cards, digital cards or virtual cards, and they refer to gift cards that are sent and redeemed electronically (Incomm Market Metrics, 2020). Electronic gift cards are rated highly by customers because they offer flexibility in terms of operations and usage, as they are directly delivered in the form of a link or code to the recipient by e-mail or SMS. Prominence of these digital cards over plastic cards is increasing significantly.

The purchase of gift cards by customers has been increasing over the past twenty years, and this has puzzled economists and advocates of customers while at the same time encouraging suppliers in what has been a predominantly stagnant retail environment (Horne & Bendle, 2016:154). Today, almost all suppliers in South Africa and in the world offer gift cards as a promotional tool to grow sales and increase profits. This tool represents cost-effective advertising that helps keep businesses top-of-mind with their market. Gift cards are increasingly being used

as a promotional tool as suppliers such as retailers use them to enhance their customer loyalty programmes and to strengthen the value proposition of customers, increase referrals, and retain customers (Persistence Market Research, 2021). The redemption of gift cards by gift card recipients creates incremental revenue because the recipients tend to spend more than the value of the cards, thus providing additional sales for the supplying merchant. Khouja *et al.* (2011:446) estimates that on average, customers spend about 20% beyond the value of the gift card.

The gift card business is big. In 2012, an excess of US\$110 billion in the value of gift cards were activated in the USA (Research & Markets, 2021a). This represents approximately one percentage of the whole retail industry in the USA and is larger than the national economies of all but the 60 richest countries (Horne & Bendle, 2016:157). According to Persistence Market Research (2021) the global gift card market has significantly grown in the previous years and is projected to keep expanding in the future. Research and Markets (2021a) agree that the global gift card market has had a substantial growth in the past years and is expected to proliferate in the near future. The Global Gift Card Market size was valued at US\$ 615.34 billion in 2019 and is predicted to reach US\$2 097.13 billion by 2030 (Research & Markets, 2021a). In South Africa, the gift card market will increase from US\$ 794.1 million in 2020 to reach US\$1 552.4 million by 2025; this growth momentum is expected to continue to rise over the forecast period (Research & Markets, 2021b). The rise in the gift card market can be attributed to various factors as well as rapid technological developments. This is an indication that the popularity of the use of gift cards by supplying merchants and customers is increasing (Nel, 2020:5).

Gift cards have a ubiquitous presence in many markets. They are unique products with unusual characteristics that warrant research (Horne & Bendle, 2016:155). Gift cards have a wide range of varying features, and they differ in terms of form, value and the goods or services that the holder of the gift card would be entitled to upon redemption (SARS, 2014a:1). These different variations could result in different treatments for income tax purposes. Suppliers who issue gift cards may be uncertain of what the correct income tax treatment of gift card transactions is and there may be different treatments across different suppliers resulting in inconsistencies.

### **1.1.2 General overview on income taxation of gift cards**

There is currently no specific income tax legislation, income tax advance rulings or income tax interpretation notes that deal with the income tax treatment of gift card transactions in South Africa (KPMG, 2019b). The income tax treatment of gift cards in South Africa has been a conundrum for which the South African Revenue Services (hereafter referred to as “SARS”) has not had a ready answer to and as such, there has not been any specific guidance issued by SARS on the income

tax treatment of gift cards. Following the promulgation of the Consumer Protection Act 68 of 2008 (hereafter referred to as the “CPA”) which came into effect on 31 March 2011, questions arose as to whether suppliers should take into consideration its provisions when taxing gift cards. SARS issued Interpretation Note (hereafter referred to as “IN”) No. 117 (issue 1) on 17 May 2021 dealing with the taxation of the receipt of deposits. However, it is not directly specific to the income taxation of gift cards and it clearly stated that the provisions of the CPA are not dealt with.

The SAIT (2020:2) pointed out that the carve-out of the CPA from the IN greatly undermines the value of the IN given the wide scope of the CPA, as such; IN No. 117 has little practical meaning regarding the income tax treatment of gift cards. The SAIT (2020:2) further stated that deposits are better understood when gross income as defined in the Income Tax Act 58 of 1962 (hereafter referred to as the “ITA”) is combined with the application of section 24C (allowance for future expenditure) of the ITA and thus integration with other provisions such as section 24C would be useful in this area, which was not covered in the IN. Therefore, IN No. 117 provides little guidance to assist South African suppliers on the income tax treatment of gift card transactions.

The recent tax court case of *ITC 1918* (2019) which dealt with when revenue from the sale of gift cards should be included in gross income for income tax purposes, has also created uncertainty about what the correct income tax treatment arising from the sale of gift card transactions in the hands of suppliers is. In addition, suppliers may not be accounting for gift card transactions uniformly for income tax purposes. The uncertainty with regards to the income tax treatment of gift cards in the hands of suppliers gives rise to questions such as when should the income that arises from the sale of gift cards be included in gross income; what effect, if any, does the CPA have on how suppliers should account for gift card receipts for income tax purposes; when should suppliers claim a deduction for costs incurred to fulfil gift cards and could suppliers possibly claim a section 24C allowance of the ITA which represents an estimation of cost of goods that it would be obliged to provide to gift card holders.

In terms of the ITA, for an amount to be taxable it needs to be included in taxable income of the taxpayer in terms of the gross income definition or under a special inclusion provision that specifically addresses that income (Marais, 2010:2). As the ITA currently does not specifically include the income taxation of gift cards, it then follows that the gross income definition is the base for the determination of the treatment of the taxability of proceeds arising from gift cards for income tax purposes. Similarly with deductions, the ITA does not provide a specific deduction provision for gift cards. According to Hendricksoon (2011:7) gift card transactions can pose several problems for taxation and the basic issue is at what point suppliers should account for income received from the sale of gift cards for purposes of income tax, thus gift cards are a timely

issue for income tax. Over the years the courts had to decide on the timing of receipts of income for tax purposes. The words “received by” from the gross income definition will be relevant in this study. The timing of the costs incurred to fulfil gift cards is also relevant and the words “actually incurred” from the general deduction formula will be relevant. As such, general principles from case law relevant to this study will be considered.

There appears to be gaps in the South African income tax legislation regarding the income tax treatment of gift cards and there is therefore lack of consensus on the correct treatment as a result of all the uncertainty that arises. Unlike countries such as the USA which provide guidance with regards to the income tax implications of gift cards, the ITA contains no such guidance. As such, this study will also seek understanding from the USA on how it deals with the income tax treatment of gift cards.

### **1.1.3 Motivation of topic actuality**

A limited number of academic studies have been conducted on gift cards from a South African tax perspective. Horne and Bendle (2016:154) agreed that taxation on gift cards has received limited studies in spite of being a key element for business strategies of many suppliers. Gift cards have become in demand as the technology for processing and producing them has become inexpensive (Khouja *et al.*, 2011:445). More and more retailers are making gift cards readily available every year, from large chain stores down to small local businesses, as they provide convenience to customers (Anistal *et al.*, 2013:41) and increase profits for suppliers.

According to Grant Thornton (2011) gift cards have become an area of both risk and opportunity for supplying merchants. They are a critical source of profits and at the same time its regulatory environment such as financial reporting and taxation has become more and more complex. As a result, gift cards create income tax issues for supplying merchants (Grant Thornton, 2011). The enormous amount of money represented by gift cards indicates that they must clearly be regulated from a tax perspective (Hendricksoon, 2011:3). However, this is not entirely the case in South Africa as there is no specific literature to address how gift cards should be taxed. According to Fitzpatrick and Suttora (2011) the increasing use of gift cards and tax accounting treatment have led to inconsistent treatment by taxpayers and confusion on the proper timing inclusion of income from gift cards sold.

Academic research has been undertaken in South Africa by Nel (2020) regarding the taxation of gift card transactions. However, this research study was limited to the Value-added Tax (VAT) treatment of gift cards or vouchers in South Africa. The study focused on analysing the VAT

legislation to determine the taxation of vouchers and whether the VAT legislation is clear and comprehensive regarding the application of vouchers (Nel, 2020:6). It is anticipated that the SARS draft IN on the VAT treatment of vouchers (SARS, 2014b) should assist in providing answers to the questions raised in the studies of Nel (2020). However, uncertainty about the income tax treatment of gift card transactions in South Africa has not been attended to. Therefore, the aim of this study is to provide guidance on the income tax treatment on the sale of gift card transactions in South Africa as this has not yet been considered by academic studies. In addition, this study will contribute to South African legislation as this issue has not been given the necessary attention by South African legislators. No definitive income tax treatment of gift cards in the hands of suppliers is yet known.

## **1.2 Problem statement and research question**

The problem identified in this study is that there are no clear and specific guidelines from the South African tax legislators on the income tax treatment of gift card transactions. As a result of the lack of guidance, South African suppliers that sell gift cards could have a mixed understanding on how to correctly account for gift cards for income tax purposes.

The question that arises is thus: What are the areas of uncertainty in the current South African income tax legislation on the income tax treatment of gift cards in the hands of suppliers and how has this issue been dealt with elsewhere?

## **1.3 Research aim and objectives**

The following research aim, and research objectives were formulated to address the research question:

### **1.3.1 Primary objective**

The main objective of this study is to analyse the South African income tax legislation to determine what the areas of uncertainty are in the current legislation on the income tax treatment of gift cards in the hands of suppliers and how these uncertainties have been dealt with in the USA.

### **1.3.2 Secondary objectives**

To achieve the main objective the following secondary objectives have been formulated:

- i. To provide a detailed overview of the concept of gift cards by describing their commercial nature and characteristics. This objective is discussed in detail in chapter 2.
- ii. To analyse the current South African income tax legislation and case law to determine the income tax treatment of gift cards in the hands of suppliers. This objective is discussed in detail in chapter 3.
- iii. To analyse the areas of uncertainty on the income tax treatment of gift cards in South Africa and to determine how the USA has dealt with these shortcomings. This objective is discussed in detail in chapter 4.

#### **1.4 Research design/method**

According to McKerchar (2008:5) “taxation is a social phenomenon that can be studied through various disciplinary lenses, and it is much more than the study of the revenue law itself”. A paradigm is defined as an organising framework for research and theory and includes key issues, pivotal assumptions, models of standard research and methods for looking for answers (Neuman, 2006:96). According to Tuli (2010:103) the research paradigm chosen by researchers depends on their views of the truth in the real world (ontology) and how researchers know it to be real truth (epistemology). The ontological and epistemological assumptions are discussed below, followed by a discussion on the selection of the research paradigm adopted in this study.

##### **1.4.1 Ontological assumptions**

Ontological assumptions are concerned with what is reality, in other words what is discerned to be “real” (Scotland, 2012:9). There are two basic positions within ontology which are realism and relativism (Neuman, 2006:94). A realist’s view is that the existence of reality is external and not dependent on social factors and their interpretations of it (Wahyuni, 2012:69). In this view, research findings are generally represented quantitatively in numbers which speak for themselves (Tuli, 2010:101). On the contrary, a relativist assumes the experience with what is called “the real world” is always occurring through a scheme of interpretations (Neuman, 2006:94) i.e., the view of the world is dependent on a number of factors and circumstances. According to Tuli (2010:101) interpretive researchers use research methodologies that are qualitative in nature to investigate, describe and interpret social realities. The research findings for a relativist are thus reported descriptively using words.

This study followed a relativist view as tax legislation involves an element of interpretation. A descriptive theoretical research was conducted to understand the commercial, economic and legal nature and characteristics of gift card transactions as perceived by different suppliers. This context will form a base to assist in interpreting the income tax legislation which will be analysed. The aim of following a relativist view is to decipher the income tax legislation as it is interpreted differently by researchers who form subjective views subsequently. Furthermore, relevant case law and articles consulted in this study include subjective views which are influenced by human participation and thus an interpretive approach was employed.

#### **1.4.2 Epistemological assumptions**

Epistemological assumptions are concerned with what it means to know, in other words, how knowledge can be acquired, produced, and communicated (Scotland, 2012:9). A researcher that adopts a realist position can create knowledge and learn about reality by making careful observations of it (Neuman, 2006:95). However, when a researcher adopts a relativist position making observations, it will not lead to knowledge about reality because all observations will be significantly influenced by interpretations and views that are subjective (Neuman, 2006:95). Wahyuni (2012:70) agreed that relativists focus upon the details of situation, the reality behind these details, meanings that are subjective and actions that are motivating.

This study mainly focused on theoretical knowledge as such; theoretical research will be considered as a source of evidence with the aim of answering and forming a conclusion on the research question. Knowledge was obtained by analysing and interpreting the South African income tax legislation in its current form as well as relevant case law on the topic. The income taxation of gift cards in the USA was studied to gain an understanding of how the country deals with the shortcomings in the South African income tax legislation on the taxation of gift cards. This study thus considered subjective interpretations and viewpoints of different theoretical sources.

#### **1.4.3 Paradigmatic assumptions and perspectives**

The option of a paradigm sets down the intention, motive and expectations for the research (Mackenzie & Knipe, 2006:2). According to McKerchar (2008:6) there are two core research philosophical paradigms that are traditionally used to design research. These are commonly referred to as positivism and interpretivism. Positivism is adopted by researchers who look for objectivity in their explanation and who are detached from the subjects being studied. The explanations they derive at are based on empirical evidence and hypothesis that are tested (McKerchar, 2008:7). A positivist approach produces knowledge based on deductive reasoning

and a researcher in this philosophical paradigm is more likely to assume an approach that is quantitative in nature (McKerchar, 2008:7).

In contrast, interpretivism gives an apprehension of social reality that is focused on the researcher's subjective interpretation (McKerchar, 2008:7). As such, interpretivists follow inductive reasoning that is aligned towards detection and process, is highly viable and is less concerned with generalisability and more bothered with deeper understanding of the research problem in its unique context (Tuli, 2010:100). According to Wahyuni (2012:71) interpretivists work with qualitative data which impart an account of social constructs and use a narrative form of analysis to interpret specifics and a high description of accounts of a specific social reality being considered. An interpretivist researcher therefore employs a qualitative approach.

Given the broad variation between these two traditional research paradigms, this study followed the interpretive research paradigm which is in line with the relativist view adopted in this study.

#### **1.4.4 Research methodology**

There are a variety of research methodologies with no single accepted methodology applicable to all research problems (Tuli, 2010:99). Wahyuni (2012:70) defined research methodology as a model to conduct research within the context of a specific paradigm. The selection of a research methodology depends on the paradigm that guides the research activity; therefore, research methodology transcribes ontological and epistemological assumptions into recommendations that indicate how research is to be conducted (Tuli, 2012:99,102).

According to Tuli (2012:106) a quantitative research approach endeavours to quantify social phenomena, to collect and analyse numerical data and to focus on the relationships among a small number of characteristics across many cases. On the other hand, a qualitative research approach is more concerned with understanding the meaning of social phenomena (Tuli, 2012:106). Qualitative research is generally about searching for answers and solutions to questions and not about proving or disproving theories (McKerchar, 2008:15). Furthermore, qualitative research approach seeks understanding and clarification rather than a conclusive solution about the size and scale of a phenomenon (McKerchar, 2008:15). This study followed a qualitative approach as the main objective is to analyse and interpret the South African income tax legislation. Inductive reasoning is followed to discover shortcomings in the legislation on the income taxation of gift cards and how the USA has dealt with these shortcomings; the study therefore deals extensively with qualitative data.

This study's overall research approach consisted of an analysis and interpretation of the current South African income tax legislation, case law and other literature; the study thus followed the traditional legal doctrinal methodology. According to McKerchar (2008:18) doctrinal research is embodied by the systematic action of recognising, analysing, arranging and synthesising statutes, and legal decisions and explanations. It is often expressed as the traditional or 'black letter law' approach. McKerchar (2008:19) was of the opinion that doctrinal research is typically focused on reading and overseeing intensive scholarly analysis. This study also followed the content analysis and triangulation methodology. Neuman (2006:166) defined triangulation as the idea that looking at something from multiple viewpoints improves accuracy. Du Preez (2018:33) explained that the logic behind the concept of triangulation is that there is no one method that is adequate to solve a problem; multiple methods provide an in-depth understanding of a phenomenon and increase research credibility. As such, gaining an understanding of how the USA deals with shortcomings identified in the South African income tax legislation will assist the researcher to deal with the research problem in this study. This kind of research method will enhance certainty and reduce research bias in this study (Du Preez, 2018:34).

Tax laws of different countries differ to a vast extent; however, comparing different countries provides an idea of alternative measures to an issue and allows researchers to obtain a profound understanding of the law (Buijze, 2016:189). Comparative research method is descriptive in nature as it describes the legal practice of a particular topic in a selection of countries. As such, it stimulates researchers to think creatively about legal and tax issues to broaden their perspective on available technical measures to find an answer to a research question (Buijze, 2016:191). This study will consider the income tax treatment of gift cards in the USA to gain insight into its management of the areas of uncertainty identified in the South African income tax legislation. The USA was specifically selected as it is one of the few countries where sufficient information and guidance regarding the research topic of this study was available. In addition, the USA is a first-world country that has numerous tax laws in place; it is also one of the most stable economies in the world (World Population Review, 2021).

The above-mentioned further serves to demonstrate the qualitative nature of this study and illustrates that it is in line with the triangulation method and legal doctrinal methodology which, according to Langbroek *et al.* (2017:2), state that texts that are authoritative in nature such as tax legislation, case law and doctrinal literature are regarded as the main formal sources of knowledge for comprehending positive law. Langbroek *et al.* (2017:2) further asserted that researchers can arrange, analyse and decipher this knowledge in such a way as to convince lawmakers, the courts and practitioners to follow their line of reasoning and perception.

The nature of this study is non-empirical, and theory related sources rather than numerical data were relied upon. The secondary data sources that were utilised to conduct the study consisted of the ITA, the CPA, case law, income tax legislation of the USA, tax articles in accredited journals, academic textbooks on tax and relevant dissertations or theses found in academic databases. These sources assisted in providing clarity to the research question as the ITA is the law which should be adhered to and all other sources such as case law interpreted and provided guidance to undefined terms in the ITA. The data will be interpreted and analysed in order of pertinence and effectiveness by probing principles and facts that could aid the topic.

### **1.5 Ethical considerations**

No participants were involved in this study and available existing data was used. The sources used in this study are all publicly accessible. No ethical concerns were identified.

### **1.6 Chapter overview**

#### **Chapter 1: Introduction**

This chapter serves as an introduction to the study and delineates the background and general overview on the income taxation of gift cards. Furthermore, the chapter presents the problem statement including a research question, an outline of research objectives and the research design or methodology adopted.

#### **Chapter 2: The concept of gift cards**

This chapter provides a detailed overview of the concept of gift cards by describing their commercial nature and characteristics. The overview includes a discussion on gift cards' business strategy, a description of its transaction process and the different types of gift card transactions. The accounting treatment, as well as the legal nature of gift cards, is also discussed. The chapter addresses the secondary research objective identified in paragraph 1.3.2(i).

#### **Chapter 3: An analysis of the South African income tax legislation and case law on gift cards**

This chapter provides an analysis of the current South African income tax legislation and relevant income tax principles from existing case law to determine if they contain any provisions which could provide guidance on the income taxation of gift cards in the hands of South African

suppliers. The chapter addresses the secondary research objective identified in paragraph 1.3.2(ii).

#### **Chapter 4: An analysis of uncertainties about the income tax treatment of gift cards in South Africa and guidance from the USA**

This chapter provides an analysis of the areas of uncertainty about the income tax treatment of gift cards in South Africa. The chapter also provides guidance from the USA on how they deal with the shortcomings identified in the South African income tax legislation. The chapter addresses the secondary research objective identified in paragraph 1.3.2(iii).

#### **Chapter 5: Summary and conclusion**

This chapter presents an overall conclusion of this study. It provides a summary of the research findings and suggests possible tax research on the topic in the future.

## **CHAPTER 2 THE CONCEPT OF GIFT CARDS**

### **2.1 Introduction**

The objective of this chapter is to provide a detailed overview of the concept of gift cards by describing their commercial nature and characteristics. The chapter commences with an overview regarding the selling company's business strategy in issuing gift cards, i.e., the benefits of and costs associated with issuing gift cards, and the reasons why customers purchase them. This overview will provide the context as to why gift cards are used. The different types and classifications of gift cards, as well as examples of some gift cards that exist in South Africa are identified and explained. Thereafter, the chapter explains how a gift card transaction is effected by means of a transaction process. To enhance the understanding of the transaction flow, a background overview of the accounting treatment of gift cards is provided as this reflects the economic reality of gift cards transactions.

The chapter further considers the legal aspects of gift cards by analysing the provisions of the CPA and the general terms and conditions of gift cards. This will provide further insight into the commercial nature of gift cards and will also help to achieve the objective in this chapter. The chapter will then conclude by providing insight into which income tax principles should be considered. The conclusions drawn in this chapter are important for the analysis of the South African income tax legislation in chapter 3, because an understanding of the commercial nature and characteristics of gift cards forms the basis on which the topic at hand can be evaluated from an income tax perspective.

### **2.2 Gift cards business strategy**

A gift card is defined as a restricted monetary equivalent issued by retail merchants or banks to be used by customers as a substitute for a non-monetary gift (Definitions.net, 2022). Gift cards mean any pre-paid balance cards, gift certificates, store value cards, gift tokens or similar instruments supplied by the issuing merchant to customers to be used or redeemed to purchase the issuing merchant's products for a specified value (Law Insider, 2022). They are usually subject to terms and conditions set out by the issuing party. The gift card market consists of numerous participants as depicted in the diagram below:

**Figure 2-1: Gift cards market participants**



*Source: The Treasury Australian Government (2012)*

According to the Treasury Australian Government (2012) gift card market participants include gift card issuers (retailers or banks) which are those who issue the gift cards and are thus in charge of honouring the redemption of the gift cards issued. It also includes gift card program operators who are responsible for maintaining information systems and networks required for the usage of gift cards. There is also a growing market for *secondary participants* who are involved in distributing gift cards goods. The ultimate participants are the customers who give and receive the gift cards (Diamond, 2011:977). This study focuses primarily on the gift card issuers (hereafter referred to as supplying merchants or issuing merchants); however, understanding who the market participants are and how they fit in and connect with the issuing merchants is of vital importance to understanding their commercial nature.

In recent years gift cards have gained immense popularity with both customers and issuing merchants (Diamond, 2011:977). Issuing merchants like gift cards because they are big business and a huge source of revenue, whereas customers like them because they are convenient, an alternative to buying a physical gift (Reinholtz *et al.*, 2015:598), and they provide the recipient with a variety of product options to choose from (Kile Jr., 2007:1). Kile Jr. (2007:1) noted that gift cards have a customer-retailer trade-off which is economically justifiable for both parties as retailers derive various commercial and economic benefits from this trade-off. The latter will be discussed below.

### **2.2.1 Benefits of gift cards - issuing merchant's view**

The benefits of issuing gift cards as part of the issuing merchant's business strategy can be grouped into two categories. Firstly, they increase sales and profits and secondly, they result in growth in marketing opportunities for the business (Kile Jr., 2007:1). Yao and Chen (2014:490) noted that the usage of gift cards has become increasingly widespread in retail spaces and

retailers are more and more depending on sales of gift cards for profitability and growth. Horne and Bendle (2016:161) identified numerous components that drive the increase in sales and profitability for issuing merchants. These include an increase in spending by customers, financial benefits that stem from non-redemption ('breakage'), a reduction in price sensitivity by customers as they may spend more than if they were to spend their own money, and a reduction in competitive intensity in the case of closed-loop gift cards (explained in 2.3.1 below). The latter implies that customers are locked and tied into a particular store which overall dampens price comparison by limiting customers shopping at a diverse range of merchants in looking for bargains.

Studies show that there is an increase in spending by customers when they shop using gift cards; they tend to spend less money if they do not have such cards. This means that over and above the initial gift card purchase value that issuing merchants receive, they also generate extra revenue as a result of the gift card sale; this makes gift cards effective marketing tools to increase issuing merchants' revenue (Norvell & Horky, 2018:399). It is estimated when research was done that gift card recipients spend about 20% to 40% beyond the initial value of the gift card (Horne, 2007:193). Hendricksoon (2011:5) agreed that gift card sales result in increased revenue because customers are most likely to spend more than the value that is on the gift card when they redeem it. On average customers spend about 1.4 times the value of the gift card (Marden & Forsyth, 2007:28).

The increase in spending is explained differently by many researchers. Kile Jr. (2007:1) explained that the product selection of a gift card can persuade those buyers who are indecisive to make purchases that they may not have made in the first place, thus resulting in additional spending, whereas Yao and Chen (2014:490,491) mentioned that users of gift card users tend to deviate from their normal spending habits because they view the redemption of gift cards as a reward and as such it results in additional spending. According to Norvell and Horky (2018:399) this concept of additional spending can be referred to as "windfall gains" which refers to gains in income that may not have been anticipated. Diamond (2011:983) put it differently and noted that this concept means to gain an "economic gain independent of work, planning or other productive activities, which is desirable to society".

This phenomenon of increased spending on gift cards is further explained by Norvell and Horky (2018:399) who used the idea of the "pain of paying" for something. In this scenario gift card users would normally spend more than they would usually spend in a given consumption circumstance since they will not be using their own money and as such gift cards are easily spent and

consumers experience a “low pain of paying” in contrast to paying cash. Whatever the reason is for an increase in spending, gift cards are a material and a significant contributor to the issuing merchants’ business profit in its own right (Kile Jr. & Wall, 2008:80).

Non-redemption of gift cards is an important benefit to merchants (Zhang *et al.*, 2018:93) and a notable part of the retail sales economy (Jones, 2009:215). Non-redemption of gift cards can boost merchants’ cash flows in the short term and enhance their profits in the long term (Kile Jr. & Wall, 2008:76). According to Grant Thornton (2011) there are a lot of gift card purchases that are never redeemed which is perhaps the greatest benefit to merchants. On average, an estimate of balances on gift cards that are never redeemed, also known as breakage, span from 10% to 19% (Grant Thornton, 2011). Horne (2007:193) agreed that on average it has been estimated that on average 10% of the value of gift cards may not be redeemed. According to Horne (2013:1) non-redemption occurs for varying reasons which include the loss of the card, inappropriateness, inconvenience, undesired store choice, or values which are too low to worry about, as well as procrastination. These unredeemed amounts can have a notable influence on many businesses’ profits (Grant Thornton, 2011).

Hendricksoon (2011:5) stated that the sale of gift cards is beneficial to businesses because it leads to increased marketing opportunities. These marketing opportunities reduce the burden of unwanted gifts being returned by customers, they create store loyalty, attract new customers and raise brand awareness (Jones, 2009:215). Miron (2019:1) explained that gift cards raise brand awareness which is valuable for issuing merchants because it results in the introduction of new customers to a retailer’s brand or store that customers may have been ignorant about. Thomas and Dillenbeck (2004:53) noted that gift cards work as a marketing tool because over and above them being used as traditional gifts, they can be used in exchange for returned products, as rechargeable credit cards or even as reward incentives for frequent customers. Another benefit that yields an increase in marketing opportunities is that incremental information that is gathered from gift card transactions can be used in designing future promotions and other marketing plans (Hendricksoon, 2011:5).

### **2.2.2 Benefits of gift cards - customer’s view**

There are two groups of customers, the giver which is the person who purchases the gift card, and the recipient who ultimately receives and uses the gift card by redeeming its value. Both benefit from the use of gift cards. There are numerous reasons why customers purchase gift cards. Gift cards offer customers ease of convenience because according to Diamond (2011:977) they result in a reduction in transaction costs. They are easy to utilise, easy to hold and are

appropriate for everyone from family members, friends or employees (Hendricksoon, 2011:4). According to Horne and Bendle (2016:158) the customer that purchases the gift card only has to select the merchant where the recipient will eventually select the actual good or service they prefer, which will lead to satisfaction as the purchaser may have little knowledge on what the recipient prefers. In addition to this, the purchaser will notably decrease the time spent and invested in searching and purchasing a gift. Therefore, gift cards are valued by customers because they reduce the risk of buying an unwanted gift (Horne & Bendle, 2016:159).

Customers prefer gift cards to receiving cash as a gift because the latter is often viewed as inappropriate as it indicates that the purchaser did not put in much thought in finding the right gift (Felső & Soetevent, 2014:284). However, this is more beneficial in respect of open-loop gift cards (explained in 2.3.2 below) which may be redeemed anywhere (Anistal *et al.*, 2013:41) as opposed to closed-loop gift cards (explained in 2.3.1 below) which may be redeemed at selected issuing merchants (Marden & Forsyth, 2007:28). Waldfogel (1993:1328) noted that gift cards lessen the dead weight loss of gifts that do not cater for the needs and preferences of recipients. This is one of the reasons gift cards are becoming useful to many customers.

Based on a study conducted by Anistal *et al* (2013:46), recipients of gift cards perceive it as a positive event because they may shop for and select any good or service they want. The cards are economically viable because recipients do not spend their own money in acquiring the good or service. Recipients, therefore, have the benefit of choosing whichever gift they want from multiple alternatives, and this results in a rise in utility and satisfaction as the recipients would choose something they desire (Waldfogel, 1993:1329). Miron (2019:1) agreed that recipients of gift cards view them as “free money” and this gives them positive emotions towards the issuing merchant where they will redeem the gift card. This is a gain for the issuing merchant because it expands their customer base as the recipient is more likely to return to the store as a new customer.

### **2.2.3 Costs linked to gift cards**

Zhang *et al.* (2018:93) pointed out that gift cards can become costly for both issuing merchants and customers. The issue of gift cards may result in costs incurred for issuing merchants with respect to printing and selling the cards, whereas customers may receive gift cards for brands they do not favour. According to Norvell and Horky (2018:400) there are direct and indirect costs associated with gift cards for issuing merchants which include the costs of designing, creating and administering the cards. In addition, issuing merchants may incur reverse logistical costs

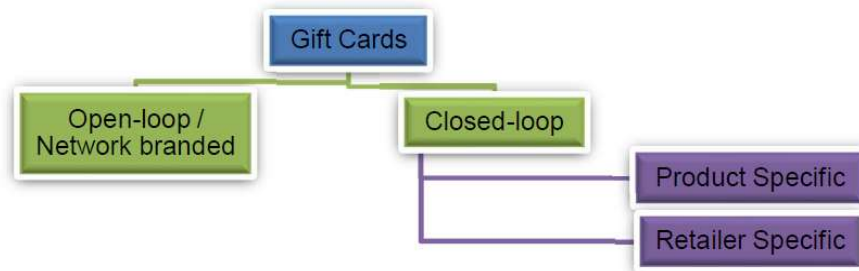
such as handling fees and restocking costs in instances when customers return items to the store (Horne & Bendle, 2016:161).

Customer loss, on the other hand, occurs in rare cases when a supplier or issuing merchant goes into bankruptcy or administration. The customer will become an unsecured creditor who will bear the risk of default and will have less chance of recovering any value associated with the gift card (Horne & Bendle, 2016:156). It can be undoubtedly stated that businesses gain or benefit more from their gift card programs and such gains outweigh the losses they may incur (Norvell & Horky, 2018:398). Yao and Chen (2014:481) explained that it is important that retail organisations prudently develop their gift card program strategy to maximize profits.

### 2.3 Types of gift cards

Two broad categories of gift cards can generally be distinguished, i.e. closed-loop gift cards and open-loop gift cards (Diamond, 2011:976). According to Zhang *et al.* (2018:92) closed-loop gift cards have two sub-categories which are product-specific gift cards and retailer-specific gift cards. Open-loop gift cards have a similar concept to network-branded gift cards. The broad categories of gift cards can be illustrated by means of the diagram below, developed by Nel (2020:13).

**Figure 2-2: Broad categories of gift cards**



Source: Nel (2020:13)

The two broad categories of gift cards will be discussed in more detail below.

#### 2.3.1 Closed-loop gift cards

Closed-loop gift cards are those that are directly issued by or on behalf of a specific merchant or retailer (Horne & Bendle, 2016:155). They are usually non-refundable and as a consequence are highly spendable (Yao & Chen, 2014:491). As illustrated in figure 2-2 above, closed-loop gift cards have two sub-categories, i.e. product-specific and retailer-specific gift cards. Product-specific gift

cards are those that are used to purchase a particular product at a retailer that normally has the type and quantity of goods to be redeemed as pinpointed on the card (Zhang *et al.*, 2018:92). One of their features is that they are used by retailers for seasonal products that have short life spans (Zhang *et al.*, 2018:92). In distinction, retailer-specific gift cards (also known as store-specific gift cards) are used to purchase any type of product from a particular retailer (Yao & Chen, 2014:483) or they can be redeemed at other issuing merchants which are usually a chain of stores of a particular retailer group (Dennis-Escoffier, 2015:121).

It is fair to infer that both retailer-specific and product-specific gift cards have some common features as both are only redeemable at any particular retail merchant or a group of retail merchants. They are more restrictive (as compared to open-loop gift cards explained below in 2.3.2) and their flexibility is of a lower degree with regards to their consumption options; they have a limited choice for the recipients of the gift cards as the redemption of the value of the card can only occur at specific issuing merchants (Yao & Chen, 2014:483). There are a wide range of suppliers in South Africa that issue both sub-categories of closed-loop gift cards. Examples range from departmental shops such as Makro (2021) and Edgars (2021) to restaurants such as the Spur restaurant chain (Spur, 2021), as well also movie theatres such as Ster kinekor.

One of the features of closed-loop gift cards is that they are directly purchased from retailers for fixed amounts and their accounts are maintained directly by that retailer (Diamond, 2011:976). According to Norvell and Horky (2018:400) closed-loop gift cards can be used in various ways which include the obvious method where it is sold to a customer who would then offer it as a gift to a recipient. Another way is that the gift card is offered for free as a promotional tool. Closed-loop gift cards used for promotional purposes are in most cases offered to existing customers. Whereas new customers are mainly targeted to encourage them to return to the specified stores (Ernstberger *et al.*, 2012:191).

### **2.3.2 Open-loop gift cards**

According to Thomas and Dillenbeck (2004:53) open-loop gift cards are issued by financial institutions (banks and credit card companies) and are redeemable anywhere a debit or credit card is accepted. They have similar features to network branded gift cards, which according to Zhang *et al.* (2018:92), work in a credit card set-up and are redeemable at any merchant (related or unrelated) that will accept the card. These type of gift cards operate in a similar manner to debit or credit cards as they also have funds stored on the card held by an issuing bank (Zywicki, 2013:1486). As such, open-loop gift cards (or network branded gift cards) offer similar benefits to a debit or credit card which include convenience, acceptance anywhere, and the ease

of making electronic payments (Zywicki, 2013:1479). Open-loop gift cards are not restricted in terms of usage and can thus be used for almost any type of product purchase at any store (Reinholtz *et al.*, 2015:599). For example, Standard Bank in South Africa (2021) offers prepaid cards; the terms and conditions specifically note that the prepaid open-loop gift card can be used where a Visa or Mastercard is accepted.

Research shows that customers prefer open-loop gift cards to credit cards because of ambivalence in the banking system, and they can be more cautious about their spending decisions (Zywicki, 2013:1503). According to Zywicki (2013:1520) the use of open-loop gift cards is growing the retail consumer banking system rapidly. In South Africa, quite a number of banks launched prepaid open-loop gift cards in 2008 (Groine, 2009:11). An example is the prepaid card offered by Standard Bank (2021), as mentioned earlier. Groine (2009:10) also noted that shopping centres countrywide implemented open-loop gift card programs that have a Visa or Mastercard brand if local banks were involved as Bank Identification Number (BIN) sponsors. Open-loop gift card transactions will thus have similar characteristics to those of a debit or credit card transaction (Ammons *et al.*, 2012:2). Open-loop gift cards are not limited by a specific period of time, and they are widely accepted (Korpus Prava, 2021). However, a disadvantage is the high fees associated with them (Horne & Bendle, 2016:162) such as handling fees in contrast to closed-loop gift cards (Offenberg, 2007:228).

#### **2.4 Gift cards transaction trail**

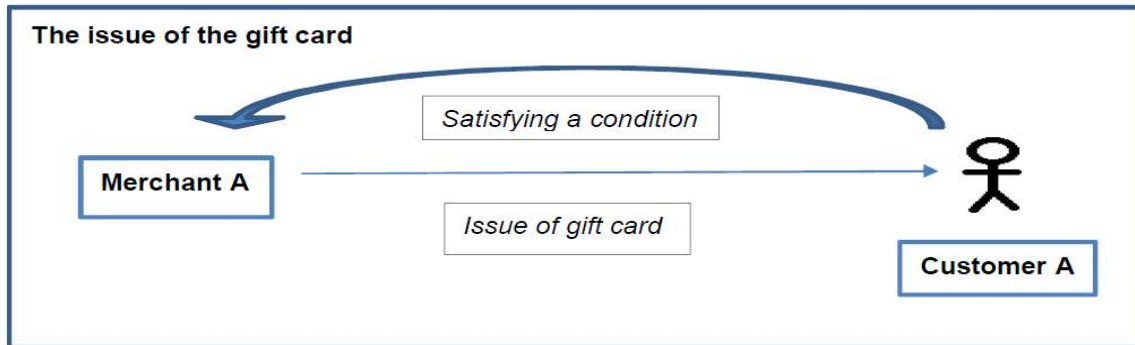
From the discussion above it is clear that gift cards have various features and different variations. What can be discerned, however, is that the core of every gift card transaction is the same. For any type of gift card there are four characteristics that Wright (2016:1) considered to be the most common and these are:

- There is an obligation on the issuing merchant to supply promised goods or services in future to the gift card recipient;
- the gift card recipient has the right to claim the promised goods or services in future;
- gift cards are in their nature prepaid; and
- gift cards cannot be refunded and are non-redeemable for cash.

It is important to understand how gift cards operate. Nel (2020:15) explained that by breaking down the transaction process into three stages and developed a “three-stage model” which demonstrates the different stages that have been identified about most gift card transactions while

being cognizant that the stages might differ based on the terms and conditions of specific gift cards, the intention of the issuing merchant, and preferences of the recipient. The figures below give a summary of the operation of the three-stage model.

### **Stage 1 - Issue**



**Figure 2-3: Stage 1 - Issue**

Source: Nel (2020:16)

According to Dennis-Escoffier (2015:121) in a typical gift card arrangement the issuing merchant (the issuer) accepts cash in exchange for a promise to supply goods or services in future and the customer (the purchaser) is given the card as proof of this payment in advance. Simply put, the issuing merchant will issue a gift card to a customer after a customer has satisfied a condition (i.e. after having paid for the gift card). When customers partake in gift card transactions, they are deemed to have accepted the terms and conditions of the gift cards by virtue of them partaking in the transaction. It is thus important for customers to read the terms and conditions of the card they have bought as these may vary from issuer to issuer (These will be discussed below in section 2.6.1).

### **Stage 2 - Redemption**

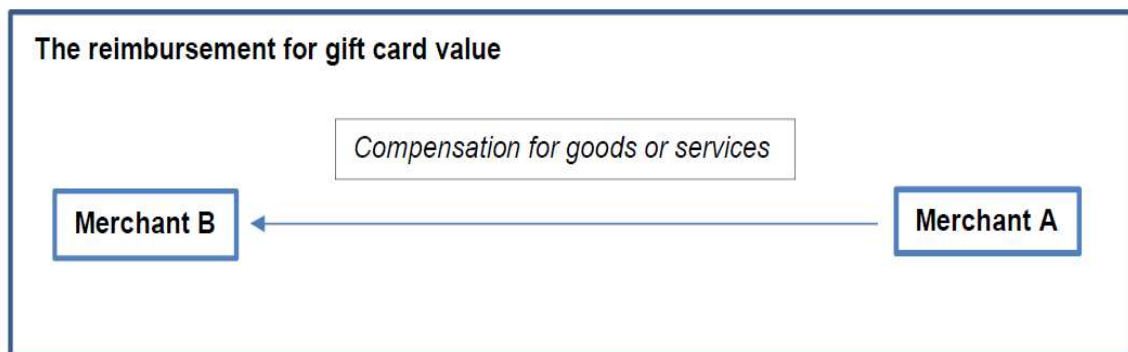


**Figure 2-4: Stage 2 - Redemption**

Source: Nel (2020:17)

The second stage as illustrated in figure 2-4 depicts that once a gift card has been issued, the customer (either the purchaser or the recipient of the gift card) will redeem the gift card value for goods or services in future. The card may be redeemed at either merchant A, the original issuing merchant of the card or merchant B, another issuing merchant who generally has an arrangement with the original issuing merchant of the gift card to provide the goods or service. This arrangement is normally specified on the terms and conditions of the gift card (Dennis-Escoffier, 2021:121). For example, the terms and conditions of gift cards issued by Shoprite Checkers (Pty) Ltd (2021) stipulate that their gift card can be redeemed at any retail supermarket outlet that is conducted by Shoprite Checkers (Pty) Ltd which includes Shoprite, Shoprite Hyper, Checkers and Checkers Hyper stores.

### **Stage 3 - Reimbursement**



**Figure 2-5: Stage 3 - Reimbursement**

Source: Nel (2020:17)

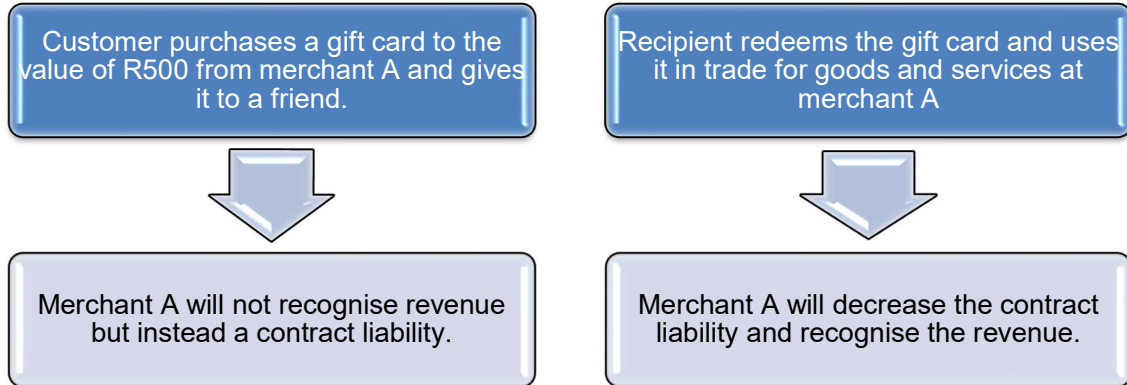
The third stage normally occurs in an arrangement when the customer has redeemed goods or services from another issuing merchant (merchant B as illustrated in figure 2-5) and not the original issuing merchant. The original issuing merchant (merchant A as illustrated above) will reimburse the other issuing merchant (merchant B) for the value of goods or services that have been redeemed by the customer. In cases where the customer redeems the goods directly from the original issuing merchant of the gift card, for example Makro gift cards may only be redeemed at Makro branches (Makro, 2021), then stage 3 will not be applicable. Usually there is an agreement that stipulates that there should be a reimbursement between the participating merchants in instances when customers redeem gift cards at another issuing merchant that did not issue the gift card (Nel, 2020:44).

## 2.5 Accounting treatment of gift cards

In order to enhance the understanding of the transaction flow of gift cards, the accounting treatment needs to be considered. The accounting treatment of the sale of gift cards is important as it reflects the economic reality of the nature of gift card transactions. It can also assist in distinguishing if there could be any correlation between the operation of gift cards from an accounting perspective to a tax perspective and whether the treatment between the two disciplines can be aligned. IFRS 15 – *Revenue from contracts with customers* is the accounting standard that governs the accounting implications of gift card transactions. The standard has been adopted by numerous businesses in South Africa as their financial reporting standard for revenue. In terms of IFRS 15 (2014: A799), the core principle of the standard is that “an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services”. Therefore, revenue recognition for accounting purposes will occur as goods or services are transferred to a customer.

According to PWC (2016) when a customer buys a gift card, he/she is paying in advance for goods or services that are to be delivered in future by the supplier or issuing merchant. As a result, the issuing merchant has an obligation to deliver those goods or services in future, thereby creating a performance obligation. Under the general framework of IFRS 15, a company should recognise revenue as and when a performance obligation is satisfied by transferring the guaranteed goods or services to a customer. In the case of gift cards, the issuing merchant will satisfy its performance obligations when a customer redeems a gift card, and the issuing merchant will supply the promised goods or services to the customer (Deloitte, 2018). IFRS 15 stipulates that when a supplier receives a prepayment for goods or services from a customer, it should recognise a contract liability and only recognise the revenue when those promised goods or services are transferred in the future (IFRS 15, 2014: A841). For gift card transactions, the following basic example illustrates the recognition of gift cards for accounting purposes:

**Figure 2-6: Example of revenue recognition for gift cards**



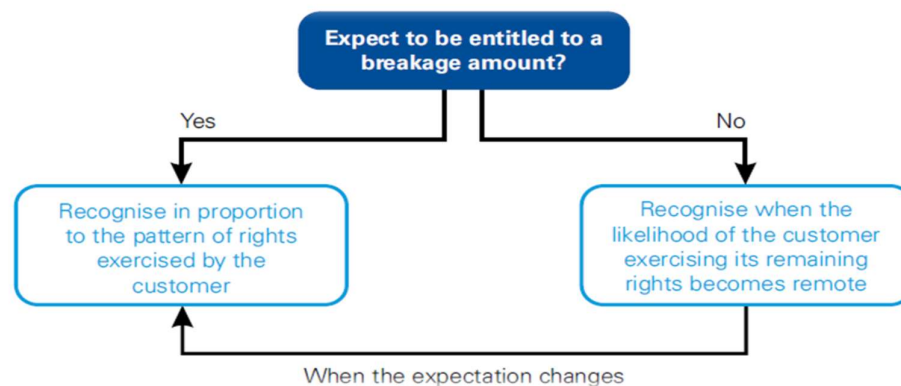
*Source: Author's own*

When issuing merchants sell gift cards, a contract liability is recognised and it will be derecognised when customers redeem the cards for goods or services in future. At that point revenue can then be recognised because the related performance obligation has been fulfilled (Chartered Professional Accountants, 2015:37). There may be instances where customers do not use their contractual rights to redeem the gift cards in full (or at all) and as a result some of the amounts may be forfeited. The amount that is forfeited or unredeemed is referred to as breakage or the 'unexercised right' (Chartered Professional Accountants, 2015:37). Some gift card recipients may use the card and leave some money on it which might end up being disregarded because it may be viewed as immaterial or it can simply be forgotten (Hendricksoon, 2011:7). The unredeemed value of the gift card represents a loss in customer value (Horne, 2013:2).

Companies do not all recognise breakage from gift card sales in the same way. For instance, some companies rely on prior experience to determine the likelihood of the card to be redeemed. As such, it takes experience and time for businesses to establish patterns of breakage accurately (Hendricksoon, 2011:13). PWC (2016) noted that breakage will typically result in the issuing merchant recognising the income; however, the timing of the recognition will depend on the expected behaviour of the customer and any legal restrictions, if applicable, in a pertinent jurisdiction.

The following figure illustrates the timing of the revenue recognition for breakage for accounting purposes.

**Figure 2-7: Timing of revenue recognition related to breakage**



Source: KPMG (2019a)

Figure 2-7 illustrates that the timing of recognition for revenue related to breakage will depend on whether a business expects to be entitled to the breakage amount (IFRS, 2014: A811). IFRS 15 (2014, A811) states that the amount of breakage that an entity determines it is entitled to, is the amount that is considered highly probable that the occurrence of a significant reversal will not happen in future. If a business expects that it will be entitled to a breakage amount in a contract liability, then it may recognise the revenue in breakage in proportion to the pattern of rights exercised by the customer (Deloitte, 2018). However, if a business is unable to sufficiently predict whether it will be entitled to the breakage amount or if it is unable to estimate it, then revenue on breakage will be recognised when the chance of the customer exercising its outstanding right becomes remote (PWC, 2016). An example of an instance of a likelihood that a customer exercising its rights has become remote is when the gift card expires (KPMG, 2019a).

## 2.6 Legal nature of gift cards

A gift card can be classified as an advance payment which assumes that there is a contract (Korpus Prava, 2021:1). According to Joubert *et al.* (2004:370) a contract is defined as “an agreement entered into with the intention of creating an obligation or obligations”. A contract is considered binding and valid in South Africa when consensus (in the manner of an offer and a corresponding acceptance) is reached regarding the rights and obligations created by the terms and the parties of the contract (The Law Reviews, 2021).

There is debate in law whether a gift card is a contractual document, or if it should be regarded as merely a voucher that just sets out promised goods or services. A contract is only enforced

when there is unanimity between the parties of the agreement as to its terms and conditions (Jones, 2009:219). Terms and conditions can only be effective if they are what a reasonable person would expect to see in a gift card, the customer is aware of them, and the issuer has done everything to draw the buyer's attention to the terms and conditions (Jones, 2009:220).

The CPA implies that a gift card transaction is some form of agreement or contract. Section 63(1) of the CPA notes that:

The section applies only to a transaction in which a supplier -

(a) accepts consideration from a person in exchange for a prepaid certificate, card, credit, voucher or similar device; and

(b) expressly or implicitly agrees to provide goods or services to any person who subsequently presents that certificate, card, credit, voucher or similar device, up to the value represented by it,

but does not apply with respect to such a device, or the value represented by it, after all of the value of the device has been exchanged for goods, services or future access to services. (p. 116)

In essence a gift card is essentially a contract or an understanding between parties (the issuing merchant and the customer) where the customer has a right to receive goods or services in future at an amount equal to the value specified on the gift card (Jones, 2009:219). According to Korpus Prava (2021:1) a gift card can be classified as a deposit given by one party to another as evidence to contract and to ensure execution of the contract. A deposit is defined as "a sum of money which is part of the full price of something, and which you pay when you agree to buy it" (Collins Dictionary, 2021), or a "down payment or prepayment instalment" (Oxford Dictionary, 2021). Further consideration of deposits will be analysed and discussed in chapter 3 of this study.

The terms and conditions on a gift card are usually what a reasonable person would expect to see in a gift card. The issuing merchant stipulates them on the gift card to make the customer aware of those conditions. Accordingly, a gift card is a certification of certain rights, the content of which is set out in the terms and conditions formulated by the issuing merchant of the gift card. The buyer of the gift card is merely acquiring a right by being in possession of the gift card and when the card is transferred from one owner to the other, the recipient, the new owner then becomes the holder of the right (Kile Jr. & Wall, 2008:79). Likewise, the issuing merchant has an obligation for the provision of goods or services when it accepts a consideration for the gift card (TaxGuru, 2021). The terms and conditions of various gift cards will now be analysed to further understand their legal nature.

## **2.6.1 Terms and conditions of gift cards**

Each gift card has attached terms and conditions. When a customer purchases a gift card, he/she automatically accepts the terms and conditions attached to the said gift card even though they may not be required to physically sign an agreement. According to Diamond (2011:977), gift cards in either of the two categories, closed-loop and open-loop, have various terms and conditions which include the ability to top up the card to put in additional funds, options to replace the card if it is lost or stolen, expiry dates, and some may have fees charged to it. Marden and Forsyth (2007:28) agreed that gift cards have a variety of conditions attached to them, for instance it may include monthly fees, carry activation fees and have expiry dates which would lead to the value of the card being nil if not used within a certain period. According to the Treasury Australian Government (2012) the terms and conditions of gift cards can be summed up as expiry date, restrictions on using the card when it has a low balance, fees and charges, limitations on the use of the card, receiving change, and lost, damaged or stolen gift cards.

It can thus be deduced that the most distinguishing variances in the terms and conditions of gift cards in general include the validity or expiry dates on the cards, restrictions on the use of the cards, types of fees applicable, reloading the card and replacement of lost or stolen cards. Some of these terms and conditions will be discussed briefly below.

### **2.6.1.1 Validity of gift cards**

Thomas and Dillenbeck (2008:53) explained that expiry dates on gift cards can be one of the most difficult and trickiest legal issues for issuing merchants. An expiry date sets a time frame in which a gift card must be redeemed by the gift card holder. It is important that the gift card holder is aware of the expiry date because should the he/she not redeem the gift card value within the prescribed time frame, he/she will not be able to receive anything, which is a loss on the customer's part (Jones, 2009:221). Jones (2009:221) further stated that this is why the expiry date is regarded as a contract term for a gift card sale transaction. Most vendors in South Africa draw refer to the CPA with regard to the validity period of gift cards. Section 63(2) of the CPA states the following:

A prepaid certificate, card, credit, voucher or similar device contemplated in subsection (1) does not expire until the earlier of -  
(a) the date on which its full value has been redeemed in exchange for goods or services or future access to services; or

(b) three years after the date on which it was issued, or at the end of a longer or extended period agreed by the supplier at any time. (p.116)

Based on research conducted in this study, it appears that most terms and conditions of gift cards issued in South Africa have a three-year validity period. The Shoprite Checkers (Pty) Ltd gift card's terms and conditions specifically mention the CPA. It stipulates that it legislates a three-year validity period as per the CPA, i.e. their gift cards will expire after three years from the date they have been issued or until the full value of the card is redeemed whichever occurs first (Shoprite Checkers, 2021). Makro (2021), Exclusive Books (2021) and Takealot (2021) also specify that their gift cards should be redeemed within three years after they have been bought. In addition to the three-year validity period, Edgars (2021) notes in their terms and conditions that should the gift card be topped-up or loaded with additional funds, it will remain valid for three years from the top-up date or until they have been redeemed in full, whichever occurs first. Clicks (2021) also state that their voucher is valid for three years from the date they have been issued or the date when additional funds have been loaded. It can be deduced that most gift cards in use in South Africa are valid for three years from the date of issue or until they expire or until the date they have been fully redeemed, whichever occurs first. This is also consistent with the provisions of the CPA.

#### **2.6.1.2 Restrictions on the use of gift cards**

Some gift cards have restrictions in terms of usage such as whether they are redeemable for cash or refundable, and some may be restricted in terms of where they can be redeemed. According to paragraph 2 and 4 of Makro's terms and conditions, gift cards can only be redeemed at Makro stores, and they cannot be exchanged for cash or credit, and in addition they cannot be returned (Makro, 2021). Green Cross South Africa (2021) has similar provisions in that their gift card is only exchangeable for goods at any Green Cross shop within South Africa and they may not be redeemed for cash or the customer will not be refunded. Shoprite Checkers (Pty) Ltd noted that any value remaining on the gift card after the expiry date will not be refunded to customers (Shoprite Checkers (Pty) Ltd, 2021). Standard Bank's (2021) restriction on the use of its prepaid cards states that the card cannot be reloaded with more money. These are some of the significant restrictions found on gift cards' terms and conditions.

#### **2.6.1.3 Fees on gift cards**

The charging of fees applies in most instances to open-loop gift cards as opposed to closed-loop gift cards as the issuers of open-loop gift cards are usually financial institutions (Ammons *et al.*,

2012:2). Zywicki (2013:1488) explained that open-loop gift cards have many types of fees attached to them, such as fees for the issuance of the card, for activating the card, reloading it, charges for using the card at an ATM, fees to cover processing costs, fees for stolen or damaged cards, and in some cases, fees charged for customer service. There are also dormancy fees that may be charged for failure to use the gift card. Financial institutions typically earn a large sum of money from balances of unused gift card which result in standard interchange fees that are typically applied to a normal debit or credit card (Ammons *et al.*, 2012:2). Since gift card programs are often expensive to operate, merchants charge service fees e.g. a dormancy fee when a customer fails to redeem the gift card value within a certain period (Thomas & Dillenbeck, 2008:54).

Fees are not usually applicable for closed-loop gift cards According to Kile Jr. and Wall (2008:78), issuing merchants have reduced the number of fees charged in recent years, or they charge small fees, and some have stopped charging fees altogether. For instance, Starbucks (2016) noted in their terms and conditions that they do not charge any fees for activation, service, and dormancy, or for the card being inactive. As a result, companies have started to eliminate charging service fees on their gift card programs (Thomas & Dillenbeck, 2008:54).

## **2.7 Conclusion**

This chapter described the concept of gift cards in order to understand their commercial nature and characteristics. There are numerous benefits for using gift cards from both the issuing merchant's and the customer's viewpoint. These benefits are the main reason why businesses sell gift cards as part of their marketing strategy, and it is thus important that businesses understand the regulatory environment of gift cards such as their taxation as gift cards are big business and a major part of the issuing merchants' profits. Two main types of gift cards, closed-loop and open-loop gift cards with their sub-categories were identified, together with their characteristics and various features. The transaction process of gift cards was also demonstrated using the 'three stage model' to describe how gift cards operate commercially.

To further elaborate on the transaction flow, the accounting treatment of gift cards was explained. Accounting literature notes that the sale of gift cards is recognised as revenue at the time when the value of the card is redeemed. In instances of non-redemption, the recognition of revenue will depend on whether the issuing merchant expects to be entitled to that revenue amount or not. The legal nature of gift cards was also discussed, and the terms and conditions of gift cards were identified. What can be discerned from this discussion is that gift cards are essentially a contract or agreement between the issuing merchant and the customer. In this agreement the customer

has a right to claim goods or services in future from the issuing merchant and the issuing merchant is obliged to provide those goods or services to the customer. Both parties are bound by the terms and conditions of the gift card. It can be deduced that the sale of gift cards is similar to a deposit, amounts received in advance, or a prepayment.

The conclusions drawn from this chapter are essential to the analysis of the South African income tax legislation in chapter 3 as understanding the commercial nature and characteristics of gift card transactions forms the basis of the income taxation of gift cards. This understanding will assist in analysing the South African income tax legislation to determine if it provides any provision on the income tax treatment of gift cards in the hands of suppliers in South Africa.

## **CHAPTER 3     AN ANALYSIS OF THE SOUTH AFRICAN INCOME TAX LEGISLATION AND CASE LAW ON GIFT CARDS**

### **3.1 Introduction**

The purpose of this chapter is to provide an analysis of the South African income tax legislation and of the relevant income tax principles from existing case law in South Africa on the income tax treatment of gift card transactions. As noted in chapter 1, there is currently no guidance from the South African legislators on the income taxation of gift cards. Therefore, the South African income tax legislation and case law are analysed in this chapter to determine if there are any provisions contained in the South African law which could provide direction on the income tax treatment of gift cards by South African suppliers. The theoretical construct of this study will be established first in order to identify the relevant aspects of the income tax legislation to be considered for gift cards.

In order to achieve this, the gross income definition in section 1 of the ITA, together with principles from relevant case law, will be analysed. The case of *ITC 1918 (2019)* will then be analysed in detail as it specifically deals with the issue of the timing of gift cards from an income tax perspective by a South African supplier. Thereafter, these income tax principles from the legislation and case law will be applied to analyse the income tax treatment of the two broad categories of gift cards identified in chapter 2, being closed-loop and open-loop gift cards. The tax implications of the outflows to honour gift cards will thereafter be briefly discussed by analysing the general deduction formula in section 11(a) of the ITA with relevant case law principles, and the availability of the section 24C allowance contained in the ITA. This approach will assist in determining what the areas of uncertainty are about the income tax treatment of gift cards in the hands of suppliers in South Africa.

### **3.2 An analysis of the South African income tax legislation on the taxability of the proceeds from issuing gift cards**

In terms of the South African income tax legislation, for an amount to be taxable it needs to be included in the taxable income of the taxpayer in terms of the gross income definition contained in section 1 of the ITA. According to the section:

- gross income, in relation to any year or period of assessment, means –
- (i) in the case of any resident, the total amount, in cash or otherwise, received by or

accrued to or in favour of such person...during a year or period of assessment, excluding receipts or accruals of a capital nature... (p. 10)

This study only focuses on South African resident suppliers and as such the second proviso of the gross income definition referring to any amount from a source within or deemed to be within the Republic will not be considered. Paragraphs (a) to (n) of the gross income definition in section 1 of the ITA contains specific inclusions which deem the amounts listed in these paragraphs to be included in gross income irrespective of whether the amounts are revenue or capital in nature. The ITA does not specifically include the income taxation of gift cards; therefore, the gross income definition is the base for the determination of the treatment of gift cards for income tax purposes. As such, a supplier who sells gift cards in South Africa must comply with all the requirements of the gross income definition before amounts from the sale can be subject to income tax. The taxpayer has, in terms of section 102(1)(a) of the Tax Administration Act 28 of 2011, the burden to prove whether such amounts or transactions are not taxable.

The ITA does not define the terms of the elements of the gross income definition, therefore relevant case law is analysed to provide clarity to the meaning of the different elements of the definition.

### **3.2.1 Total amount in cash or otherwise**

The first element of the gross income definition refers to the presence of an amount in cash or otherwise. It was held in *Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd* (1945) that the word “amount” means a thing that has value monetarily. Further, in *Commissioner for Inland Revenue v People’s Stores (Walvis Bay) (Pty) Ltd* (1990) it was ruled that accruals or receipts include “every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a money value”. It is submitted that gift card transactions have a monetary value. As illustrated in stage 1 of the gift card transaction trail in chapter 2.4, when a gift card (whichever type) is issued, a business accepts cash in trade for a promise to supply goods or services in future. Therefore, there is an amount which has a money value that is ascertainable. Gift cards thus meet the first element of the gross income definition.

### **3.2.2 Received by or accrued to during a year or period of assessment**

The terms “received by and accrued to” are not defined in the ITA, and thus case law will again be considered and interpreted. This is the fundamental aspect in determining the timing of inclusion of proceeds in gross income in respect of gift cards. It was held in the case of *WH*

*Lategan v CIR* (1926) that the term “accrued to” means an amount to which a taxpayer is “entitled to”. This principle was also confirmed and amplified in *Mooi v Secretary for Inland Revenue* (1972) to mean to become “unconditionally entitled” to. The implication is that proceeds from the issue of gift cards will only accrue to taxpayers when they are unconditionally entitled to the amounts. While it was held in *Geldenhuis v Commissioner for Inland Revenue* (1947) that the term “received by” means “received by the taxpayer on his own behalf for his own benefit”. Furthermore, it was held in the *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* (1955) that physical control over an amount does not constitute a receipt. Therefore, mere receipt of an amount does not certainly mean that the amount should be included in gross income.

As deduced in chapter 2, receipts of gift cards sold by issuing merchants are in their nature similar to deposits; it is therefore relevant to consider interpretations provided by the courts with regard to the taxation of the receipt of deposits. In *Pyott Ltd v Commissioner for Inland Revenue* (1945) the taxpayer provided a refundable deposit to customers who returned tin containers. It was stated by the court that if the money received as deposits for the tin containers were “banked in a separate trust account set up specifically for the deposits received, then such amounts deposited would not constitute gross income”. In *Brookes Lemos Ltd v Commissioner for Inland Revenue* (1947) the taxpayer also charged a refundable deposit for the return of containers by the customers without imposing any obligation to do so. It was held that “the seller was in no sense a trustee or pledgee. On the contrary the deposits became the absolute property of the company” and thus they were beneficially received by him for the purposes of gross income. The fact that the taxpayer was to pay the customers for the returned containers did not make the company a trustee with respect to those deposits.

These principles were also confirmed in *Greases (SA) Ltd v CIR* (1951) where it was ruled that the amounts of deposits were received by the taxpayer for its own benefit as they were used by the taxpayer in its ordinary business and were not held in a trust account. The principles established in these so-called deposit cases is that for a taxpayer to exclude an amount from gross income, the amount received must be held in a ‘trust’ in the legal sense of the word (Williams, 2015:153). According to SARS (2021:6) having a separate bank account or keeping strict record of funds is not sufficient for a deposit to not be regarded as being received within the definition of the meaning of gross income. Therefore, the critical question according to Williams (2015:154) is how a taxpayer is entitled by law to deal with the amounts. If the taxpayers in these deposit cases had some sort of trust or pledge, then it would have probably convinced the courts that the amounts should not be included in gross income. Further, with efficient tax planning, the

taxpayers could have sold the products on contractual terms and provide that the amounts deposited would be held in a trust (Williams, 2015:154).

According to Eastes (2018:7) the valuation and date of a “receipt or accrual” needs to be considered when interpreting tax legislation to ensure that the timing for the inclusion of an amount in gross income is correct. It was held in the case of *SIR v Silverglen Investments (Pty) Ltd* (1969) that an amount should be included in gross income at the earlier of its receipt or accrual. This was confirmed in *CSARS v Cape Consumers (Pty) Ltd* (1999) that “there must be either a receipt or accrual...when a person neither receives anything nor has anything accrued to him, there can be no amount included in his gross income”. Therefore, the same amount cannot be taxed twice. According to Marais (2010:29) there are three likelihoods that exist for the timing of receipts and accruals –

- The first occurrence happens when the accrual and the receipt of income take place at the same time. An example is when there is a cash sale transaction, the seller receives income at a point in time and at the same time the income accrues to him.
- The second one is when the accrual takes place first before the receipt. An example is when there is a credit sale where a sale takes place at a particular time, but the amount of the relevant goods or services would only be received by the taxpayer in the future.
- The last possibility is when the receipt takes place first before the accrual i.e. before the ‘*quid pro quo*’ (exchange of goods or services). Examples of these include arrangements where the supplier would require a deposit or an upfront payment first before it discharges its obligation to supply the goods or services.

As noted in 2.4 in a normal gift card arrangement the issuing merchant accepts cash in exchange for goods or services to be provided in future, therefore it would seem that the sale of gift cards where a receipt takes place first before an accrual, the third possibility, would be a better fit.

### **3.2.3 Excluding receipts or accruals of a capital nature**

The last element of the definition is that only amounts that are revenue and not capital in nature should be included in gross income. There is no set of rules that describe what it means for an amount to be capital in nature and the ITA does not define what capital in nature means. It was held in the case of *Commissioner for Inland Revenue v Pick ‘n Pay Employee Share Purchase Trust* (1992) that amounts from sale of assets will only be taxable where the realisation occurs in the course of a scheme of making a profit. It is submitted in this study that issuing merchants who sell closed-loop gift cards as stated in 2.3.1 and financial institutions who issue open-loop gift

cards as stated in 2.3.2 do so with the intention of making a profit. It is also the issuing merchant's business strategy to sell gift cards in order to increase profits as explained in 2.2. Therefore, income received from gift cards sold is not capital in nature.

### **3.3 An analysis of the *ITC 1918* (2019) case**

The recent case of *ITC 1918* (2019) dealt with the timing of receipts of gift cards sold by a South African retailer; this case may therefore provide insight on the taxability of the proceeds from the of gift card sales in South Africa. The case focused on whether revenue from the sale of the taxpayers' gift cards comprised part of its gross income as defined in the ITA as soon as it was received by the taxpayer, or only when the gift cards are redeemed or have expired. The background of the case is discussed briefly in the paragraph below. This will be followed by an analysis of the findings of the principles established in the case.

#### **3.3.1 Background of the case**

The taxpayer carried on business as a retailer selling clothes, comestibles and general goods. As part of its business operations, it sold gift cards which could be redeemed at any of its stores. The taxpayer banked the proceeds from the sale of gift cards together with the proceeds from the sale of its ordinary general merchandise. It has been the taxpayer's norm at the end of every month to do a reconciliation of its gift card sales and redemptions and thereafter transfer amounts received from the sale of gift cards into a separate bank account. This bank account was set up solely to appropriate amounts that represent the value of redeemed gift cards and the value of unredeemed gift cards that would have expired during that particular month. The taxpayer historically declared amounts received from gift card sale as gross income as soon as it had received them and claimed a section 24C allowance in terms of the ITA. However, in subsequent years, following the promulgation of the CPA in 2011, the taxpayer changed its treatment and included the proceeds from gift card sales as gross income when the gift cards had been redeemed for merchandise or had expired.

#### **3.3.2 An analysis of the principles laid down in the case**

##### **3.3.2.1 The issue**

The issue in this case is:

whether the revenue from the 'sale' of the taxpayer's gift cards during that year constituted part of its '*gross income*' for the purposes of the ITA as soon as it was received by the taxpayer

(as contended by the Commissioner) or would become such only when the card was redeemed, or having not been redeemed, expired (as contended by the taxpayer). (p. 1)

Therefore, this case looks at whether amounts received by the taxpayer in respect of gift card sales had been 'received' within the meaning of the word in the gross income definition at the time the gift cards were sold or redeemed, or had expired.

### **3.3.2.2 The arguments**

The Commissioner's first argument was that the sale of gift cards is similar to a normal cash sale because in a gift card transaction there is an issuing merchant (the taxpayer) being the seller, a customer paying for the gift card being the purchaser, the thing being sold being the gift card and the price being the consideration that is paid for the issuance of the gift card. Therefore, it means that when the issuing merchant sells gift cards to customers, the consideration paid for the gift card should be treated as a normal cash sale when the gift card is issued whereby the accrual and receipt of the income occurs at the same time as described by Marais (2010:29) and thus should be included in gross income. The judge noted that a gift card transaction is not a contract of sale as neither the identification of the goods to be supplied, nor services to be rendered in future nor the price thereof is determined at the time when the gift card is issued. The customer is merely making a prepayment of goods to be identified later when the gift card is redeemed. The judge noted that the true nature of gift cards is that it is "a piece of paper that vouches for the existence of the bearer's personal right against the taxpayer for the redemption of the prepayment. It is not the subject of a sale" (*ITC 1918*, 2019).

The taxpayer argued that amounts received from gift card sales were held in a separate bank account set up specifically for gift cards receipts and were not used in the conduct of their business operations until such time that the gift cards are redeemed or expired. Receipts of gift card sales were also recorded as 'unredeemed gift card liability' in the taxpayer's accounting records and on this basis the amounts were not 'income' within the ordinary meaning of that term until the time that it was appropriated. Based on this argument, the taxpayer noted that proceeds from gift card sales were not received for its own benefit but were received for the benefit of the gift card holder. The court noted that this practice of separating monies received for gift cards and holding them in a different bank account had been applied in the United Kingdom (hereafter referred to as "UK") by some issuing merchants and had been confirmed in the *Re Kayford Ltd* (1975) case. However, this practice was found lacking as it did not protect gift card bearers should a retailer become insolvent.

In the UK case of *Re Kayford Ltd* (1975) it was held that the practice of sequestering moneys received in respect of prepayments from the company's normal operating accounts was deemed to be consistent in the formal sense with the concept of effectively creating a trust in a legal way because the company was placed into liquidation. However, this practice was not accepted in the *ITC 1918* (2019) case because the manner in which the taxpayer segregated the receipts of gift card sales was not done in a legally effective way. The court stated that it was important to look at a taxpayer's practice with regard to separating receipts of gift card sales from normal operations to assess whether there was a 'cognisable legal context' that existed, for example by way of the establishment of a trust or a will or an agent-principal relationship. The court thus rejected the taxpayer's first argument as it could not be discerned how the taxpayer's practice was different from a normal cash sale as the receipts of gift card sales became that of the issuing merchant as soon as it had received it, irrespective of where they were kept or how they were accounted for. The mere segregation of gift card receipts thus did not convey that the taxpayer did not hold the receipts on its own behalf for its own benefit and the taxpayer might do with the receipts as it wished.

The Commissioner's second argument was that monies received in respect of gift card sales were not distinguishable from any other receipts at the taxpayer's tills in respect of general merchandise sold and as a such the taxpayer could use the money received for gift cards as part of its daily operations if it chose to; the receipts were therefore property of the taxpayer. The commissioner did not see any significance in the fact that subsequently the taxpayer would transfer a sum of money in respect of gift card sales into a different bank account. The court considered the case of *Holley v Commissioner for Inland Revenue* (1947) where the taxpayer (a 'fiduciary') was required by the terms of a will to pay his aunt (the 'fidei commissary') a portion of income as an annuity from business income that was received in his hands. It was held that the fiduciary received the portion for the annuity in his capacity as a 'trustee' in terms of the meaning of that word in the ITA and not in his personal capacity; therefore, that portion of income would not form part of his gross income.

The Commissioner in the *ITC 1918* (2019) case noted that the fiduciary in *Holley v Commissioner for Inland Revenue* (1947) would be able to calculate his gross income irrespective of whether the money he received for his own benefit would mix with that portion of the business income that he would have to pay as an annuity, thus there should not be an obstacle in deciding what he had received for his own benefit and what he had received as a 'trustee' for the benefit of someone else. The court noted that it would have agreed with this view by the Commissioner if it were not for the provisions of the CPA which were advanced by the taxpayer in its second argument.

The second argument of the taxpayer was that it was required by the provisions of Sections 63 and 65 of the CPA to hold the income received for gift cards on a fiduciary basis for the benefit of the gift card holder and not for itself. Therefore, the taxpayer was of the view that the proceeds in respect of gift card sales were not 'received by' it within the accepted meaning of the term in the definition of gross income. The court agreed that the provisions of the CPA state that any consideration paid in respect of gift cards is property of the holder of the card and the issuing merchant must not take the receipts as if they were its own property until the cards have been redeemed or have expired. As a result, the receipts in respect of gift cards were 'received by' the taxpayer to be held on the gift card bearers' behalf. As such, the court held that the taxpayer was accurate to not include receipts of gift cards in its gross income.

### **3.3.2.3 Findings of the case**

The Commissioner agreed that gift card sales are regulated by the provisions of the CPA. However, he noted that the purpose of the CPA was mainly to protect customers' rights and not to defer taxation. According to the Commissioner, the provisions of the ITA could not be overridden by other 'non-tax' legislation. The court rejected the argument of the Commissioner and described the interaction between the ITA and the CPA as follows:

the object of the CPA is the protection of consumers, and not the deferral of tax liability. But if the manner in which the CPA protects consumers entails the deferral of beneficial receipt of revenue by suppliers as a matter of fact, then the knock-on effect on the determination of the suppliers' taxable income is only to be expected. Were it otherwise, the necessary implication would be that suppliers fail to be taxed on income they have not yet received, and which has not yet accrued to them. The CPA does not express any such intention. And any such effect would be at odds with the scheme of the Income Tax Act. A conflict between the two sets of legislation arises only if it is construed in the manner contended for by the Commissioner.  
(p.17)

The court noted that the Commissioner cannot not apply authoritative laws in a vacuum and had to "determine the incidence of tax in the real world and in light of all relevant facts and circumstances, including common law that requires taxpayers to act in a certain manner" (*ITC 1918*, 2019). Thus, there was no reason to separate statutory provisions to testamentary or contractual provisions. Further, the court noted that the aim of the CPA was to protect customers by requiring issuing merchants to segregate receipts from gift card sales from other income received for its general business operations. The taxpayer did a monthly reconciliation where receipts for gift cards were credited in a separate bank account and the court noted there was no other way that the taxpayer could keep receipts of gift cards as a separate property from its other

business receipts as required by statute. Furthermore, legislation required that there needed to be some form of statutory trust, even if the trust was not recognised by common law. The taxpayer had a fiduciary duty to the card holder in terms of the statute to safeguard the proceeds of gift cards until such time that the prepayment was redeemed. Therefore, the taxpayer's practice of segregating gift cards receipts was in the manner in which the CPA characterised such receipts.

The court concluded that proceeds in respect of gift card sales, to the extent that they were property of the card bearer in terms of the CPA, were not 'received by' the taxpayer for its own benefit and as such the taxpayer would only be legally entitled to the receipts in question at the time that the gift cards were redeemed or had expired, thus the taxpayer did not constitute gross income as defined until the earlier of redemption or expiry.

### **3.4 The application of the South African tax legislation and the *ITC 1918 (2019)* case on the taxability of the proceeds from issuing gift cards**

The application of the current income tax legislation will be considered below to the conceptual features of gift cards identified in chapter 2. The treatment of the taxability of the proceeds from issuing a gift card in the current income tax legislation will be broken down using the three-stage model defined in chapter 2.4 for closed-loop gift cards and open-loop gift cards respectively. There are very few sources on which to base the interpretations below; however, the current income tax principles discussed above are a starting point to enable a better comprehension of the income taxability of the proceeds from issuing gift card transactions in each stage of the transaction trail. As such, the treatment of gift cards for income tax purposes involves a high degree of interpretation by the researcher. This study contributes to the body of knowledge by conjugating the elements of the income tax legislation to the conceptual features established in chapter 2.

#### **3.4.1 The treatment on the taxability of the proceeds from issuing closed-loop gift cards**

As defined in 2.3.1 closed-loop gift cards are sold by issuing merchants. They are divided into two sub-categories, viz. retailer-specific and product-specific gift cards. These categories have similar features and characteristics in the way that they are usually issued by issuing merchants and are redeemable at a particular merchant or merchants in the same group. It is thus not relevant to assess the income tax implications for both product specific and retailer specific gift cards as they are of the same nature.

### 3.4.1.1 Stage 1 – The issue of closed-loop gift cards

As stated in 2.4, the issuing merchant (a retail merchant in the case of closed-loop gift cards) issues or sells a gift card to a customer for a certain amount of cash in stage 1. The recipient of the gift card will use the gift card in future as payment for the provision of goods or services by any issuing merchant specified on the gift card. The question is whether during this stage the amount needs to be included in gross income. As mentioned in 3.2.2, a taxpayer needs to include any amounts in its gross income on earlier of receipt or accrual. When a gift card is sold by the issuing merchant, the proceeds of the sale (the actual cash amount) is immediately ‘received by’ the merchant, similar to a normal sale transaction. However, the case of *Geldenhuys v Commissioner for Inland Revenue* (1947) established the principle that the term “received by” means that a taxpayer must have received an amount for its own behalf and for his own benefit. Therefore, it needs to be established whether the amount received by the issuing merchant at the time when it sells the gift cards is for its benefit or not.

In the course of stage 1 of the transaction process the issuing merchant has an obligation to the customer to provide goods or services in future per the terms and conditions of the gift card. The court in *ITC 1918* (2019) as described in 3.3 noted that when a gift card is sold, the issuing merchant is merely issuing a thing (“a piece of paper”) that results in the existence of a customer’s personal right against the merchant for the prepayment of the gift card or advance payment to be redeemed in future. It was established in 3.2.2 that regarding deposits, amounts are usually received by the taxpayer for its own benefit because the taxpayer can use the amounts as it wishes in its ordinary business unless he holds these amounts in some form of trust account. This means that when a taxpayer receives a payment made in advance or a deposit, he may use the money in his business how he wishes which may result in the money being intermingled with other receipts in the business. If he does not distinguish proceeds separately from gift card sales by setting up some form of trust account, then that money is the taxpayer’s money and should be included in the taxpayer’s gross income.

According to the judge in the case of *ITC 1918* (2019) as stated in 3.3, what muddies the waters in the case of gift card sales is the impact that the CPA has. Firstly, the issuing merchant that issues gift cards is considered a supplier as defined in the CPA. Secondly, sections 63 and 65 of the CPA regulate the sale or issue of gift cards. As described in 2.6, according to section 63 of the CPA when a customer pays the issuing merchant for the issuance of a gift card, that consideration received by the merchant is property of the gift card bearer provided that the value of the gift card has not been redeemed yet for any goods or services. Section 65 of the CPA provides that when a supplier is in custody of a customer’s consideration, it must not treat that

consideration as its own property and is essentially responsible for managing another person's property. The effect that the CPA has is that money paid in advance by a customer to the issuing merchant is not actually the merchant's property and should not be treated as such. SARS (2021:12) noted that the effect that the CPA has created is some form of statutory trust where a proprietary interest is given to the holder of the gift card and the issuing merchant has a fiduciary duty to it. As such, it cannot be said that a merchant who issues gift cards and receives a payment from a customer for the issuance of the gift card, will receive that money on its own behalf and own benefit; therefore, the amount should not be included in the issuing merchant's gross income at this stage.

The accounting literature in 2.5 prescribes that when the issuing merchant receives a prepayment from a customer in exchange for the issuance of a gift card, the issuing merchant should recognise a 'contract liability' for accounting purposes as per IFRS 15. The reason is revenue cannot be recognised at this point because the issuing merchant has not fulfilled its obligation to the customer. As such, a liability is recognised on the company's balance sheet to indicate that the issuing merchant still has an obligation to the customer and has not earned the revenue from the sale of gift cards yet. If the accounting rules were to be applied to the income tax treatment of gift cards at this stage of the transaction trail, when a contract liability is created for accounting purposes, it becomes clear that no income can be included in gross income for income tax purposes because there is no 'revenue' or 'income' at this stage. The question that may arise is whether it can be said that the amount has accrued to the taxpayer when the advance payment is received. As noted in 3.2.2, the established principle with respect to the term 'accrued to' means a taxpayer is entitled to an amount. In this stage, the amount of proceeds from the sale of gift cards cannot be said to have accrued to the issuing merchant because the issuing merchant is not legally entitled to the monies as it is merely holding and managing the consideration for another person, the customer.

It can thus be deduced that during stage 1 the advance payment paid by a customer for the issue of the gift card by the issuing in exchange for future goods or services is not 'received by' the issuing merchant as the issuing merchant does not have a right to benefit from the consideration paid; it is holding the consideration in a fiduciary capacity. Therefore, on the date of sale the issuing merchant may not include an amount received from the sale of closed-loop gift cards in its gross income.

### 3.4.1.2 Stage 2 – The redemption of closed-loop gift cards

As stated in 2.4 in stage 2 a customer redeems the value of the gift card (either in full or in part) in trade of goods or services at either the issuing merchant who originally issued the gift card (merchant A) or another merchant who did not originally issue the gift card (merchant B). Following from the discussion above, it was noted that during stage 1, no amount may be included in the issuing merchant's gross income at the date when the gift card is issued to a customer because the issuing merchant is holding property belonging to another person. However, when a customer now redeems the value of the gift card, he or she is exercising his personal right in exchange for the goods or services. At this point, once the gift card is redeemed, then that personal right falls away and the issuing merchant is legally entitled to the proceeds on the sale. The consideration for the gift card no longer become the property of the gift card holder.

For accounting purposes as noted in 2.5, upon redemption of the gift card by customers in exchange for goods or services, the contract liability that was recognised then gets derecognised and revenue can now be recognised because the issuing merchant is now fulfilling the obligation when it provides for the goods or services. In line with accounting practice, when a customer redeems the value of the gift card, income can be included in gross income by the issuing merchant because at this point it is now receiving the proceeds on its own behalf for its own benefit. The issuing merchant can use the money as it pleases as it is its own property. In this stage the receipt and accrual can actually take place at the same time similar to a normal sale transaction, because the merchant actually receives the income at that point for its own benefit and for its own behalf and at the same time the income accrues to it as it is legally entitled to it.

The issue in stage 2 is who - merchant A (the original issuing merchant) or merchant B (another issuing merchant) as described in 2.4 - should include the proceeds in its gross income, as merchant B did not originally issue the gift card. Ownership of the goods or services issued by merchant B transfers to the customer and in exchange merchant B receives the gift card from the customer as full or part payment for the goods or services supplied. A consideration can be that merchant B is in effect receiving a right to the gift card value in return for the supply of goods or services and not actual money. It was noted in the case *Commissioner for Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd* (1990) that income can be in any other form other than money, but in essence there must be some form of value attached to it. Therefore, it can be argued that merchant B can include the value of the gift card in its gross income. It should also be noted that in stage 3 to be discussed below merchant B will be able to recover the money of the gift card from merchant A, the original issuer.

### **3.4.1.3 Stage 3 – The reimbursement of closed-loop gift cards**

Stage 3 of the transaction process as described in 2.4 is only applicable when the value of the goods or services is redeemed by a customer at another issuing merchant (merchant B) and not at the one who originally issued the gift card (merchant A). In this stage merchant A reimburses merchant B because merchant A is technically supposed to supply the goods or services to the customer as it issued or sold the gift card; however, it has not done so, and it thus allows the customers to redeem the value of the gift card elsewhere.

In 3.4.1.2 above the question was whether merchant A or merchant B should include the proceeds in gross income. This depends on the terms of the agreement between merchant A and merchant B and if they state that merchant A is legally liable to reimburse merchant B an amount equal to the value of those goods or services redeemed by a customer, then it can mean that the income accrues to merchant B as it is legally entitled to it, and it may thus be included in its gross income. Another view is that since merchant A is holding the money or consideration on behalf of a customer when a gift card is initially issued or sold, when the gift card is redeemed elsewhere it is still not the property of merchant A but the property of the issuing merchant who provided the goods or services where the gift card was actually received. Thus, merchant A cannot do with the cash as it deems fit because it has to reimburse it to merchant B.

Another factor to note is that the reimbursement paid by merchant A to merchant B is equivalent to the value of the actual redemption of the gift card by the customer and not the full value that was paid for the gift card itself. Thus, merchant B may only include the amount in gross income to the degree of the value of the redeemed gift card.

### **3.4.2 The treatment on the taxability of the proceeds from issuing open-loop gift cards**

As defined in 2.3.2 open-loop gift cards (referred to some as network-branded gift cards) are those that are generally issued by financial institutions and can be redeemed for any type of goods or services from anywhere a debit or credit card may be accepted. They have similar characteristics to cash as they are usually used and spent the same way cash would be. The issuing merchant in the case of open-loop gift cards would thus refer to financial institutions.

#### **3.4.2.1 Stage 1 – The issue of open-loop gift cards**

As described in 2.4 the first stage entails the issuing merchant (a financial institution in this instance) accepting cash from a customer in exchange for the issuance of an open-loop gift card

with the promise to provide goods or services at a future date. According to Nel (2020:37) when an open-loop gift card is issued, the customer will pay the financial institution a sum of money in exchange for the gift card and the financial institution will generally credit a specific account which relates to the customer which will in future be used as payment or part payment for the desired goods or services at any financial institution that has the facilities that accepts open-loop gift cards as payments, similar to how a debit or credit card works as described in 2.3.2. This essentially entails that the financial institution is making a facility available to customers by temporarily retaining the money used to purchase the gift card and instantly paying it over to the merchant where the gift card holder will redeem the gift card.

Similar to the discussion in 3.4.1.1 on the issuance of closed-loop gift cards, the term “received by” means that a taxpayer, the financial institution, must have received the amount in respect of the issuance of the gift card on its own behalf and for its own benefit. From the analysis on the issuance of closed-loop gift cards when the issuing merchant receives money from the sale of gift cards, it can be deduced to have been received by the taxpayer for its own benefit as the taxpayer can do with it as it deems fit, unless there is some form of trust account which is set up specifically to hold these moneys for the issue of gift cards.

However, the CPA can change this position because in terms of sections 63 and 65 of the CPA the gift card is the property of the bearer of the card and the issuing cannot treat it as its own property. A question may arise as to whether a financial institution is also bound by the provisions of the CPA. Sections 63 and 65 are both applicable in respect of suppliers in relation to gift cards. A supplier is defined in the CPA as “...a person who markets any goods or services...” and a service is defined to include, but not limited to “...any banking services or related or similar financial services...”. It can thus be deduced that a financial institution is a supplier as defined in terms of the CPA. As such, one could argue that the provisions of the CPA should apply similarly as is the case with closed-loop cards. The impact that the CPA may have would then be similar to closed-loop gift cards in that the amount that the financial institution receives for the issuance of gift cards can be said not to have been received for its own benefit or on its own behalf. Therefore, the financial institution should not include the proceeds in gross income when it issues an open-loop gift card. However, it is not clear whether indeed the CPA does apply to open-loop gift cards and there are not many sources available to base these interpretations on.

#### **3.4.2.2 Stage 2 – The redemption of open-loop gift cards**

As stated in 2.4 in stage 2 a customer will redeem the value of the open-loop gift card at any merchant that accepts this type of gift card, generally those that accept a visa or credit card. The

merchant that has the payment facilities to accept this type of gift card will then provide the customer with goods or services equal to the value that the customer applies on the gift card against its available credit on the card. The merchant who provides the goods or services in exchange of the gift card is now transferring the ownership of the property to the customer and in return receives payment from the financial institution for these goods or services. On the other hand, when the financial institution pays the merchant, it debits the customer's account with the value that is spent by the customer at the merchant.

The financial institution acts as some sort of intermediary as it just provides a facility for the gift card transaction. The merchant who provides the goods or services to the gift card holder is thus receiving money from the financial institution, similar to a payment made by using a debit or credit card. As the merchant is discharging its obligation to provide goods or services in exchange for the consideration received in respect of the gift card, it can be said to have received the money in respect of the gift card for its own benefit and on its own behalf, similar to the discussion in 3.4.1.2. about the redemption of closed-loop gift cards.

Stage 3 will not be applicable in the case of open-loop gift cards because when the gift card value is applied by a customer interchanged for goods or services, there seems to be an instant transfer of money to the merchant akin to how a normal debit or credit card transaction operates. As such, the third stage will not necessarily be applicable for open-loop gift cards.

### **3.5 An analysis of the deductibility of costs to fulfil gift cards by the current South African income tax legislation**

As part of the gift card transaction trail depicted in chapter 2, the customer or the recipient of the gift card can redeem the value of the gift card at the supplying merchant who issued the gift card and/or at a third party (merchant B as illustrated in figure 2-4 in chapter 2), another supplying merchant who did not issue the gift card but had an arrangement with the taxpayer to supply the goods or services to the customer. An expense will be incurred by the supplying merchant in supplying goods or services to the customer or in reimbursing the third party (merchant B) for supplying the goods or services, as discussed in stage 3 of the transaction trail in chapter 2.

Section 11 of the ITA notes that in determining taxable income of a taxpayer, amounts that are allowed as deductions in the ITA must be deducted from income, which is defined in section 1 of the ITA as gross income less all exempt income. For the expense to be deductible it must satisfy the requirements of section 11(a) (the so called "positive test") of the ITA read together with

section 23(g) (the “negative test”) of the ITA. This is referred to as the general deduction formula. Section 11(a) of the ITA states:

(1) For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived – (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature. (p. 69)

Section 23(g) of the ITA denies a deduction claimed from income obtained from trade of any amounts to the degree to which such amounts were expended or not laid out for the purpose of trade. It reads as follows:

No deductions shall in any case be made in respect of the following matters, namely—  
(g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade. (p. 115)

Therefore, in accordance with the ITA, an amount qualifies for a deduction if all the requirements of the definition of section 11(a) read together with section 23(g) are met. All the elements of the definition need to be considered on an individual basis as discussed below.

### **3.5.1 Carrying on a trade**

In order for the expenditure to be deductible, the taxpayer must be carrying on a trade. Gift cards are used in a wide range of consumer market industries, such as retail, as part of a profit-making scheme and a marketing strategy as discussed in chapter 2. Therefore, taxpayers or supplying merchants who issue gift cards and supply goods or services for the redemption of such gift cards are carrying on trade activities and thus this requirement of the definition is met.

### **3.5.2 Expenditure and losses, actually incurred**

In terms of the *CSARS v Labat Africa Ltd* (2011) case, ‘expenditure’ is not restricted only to cash payments, but it also includes any other form of payment other than cash. A taxpayer who supplies goods or services or who reimburses a third party for the provision of goods or services to the customer for the redemption of the gift card, incurs an expense and thus meets this requirement of the definition. An expense with regards to the supply of gift cards is actually incurred when the taxpayer provides the goods or services to the customer itself or when it compensates the third party for the provision of the goods or services.

Expenditure with regards to gift cards is actually incurred in two instances, the first instance is when the taxpayer supplies the goods or services to the customer upon redemption of the value of the gift card and the second instance is when the taxpayer compensates the third party (merchant B as described in 2.4) for the provision of the goods or services to the customer should a customer redeem the value of the gift cards with the third party. Basically, when redemption occurs, the taxpayer provides the goods or services or the taxpayer pays the third party for the supply of the goods or services, then the requirement of “actually incurred” will be met. However, as with the taxability of the proceeds from issuing a gift card, the timing of when an expense is actually incurred may be uncertain if redemption of the gift cards does not occur in the same year as when the gift cards were issued or if redemption never occurs. The uncertainty that exists is whether the liability for the taxpayer arises when gift cards are received in a particular year, but the provision of goods or services takes place in a different year of assessment or does not take place ever, due to the gift cards not being redeemed.

It was held in *Caltex Oil (SA) Ltd v SIR* (1975) that the expression “any expenditure actually incurred” means “all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not”. In other words, as Williams (2015:428) put it that “it is in the tax year in which liability for the expenditure is incurred, and not in the tax year in which it is actually paid (if paid in a subsequent year), that the expenditure is actually incurred for the purposes of section 11(a)”. In applying the principles of the *Caltex Oil (SA) Ltd v SIR* (1975) case to the outflow of gift card transactions, in both instances when a customer redeems the value of the gift cards with the taxpayer or with a third party, then the obligation for the taxpayer to provide the goods or services arises when the gift card is issued and not when redemption occurs. This is owing to the fact that in the case of *Caltex Oil (SA) Ltd v SIR* 1975) the principle that was established is that an expense is actually incurred by a taxpayer when the liability has been incurred and not necessarily when payment occurs (which would be the time when the goods or services are provided, or the third party being paid by the taxpayer).

It therefore means that when a gift card is issued in the course of a particular tax year, it means that the expenditure is actually incurred by the taxpayer in that same year of assessment, irrespective of whether the goods or services were supplied in that same year or not. It was held in the case of *Edgars Stores Ltd v CIR* (1988) that an expense is “actually incurred in a year of assessment only if there is an unconditional legal obligation to incur the expenditure in that year”. In *Nasionale Pers Bpk v KBI* (1986) the principle that was established is that if the liability has any condition, whether resolutive or suspensive, or that the liability is contingent instead of actual, then no expense has actually been incurred. That is, “where the taxpayer’s legal obligation in

respect of expenditure is, at the end of the tax year, uncertain, in the sense that the obligation will come into existence on the occurrence of a future uncertain event, the expenditure has not been 'actually incurred' during that tax year" (Williams, 2015:425).

In applying the principles confirmed in the *Edgars Stores Ltd v CIR* (1988) case and the *Nasionale Pers Bpk v KBI* (1986) it could be argued by some taxpayers that the expenditure with regards to gift cards is not actually incurred when the gift card is issued. This is because it is uncertain whether a customer will redeem the gift card value for the promised goods or services in the same year as when the gift card was issued or if the customer will ever redeem the value on the gift card. Therefore, the obligation could possibly arise when an uncertain future event occurs, viz. redemption. The expense will then not actually be incurred in that same year of assessment. Therefore, for the outflow of gift cards, a liability arises in the taxpayer's hands but it is not certain when exactly the obligation occurs.

### **3.5.3 In the production of income**

The next requirement for a deduction is that the expense and loss must actually be incurred in the production of income. The landmark case on the meaning of the phrase "in the production of income" is the case of *Port Elizabeth Electric Tramway Company Ltd v CIR* (1936) where the so-called "close connection" test was determined which entails that the basis of the expense must be for the production of income and it must be closely linked to that income to an extent that it may be viewed as part of the cost performing it. The action that leads to the expense for the taxpayer to supply the goods or services itself or to reimburse the third-party is the actual supply or provision of the goods or services. This action is closely connected to the income earned for the gift cards for it to be considered as part of the cost of performing it because the taxpayer supplies the goods or services or pays the third party for the purposes of producing income and making a profit for its business. It is part of its marketing strategy to increase sales and profits.

### **3.5.4 Not of a capital nature**

Lastly, an expense will only be deductible in accordance with section 11(a) if the expense is not capital in nature. Capital expenses are not allowed as a deduction in terms of the ITA and there are a number of factors derived from case law which would show whether an expense is capital in nature or not. In the case of *New State Areas Ltd v CIR* (1946) it was held that it must be determined whether the expense ought-to be considered "as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning structure". The expense incurred to supply goods or services or to pay a third

party for the supply of goods or services can be considered as part of the cost of performing the income earning operations, because the main reason the expense is incurred is to honour the gift cards which were issued as a marketing strategy for the taxpayer to improve its profits. Some entities may even classify these expenses as part of 'marketing expenses' in its financial statements. Therefore, the requirement of 'not of a capital nature' is met.

### **3.5.5 Section 23(g) requirement**

Expenditure in respect of gift card transactions should meet all the requirements of the general deduction formula as contained in section 11(a) of the ITA, except with the requirement of 'actually incurred' as discussed in 3.5.2 as it is not quite clear if they would satisfy this requirement. Even though an expense may be deductible in terms of section 11(a), it must still pass the section 23(g) requirement. Expenditure incurred to supply goods or services or to pay the third party for the provision of goods or services as a result of gift cards, is incurred for business purposes as the main point of gift cards transactions is to grow profits, therefore the expenditure will pass the 'negative test' laid out in section 23(g) of the ITA.

### **3.5.6 The section 24C allowance**

The general timing rule for expenditure in terms of section 11(a) of the ITA is that an expense is only deductible for income tax purposes by a taxpayer in the year of assessment in which it is actually incurred as discussed above in 3.5.2. Section 24C of the ITA, however, provides an exception to this rule. It allows for the payment of tax on income accruing to a taxpayer arising from a contract in which the taxpayer has an obligation to finance future expenses (those incurred in a subsequent tax year) to be deferred to the tax year in which that future expenditure is actually incurred. The reason that is there may be instances where income earned by a taxpayer and expenditure incurred do not occur in the same tax year thus creating a 'mismatch' between the timing of the income and the expense. Section 24C of the ITA provides relief to taxpayers because of this mismatch and it aims to put the taxpayer in the same place had the income been earned and the expense been incurred in the same tax year (Van den Berg, 2013). Section 24C reads as follows:

24C Allowance in respect of future expenditure on contracts

(1) For the purposes of this section, "future expenditure" in relation to any year of assessment means an amount of expenditure which the Commissioner is satisfied will be incurred after the end of such year –

(a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or

(b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.

(2) If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance (not exceeding the said amount) in respect of so much of such future expenditure as relates to the said amount. (p. 126)

Therefore, section 24C provides relief to taxpayers who have received income in advance in respect of a contract in a particular year of assessment and who will use this amount, in full or part, to finance expenses to be incurred in a subsequent year of assessment when the taxpayer performs its obligations with reference to the contract. According to Van den Berg (2013) amounts received from gift cards which remain unredeemed at the end of a particular tax year of assessment, constitute income received in advance by a taxpayer, and it is common practice that merchants claim a section 24C allowance for these amounts. The reason merchants claim the allowance is because they have to honour the contractual obligation in respect of the redemption of the gift cards (Van den Berg, 2013). However, Van den Berg (2013) noted that SARS has in practice not allowed taxpayers to claim the section 24C allowance. Thus, it is uncertain whether section 24C can be claimed by taxpayers in respect of gift card sales so that there is no mismatch between income and the expense to ensure that balance is achieved from a fiscal point of view. The recent tax case of *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) provides some guidance on this matter. It is briefly considered below.

#### **3.5.6.1 The *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) case**

In the *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) case the taxpayer conducts a 'ClubCard' loyalty programme whereby customers receive loyalty points, subject to the terms and conditions of the loyalty programme, for each qualifying purchase. The loyalty points can be redeemed for merchandise at any Clicks store as payment or part of a payment for a purchase to be made in future and are not redeemable for cash. When the loyalty points are redeemed, the taxpayer is obliged to supply goods to the customer at the price which is in proportion to the value of the loyalty points being redeemed (CDH, 2021:2).

The *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) case dealt with whether the taxpayer (Clicks stores) was allowed to claim a section 24C allowance arising from its obligation in terms of its ClubCard loyalty programme consequently because of the revenue income it earned from its customers who participated in the programme. There were two types of contracts being referred to in the case. The first one is the contract of sale which relates to a customer presenting their ClubCard during a purchase to earn loyalty points, in other words purchases made by a customer for which the customer earns points, without redeeming them. The second one is the ClubCard contract, also referred to as the redemption contract, which relates to the actual redemption of the loyalty points by the customer.

According to the taxpayer in the *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) case, the contract of sale gives rise to income which accrues to the taxpayer and it also gives rise to an obligation which is incurred to finance expenditure in future, and therefore the taxpayer claimed the section 24C allowance on this basis. The taxpayer's argument is that the contract of sale and the ClubCard contract work together in bringing about the income and the obligation to incur future expenses for the taxpayer, thus there is an inextricable link between the two contracts (CDH, 2021:4). SARS disagreed with this view because according to SARS the income arises from the contract of sale and the onus to incur future expenses arises from the ClubCard contract, thus the income and the obligation to incur expenses in future do not arise from the same contract and there is no inextricable link between the two. SARS argued that the contracts can stand on their own, for instance customers can earn points with the ClubCard contract from purchasing as third-party merchants to redeem them at Clicks stores: this is an indication that the ClubCard contract can work independently. In this instance the income earned will accrue to the third-party merchant whereas the obligation to incur future expenses will be on the taxpayer. Therefore, according to SARS, there is no link between the two contracts and it disallowed the deduction for section 24C for the taxpayer.

The judgement is thus based on whether the income earned and the onus to incur expenses in future arise from the sale contract instead of both the contract of sale and the ClubCard contract. It was held by the court that the requirements of section 24C (2) are that:

- (1) Income accrues to a taxpayer in terms of a contract;
- (2) there is an obligation on the taxpayer to incur future expenditure which, whether in part or in whole, will be financed by this income; and
- (3) that the income earned and obligation to incur future expenditure should flow from the 'same' contract. (p.15)

This third and last requirement was the key factor in the case. It was held that this requirement would be met on two bases, viz. the same-contract basis and the sameness basis. The same-contract basis means that the contract from which income accrues and the contract which gives rise to the obligation to incur expenses in are almost a similar contract' (CDH, 2021:5). The sameness basis means that the contract from which income accrues and the contract which gives rise to the duty to incur expenses in future are "so inextricably linked that they meet the requirement of sameness" (CDH, 2021:5). The court held that the contract of sale which gives rise to the income triggers the obligation in the ClubCard contract and the two are closely linked; however, the ClubCard contract gives rise to the actual obligation for the taxpayer to incur future expenses. Therefore, it held that the taxpayer did not meet the same-contract basis requirement as the income and the obligation to incur future expenses do not occur from the same contract.

With regard to the sameness basis, the court noted that at a minimum, section 24C requires that the contract that gives rise to the income earned and the contract from which the obligation to incur future expenses must be dependent on each other's existence and not any one of the contracts must exist without the other (CDH, 2021:5). The court held that the contract of sale which gives rise to income accruing to the taxpayer initiates and quantifies the taxpayer's obligation to incur future expenses. However, the actual obligation for the expenditure to be incurred in future is embedded in the ClubCard contract which does not depend on the contract of sale's existence. As such, the court ruled that although an inextricable link between the two contracts could be established as the contracts function together within the scope of the Clicks loyalty programme, the link is insufficient as the two contracts are just too independent of each other and cannot be regarded as the same contract. As a result, the sameness requirement in section 24C could not be satisfied by the taxpayer and the taxpayer could therefore not claim the section 24C allowance on this basis as well.

Gift cards function similar to customer loyalty reward programs. A gift card (the actual card) and the subsequent sale and obligation to supply the goods or services as per the gift card's terms and conditions can possibly be viewed as different contracts which are inextricably linked. If one then follows the case of *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service* (2021) it would mean that taxpayers may be denied the claim for the section 24C allowance as they might not satisfy the same-contract basis and the sameness requirement as discussed above.

### 3.6 Conclusion

In this chapter the relevant aspects of the South African law with regards to gift cards income taxation were considered to determine if they provide any guidance on the income tax treatment of gift card transactions in South Africa. Firstly, the gross income definition was analysed with specific focus on the timing of receipt as this is where uncertainty exists in respect of the income taxation of gift cards. The analysis was supported by principles from relevant case law. It can be deduced that the principle to be considered for the income taxation of gift cards is that of *Geldenhuis v Commissioner for Inland Revenue* (1947) which noted that an amount is received by a taxpayer for his own benefit on his own behalf. This principle is still the legal position held in South Africa as there has not been a case in any high court in South Africa that has taken precedence and overruled the judgement. As such, it is accepted that any amounts that are received by a taxpayer on his own behalf and for his own benefit are “received by” him within the meaning of gross income of the ITA.

Amounts received with respect to gift cards sold can be viewed to have been received by the taxpayer on his own behalf and for his own benefit; however, the CPA plays a key role in the income tax implication of gift cards. The case of *ITC 1918* (2019) was critically analysed as it accentuates that if the CPA provisions are applicable and have been complied with fully, the conclusion on the timing of inclusion of gift cards into taxable income may be different to the principles in the South African legislation. If the provisions of the CPA apply, then the proceeds in respect of gift cards cannot be said to have been received by the taxpayer but they are held by the taxpayer for the benefit of the gift card holder. It was thus deduced that the amounts can only be included in gross income if the gift cards have been redeemed by the gift card holder or have expired. Any court may reach a different conclusion to the one reached in the matter of *ITC 1918* (2019) as the case was held at a special tax court and generally it does not create any legal binding precedent on any other court. The tax court is also valuable, however, and can be referred to in a similar matter.

The outflow to honour the gift cards was then briefly discussed by applying the principles in the general deduction formula in section 11(a), read together with section 23(g) of the ITA. Uncertainty exists on whether it can be said that the expenditure to honour the gift card transactions is ‘actually incurred’ by the taxpayer. The availability of the section 24C allowance was briefly explored as taxpayers may be entitled to a deduction of future expenditure when they include amounts received in advance in their gross income. It would prevent a mismatch of the income and expense inclusion in taxable income.

It is worth noting that the analysis of the definition of gross income as contained in section 1 of the ITA and the general deduction formula in section 11(a) read together with section 23(g) is not an exercise in isolation and tax legislation interpreters should take specific facts and circumstances of each matter into consideration and any spheres of laws which may be applicable to a specific case (Eastes, 2018:8). Therefore, the views in the above analysis are the researcher's own interpretation of the law and the questions raised prove that there are numerous uncertainties that exist with the income tax treatment of gift cards that may result in inconsistencies by South African suppliers. The conclusions drawn in this chapter will assist in analysing these uncertainties and determining how the USA has dealt with these shortcomings.

## **CHAPTER 4 AN ANALYSIS OF UNCERTAINTIES ABOUT THE INCOME TAX TREATMENT OF GIFT CARDS IN SOUTH AFRICA AND GUIDANCE FROM THE USA**

### **4.1 Introduction**

An analysis will be provided in this chapter about the areas of uncertainties stemming from the South African law analysed in chapter 3. As there is currently no guidance in South Africa on the income tax treatment of gift cards, there could be inconsistencies in the manner in which South African suppliers treat gift cards for income tax purposes. Therefore, there are potential concerns with regard to the income taxation of gift cards by South African suppliers. The income tax treatment of gift cards in the USA will be explored in order to seek guidance from an international perspective on how gift cards are treated for income tax purposes and to determine how it has dealt with the shortcomings and uncertainties in the income tax treatment of gift cards in South Africa, thereby providing possible solutions and guidance to these uncertainties. The method for the selection of the USA has been discussed in 1.5. and in addition, the USA has been identified as part of an explorative investigation to give more insight into the topic at hand.

The approach followed in this chapter is first to provide a brief general overview on income taxation of gift cards in the USA, then the chapter will demonstrate the concerns or anomalies created by applying the general income tax rules contained in the South African legislation on gift cards. These concerns are grouped into two, income related, and expense related. Thereafter, guidance from the USA is provided on the issues discussed to ascertain if and how the USA has dealt with the shortcomings as found in the South African legislation. This study does not intend to provide an in-depth analysis on these uncertainties, and it does not intend to provide answers to them either. The intention is rather to point out gaps that exist in the South African law with regard to the income tax treatment of gift cards in South Africa and to seek possible guidance from the USA to assist in dealing with these shortcomings.

### **4.2 An overview of the income tax treatment of gift cards in the USA**

As discussed in chapter 1, the USA is one of the very few countries which provide guidelines regarding the income tax treatment of gift cards. Gift cards in the USA contribute an enormous amount of the country's retail sales economy (Jones, 2009:213) because of the large amounts of profits that issuing merchants who sell the gift cards make on an annual basis, mainly because of gift cards expiring before being used or as a result of those gift cards that may be forgotten or

lost by consumers (Jones, 2009:13). The US Internal Revenue Services (hereafter referred to as "IRS") has issued ample advice and guidance to companies that operate gift card programs in the USA (Latham & Watkins, 2010:1) and hence in this chapter, guidance will be sought from them.

Due to the significant increase of gift card sales in the USA, the IRS has been addressing some of the income tax issues that gift card sales pose by publishing Field Attorney Advice and Industry Director's Directive (Biek, 2008:14). The IRS is striving to centralise the management of gift card taxation issues through IDD's which require tax agents who come across gift card tax issues when analysing a taxpayer's tax return to contact IRS's technical advice team for assistance and coordination (Biek, 2008:14). Most of the guidance published in the USA on the income tax treatment of gift cards is through FAA and IDD's, and numerous tax advisors have written articles and journals to provide further guidance on these directives.

Gift cards taxation has been dubbed an unfriendly area for taxpayers (Latham & Watkins, 2010:2) because there are numerous challenges that gift cards in general and the taxation thereof pose in the USA. According to Horne (2007:192) there have been legal issues with regard to the treatment of unredeemed gift cards in most States in the USA and it is uncertain to whom these unredeemed funds belong. Horne (2007:192) further noted that the different States in the USA do not have a uniform approach on how to treat these unredeemed balances, as some have escheatment laws which propose that any balances on gift cards that are not redeemed have to be handed over to the government as property that is deserted, same as how a bank account that is forgotten or a cheque that is not cashed is handled in the USA. Some States do not have such rules about gift cards and to make matters worse, the federal government in the country does not say anything about this matter. This makes income tax reporting a thorny issue (Horne, 2007:192).

To further complicate the matter, there are some major issuing merchants such as retailers in the USA who operate across numerous States in the country which makes it difficult to monitor and report unredeemed balances on gift cards (Horne, 2007:192). In the USA some open-loop gift cards are issued by federal banks and according to the rules in the country, these are exempt from statutes of the States (Horne, 2007:192). As a result of this, Horne (2007:192) noted that some issuing merchants would consider tactics of moving operations with respect to gift cards to friendlier jurisdictions in order to increase their unredeemed balances on gift cards. It thus makes it difficult to even account for the unredeemed balances on gift cards for income tax purposes as a result of how unredeemed balances are handled in different States.

### **4.3 An analysis of uncertainties about the taxability of the proceeds from issuing gift cards and guidance from the USA**

#### **4.3.1 The issues**

##### **4.3.1.1 Timing of inclusion in gross income and the impact of the CPA**

The first issue is when the income from gift card sales should be included in gross income. As discussed in the analysis of the South African legislation on the taxability of the proceeds from issuing gift cards in 3.4., income is generally included in gross income when it satisfies the requirements of gross income contained in section 1 of the ITA. Specifically with the nature of the transaction being discussed, it was noted in 3.4 on the tax treatment of gift cards by the current legislation that proceeds generated from gift cards sales would only be included in gross income when a taxpayer can satisfy that all the requirements of the gross income definition have been met. The principle of timing is also significant, viz. when the gift card has been received by the taxpayer on his own behalf and for its own benefit. The South African legislation is unclear on whether the proceeds from gift card sales should be included in gross income in either stage 1, 2 or 3 as described in the transaction trail in chapter 2.4.

However, it is assumed in this study in 3.4.1.1 and 3.4.2.1 that the proceeds from the sale of gift cards should not be included in gross income during stage 1 of the transaction process because the income is not received by the taxpayer on his own behalf for his own benefit. The income should possibly be included during stage 2 of the transaction process as discussed in 3.4.1.2 and 3.4.2.2 when the gift cards are redeemed. The reason is when the customer redeems the value of the gift card in stage 2, the issuing merchant becomes the property holder of the gift card and thus it can be said that the money is received for the taxpayer's own behalf and his own benefit. Some tax authors and tax experts in South Africa are of a different view. The SAIT, e.g., (2020) noted that: "Gift card/vouchers are often more akin to advanced payments on goods (especially if non-refundable). Presumably, these amounts should be taxable when initial payment is made".

Therefore, as there is no clear indication when the proceeds should be included in gross income, taxpayers can include the proceeds in gross income during any stage of the transaction trail. It is also not clear whether the timing of inclusion in gross income will be the same or different for closed-loop gift cards and open-loop gift cards; however, it is assumed in this study that the treatment of the two should be fairly similar. The analysis followed in this study on the treatment of the taxability of the proceeds from issuing gift cards described above in 3.4 is in line with accounting rules described in chapter 2.5. The South African tax legislators could perhaps

consider a legislative intervention to enhance certainty by emulating the IFRS 15 accounting rules for the treatment of income tax. This will enhance the understanding of the economic reality and substance of the transaction under study and ensure the two are aligned; less confusion will thus ensue.

Careful thought should be given to whether the CPA applies to open-loop gift cards as this may potentially affect the timing of the income inclusion. The impact of the CPA was introduced in the *ITC 1918 (2019)* case where the court had to consider at which point the revenue from the sale of gift cards should be included in gross income. The taxpayer had previously included the proceeds from sale at the point of sale; however, after the introduction of the CPA it changed its practice (KPMG, 2019b), as discussed in detail in 3.3. Therefore, the CPA can possibly influence the timing of inclusion of proceeds arising from gift card sales in gross income for the purposes of the ITA. The relevant provisions of the CPA were analysed in 2.6 where the legal nature of gift cards was discussed. It was then applied in the consideration of the tax treatment of the taxability of the proceeds from issuing gift cards in chapter 3. It is as a result of the provisions of sections 63 and 65 of the CPA that it was assumed in this study that the timing of the inclusion of proceeds of gift cards in gross income should occur during stage 2 of the transaction process, because the CPA has created a legal context that is cognisable which refrains taxpayers from holding gift card receipts as if they were their own property. This interpretation, however, is limited to the researcher's analysis in sections 3.2 to 3.4.

The uncertainty that arises regarding the CPA is whether the CPA applies in all circumstances for all taxpayers, and whether it applies to all gift card types. As discussed in 3.4.2 there is no clarity on whether the CPA applies to open-loop gift cards and therefore taxpayers who operate open-loop gift cards could come to a different conclusion regarding the timing of inclusion in gross income of the proceeds from the sale of gift cards than those who operate closed-loop gift cards. The taxpayer in the *ITC 1918 (2019)* case was a retail merchant selling closed-loop gift cards and that is where the CPA factor was brought into consideration. KPMG (2019b) specifically noted, with regards to the CPA, as it was considered in the *ITC 1918 (2019)* case that:

In addition to the provisions considered by the Court, the CPA contains similar provisions relating to prepaid services which could impact a wider range of taxpayers. The impact of the judgment on other industries with significant prepayments for goods or services (such as the airline industry, hospitality industry, etc.) would need to be explored further to determine the applicability thereof (p. 2)

This is an example that shows that there is a wide range of industries, and the CPA provisions could or could not impact the numerous taxpayers in these industries. As such, it is not clear whether the CPA applies to all. There may be instances where the CPA should apply but some taxpayers may not comply with it, which would mean that the provisions of the CPA cannot be taken into consideration in the argument of the timing of the gift card receipts' inclusion in gross income, and thus taxpayers may come to different conclusions as to at which stage the proceeds should be included in gross income as discussed in 3.4. As discussed in the case of *ITC 1918* (2019) in section 3.3., SARS is of this view that the CPA is irrelevant and has no impact on the income tax legislation because it is 'non-tax law'. KPMG (2019b) is of the view that SARS may be correct that legislation like the CPA cannot alter the regulatory provisions of the ITA, but it is viable that such legislation can change principles on common law with regards to beneficial receipt which will have a direct impact on how the provisions of the ITA are interpreted and applied.

The SARS (2021:1) IN no. 117 does not provide an analysis of the impact of the CPA, and it specifically stated that the provisions of the CPA are outside of the scope of the IN. The SAIT (2020:2) commented with regards to the CPA not being considered in the SARS IN no. 117 that not considering the impact and application of the CPA provides "little practical meaning" to the interpretation note. The *ITC 1918* (2019) case discussed in 3.3 shows that should the relevant provisions of the CPA be applicable and complied with, then the result in the case may not be similar to the principles discussed and established in the SARS IN no. 117. KPMG (2019b) released a tax alert asking the question "Can the Consumer Protection Act influence the timing of gross income inclusions?". No clear answer was provided, and KPMG (2019b:3) further noted that: "The judgment was issued by a lower court, is not a binding precedent and may still be overturned in the likely event that SARS decides to take the judgment on appeal to the High Court or the Supreme Court of Appeal".

As such, another court may come to a different verdict to that held in the case of *ITC 1918* (2019). There is thus no definite answer to the question whether the CPA should be considered for the inclusion of gift cards receipts in gross income. SARS has not to date appealed against the judgement in the *ITC 1918* (2019) case. This might indicate that SARS agrees with the judgement in the case; however, that is not certain and from the analysis and discussion in this study it seems that the viewpoint of SARS is that the CPA should not be taken into consideration.

#### **4.3.1.2 Breakage consequences**

The consequences of breakage (unredeemed values of gift cards) are also problematic and there is no clarity on how breakage should be treated for income tax purposes. Breakage (an 'unexercised right') refers to the value of gift cards that is unredeemed. As described in 2.2.1 many gift cards remain long outstanding for various reasons; they may be lost or forgotten by consumers, or the gift cards may eventually expire without being used. When non-redemption occurs, the value on the gift card is lost voluntarily by the customer which does not mean failure from the issuing merchant's side (Horne & Bendle, 2016:167). When a gift card is still within its validity period (which is usually a period of three years in South Africa as described in 2.6.1.1), the gift card holder still possesses a personal right to redeem the gift card value before it reaches its expiration date. However, as time passes by, the chances of a customer redeeming the gift card from the date it was issued, diminishes. Hennes and Schenck (2014:561) noted that when a gift card expires without the customer redeeming the value on the card, the issuing merchant may be entitled to the proceeds on sale without any obligation attached to the gift card being fulfilled. There is currently no specific treatment on how to treat unredeemed values on gift cards for income tax purposes.

This is a big issue as with accounting, as noted in 2.5, there is no set rule of how breakage is recognised for accounting purposes because this differs from business to business. According to IFRS 15 recognition of breakage for accounting purposes is dependent on whether a business expects to be entitled to that amount or not, which is a grey area and is based on predictability. However, unredeemed values on gift cards may for accounting purposes be recognised when the gift card expires because the possibility of the gift card holder redeeming the gift card value is remote. Tax could possibly follow the accounting rules. In this instance, when the gift card expires (after its validity period which is mostly three years in South Africa as discussed in 2.6.1.1), the taxpayer may then include the unredeemed value of the gift card in gross income after this period because the gift card holder no longer has any rights to the gift card. Nevertheless, there is still no clear treatment by the South African legislators on how breakage should be treated for income tax purposes.

As noted in 2.5 there is no uniform accounting treatment of breakage by businesses. IFRS 15 prescribes that the recognition of breakage for accounting purposes is dependent on whether a business expects to be entitled to the breakage amount. For accounting purposes, when a business is not able to predict whether it will be entitled to the breakage amount, it should recognise the revenue on breakage when there is a remote chance that a customer will exercise its outstanding right. This applies to gift cards that remain unredeemed for a long time and are

reaching their expiry date because there is a remote chance that the gift card holder will exercise its right to the gift card because it would have expired. Therefore, the unredeemed value will be recognised as revenue for accounting purposes when the gift card expires.

As noted above and discussed in 2.6.1.1 the validity period of gift cards in South Africa is usually three years. It could therefore be contended that the chance of a gift card being redeemed after three years is low. Taking into consideration the accounting literature on the treatment of breakage, it can be deduced that after the three-year validity period there is a remote chance that consumers will redeem the gift card value in future which results in the issuing merchant retaining the value on the gift card which is non-refundable. It can be argued that issuing merchants should thus include an amount in gross income when the probability of the gift card being redeemed is low, which is after the three-year validity period.

However, regarding the expiration of the gift card, the holder of the gift card forfeits all the rights and benefits to the value of the unredeemed amount of the gift card and the issuing merchant will cease to have any further obligations to the holder of the gift card. Nel (2020:53) noted that in this instance there is a “definitive transfer of value from the customer to the merchant and not just reliance on the intention of the consumer as with long outstanding gift cards”. The prepaid amount or amount paid in advance by the customer during stage 1 of the transaction process which was applied in exchange for the right to receive goods or services in future will result in the customer forfeiting this right when a gift card expires, and the consideration paid will become non-refundable by the issuing merchant. As a result, from the date a gift card expires, the value of the unredeemed balance whether in full or part, may become property of the issuing merchant. At this point, the amount may be received for the issuing merchant’s own behalf and for its own benefit and thus the issuing merchant should include the unredeemed amount (the full amount or a part of it) in its gross income.

When a gift card expires, it results in the terms and conditions regarding the validity period of the gift card not being met, and as a result a customer loses the right to spend any value on the gift card. In the case of open-loop gift cards, financial institutions will keep the value of the balance remaining on the gift card when the gift card expires before it is redeemed. Nel (2020:39) explained that a financial institution is basically providing a service to customers by issuing a gift card. It is making a facility available to customers to safely use the money topped-up on the open-loop gift card at any issuing merchant of the customer’s choice within a specified time frame as per the gift card’s terms and conditions. Usually when customers do not redeem the gift card value within the stipulated period, financial institutions will try to recoup the value on the card by

charging customers a dormancy fee (or any similar fee) on the balance remaining on the gift card, which is similar to a bank charge (Nel, 2020:40). Financial institutions need to consider how the dormancy fees charge should be treated for income tax purposes. This aspect will not be considered as it falls outside the scope of this study.

#### **4.3.2 Guidance from the USA on the uncertainties**

According to Fitzpatrick and Suttora (2011:382) even in the USA there is no uniformity in the treatment of gift cards for income tax purposes and this has led to inconsistencies by taxpayers on the correct timing for the recognition of receipts from gift card sales. Dennis-Escoffier (2015:121) noted that the IRS keeps changing and evolving its interpretation when income received in respect of gift cards should be taxed. However, unlike in South Africa the topic at hand is receiving the necessary attention in the US by its tax legislators and ample guidance has been formulated by the IRS.

Taxes that are imposed by the federal government in the US are found in Title 26 of the United States Code (26 U.S.C.) which is generally referred to as the Internal Revenue Code (IRS, 2022) (hereafter referred to as "IRC"). Subtitle A of the IRC provides rules for the imposition and calculation of federal income taxes and chapter 1 contains sections relating to normal taxes. The definition of gross income is found in section 61 of the IRC, and it is defined as income from any source including income derived from business. Section 451(a) of the IRC provides the general timing rule for inclusion of amounts in gross income and it provides that:

The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

This means, according to Suttora and Shi (2020), that section 451(a) of the IRC generally requires a taxpayer to include an amount in gross income in the tax year that he receives it, except if there is a specific accounting method such as the cash or accrual basis to calculate taxable income. The income inclusion is then to be accounted for in a different year. Income is included in the year that it has been received for companies that use the cash basis. In the case of gift cards, Farr (2018) noted that on the cash basis, revenue from gift card sales is included in gross income upon sale of the gift card and the timing of when the gift card is actually used is not relevant (Bradley, 2019).

Section 451(b)(1)(C) of the IRC stipulates that taxpayers using the accrual accounting method should include amounts in gross income for income tax purposes when “all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy”; this is referred to as the “all-events test” (Fitzpatrick & Suttora, 2011:382). According to Suttora and Shi (2020) “all the events that fix the right to receive income occur when payment is due, payment is made; or when the required performance takes place, whichever happens first”. This is in line with the judgement in the *Schlude v Commissioner of Internal Revenue* (1963) case where it was held that the “all-events test” means the earliest of when payment is received, earned or due.

Revenue arising from gift card sales is considered by the IRS to be a payment made in advance for the provision of goods or services (DeMarco, 2006:22). Section 451(c)(4) of the IRC defines the word advance payment as “any payment the full inclusion of which in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting under this section or which is for goods, services, or such other items as may be identified by the Secretary for purposes of this clause”. For the purposes of this section the IRC notes that an amount for gross income is received by a taxpayer “if it is actually or constructively received, or if it is due and payable to the taxpayer”.

According to LII (2022) Section 1.451-8(a) of the Code of Federal Regulations (hereafter referred to as “CFR”) which refers to rules and regulations by agencies and executive departments provides further clarification of the meaning of a payment made in advance. Section 1.451-8(a)(1)(i) of the CFR defines an advance payment as follows:

An advance payment is a payment received by a taxpayer if:

- (A) The full inclusion of the payment in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting...
- (C) The payment is for...
- (9) An eligible gift card sale.

An eligible gift card sale is defined in section 1.451-8(a)(10) of the CFR as:

The term eligible gift card sale means the sale of a gift card or gift certificate if:

- (i) The taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and
- (ii) The gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment.

Therefore, gift card sales in the USA are seen and treated as advance payment and the tax rules governing advance payment provide guidance on the income tax treatment of gift card sales. According to the IRS (2022) the general rule for the timing of payments made in advance in gross income is provided in section 451(c)(1) of the IRC and it notes the following:

A taxpayer which computes taxable income under the accrual method of accounting, and receives any advance payment during the taxable year, shall –

(A) ...include such advance payment in gross income for such taxable year, or

(B) if the taxpayer elects the application of this subparagraph with respect to the category of advance payments to which such advance payment belongs, the taxpayer shall –

(i) to the extent that any portion of such advance payment is required...to be included in gross income in the taxable year in which such payment is received, so include such portion; and

(ii) include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received.

Section 451(c)(1) of the IRC basically provides a general rule for accrual-method taxpayers who receive advance payments to include them in gross income in the tax year of receipt (the full inclusion method). The section also provides these taxpayers with an election to defer the inclusion of amounts in gross income for payments made in advance for goods, services and other specific items such as gift cards to a later year of assessment of receipt, should that income also be deferred for AFS purposes. This is in line with the interpretation in section 1.451-8 (b)-(c) of the CFR to which Suttora and Shi (2020) agreed. Gift cards fall under the category of a type of revenue that qualify for the deferral as per these sections. Therefore, the timing for the recognition of gross income in respect of gift card sales in the USA is dependent on whether the cash basis or accrual basis of accounting is used by a supplier when reporting its income taxes (Bradley, 2019).

The IRS offers two methods to accrual basis taxpayers to include an amount in gross income which are the full recognition and deferral recognition methods (Farr, 2018). As a general rule the IRS provides for income tax purposes under section 451(c) of the IRC that accrual-method taxpayers who receive advance payment amounts for goods or services to be supplied at a future date to include those amounts in their gross income in the taxable year of receipt (BDO USA, 2016:1) and (Fitzpatrick & Suttora, 2011:383). The full recognition method is similar to the cash basis which means that issuing merchants should include income for income tax purposes from the sale of gift cards as the cards are sold (Bradley, 2019). This method simplifies the income tax reporting for those issuing merchants who do not have a robust tracking system for gift cards

(Farr, 2018). Issuing merchants have to include proceeds arising from gift card sales as income on date of sale; this includes those gift cards that may be unredeemed (Farr, 2018).

For deferral recognition, businesses are allowed to defer the recognition of gift card sales for income tax until the gift card has been redeemed (DeMarco, 2006:22). Farr (2018) explained that unlike Generally Accepted Accounting Principles (GAAP) rules which allow for a deferral to recognise revenue from the sale of gift cards until the card is actually used, the IRS only allows taxpayers to include income from gift card sales for either one or two years. BDO USA (2016:1) agreed that the receipt from the sale of gift cards is deferred for federal income tax purposes for a one-year deferral or a two-year deferral. The one-year deferral works as follows: the year in which the gift cards are sold issuing merchants must include income for those gift cards that are redeemed in that year. At the end of the next year all the remaining income must be included in gross income notwithstanding whether the gift cards have been redeemed or not (Farr, 2018). The one-year deferral applies to those gift cards where the redemption is for either goods or services or both.

According to Nesi (2006:265) section 451(c) of the IRC permits taxpayers a two-year deferral in respect of advance payments received for goods sold in respect of gift cards. According to Farr (2018) the two-year deferral entails that income from the sale of gift cards must be included on the income tax return at the end of the second year from date of sale, and this deferral is primarily for goods. With regard to services, Farr (2018) explained that for incidental services to the sale of goods, for example installation fees for televisions sold, that portion of the redemption for service must then be estimated and included in income in year one. Fitzpatrick and Suttora (2011:383) referred to these services as 'integral services' as they form an integral part of sales of goods. In the case of advance payments received for both goods and services, the tax treatment should allocate each item objectively and can apply to each item to the service and to the goods in terms of section 451-5(c) of the IRC (Farr, 2018). According to the IRS (2022), should gift cards expire prior to the two-year deferral period, the income arising from gift card sales should be included in gross income on the expiration date (Hendricksoon, 2011:8).

Farr (2018) provides the example below to explain the two-year accrual method:

**Figure 4-1: Example of the income tax revenue recognition on the deferral method**

	<b>Total cards sold by year</b>	<b>Unredeemed balance at 1/1/17</b>	<b>Redemptions</b>	<b>Unredeemed balance at 12/31/17</b>
2017	15,398.00	-	12,459.00	2,939.00
2016	14,329.00	2,543.00	1,289.00	1,254.00
2015	12,352.00	996.00	76.00	920.00
2014 and earlier	34,876.00	3,011.00	34.00	2,977.00
<b>Totals</b>	<b>76,955.00</b>	<b>6,550.00</b>	<b>13,858.00</b>	<b>8,090.00</b>

Source: Farr (2018)

In this example a company sells gift cards and has elected the two-year deferral method. The company will include these amounts on its 2017 income tax return in respect of gift card sales:

- An amount of \$12 459 for those cards sold in 2017 and redeemed in the same year;
- an amount of \$1 289 for the cards sold in 2016 but redeemed in 2017;
- an amount of \$76 for the cards sold in 2015 but redeemed in 2017, and
- an amount of \$920 which represents the outstanding balance of gift cards sold in 2015 as at the end of 2017.

In the example above, the company will include income from gift card sales for an amount of \$14 744 whereas the actual redemptions amount to \$13 858. Revenue from cards sold before 2015 and redeemed in 2017 will not form part of income in the 2017 tax return as it would have been included in earlier years. Should the company elect the full recognition method, the full amount of \$15 398 for gift cards sold in 2017 would have to be included as income for tax purposes (Farr, 2018). In summary, gift card sales are recorded as income for tax purposes in the year when payment is received or the year they are redeemed; however, they may not be recorded later than two years from the date they have been sold even if they have not been redeemed by the end of the second year (DeMarco, 2006:22).

Further suggestions on the income tax treatment of gift cards in the USA is found in the Revenue Procedures. According to RSM US LLP (2019), Revenue Procedure 2004-34 provides for the deferral of the inclusion of income for state income tax purposes in respect of gift card sales under

two circumstances. It distinguishes the treatment for taxpayers that have an Applicable Financial Statement (AFS) which is defined as an audited financial statement, and those that do not. Taxpayers who have an AFS can defer the recognition of income of unredeemed gift card sales in a current tax year to the next tax year provided that revenue is also deferred for financial reporting purposes (RSM US LLP, 2019). Issuing merchants can, however, include income for tax purposes in year two for income deferred from the year of the receipt of cash. Those taxpayers that do not have an AFS must include the receipt of cash from the sale of gift cards redeemed in the year it is received and defer the remaining amount to the subsequent tax year (RSM US LLP, 2019). For issuing merchants to qualify for this treatment under Revenue Procedure 2004-34, it is important that they carefully keep track of gift cards and redemptions (Battersby, 2009).

It therefore appears that taxpayers in the USA have an option to elect which approach they will follow for the recognition of income arising from the sale of gift cards based on their facts and circumstances. Battersby (2009) noted that what complicates the income tax treatment of gift cards and keeping track of gift cards redeemed, used and/or unredeemed, is the selling of gift cards by other entities who did not issue the gift cards originally. The IRS concluded that when a merchant sells gift cards that are redeemable by other merchants who did not issue them, the income tax treatment should be the same as when gift cards are redeemed by the merchant that issued them, provided that the other requirements of Revenue Procedure 2004-34 are met (Fitzpatrick & Suttora, 2011:383).

Additional considerations that merchants need to take into account in the USA are unclaimed property law rules. Some States in USA source their revenue by means of their unclaimed property laws instead of increasing taxes (Diamond, 2011:973). Diamond (2011:973) explained that unclaimed property laws (sometimes referred to as escheat laws) allow for property that has not been claimed for a selected period by its owner to be taken for custody by the State. An attempt to claim the remaining value of gift cards that have not been redeemed for a long period of time is an example of this trend which on its own results in small amounts of money but constitute a big sum in aggregate (Diamond, 2011:973).

According to Hendricksoon (2011,11) almost half of the States require taxpayers to report and pay unredeemed balances on gift cards to the state once the gift card has expired or has not been redeemed three to five years from date of issue. These balances are also subject to income tax. Bradley (2019) noted that each State decides on how to treat unused gift cards with the result that there is no uniformity across the entire country. Escheat laws with regard to unredeemed gift cards are applied differently in each State and its rules vary significantly from one State to another

(Nesi, 2006:264). The form of gift card (electronic or physical), where the gift card was bought, and the period that the gift card remains unused, are some of the factors that are considered by each State (Bradley, 2019).

In summary, the position of the IRS regarding receipts of gift card is that generally they represent payments in advance for goods or services and should be included in gross income (Biek, 2008:19). In terms of the timing for the inclusion, the IRS in general seems to be of the view that the inclusion of gift card receipts in gross income should be in the taxable year of receipt (cash basis or full inclusion method) or a taxpayer may elect to defer the inclusion of the proceeds of gift cards if the taxpayer satisfies the requirements of section 451 of the IRC (Biek, 2008:19). However, some taxpayers defer the inclusion of receipts of gift cards beyond the period prescribed by the IRS and are of the view that the gift cards should be taxed on the earlier redemption of the gift card or the time the unredeemed value will be reported and handed over to the state as unclaimed property (Biek, 2008:19).

Farr (2018) noted that it is imperative that suppliers who sell gift cards are able to track sales from gift cards and their actual redemptions, should they want to use the deferral method as the timing between the actual sale and the date of recognition for tax will differ and will result in a book-tax difference on taxpayers' tax returns in regard to gift cards. Therefore, issuing merchants have the administrative burden to track any outstanding balances on gift cards over several time periods (Battersby, 2009:32). It is also a requirement by the IRS in terms of section 1.451-5(4)(d) of the CFR that taxpayers must attach an annual information schedule to their income tax returns for each tax year, reflecting:

the total amount of advance payments received in the taxable year, the total amount of advance payments received in prior taxable years which has not been included in gross income before the current taxable year, and the total amount of such payments received in prior taxable years which has been included in gross income for the current taxable year

to keep track of taxpayers reporting obligation in respect to gift cards (LII, 2022). The IRS also addresses other factors relating to gift cards which include the following: gift cards that are topped up start their period of deferral when those extra funds are loaded onto the card and not on the initial date they were purchased; any fees such as dormancy fees that may arise in respect of open-loop gift cards should be recorded when they arise; the same income tax rules should be followed in respect of electronic gift cards, rules for the income tax treatment of a gift card company whose purpose is solely to administer gift card programs and the income tax implications for gift cards issued in exchange for merchandise returned (Hendricksoon, 2011:8-

9). This shows that the topic at hand is receiving the necessary attention from the IRS and various tax provisions have been provided and legislated for taxpayers to consider, whereas in South Africa SARS is silent on the matter. South African legislators should perhaps consider including a specific tax provision which specifically addresses how gift cards should be treated for income tax purposes in general, similar to how the IRS has included general provisions for the treatment of advance payments, which include gift card sales. To avoid confusion for taxpayers, SARS should take a specific policy stance on when the proceeds from gift card sales should be included in gross income and should then legislate it.

#### **4.4 An analysis of uncertainties about the deductibility of costs to fulfil gift cards and possible guidance from the USA**

##### **4.4.1 The issues**

###### **4.4.1.1 Timing of expenditure for deductions**

The deductibility of the outflow of gift card transactions was discussed in section 3.5. It was deduced that the outflow of gift card transactions by a taxpayer meets all the requirements of the general deduction formula in section 11(a) of the ITA when read together with section 23(g); however, it was uncertain whether the requirement of 'actually incurred' would be satisfied. The issue regarding the deductibility of costs to fulfil gift card transactions is thus a question about timing: when does the taxpayer have an obligation to supply goods or services to the customer or to pay the third-party compensation for the supply of the goods or services? It is not certain whether it is at the time when the gift card is issued, or only when redemption occurs. It is not clear what would happen if the gift cards are never redeemed.

It is an accepted principle in tax law that an expense must be deducted in the year of assessment in which it is incurred (*Concentra (Pty) Ltd v CIR*, 1942). In applying the principles of the case of *Caltex Oil (SA) Ltd v SIR* (1975) as discussed in 3.5, a position may be taken that the expense regarding the supply of goods or services by the taxpayer is actually incurred at the time that the gift card is issued and not when the value of the gift card is redeemed. A question may then arise as to what the value of the expenditure would be for the taxpayer to deduct from taxable income, because the value is not actually known until the day the customer redeems the gift card value in exchange for goods or services. It may occur that a customer redeems the full value of the gift card voucher, or he/she may redeem only part of it.

There may be instances where the actual amount of the deduction is not quantifiable at the end of the tax year in which the expense was 'incurred'. Williams (2015:440) agreed that there may

be situations where the amount of the expenditure is unquantified at the end of the year of assessment during which it has been incurred, the amount for the expense can only be determined in a subsequent tax year. Williams (2015:440) raised the following questions in relation to the point under discussion:

- Can an expense be said to have been incurred in one fiscal year if the obligation to pay in a subsequent fiscal year is defeasible?
- Can the expense be incurred in one fiscal year if the quantum of the expense can be determined only in a subsequent fiscal year, and if so, how is the quantum of the deduction in the first fiscal year determined?
- What are the tax consequences if the payment obligation, once quantified, exceeds or is less than the amount of the deduction allowed in a prior year? (p. 440)

The questions arise because the liability to pay an expense subsequent to the year in which it was incurred may be waived, reduced or extinguished without actual payment in that subsequent year (Williams, 2015:440). There is no certain answer to this question of quantification of amount. However, Williams (2015:443) further noted that the basis of the ITA is that an expense that qualifies for a deduction in a given tax year must be claimed in that year, and the deduction should not be defeated because that the amount can only be determined in a subsequent tax year. As noted above, the specific amount for the supply of goods or services cannot be exactly determined when gift cards are issued as it depends on the actual value redeemed by the gift card holder. If a position is taken that the expense to supply goods or services or pay the third party is incurred in the year the gift card is issued (*Caltex Oil (SA) Ltd v SIR*, 1975), it remains uncertain what amount or what basis taxpayers should use to quantify the amount of the expenditure they would deduct in that year of assessment. Taxpayers can use varying methods, such as estimates and make adjustments to the amount in the subsequent year (Williams, 2015:443-444). This would vary from taxpayer to taxpayer and would not be consistent.

A different position may be taken, in applying the principles of *Edgars Stores Ltd v CIR* (1988) and *Nasionale Pers Bpk v KBI* (1986) as discussed in 3.5.2 that the taxpayer's obligation with regards to claiming the deduction for the expense in respect of the supply of goods or services or to pay a third party for the supply of goods or services may be uncertain at the time the gift card is issued because the words actually incurred do not allow deduction of expenditure that is uncertain or contingent. It all depends on whether the gift card holder redeems the value of the gift card or not. There is a possibility that some gift cards may never be redeemed in time, i.e. before they reach an expiry date. The taxpayer will never know if the gift card holder will redeem the gift card value or not until such a point that the gift card expires. Therefore, it must be

determined whether a taxpayer still has an obligation to supply the goods or services when the gift card is issued if it is not certain that the customer will redeem it, and whether the taxpayer should wait until the expiry date is reached before it can claim the deduction.

It must also be considered what would happen if the taxpayer does claim the deduction when the gift card is issued but the customer does not redeem the gift card and it reaches expiration. This would mean that the taxpayer is allowed a deduction for an expense that has not actually been incurred. Should the taxpayer take a position not to include the receipt of the gift cards in gross income when they are issued, it would mean that the taxpayer's taxable income in the year of assessment, when he claims the deduction, would be less and would possibly create a mismatch between the timing of the inclusion in gross income and deduction. There should thus be a possible recovery if it is ascertained that a taxpayer claims a deduction in the year the gift card is issued however the customer has not redeemed it. An option to consider is a possible recovery in terms of section 8(4)(a) of the ITA, viz. a recoupment.

It is easier for the taxpayer to determine whether a liability exists or not in the year of assessment when the gift card has reached the expiry date because it will not have any obligation to supply the goods or services or to pay third-party compensation. Therefore, the gift card issued will not meet the requirement of actually incurred after the expiry date. Some taxpayers may thus only wait until the year of assessment that the gift cards expire to determine if they should claim the deduction or not. It is thus not certain what the timing of the deduction would be when a gift card is not redeemed or reaches its expiry date.

As discussed in 3.5.6 SARS has in practice not allowed taxpayers to claim a section 24C allowance in respect of gift cards, which happened more or less in 2013 (Van den Berg, 2013). Its view is that issuing merchants do not necessarily have an obligation to incur any future expenses in terms of section 24C with respect to gift cards because the cost of the goods essentially makes up the future expenditure and the goods may most likely be on hand at the end of a year of assessment. The view that SARS thus holds is that the section 24C allowance should not be claimed on income received in respect of gift cards to the extent that that income received will be funded by the trading stock which, at the end of a tax year, is already on hand (Van den Berg, 2013).

However, SARS (2014b:25-26) in its IN no. 78 on section 24C noted that a taxpayer that has an advance income in respect of gift cards sold but not redeemed at the end of a tax year may be entitled to claim a section 24C allowance. The IN does not discuss in detail the implications of the section 24C allowance on gift cards. It notes that a taxpayer may be entitled to claim the allowance

on the income received in advance using a gross profit percentage, taking into account any income or costs that must be disbarred from the gross profit percentage formula as explained in detail in the IN. SARS. however. cautions that taxpayers need to take into consideration the age of the gift cards because there comes a point when unredeemed gift cards will unlikely ever be redeemed, e.g. if they get lost, and this will mean that there will not be any future expenditure (SARS, 2014b:26).

Therefore, the position of SARS on the effect of section 24C on gift cards appears to be contradictory; it is also not clear whether it is applicable or not. KPMG (2019b) is of the view that taxpayers should consider the availability of the section 24C allowance. KPMG (2019b) noted in respect of the *ITC 1918* (2019) case that:

As the taxpayer's appeal was solely in relation to the tax treatment of the receipts from the sale of the gift cards, the Court did not address the availability of the section 24C allowance in the event that the proceeds on the sale of gift cards are taxed on receipt. Nonetheless, should a taxpayer find itself in a position where the receipts are taxable, to the extent possible, eligibility for the section 24C allowance will have to be considered based on a specific set of facts and circumstances (to the extent future expenditure is to be incurred to meet the taxpayer's obligations in terms of the token, voucher or stamp). (p. 2)

If a position is taken that gift cards are only taxable when redemption occurs or upon breakage, i.e., during stage 2 of the transaction trail as described in chapter 2, it may suggest that section 24C should not be relevant because there is no income before an expense. It may therefore mean that the assertion in IN no. 78 is contradictory to the researcher's above-mentioned analysis of the income tax principles and the analysis of the *ITC 1918* (2019) court case where the provisions of the CPA were considered. It may indicate that SARS may be of the perception that the CPA does not apply and/or the *ITC 1918* (2019) case is not relevant. It is therefore uncertain whether the availability of the section 24C allowance is relevant for taxpayers.

#### **4.4.2 Guidance from the USA on the uncertainties**

According to Suttora and Shi (2020) the provisions for advance payment in terms of the IRC seem to only work at gross receipts level. This means that there is no corresponding offset for the cost of goods sold and as such taxpayers find themselves in situations where they can recognise income in one year but are not able to recognise the offset for the cost of goods sold until a later tax year (Suttora & Shi, 2020). The deductibility of expenditure in general lies in the general deduction formula in section 162(a) of the IRC. According to the IRS (2022), in terms of section

162(a) of the IRC, trade or business expenses are defined as follows: “There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business”.

The wording is rather similar to that found in section 11(a) of the ITA in that ‘ordinary and necessary expenses’ is akin to ‘expenditure and losses’, ‘incurred’ analogous to ‘actually incurred’, and ‘in carrying on any trade or business’ is close to the ‘in the production of income’ and ‘carrying on a trade’ requirement. With regards to the timing rule, section 461(a) of the IRC provides the general rule for the taxable year of deductions, and it provides that: “the amount of any deduction...shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income” (IRS, 2022).

According to IRS (2022) the timing of deduction of expenditure depends on a taxpayer’s accounting method. The two basic methods are the cash receipts method and the accrual method. With regard to the cash receipt method, expenses are usually deducted in the tax year they are paid. Under the accrual method expenditure is deductible when the all-events test has been met and the economic performance has occurred (IRS, 2022). In terms of section 461(h)(4) of the IRC it entails that the all-events test is met when “all events have occurred that fix the fact of liability and the liability can be determined with reasonable accuracy”. According to the IRS (2022) this means that “there cannot be an accrual for expenditure until the liability is fixed and certain and there is no contingency”. Section 461(h)(2) of the IRC notes that economic performance means “the time when activities are performed that satisfies the liability”.

According to Rohrs (2009) taxpayers that have elected to use the deferral method for income inclusion have submitted that they are entitled to a deduction in respect of cost of goods sold for gift cards that have not been redeemed that they have included in gross income in the second year after the gift card has been sold. The IRS (2022), however, states in terms of section 1.451-5(c)(1) of the CFR rules that:

- (ii) ...the taxpayer must take into account in such taxable year the costs and expenditures included in inventory at the end of such year with respect to such goods (or substantially similar goods) on hand or, if no such goods are on hand by the last day of such second taxable year, the estimated cost of goods necessary to satisfy the agreement.
- (iii) ...Subdivision (ii) of this subparagraph does not apply if the goods or type of goods with respect to which the advance payment is received are not identifiable in the year the advance payments are required to be included in income... (for example, where an amount is received for a gift certificate).

Rohrs (2009) explained that this section means that the deduction for the cost of goods is not applicable if the goods in respect of the advance payment received, such as gift cards, cannot be identified in the tax year when the advance payment is included in gross income. Therefore, taxpayers are not allowed to reduce the cost of goods sold until such time that the goods have been identified to the contract because a taxpayer will not know which goods the gift card holder will redeem Rohrs (2009). Hendricksoon (2011:7) agreed that the IRS prohibits taxpayers to realise cost of goods sold before the gift card is redeemed by customers because it cannot be envisaged which goods or services will be redeemed by the gift card holder. Therefore, expenditure is deducted for income tax purposes in respect of gift cards when the gift card value is redeemed.

To support the understanding of tax deductions in respect of gift card transactions, reference is made to the deductibility of customer loyalty rewards programs by taxpayers. A recent court case of *Giant Eagle, Inc. v Commissioner of Internal Revenue* (2016) in the USA dealt with whether the taxpayer could claim deductions for expenses in respect of customer loyalty programs. The taxpayer in the case *Giant Eagle, Inc. v Commissioner of Internal Revenue* (2016) had a customer loyalty reward program where customers were awarded discounts for subsequent fuel purchase if their reward points reached a designated threshold. The taxpayer (Giant Eagle Inc.) determined its year end liabilities for those discounts that had not been used or redeemed using various statistical analyses (Simons, 2016). The tax court in the case held for the IRS that Giant Eagle Inc. should not claim a deduction for the customer loyalty program because the customers had not yet redeemed the rewards earned. The IRS's view is that the expenditure should be treated as non-deductible for income tax purposes because it does not satisfy the "all-events test".

The Giant Eagle Inc. argued that the expenditure did satisfy the all-events test because its liability became fixed when the discounts in respect of the loyalty program were issued. The tax court disagreed with Giant Eagle Inc. in that the all-events test had not been met because the purchase of the Giant Eagle Inc. 's products (fuel) was as a result of a condition precedent to customers redeeming the discounts (rewards) earned (Simons, 2016). As such, the tax court held that a liability only became fixed after customers had redeemed or applied the discounts to purchase the fuel, which in the case of Giant Eagle Inc. only occurred in subsequent years and not when the discounts had been issued (Simons, 2016). Giant Eagle Inc. appealed this view and the judge in the Court of Appeal disagreed with IRS and held that the all-events test in section 461(h)(4) of the IRC permits taxpayers to deduct expenses for income tax purposes prior to them being paid, as long as all events have happened which ascertain the fact of liability and the amount for that liability can be established with reasonable precision. As such, the Court of Appeal noted that

Giant Eagle Inc. could claim a deduction for the expenses under consideration. The judge noted that: "Giant Eagle characterizes its issuance of fuel perks rewards as a unilateral contract formed at checkout, which conferred instant liability on the supermarket chain to its customers for the rewards they accrued" (*Giant Eagle, Inc. v Commissioner of Internal Revenue*, 2016).

The Court of Appeal in the *Giant Eagle, Inc. v Commissioner of Internal Revenue* (2016) case concluded that a fixed liability was incurred at the time of purchase and it was not relevant that the total amount should have been established by the end of the year. The court noted that the all-events test only demanded that the chance of non-redemption was computed with reasonable accuracy and that Giant Eagle Inc. achieved that as it calculated the amount by using statistical analysis and its continuous monthly customer review of redemption rates (Simons, 2016). Some judges in the USA, however, disagreed with the decision of this court in that the Giant Eagle Inc's loyalty program contained an expiration period of only three months for instance and in any case would have disallowed the deduction because the obligation for the Giant Eagle Inc. is contingent upon the customer redeeming the rewards.

In summary, the position of the IRS is that a taxpayer should not take a deduction for the expense until customers actually redeem the points because the event that fixes the taxpayer's liability arises when a customer has reached the minimum designated threshold of points to be redeemed and the customer actually redeems the points (McEowen, 2022). The appeal court in the case of *Giant Eagle, Inc. v Commissioner of Internal Revenue* (2016) is of the view that a deduction should be claimed at the time the rewards are earned by customers because that is when the liability becomes fixed, and thus a deduction must not be deferred until the rewards are redeemed by the customer (McEowen, 2022) and (Simons, 2016). The IRS, however, does not agree with this point.

#### **4.5 Conclusion**

In this chapter uncertainties about the income tax treatment of gift cards in South Africa were analysed and guidance was sought from the USA. The uncertainties were grouped into income, which included the timing of inclusion in gross income issue and the issue of breakage; the other was expense related which discussed the timing of deductions for the expenditure to honour the gift cards. The main objective of this chapter was not to compare the income tax legislation in respect of gift card sales in South Africa to that in the USA, therefore the chapter did not perform a comprehensive analysis of how gift cards sales are treated for income tax purposes in the USA. One country's tax law is not exactly the same as another's, but it is valuable to consider how other

jurisdictions tax sales from gift cards as it may provide room for improvement in the South African income tax legislation.

The issue with regards to the timing of the inclusion of gift cards in gross income mainly focuses on when the proceeds from gift card sales should be included in the gross income of the taxpayer, and the impact that the CPA has on the timing inclusion. Some taxpayers may or may not consider the effect and application of the CPA which would mean that taxpayers may come to different conclusions about the time they include proceeds from the sale of gift cards in gross income. In some instances, some taxpayers may be of the view that the CPA is not applicable to them. It is also unclear whether the CPA is applicable to all types of gift cards such as open-loop gift cards because the *ITC 1918* (2019) case which brought the attention of the CPA was focused on closed-loop gift cards. There is also uncertainty about breakage (unredeemed gift cards) for income tax purposes. There is simply a lack of guidance on how taxpayers should treat unredeemed gift cards for tax purposes. The USA has established numerous guidelines on this issue and the IRS has noted that gift cards should be included in gross income for cash basis taxpayers in the year of receipt. Accrual basis taxpayers can elect to defer the inclusion for up to two years. This is applicable to gift cards which may also not be redeemed.

With regards to deductibility, it is not certain when taxpayers should deduct the expenditure for the supply of gift cards, and it is also not clear whether taxpayers may be entitled to claim the section 24C allowance. SARS seems to have a contradictory view about this which may result in confusion for taxpayers. The IRS is of the view that taxpayers should only claim the deduction once the holder of the gift card has redeemed it because that is when the taxpayer's liability is fixed, and the amount can be established with reasonable accuracy. This view, however, was not supported by the Court of Appeal in the case of *Giant Eagle, Inc. v Commissioner of Internal Revenue* (2016).

SARS should take a policy stance and prepare guidelines on the income tax treatment of gift cards for suppliers in South Africa to ensure that gift cards are treated correctly and that there is consistency among all taxpayers. The general consensus is that there appears to be gaps in the application and interpretation of the ITA with regards to gift card transactions. As evidenced by the research conducted, there is a lack of guidance from SARS on this topic which requires attention urgently because the incorrect treatment of gift card transactions could lead to possible understatements (in the case of deductions) which might raise penalties for the taxpayer.

The lack of guidance on the income tax treatment of gift cards in South Africa by SARS is accentuated in view of the guidance offered by the USA. This is summarised in the table below.

**Table 4-1: Comparison between South Africa and the United States of America.**

<b>Concerns</b>	<b>South Africa</b>	<b>United States of America</b>
Specific legislation with regard to the income taxation of gift cards.	Not available.	Specific provisions provided in sections 451 and 461 of the IRC code.
Guidance recommended by local revenue authority with regards to the income taxation of gift cards.	Not available.	Specific provisions provided in sections 451 and 461 of the IRC code, section 1.451-8 of the CFR regulations and also provided in Revenue Procedure 2004-34.
Guidance offered with regards to the timing of income inclusion in gross income.	No guidance provided.	Two types of taxpayers exist: (i) cash-basis method taxpayers and (ii) accrual-method taxpayers. Taxpayers who use the cash basis method should include proceeds from gift card sales in the year of receipt. Accrual-method taxpayers must either include the full amount proceeds in gross income in the tax year of receipt or can elect to defer the inclusion of proceeds in gross income for up to two years.
Guidance offered on the income tax treatment for breakage consequences (unredeemed gift cards).	No guidance provided.	The above provisions on the timing of inclusion in gross income apply, notwithstanding whether the gift card is redeemed or not.
Timing of expenditure.	No guidance provided.	Two types of taxpayers exist: (i) cash-basis method taxpayers and (ii) accrual-method taxpayers. Taxpayers who use the cash basis method should deduct the expenditure in respect of gift cards in the year they are paid. Accrual-method taxpayers should only deduct the expenditure once the

		gift card has been redeemed by the customer (or earlier of expiration).
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*Source: Author's own compilation of details presented above*

## **CHAPTER 5 CONCLUSION**

### **5.1 Introduction**

There are no clear and specific guidelines from the South African tax legislators on the income tax treatment of gift card transactions in South Africa. Therefore, South African suppliers that sell gift cards could have a mixed understanding of how to account for gift cards for income tax purposes and they may be uncertain of what the appropriate treatment is. To address this problem statement, the primary objective of the study as set out in section 1.3.1 was to analyse the South African income tax legislation to determine areas of uncertainty in the current legislation on the income treatment of gift cards in the hands of suppliers. The study also sought guidance from the USA on how the country deals with the shortcomings identified in the South African income tax legislation.

Secondary objectives which are closely linked to the chapters in the study as set out in 1.3.2 were formulated to assist in achieving the primary objective. These secondary objectives are as follows:

- i. To provide a detailed overview of the concept of gift cards by describing their commercial nature and characteristics (Chapter 2);
- ii. To analyse the current South African income tax legislation and case law to determine the income tax treatment of gift cards in the hands of suppliers (Chapter 3) and
- iii. To analyse the areas of uncertainty about the income tax treatment of gift cards in South Africa and to determine how the USA has dealt with these shortcomings (Chapter 4).

This chapter provides a summary of the research findings and conclusions reached to address the above research objectives. The chapter also recommends possible tax research in future that could be undertaken on the topic at hand.

### **5.2 Summary of research findings**

#### **5.2.1 The concept of gift cards**

Chapter 2 addressed the first secondary research objective which described the commercial nature and characteristics of gift cards in order to get a detailed overview of the concept of gift card transactions. Gift cards are used by businesses across South Africa and all over the world

mainly because they result in increased sales and profits for businesses. This is as a result of varying factors such as the non-redemption of the value of gift cards which is a significant benefit to issuing merchants. Gift cards are also a great marketing tool used by businesses to increase sales as it results in additional spending by customers. The benefits of gift cards extend also to customers in that they are viable economically because gift card recipients have the freedom to acquire their preferred goods or services without spending their own money.

In chapter 2 it was identified that gift cards can be split into two broad categories, the first one being closed-loop gift cards which are those that are typically issued by retailers and can be redeemed only at retailers specified in the terms and conditions of the gift card. This type of gift card can be sub-divided into two more subcategories being product-specific gift and retailer-specific gift cards where the main difference is that product-specific cards are limited to a particular type of product that can be redeemed, whereas retailer specific cards can be redeemed for any type of goods or services. The second category is open-loop gift cards, also known as network-branded gift cards, as they function similarly to a normal debit or credit card. Open-loop gift cards are issued by financial institutions and the redemption thereof is done by any merchant that has the facilities to accept this type of card.

Even though gift cards have different types and features, the key to the transaction process of each type of gift card remains the same. This was illustrated by means of a three-stage model developed by Nel (2020:15) which entails the issuance of the gift card by the particular merchant (retailers in the case of closed-loop gift cards and financial institutions in the case of open-loop gift cards), the redemption of the value of the gift card by the customer and the compensation of the gift card from the merchant who originally issued the gift card to the merchant where the actual redemption occurs. This is typically how a gift card transaction, whichever type, is effected but the stages may differ based on factors such as the terms and conditions of the gift cards, the preferences of the gift card recipient and the intention of the issuing merchant.

A high-level overview of the accounting treatment of gift cards in terms of IFRS 15 was set out to provide substance to the economic reality of gift card transactions. In terms of IFRS 15, when a customer pays in advance for a gift card there is a performance obligation that is created that the issuing merchant needs to satisfy in future. As such, the issuing merchant will recognise a contract liability in its accounting records and only recognise revenue until such time that the customer redeems the value of the gift card and the promised goods or services are provided to the customer. The non-redemption (breakage) of gift cards was also discussed. The breakage amount is recognised as revenue and the timing of the recognition is in the same pattern as the redemption of the actual gift card value.

Chapter 2 also described the legal nature of gift cards to provide further insight into the commercial nature of gift card transactions. Various terms and conditions of gift cards which include the validity of gift cards, restrictions on the use of gift cards and fees charged on gift cards were identified and discussed. It was deduced that most gift cards that operate in South Africa have a three-year validity period which is in line with the CPA before they expire or become unredeemed. It was concluded that a gift card is essentially a contract between the issuing merchant and a customer where a customer prepays, makes an advance payment or pays a deposit for the issuance of the gift card and the issuing merchant has an obligation to provide goods or services to a customer in future, subject to the terms and conditions of the gift card.

It is clear from the above that the first secondary research objective set out in chapter 2 was met. It provided an understanding of what gift cards are, the different types, their characteristics and how they operate in the commercial sense. The observations made in chapter 2 are imperative as understanding the commercial nature of the transaction under study formed the basis of the analysis of the South African income tax legislation addressed in chapter 3.

### **5.2.2 The South African income tax legislation and case law on gift cards**

In chapter 3 the second secondary research objective was addressed when an analysis of the current South African income tax legislation was provided to determine what provisions are there, if any, to provide guidance on how gift cards should be treated for income tax purposes.

The gross income definition was analysed, and it was deduced that gift cards satisfy the total amount in cash or otherwise element. It is clear that they are revenue and not capital in nature and thus this element is also satisfied. The element that is found lacking is that of the “received by or accrued to” particularly the timing thereof. The case of *Geldenhuys v Commissioner for Inland Revenue* (1947) is the landmark case in South Africa which provided the principle that an amount is said to be received by a taxpayer if it is received on his own behalf and for his own benefit. The principle from this case is imperative when analysing the income tax treatment of gift cards because proceeds from gift cards can only be included in gross income by taxpayers when the proceeds have been received by the taxpayer not for the benefit of others. Thus, if taxpayers can prove that the receipts in respect of gift cards have been received by them on their own behalf for their own benefit, the proceeds on sale can then be included in gross income.

The chapter also considered the so called “deposit” cases as they are in nature similar to the sale of gift cards in most respects and it is the premise on which the *ITC 1918* (2019) judgement is based. In the case of *ITC 1918* (2019) the taxpayer included proceeds from gift card sales in its gross income when the gift cards had been redeemed or had expired due to the provisions of the

CPA. It was held that the provisions of the CPA provide some form of “cognisable legal context” which requires taxpayers to take reasonable care to carry the receipts for the bearer of the gift card and to not apply them as if they were their own property. As such, the court found that the receipts in respect of gift cards were “received by” the taxpayer not for its own benefit but to be held and for the benefit of the bearer of the gift card. Therefore, according to *ITC 1918 (2019)* amounts can only be included in gross income in respect of gift cards when the gift card is redeemed or has expired.

The three-stage model identified in chapter 2 was used to attempt to determine at which point gift cards should be included for income tax purposes. It was deduced that during stage 1 of the transaction flow when the gift cards are issued, the proceeds should not be included in gross income because the advance payment received from the customer is not received by the issuing merchant for its own benefit as it still has to provide goods or services in future to the card bearer. In stage 2 when the card bearer redeems the gift card value, the issuing merchant can include the income for gift cards because when it provides the goods or services to the gift card bearer, the obligation that it has for the card bearer falls away and the consideration for the gift card becomes its own property as it has now received it for its own benefit. Stage 3 of the transaction only occurs if the card bearer redeems the value of the gift card from another issuing merchant and not the issuing merchant that issued the gift card. It then becomes a question of whether the issuing merchant or the merchant where the redemption takes place should include the receipt in its gross income.

An analysis of the deductibility of costs to fulfil gift cards was briefly discussed. The issue with the deductibility of costs to fulfil gift cards is concerning the timing of the deduction. It is not clear whether taxpayers should claim the deduction at the time the gift cards are issued or only when redemption of the gift cards occurs. It is the requirement of “actually incurred” from the general deduction formula contained in section 11(a) of the ITA that is not clear. Case law interprets this requirement as when a liability regarding that expenditure has been incurred during the year, whether paid or not, and that the legal obligation to incur that expenditure is not conditional and uncertain. Some taxpayers could argue that they have incurred the expense at the time the gift cards have been issued because it has incurred a liability that is unconditional at that stage. However, some may be of the view that the expense is only incurred once the gift cards are redeemed because at that time the obligation is certain. The *Clicks Retailers (Pty) Limited v Commissioner for the South African Revenue Service (2021)* case was briefly analysed. It was concluded that gift cards function similarly to customer loyalty programs and a view could be taken that gift card transactions have two contracts which can be inextricably linked but may fail to satisfy the same contract basis or sameness requirement, and thus taxpayers may fail to claim

the section 24C allowance. If taxpayers could prove that they have an obligation to incur future expenses in terms of section 24C with regards to gift cards they could possibly claim the allowance.

### **5.2.3 Uncertainties about the income tax treatment of gift cards in South Africa and possible guidance from the USA**

Chapter 4 sets out the last secondary research objective which analysed the uncertainties and shortcomings on the income tax treatment of gift cards following the analysis of the income tax law from chapter 3. Guidance from the USA on how they have dealt with the shortcomings was discussed next. The chapter did not perform a comprehensive analysis of the USA's income tax legislation on gift cards as its objective was more to seek further guidance on the topic and not to do a comparison between countries.

A summary of the uncertainties or shortcomings of gift cards taxation were briefly outlined in the chapter. These included the timing of the recognition of proceeds of gift cards for income tax purposes, uncertainties on whether the CPA influences the timing of gross income inclusions, the issue of how non-redemption (breakage) of gift cards should be treated for income tax purposes, and the timing of deductions for the expenditure to honour gift cards. Breakage consequences were considered for income tax purposes, and it was deduced that South African tax legislators could perhaps consider a legislative intervention to enhance certainty on this issue of non-redemption by considering IFRS 15 accounting treatment as was the case with section 11(j) of the ITA where IFRS 9 was considered for legislative enhancements.

The USA is one of the countries which provided an in-depth overview on the topic. The issue of gift cards taxation is also a problem in the USA, especially the issue of non-redemption because issuing merchants operate across numerous States in the country which does not make it easy for these merchants to track the balances of these unredeemed values. The USA appears not to have a uniform treatment to the income taxation of gift cards as well, and the legislators keep evolving its interpretation for the taxation of gift cards. However, the IRS does provide guidance on the topic. The IRS considers gift cards to be an advance payment that is made by a customer for the provision of goods or services in future by a supplier.

Businesses that make use of the cash basis of accounting report the income tax on gift cards on the date of sale and it is not relevant when the gift card gets redeemed by the bearer of the card. Taxpayers who use the accrual basis have two options to recognise the timing of gift cards for income tax. They can use the full recognition method which is the same as the cash basis or they can use deferral recognition which allows them to defer the recognition for either one year or two

years. For the one-year deferral, taxpayers must include income for gift cards redeemed in year one and at the end of the subsequent year the income remaining from gift card sales must be included whether redeemed or not. In the two-year deferral, income may not be included later than two years from the date the gift cards were sold whether they are redeemed or not by the end of the second year.

With regard to the timing of deductions, the IRS provides that taxpayers' obligation to incur the expenses only arises when the gift cards have been redeemed by customers. However, there are different views on this. A recent court case in the USA saw the IRS's view being overruled in the Court of Appeal where the court allowed and agreed with the taxpayer in the case that the obligation to incur expenses arises when the customer loyalty points are earned (similarly when gift cards are issued).

### **5.3 Recommendations for future research**

The income tax treatment of gift cards is extensive as there are numerous variations regarding gift cards which may result in numerous tax issues to be considered. The provisions of the CPA could potentially impact a wide range of taxpayers in industries such as the hospitality and airline industry (KPMG, 2019b). Therefore, further research investigation can be undertaken to explore the impact of the judgement in the *ITC 1918* (2019) on industries such as these. Chapter 4 of the study only considered the income tax treatment of gift cards in the USA. A comparative study of analysing the income tax treatment in other countries can be undertaken to gain further insight into addressing the shortfalls in the South African legislation.

Another aspect that can be considered is if the provisions of the CPA are enough to represent a contract between a supplier who acts in fiduciary capacity and the gift card holder. There could possibly be a separate taxpayer that may have come into existence in relation to monies of gift cards held in a trust, as a trust is defined in section 1 of the ITA as "any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person". This possibility would have its own tax consequences which may need to be considered.

### **5.4 Overall conclusion**

The main objective of this study was to analyse the South African income tax legislation to determine the areas of uncertainty in the current legislation on the income tax treatment of gift cards by South African suppliers and how these uncertainties have been dealt with in the USA.

The overall objective of the research was attained by identifying the shortcomings in the income tax treatment of gift cards in South Africa and exploring the treatment of gift cards in the USA to provide guidance on how the uncertainties in South Africa could be managed. In short, these uncertainties include:

- i. The timing of inclusion of gift card sales in gross income and the impact of the CPA. It is not clear when proceeds from gift card sales should be included in gross income for taxpayers and whether the CPA applies in all cases, or if there may be instances where the CPA applies but taxpayers may not comply with it. The IRS in the USA has taken a stance that gift cards should be included in gross income on the date of sale (for cash basis taxpayers) or the inclusion in gross income can be deferred for up to two years (for accrual basis taxpayers).
- ii. The consequences of breakage refer to how unredeemed values of gift cards should be treated for income tax purposes. There is no clear answer to this issue and the IRS in the USA has taken the same stance as noted in issue one above, notwithstanding whether the gift card has been redeemed or not.
- iii. The timing of expenditure for the costs to fulfil the gift cards is problematic. It is not certain when taxpayers can claim a deduction with respect to the costs it might incur to fulfil the gift card. It is also not clear whether taxpayers can claim a section 24C allowance in respect of gift card transactions. The IRS in the USA has taken a stance that taxpayers should claim the deduction for the expenditure incurred only when redemption of the gift card occurs.

The overall main objective and research question in this study has been answered. The South African income tax legislation is not clear on the income tax treatment of gift cards in the hands of suppliers, and the uncertainties identified in this study could result in inconsistencies amongst South African suppliers as to the correct tax treatment of gift card transactions. Guidance from the USA has been provided briefly on how these uncertainties could be dealt with. The South African legislators could take a specific policy stance on the income taxation of gift cards in South Africa in order to ensure consistent and clear application of the income tax legislation.

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