



# **An analysis of the VAT treatment of vouchers in South Africa**

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## **Keywords**

- Vouchers
- Gift cards
- VAT treatment
- Voucher/Gift card transactions
- Analysis

## **List of Abbreviations**

SARS – South African Revenue Service

VAT – Value-added Tax

Value-added Tax Act - Value-added Tax Act 89 of 1991

BIN – Bank Identification Number

## **Abstract**

There is a huge development in the gift card market because of various factors, which includes the rapid developing technological environment. This will also cause an increase in expiration or non-redemption of gift cards. This developing market makes it necessary to consider the implications regarding possible value-added tax consequences. This study focuses on describing the commercial nature and function of the different types of vouchers, the classification thereof, the possible permutations of voucher transactions and any related non-redemption in the retail sector. A Three-stage model, representing the transactional flow of a gift card transaction is described and then adjusted for each of the main voucher/gift card categories and sub-categories to fit the characteristics and nature of a voucher related transaction. Thereafter, the South African VAT legislation is analysed by way of the Three-stage model to determine how and why the different types of vouchers are taxed in certain ways and whether the application regarding the voucher VAT legislation is clear and comprehensive. The basic principles of the VAT legislation are also applied to the identified voucher related transactions. Voucher specific VAT legislation is also explained and any shortfalls in the legislation are highlighted.

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## Chapter 1

### 1 Introduction

#### 1.1 Introduction and background

##### 1.1.1 General overview of the development of value-added tax

Cnossen (1998:399) stated that “the nearly universal introduction of value-added tax (VAT) should be considered the most important event in the evolution of tax structure in the last half of the 20th century.” Compared to other broad-based consumption taxes, VAT raises more revenue with lower administration costs – if the system is well designed and administered no distortion is caused and neutrality is ensured (Cnossen, 1998:399). Cnossen (1998:399) also states that this is one of the main reasons why many countries started adopting a VAT system.

Despite the above-mentioned benefits of a VAT system, the adoption of VAT by different countries began slowly (Ebrill, Keen, Bodin, & Summers, 2001:4). Before the introduction of VAT, sales and turnover tax were typically levied, there was also other indirect taxes on specific items such as alcohol and tobacco (Ebrill *et al.*, 2001:4). In the year 1921 Carl von Siemens, a German business man, suggested that taxes on productive business inputs should be recoverable, while in the same year Thomas Adams also proposed a “tax on expenditures”, specifically expenditures for private purposes and not those used in the course of trade for profitmaking, as a replacement for federal income tax (Van Oord, 2015:33). Van Oord (2015:33) also suggests that a tax on personal expenditures is essentially a tax on consumption – which is the basis of VAT. According to James (2011:16) the first full VAT system in Europe was imposed by Denmark in 1967, but was introduced for the first time nationally, although not fully reaching the retail sector, during 1954 in France. The enactment of VAT spread rapidly through the late 1960s to the late 1970s in Western Europe and Latin America after which it slowed down until the late 1980s when industrialized countries such as Australia and Canada, and developing economies such as Africa and Asia also started implementing it (James, 2011:16-17).

According to Go, Kearney, Robinson, & Thierfelder (2004:2) VAT was as imposed in South Africa at a statutory rate of 10% during September 1991 replacing the general sales tax (GST) levied at that time. In 1993 the statutory rate increased to 14% (Go *et al.*, 2004:2) and again on 1 April 2018 to 15% (Lamprecht, 2018). Compared to the 37.2% contribution of personal income tax, the highest revenue source for the South African government, VAT contributed

25.3% of the total tax revenue during the 2016/2017 year (National Treasury & South African Revenue Service, 2017:19). VAT could thus be considered the government's second most important revenue source after personal and corporate income tax (Go *et al.*, 2004:2). Cnossen (1998:403) states that: "A 'good' VAT should tax the broadest possible range of goods and services which are ultimately used by or benefit consumers." This broad base on which VAT is levied contributes to the high revenue collection.

VAT is an indirect consumption-based taxation and is levied on the value added in each stage of the production and distribution process (Gurumurthi, 1993:1108; Go *et al.*, 2004:3). According to Say (1803:294) consumption means:

the destruction of utility, and not of substance, or matter. When once the utility of a thing is destroyed, there is an end of the source and basis of its value; an extinction of that, which made it an object of desire and of demand. It thenceforward ceases to possess value and is no longer an item of wealth. Thus, the terms, to *consume*, to *destroy* the *utility*, to *annihilate* the *value* of anything, are as strictly synonymous as the opposite terms to *produce*, to *communicate utility*, to *create value*, and convey to the mind precisely the same idea. Consumption, then, being the destruction of value, is commensurate, not with the bulk, the weight, or the number of the products consumed, but with their value.

Consumption is thus as described by Say, the utilization of the value of products or services.

The "value added" to a product by the manufacturer is reflected in the difference between the sales price charged to a customer, and the taxable cost of materials used to produce the product (Li & Whalley, 2017:26). The South-African VAT system uses a "credit-input" method according to the National Treasury & South African Revenue Service (2017:199). VAT payments made by retailers registered for VAT purposes, on qualifying business expenses during the production and distribution stages of the business, are allowed to be deducted from VAT levied on products produced and supplied to consumers for consideration (National Treasury & South African Revenue Service, 2017:199). This ensures that neutrality in the business chain is maintained. The effect of this is that the final consumer carries the burden of the VAT process.

According to the Value-added Tax Act 89 of 1991 (Value-added Tax Act), for VAT to take effect and to be levied, goods or services need to be supplied to a consumer for consumption at a consideration. The Oxford English Dictionary (2018) defines "supply" as follows: "To provide,

or provide with, something. To furnish or provide (a person) with something; (in early use) to satisfy the wants of, provide for..." The definition of supply is thus all-encompassing and involves anything with value changing hands. A detailed explanation of the workings of the VAT in accordance with the Value-added Tax Act, will be provided in chapter 3.

It needs to be established whether voucher transactions adhere to the general principles of VAT. For example, it needs to be determined whether there is any consumption of value when a voucher is distributed or utilised in a transaction and if or when a "supply" is made for VAT purposes and whether a voucher qualify as goods or services. To help determine the above-mentioned, a general overview of vouchers, including a discussion on their origin, is in order.

### **1.1.2 General overview of vouchers**

According to the Tax Executives Institute (2007:280) vouchers come in many different forms, including tickets, tokens, cards, and electronic messages embedded on a chip or magnetic strip. Cambridge Dictionary (2018b) defines a voucher as "a piece of paper that can be used to pay for particular goods or services or that allows you to pay less than the usual price for them". The Tax Executives Institute (2007:280) agrees that:

a voucher carries a right to receive goods or services, or to obtain a discount, when acquiring those goods or services, or to receive a refund, at the time of the redemption. That right might be shown as a value expressed in terms of monetary value or of percentage (percentage reduction) or of units or of quantity.

It is also agreed that categorisation of vouchers should not be made according to their medium.

Currently there is an extensive range of different vouchers available as it is commonly traded as payment in exchange for goods and services (South African Revenue Service, 2014:1). Gift cards (previously gift vouchers or certificates) can be classified into various conceptual areas as it is marketed and sold across all retail categories similar to a retail product, while also acting as a form of currency or financial instrument (Horne & Bendle, 2016:155). The fact that vouchers are classifiable into multiple categories makes it difficult to apply general VAT rules.

Offering gift vouchers and loyalty programs where consumers are rewarded for making repeat purchases by receiving accumulating points for redemption in the future (Liu, 2007:20) are among alternatives at a retailer's disposal to increase profits. Gift cards can be used by retailers in two ways: offering the gift card for free to a consumer in the form of an incentive, after purchasing over a certain threshold or, the more common way, selling the gift cards in

return for a consideration (Khouja, Rajagopalan, & Zhou, 2013b:333). Discounts and coupons, which are defined as “a piece of paper that can be used to get something without paying for it, or at a reduced price” by the Cambridge Dictionary (2018a), are also included among the various promotional tools available to merchants for boosting sales (Khouja, Pan, Ratchford, & Zhou, 2011:444). The multiple variations of voucher types, the different ways in which suppliers use them and that they are generally easily transferable cause numerous different transactions to arise for which the VAT treatment cannot necessarily be the same.

In the past a paper gift certificate performed a similar function to a modern gift card (Offenberg, 2007:228). According to Horne and Bendle (2016:155) gift cards evolved from vouchers/certificates issued by retailers during the twentieth century when a voucher/certificate became a popular gift to award to someone. Modern gift certificates are in the form of plastic cards – identified by using a unique barcode or magnetic strip at the back (Offenberg, 2007:229) – which are connected to an account where value is stored. This allows a consumer to pre-purchase credit, stored on the card, available for future use (Norvell & Horky, 2017:250). Voucher technology’s rapid development caused voucher transactions to rise in frequency and popularity which require VAT legislation regarding vouchers to be flexible in order to accommodate any future developments (Tax Executives Institute, 2007:279).

Gift card markets globally have shown significant growth during previous years and are expected to keep growing in the future (Horne, 2007b:342). Research and Markets (2018a) states that: “The global gift cards market was valued at \$679,743 million in 2016 and is projected to reach \$3,003,320 million by 2023”. This could be due to the rapid spreading of chain stores offering the gift cards, and the use of modern plastic card technology that reduces the issue costs for retailers and simplifies the recordkeeping of transactions (Offenberg, 2007:229). Another factor that contributes to the gift card market growth is e-commerce, as users are in a better position to access e-commerce portals on the internet than offer gift cards, such as Amazon (Research and Markets, 2018b). This could also create questions regarding the VAT treatment of vouchers used in cross-border transactions as the internet creates a platform for worldwide sales and purchases.

In some instances, only partial redemption or full non-redemption of the gift card value occur (Khouja, Park & Zhou, 2013a:665). Reasons for non-redemption by gift card holders include loss of cards, cards reaching expiration dates (Khouja, Pan & Zhou, 2016:160), undesired store choice, procrastination, and overly low gift card value (Horne & Bendle 2016:156). Hennes and Schenck (2014:561) state that the retail industry utilises the term “breakage” for

the gift cards' value never expected to be redeemed. Horne (2007b:348) states that there are indications that nine months after issue, 19% of gift cards still remain unredeemed. Other estimates indicate a non-redemption rate of 10%, although this may vary depending on the type of retailer and the initial card value (Horne & Bendle 2016:156).

When a gift card expires, the issuer may be entitled to the proceeds without fulfilling any obligation attached to the gift card (Hennes & Schenck, 2014:561), the rationale being that the value is voluntarily forfeited which is not the merchant's failure (Horne & Bendle 2016:167). According to Horne (2013:1) money lost on gift cards constitute lost consumer value. There should be considered whether, and if so when, non-redemption and expiration could constitute a "supply" triggering any consequences for VAT purposes.

### **1.1.3 Motivation for topic actuality**

As seen above, considerably more voucher transactions occur than in the past. This is due to technological developments that ease the burden of administration and record keeping of any voucher balances. Retailers all over the world offer vouchers either for sale or as promotional tools, which confirm the popularity amongst consumers as they are willing to purchase and transact with the offered vouchers. Because of this fast-growing voucher market, non-redemption of vouchers would also potentially increase.

This huge development in the gift card market makes it necessary to consider the implications regarding possible VAT consequences. Non-redemption of vouchers could mean a lot of lost consumer value, which begs the question whether it should be taxed in terms of the Value-added Tax Act. There could be the need for refinement of the current South African VAT legislation if it is found lacking. It was observed that overall not much research has been done on the topic of vouchers and their related VAT treatment in South Africa, which would make this study a valuable contribution.

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

The growth in the gift card market, attributable to various factors including rapid technological developments, indicates that the popularity of gift card usage among recipients and retailers are increasing. The variety of voucher types further complicate transactions, as well as the fact that these different types of vouchers are difficult to classify. As the transactions with vouchers increase, the non-redemption of vouchers will also be a more regular occurrence.

The question that arises is thus as follows:

Is the current South African VAT legislation regarding vouchers clear and comprehensive on the treatment of the different voucher related transactions, and if not, what are the shortfalls?

### **1.3 Research objectives**

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

#### **1.3.1 Primary research objective**

The main objective is to analyse the South-African VAT legislation to determine whether the VAT treatment of vouchers are clearly and comprehensively addressed, and if not, how these shortfalls impact the application of the VAT legislation to voucher related transactions.

#### **1.3.2 Secondary research objectives**

To achieve the main objective the following secondary objectives are formulated:

To describe the commercial nature and function of the different types of vouchers, the classification thereof, the possible permutations of voucher transactions and any related non-redemption in the retail sector. The understanding of the commercial nature and function of voucher transactions in the retail sector are paramount in determining any possible VAT related consequences when an analysis of legislation is done.

To analyse the current South African VAT legislation to determine how and why the different types of vouchers are taxed in certain ways and whether the application regarding the voucher VAT legislation is clear and comprehensive.

### **1.4 Paradigmatic perspective**

Researchers can study taxation throughout a variety of narrow disciplines, which include accounting, law, economics and psychology among others. This shows that taxation is a social phenomenon that attracts different experts across diverse disciplinary backgrounds (McKerchar, 2008:5). McKerchar (2008:6) stated that this causes taxation research to be complex and multidimensional, which in turn could lead to misinterpretation or the drawing of invalid conclusions if a researcher is not provided with appropriate context. An understanding of the various philosophical research paradigms will help supply the appropriate context to conduct research and should be rigorously applied (McKerchar, 2008:6).

According to Glesne (2011:5) a paradigm is “a framework or philosophy of science that makes assumptions about the nature of reality and truth, the kinds of questions to explore, and how to go about doing so”. The selection of a paradigm will be influenced by the researcher’s view of the world and nature of reality (ontology), theory about the knowledge informing the research (epistemology) (McKerchar, 2008:6; Tuli, 2010:99) and how knowledge might be gained (methodology) (Tuli, 2010:99). The ontological, epistemological and theoretical assumptions will, with regards to this study, be discussed in more detail below after which the methodology to gain the knowledge will be addressed.

#### **1.4.1 Ontological assumptions**

Ontology, as described by Glesne (2011:5) refers to beliefs regarding reality or the kind of things the world consists of. For example, to regard the world through the way the mind perceives, interprets and categorizes information or, in contrast, to view the world as one of matter through observation and measurement. It needs to be determined whether the researcher views the world objectively or as constructed and interpreted by people (Denscombe, 2002:18) – thus relative to situations. According to Stanford Encyclopedia of Philosophy (2016), relativism “is the view that truth and falsity, right and wrong, standards of reasoning, and procedures of justification are products of differing conventions and frameworks of assessment and that their authority is confined to the context giving rise to them”.

This study holds a relativist view. Legislation is subject to interpretation and not necessarily perceived similarly by researchers. The study will use reasoning and the assessment of legislative frameworks to determine the application of the Value-added Tax Act to voucher/gift card related transactions. The context for application of the Value-added Tax Act is an important consideration when analysing the VAT treatment of vouchers, as this will be the base to which the legislation is applied.

The context to which the legislation should be applied will be determined by researching the characteristics of different voucher/gift card transactions and circumstances to how, when and by who the different vouchers/gift cards are used. Vouchers/gift cards with similar characteristics will be categorized together to ease the application of the legislation.

### **1.4.2 Epistemological assumptions**

Epistemology refers to the study of the nature of knowledge (Glesne, 2011:5). The relationship between the knower and what is known is questioned along with how we know what is known, and what actually counts as knowledge (Tuli, 2010:99).

The study aims to answer a specific question with regards to the sufficiency of the South-African VAT legislation with regards to voucher/gift card related transactions. In this study knowledge is gained from subjective interpretation of different theoretical sources by the researcher which will mainly be the VAT legislation. Furthermore, to determine the context for the application of the legislation, knowledge already gained by other studies will be used. This study is subject to standard theoretical assumptions with regards to the VAT legislation.

### **1.4.3 Theoretical assumptions**

In this study the assumption is made that VAT legislation adhere to the underlying form of a good taxation. Van Oord (2015:31) refers to the elements of the underlying form of a good tax as the “canons of taxation”. According to Van Oord (2015:31) the “canons of taxation” include the criteria that tax legislation should be economical, equitable, certain and convenient. Tax should sufficiently contribute to national government’s revenue, without distorting production and consumption (Black, Calitz & Steenekamp, 2008:120 & Van Oord, 2015:31). Nel and Viviers (2015:158) stated that for a tax to be *certain* the amount payable, timing of payment and payment method should be clear and consistent. According to Van Oord (2015:31) for taxation to be *equitable*, the ability (measured in income) of the taxpayer to pay taxes should be taken into account – the same burden must be placed on different categories of taxpayers, taking into account their “ability-to-pay” and thus promoting fairness (Black *et al.*, 2008:122). *Convenience* implies that compliance from taxpayers is promoted and that administration is simple – efficiency is important for a successful tax policy (Van Oord, 2015:31).

### **1.5 Research methodology**

Glesne (2011:5) emphasizes the importance of identifying these philosophical and theoretical perspectives that are rooted in the researcher’s assumptions about the nature of reality and knowledge, for it will partially justify the methodology chosen to conduct research. Different methodologies will produce different research designs (McKerchar, 2008:6).

McKerchar (2008:6) states that the two core philosophical paradigms traditionally used to conduct, and design research are known as positivism and interpretivism. Legal research could fit in anywhere on this continuum.

According to Tuli (2010:100) for positivist researchers empirical facts and personal ideas or thoughts exist apart. For them law of cause and effect governs, with the goal to approximate reality, the most objective methods possible. Empirical data, usually gotten from experiments, are often used to compare variables and identify relationships in order to confirm hypothetical statements that would apply to the broader population (McKerchar, 2008:10). A quantitative methodology is thus followed when doing positivist research and deductive logic is used to arrive at a conclusion (Tuli, 2010:100).

Tuli (2010:100) also states that the interpretivist paradigm does not generalize to a population; the purpose is rather to achieve understanding of a particular phenomenon. Researchers in this paradigm tend to be naturalistic as they are usually non-manipulative and unobtrusive. Interpretivism assumes that the researcher is not detached from research but rather employs subjective interpretation and an open mind (McKerchar, 2008:7). A qualitative methodology is thus applied when doing interpretivist research and an inductive approach is followed, where the research aims toward process and discovery with more focus on a profound understanding of the research problem in its unique circumstances (Tuli, 2010:100) than on generalization and providing proof for statements made.

In this study the philosophical paradigm interpretivism will be applied to conduct research on the VAT treatment of vouchers to determine whether legislation is clear and comprehensive or if limitations exist. The study aims to achieve a better understanding of vouchers and their related VAT treatment. Different voucher/gift card related transactions and the related commercial circumstances will be researched to achieve an understanding of each phenomenon. The application of the VAT legislation to these categorized voucher/gift card related transactions will be subject to the interpretation of the researcher.

As the study will focus on achieving a profound understanding of voucher/gift card related transactions with the related VAT consequences, a qualitative methodology will be used. The research will be inductive as it will follow a logical process to discover the existence of shortcomings in the VAT legislation regarding the treatment of voucher/gift card transactions.

This study will be done mostly by doing legal doctrinal research, where legislation, case law and other aspects will be analysed and interpreted – following a traditional “black letter law”

approach (McKerchar, 2008:18). This approach considers the necessary building blocks of the relevant legislation in order to describe the impact on more sophisticated scenarios (Van Hoecke, 2011:vi). The Value-added Tax Act's application with regards to voucher/gift card related transactions will be critically analysed in order to obtain an in-depth understanding of the workings and reasoning behind the VAT treatment. This method will assist in determining whether the VAT legislation regarding vouchers/gift cards is sufficient and inclusive of all permutations of voucher related transactions.

A literature review will be conducted in order to identify voucher/gift card related transactions and to research the commercial characteristics thereof, where existing sources and studies will be consulted for more clarity. This will be done to create context for the legal doctrinal research to be performed which will be done in the form of a critical analysis of the applicable VAT legislation.

The study will be non-empirical in nature and will thus rely on theoretical sources rather than numerical data. Secondary data, which are available from other sources without any particular method of collection, will be used to conduct the study. Academic journal articles, books, legislation, court cases and previous publications will be consulted and analysed during the study as sources of information. A descriptive research reporting method will be applied to explain any findings in relation to the critical analysis of the VAT legislation.

## **1.6 Chapter Overview**

### **Chapter 1: Introduction, background, problem statement and research question, objectives, research design, and methodology**

This section illustrates the relevance of the study. A general background on VAT and vouchers places the proposed study in context and demonstrates the uncertainty that may exist in the South African VAT legislation regarding the VAT treatment of vouchers. A problem statement is made, with the inclusion of a research question, research objectives and an explanation of a research method to conduct the study.

### **Chapter 2: Description of the different types of vouchers and related transaction permutations, including circumstances regarding non-redemption**

In this section the different types and classifications of vouchers will be described together with any related transactions where vouchers are used. Circumstances and effects of non-redemption of vouchers in the retail sector will also be considered. It is crucial to understand

the voucher/gift card related transactions before any analysis of VAT legislation can be done in order to determine VAT consequences.

### **Chapter 3: Analysis of current South-African VAT legislation to determine how vouchers are taxed and whether the rules are clear and comprehensive**

In this chapter current South-African VAT legislation will be analysed to achieve an understanding of the way vouchers are taxed, whether the legislation is comprehensive and if the application of the legislation is clear enough.

### **Chapter 4: Summary and conclusion**

This chapter will serve as the conclusion and summary of the study. All the most relevant aspects that were identified during the study will be highlighted. This chapter will also include recommendations for future studies.

## Chapter 2

### 2 Description of the different types of vouchers and related transaction permutations, including circumstances regarding non-redemption

#### 2.1 Introduction

In this chapter a clear understanding of the commercial nature of vouchers and any related transactions will be achieved. It is important to understand the benefits of vouchers, the way vouchers are used, and the related characteristics of vouchers as it will give insight into the commercial nature thereof. Different types of vouchers and the related characteristics will be identified and explained in this chapter to achieve this understanding. A brief overview of the accounting treatment of vouchers will also help achieve the objective. When the commercial nature of the different types of vouchers are established, the VAT consequences can be determined.

#### 2.2 Different types of vouchers

According to Zhang, Q., Zhang, D., Segerstedt & LuoQ (2018:92) there are broadly three different categories of gift cards, namely: product-specific, retailer-specific and network-branded gift cards. However, according to Horne & Bendle (2016:155) and Norvell & Horky (2017:250) gift cards should rather be classified into the categories open-loop or closed-loop gift cards.

With product-specific gift cards the particular type and quantity of goods that are redeemable by the consumer from the particular issuer are usually identified on the card (Zhang *et al.*, 2018:92). These gift cards are usually used by retailers as a demand stimulating tool for seasonal products with shorter life durations (Zhang *et al.*, 2018:92). In contrast to product-specific gift cards, retailer-specific gift cards are redeemable in the form of any product available for sale at the particular merchant or group of firms listed on the card (Zhang *et al.*, 2018:92).

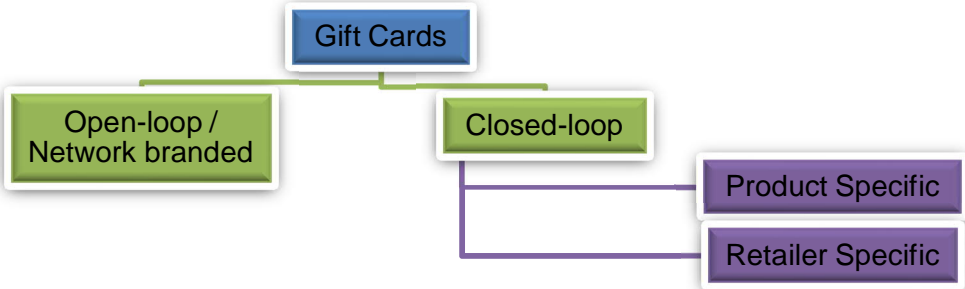
Closed-loop gift cards, according to Norvell & Horky (2017:250) and Horne & Bendle (2016:155), are issued by or on behalf of a specific merchant or group of merchants where the gift card is designated to be redeemed. It is thus fair to conclude that product-specific and retailer-specific gift cards can both be deemed sub-categories of closed-loop gift cards as both can only be redeemed at a particular merchant or group of merchants. These types of gift

cards are usually non-refundable, which causes the recipient to purposefully aim to redeem all the available credit (Yao & Chen, 2014:491).

Network-branded gift cards work on a credit card system and can be redeemed at different unrelated merchants who accepts the card (Zhang *et al.*, 2018:92) – for example a Visa gift card. Open-loop gift cards have a similar definition, according to Norvell & Horky (2017:250) and Reinholtz, Bartels & Parker (2015:599), who states the gift cards can be used for almost any purchase at a variety of firms. Network-branded and open-loop gift cards are thus concluded to be similar concepts.

Open-loop gift cards are usually issued by financial institutions (Diamond, 2011:976). This type of gift card is usually perceived by a consumer as transaction devices similar to debit or credit cards, which are viewed as much more spendable, compared to closed-loop gift cards (Yao & Chen, 2014:491). A number of South African banks have already launched prepaid open-loop cards in 2008 to take advantage of the unbanked and underbanked sections of the market (Groine, 2009:11). Open-loop gift card programs were also implemented by shopping centres nationwide with Visa or Mastercard branded cards available at information desks with local banks involved as Bank Identification Number (BIN) sponsors (Groine, 2009:10). It is clear from the above that these open-loop gift cards are also available in the South African market and are mainly issued by banks. The application of the VAT legislation to open-loop gift cards will thus be discussed using financial institutions as the issuing merchant in section 3.5 of this study.

The diagram below was developed from the above research and is an illustration of the broad categories of gift cards:



*Figure 1 – Broad categories of gift cards*  
*Source: Compiled by researcher from accumulated data*

Both open-loop and closed-loop gift cards have different uses and benefits for the retailers issuing the gift cards and for the individuals who buy or receive the gift cards.

### 2.3 Different uses of vouchers - retailer's perspective

Retailers can use closed-loop gift cards in different ways. These include offering the gift cards as a promotional tool, thus for free, after the customer reached a certain goal, or to sell it to a consumer who would offer it as a gift to a recipient (Norvell & Horky, 2018:400). The following diagram was developed from the above to illustrate how promotional gift cards and purchased gift cards relate to closed-loop gift cards.

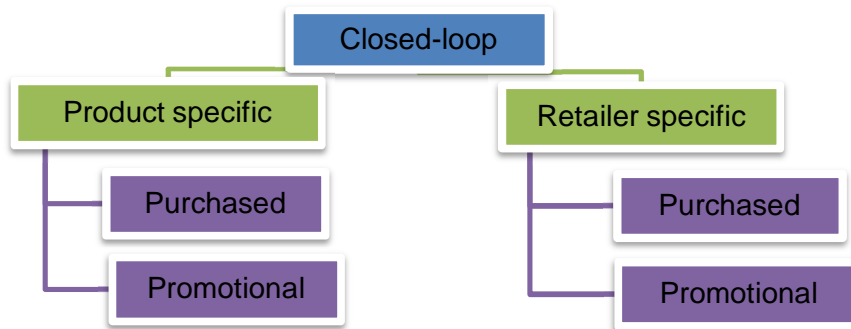


Figure 2 – Relation of promotional and purchased gift cards to closed-loop gift cards

Source: Compiled by researcher from accumulated data

According to Ernstberger, McDowell & Parris (2012:191) there are numerous variations of promotional gift cards used by retailers to boost sales which includes the following examples:

- “Discount” gift cards – this promotional gift card is very similar to a coupon. According to Narasimhan (1984:129) a coupon is a promise of reduced price on the next purchase of a specified product. Discount gift cards are usually given on the condition that the next purchase meets certain conditions.
- “Gift” gift cards – for this type of gift card there is no previous purchase goal to be reached by the customer before the gift card is awarded. For example, the gift card is included in a company’s catalogue to encourage customers to visit the company. This type of gift card seems to be similar to a “discount” gift card with the only difference that no spending threshold is required to be met for redemption.
- “Earned” gift cards – a gift card that is obtained by a customer when a goal is achieved through previous purchases. This type of promotional gift card can then be used for the next purchase.

It seems that all the above described gift cards, despite the different terms and conditions for issue and redemption, have the fact in common that the recipient does not have to pay an additional amount or fee to receive the gift cards.

Promotional gift cards can be offered by merchants instead of normal discounts with the benefit that the product value is not perceived by the customer to be less than the actual value because of the discount (Khouja *et al.*, 2013a:665). A normal discount and a promotional gift card are thus very similar in nature (Norvell & Horky, 2018:400), as both reduce the sales price of a product, without any additional costs to the customer. This leads to two potential outcomes: future sales will effectively be reduced if the consumer uses a promotional gift card to partially pay for goods that would have been purchased in cash by the customer with or without the promotional gift card. In contrast, future sales will increase if the consumer purchases something that would normally not have been bought without the gift card (Khouja *et al.*, 2013a:669). This could be one of the reasons why the value of a promotional gift card is generally less than that of a gift card that was purchased and paid for by a customer (Norvell & Horky, 2018:400).

When a gift card is purchased by a customer, cash is exchanged for a promise by the seller that goods or services would be delivered in the future if the gift card is redeemed, whether by the seller of the gift card, a related company or an unrelated company (Dennis-Escoffier, 2015:121). A gift card is then given to the customer as proof of the advance payment that was made (Dennis-Escoffier, 2015:121). A gift card service agreement usually exists between the gift card seller company and the company with whom the gift card is redeemed (Dennis-Escoffier, 2015:121). When the gift card seller company sells a gift card to a customer, the proceeds are usually retained until the gift card is redeemed from the other participating merchant. The participating merchant is then reimbursed for the sales price of the goods sold to the customer by the gift card seller company (Dennis-Escoffier, 2015:121). The gift card seller company ceases being liable for the value of the gift card after the gift card is expired or redeemed by the customer.

Clearly, from the above discussion, there seems to be a lot of different variations of voucher related transactions. It is, however clear that despite these variations, the core of the transaction stays the same – a specific merchant issues a gift card, whether promotional or purchased, with redemption of the value in exchange for goods or services, taking place at a later stage.

A model has been developed to break down the different stages of the core of every voucher transaction. The stages include the issue of a gift card, the redemption of the gift card and the reimbursement of the gift card (if applicable) as can be seen from the above research. This model will be referred to as the “Three-stage model” in the study.

The Three-stage model illustrates the different stages identified in most voucher related transactions. However, these stages might vary depending on the terms and conditions of the transaction, the intention of the issuer, and the preference of the recipient. These stages can be adapted to be applicable to the purchased gift card and the various promotional gift cards. The below figures and descriptions will provide a general summary of the workings of the Three-stage model.

**Stage 1 - Issue**

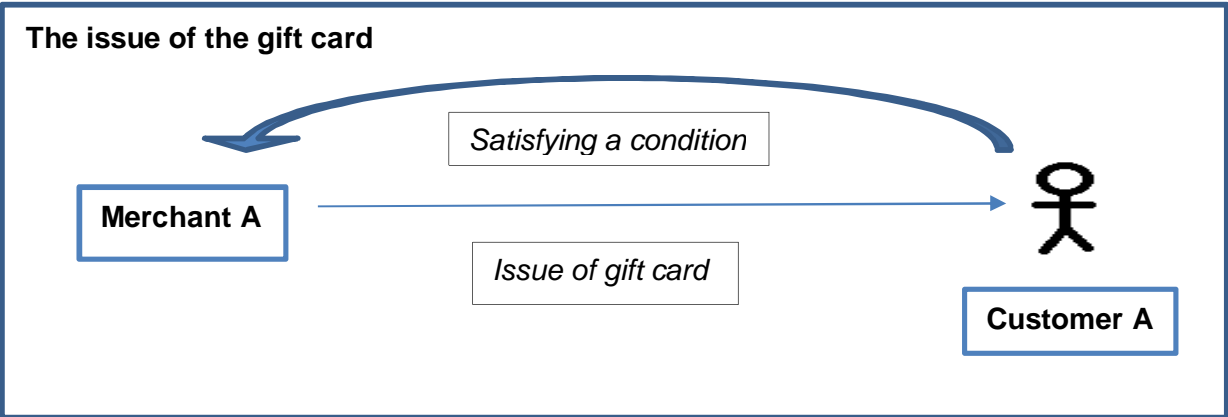


Figure 3.1 – Stage 1: Issue

Source: Compiled by researcher from accumulated data

Merchant A will issue a gift card to Customer A after a condition is met. This condition can be promotional in nature, for example when the customer meets a purchasing threshold and the merchant awards the customer for reaching the goal by giving away an “earned” gift voucher or be exchanged for a specific amount cash – thus a purchased gift card. Depending on the terms and conditions of the gift card, the value can be redeemable for specific goods or services stated on the gift card or for any goods or services available at the specified merchant. The terms and conditions of the gift card can also stipulate that the gift card is redeemable at a different merchant than the original issuer.

**Stage 2 - Redemption**

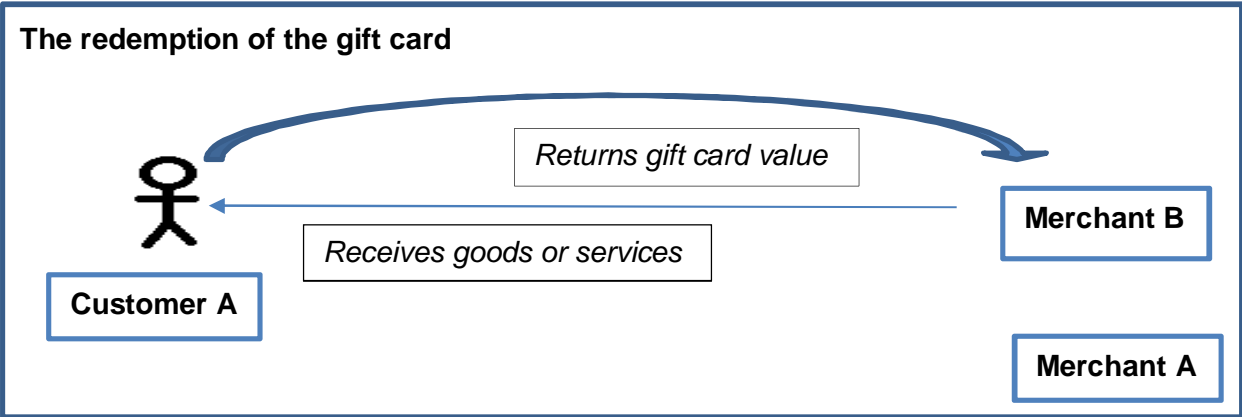


Figure 3.2 – Stage 2: Redemption  
Source: Compiled by researcher from accumulated data

Customer A will redeem the gift card value at Merchant B – who usually has an arrangement with Merchant A who was the initial issuer of the gift card. This redemption takes place by Customer A offering the gift card value to Merchant B instead of actual cash in exchange for goods or services. A simpler version of stage 2 is where Customer A redeems the value directly from the issuer of the gift card, which in this case would be Merchant A.

**Stage 3 - Reimbursement**

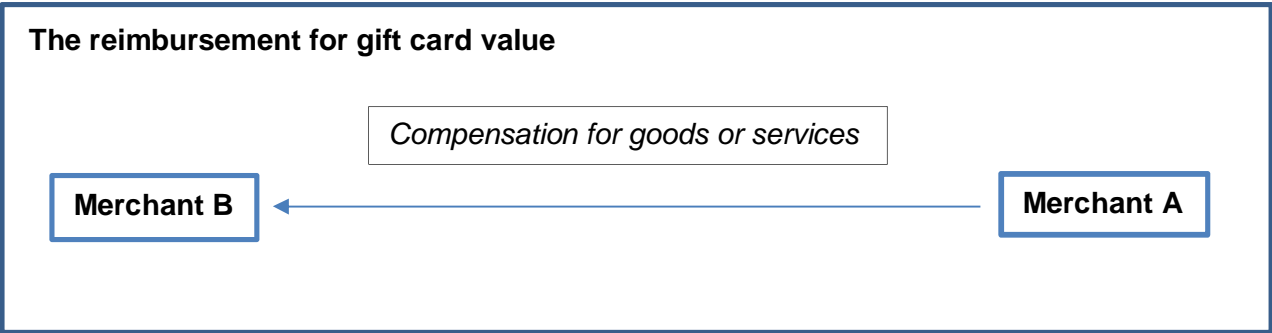


Figure 3.3 – Stage 3: Reimbursement  
Source: Compiled by researcher from accumulated data

As Merchant A was the issuer of the gift card while Merchant B had to supply the goods or services on redemption of the gift card to Customer A, Merchant A needs to reimburse Merchant B for the value of the goods redeemed by Customer A. When the gift card value is redeemed at the same merchant who issued the gift card (Merchant A in the above illustration), there will be no Stage 3 as there will be no need to compensate another selling merchant.

When an open-loop gift card, issued by a financial institution (Merchant A), is redeemed from any other applicable merchant (Merchant B) who accepts this type of gift card, the gift card will function as a transactional device similar to debit or credit card (Yao & Chen, 2014:491). The characteristics of the transaction is thus assumed to be similar to a normal debit/credit card transaction (Ammons *et al.*, 2012:2), where the credit on the card is directly transferred to the bank account of the applicable selling merchant as payment. No stage 3 will thus be applicable.

Norvell and Horky (2017:250) claim that retailers benefit from offering gift cards to customers. Gift cards increase incremental spending. Norvell & Horky (2018:399) stated that when a gift card recipient redeems the gift card value, they tend to spend above and beyond the face value of the gift card, making it a very effective tool to increase revenue. It has been estimated that gift card users spend between 20% and 40% more than the original gift card value (Norvell & Horky, 2017:250; Horne & Bendle, 2016:161).

The increased incremental spending can be attributed to the fact that the redemption of gift cards is generally viewed by consumers as a reward, which justifies less restricted spending and causes gift card users to deviate from typical shopping habits (Yao & Chen, 2014:490,491). When a recipient receives a gift card, the value is usually regarded as a “windfall gain” which means to unexpectedly receive income (Norvell & Horky, 2018:399) or to receive an “economic gain independent of work, planning or other productive activities, which is desirable to society” (Diamond, 2011:983). This value is more easily spent as it is not pre-allocated to a specific expense (Norvell & Horky, 2018:399). According to Norvell and Horky (2017:251) the concept of mental accounting explains this phenomenon – a consumer anticipates a certain level of expenditure prior to a purchase and when a gift card reduces this expected expenditure, the consumer’s mental budget allows for additional purchases. The additional spending prompted by the redemption of gift cards increases the retailer’s sales (Khouja *et al.*, 2013a:665).

By offering gift cards, the opportunity to expand the retailer’s current consumer base is also created (Norvell & Horky, 2017:250; Khouja *et al.*, 2013a:665; Horne & Bendle, 2016:161). The gift card buyer who awards the gift card and all rights to claim its value, to a recipient who made no contribution (Horne & Bendle, 2016:155; Horne, 2013:1) is not necessarily a regular customer of the retailer. This could lead to the retailer gaining potential new customers. When a closed-loop gift card is sold by a retailer, there is assurance that the gift card credit will be spent at the firm itself and not at a competitor (Norvell & Horky, 2018:399).

## 2.4 Different uses of vouchers - consumer's perspective

The strong development of the gift card market indicates that consumers derive a considerable benefit from buying gift cards (Horne & Bendle, 2016:154). Horne (2007b:342) states that the cause of this popularity could be attributed to the fact that a gift card reduces the giver's risk of purchasing an unwanted gift.

The most liquid gift is cash, as it can be the most easily exchanged for goods or services (Valentin & Allred 2012:272). However, gifting cash is generally seen as inappropriate because it gives the impression that the giver has put no thought or effort into buying a gift (Felső & Soetevent, 2014:284). According to Offenbergh (2007:231) a cash gift is not as memorable even if it would allow more flexibility to the recipient to choose where to spend it.

According to microeconomic demand theory, gift certificates (cards) gifted to a recipient should be spent in the same way that cash would have been spent (Felső & Soetevent, 2014:285), making a gift card a viable replacement option for cash. Open-loop gift cards are in nature nearly identical to cash, as these gift cards can be spent across the board at any merchant who accepts the cards (Valentin & Allred 2012:272). According to the Standard Bank (2020) website, the financial institution for instance offers a prepaid gift card with the following features:

- Any amount between R50 and R5 000 can be loaded onto the card
- The card can be gifted for use at any local retailer that accepts MasterCard or Visa cards
- The prepaid card cannot be reloaded with more money
- You cannot use a gift card to withdraw money from an ATM
- You do not get statements of transactions on the card

This type of gift card would thus be expected to be spent in the same way as cash by redeeming the value from any merchant or retailer who has the facilities to accept the card.

However, this is not the case for closed loop gift cards as they can only be redeemed at certain shops, causing a limitation of choice for the redeemer (Valentin & Allred 2012:272). A closed-loop gift card is thus much more restricted and does not offer the same flexibility as cash. As this type of gift card is less liquid, the recipient's perceived value could be less than the actual cash value (Felső & Soetevent, 2014:285).

According to Waldfogel (1993:1328) a deadweight loss occurs when the recipient values the gift received from a giver as less than the actual price thereof. This happens when a receiver of a gift card would have made a different consumption choice with an equal amount of cash (Waldfogel, 1993:1328). How a receiver values a gift depends on many factors, which include symbolic and sentimental value, serendipity and liquidity among others (Valentin & Allred 2012:272).

Yet, awarding someone a gift card instead of cash, even though restrictive, is more memorable, but still convenient and the stigma attached to a cash gift is avoided (Offenberg, 2007:231). This also avoids giving a non-cash gift that is mismatched to the recipient's preferences. According to Waldfogel (1993:1328) "gifts from friends and 'significant others' are most efficient, while non-cash gifts from extended family are least efficient and destroys a third of their value".

## **2.5 Characteristics of vouchers and related transactions**

According to Wright (2016) gift cards, whichever type, could be considered to have the following four characteristics:

- Gift cards are prepaid – in some instances by the purchaser and in others by the merchant offering a promotional gift card;
- Gift cards are non-refundable and cannot be redeemed for cash;
- Gift cards give the holder the right to goods or services claimable in future;
- Gift cards oblige the seller to provide goods or services to the holder in the future.

Ammons, Schneider & Sheikh (2012:3) stated that gift card transactions produce two sources of revenue. The first source of revenue is cash received by the retailer when the gift card is sold to a customer, which is the date from which the cash can be used at the discretion of the retailer. However, the retailer is still liable to deliver the goods in the future.

The second source of revenue (Ammons *et al.*, 2012:3) occurs when non-redemption of the gift card takes place. According to Ammons *et al.* (2012:3) non-redemption could be caused when a gift card's expiration date is reached or when the retailer estimates that the probability of the customer redeeming the gift card is close to zero, after which the gift card is written off.

## **2.6 Non-redemption and expiration of vouchers**

When a gift card is not redeemed, only partially redeemed or expires, it is generally known as breakage (Diamond, 2011:976). According to a report issued by Grant Thornton (2011), it is estimated that between 10% and 19% of gift card value remains unredeemed. This portion of unredeemed gift card value can boost the retailer's short-term cash flow and increase the retailer's profit (Kile Jr. & Wall, 2008:76). According to Horne (2007a:193) the biggest impact of gift cards on a business, however, is the incremental spending a store receives when a gift card is redeemed. When selling a gift card, the retailer's intention should thus be for the gift card to be redeemed, as it will attract customers and encourage spending, instead of intending it to expire or to remain unredeemed.

As a purchased gift card is usually given by the purchaser to another individual as a gift, the gift card might have a lesser perceived value (Horn, 2013:1) to the recipient. This might mean that the recipient would not protect the rights to the gift card value as vigorously as when the recipient bought it with their own money (Horn, 2013:1). However, a negative perception of a brand might be created if retailers are enriched at the expense of customers (Horne, 2007a:193) when a gift card value expires without appropriate notice or a reasonable period for redemption. Currently efforts are being made to extend the expiration dates on gift cards, but ironically, as there is more time to redeem the gift cards, customers seem to procrastinate which causes even less of the gift cards' value to be spent (Shu & Gneezy, 2010:943). It is thus fair to conclude that the chances of a gift card being redeemed by a consumer decreases as more time passes after original issue. In South African legislation, specifically the Consumer Protection Act 68 of 2008, consumers' rights to the value of a gift card are protected with regards the minimum period before expiration.

According to section 34 of the Consumer Protection Act 68 of 2008 when a supplier offers gift cards without receiving any consideration, for example as part of a promotional scheme, there are no specific requirements that dictate the minimum period to have passed after issue before expiration. The issuer of the promotional gift card can thus choose any period for which the promotional gift card is valid. The only requirements are that the issuer should be able to fulfil the promise made in terms of the promotional gift card offer and all the terms and details regarding the promotional gift card should be clearly stated.

However, according section 63 of the Consumer Protection Act 68 of 2008, when a prepaid gift card is issued to a person in exchange for consideration and it is agreed that the issuer will subsequently deliver goods or services to any person who present the gift card to the retailer,

the gift card value is not allowed to expire for three years after the date of issue. A longer period specified than the required three years before expiration is also acceptable. When a gift card is redeemed and thus exchanged for goods or services before the expiration date, the gift card value is utilized and deemed to have expired. Even though these regulations are implemented to protect the consumer's rights, there are still unredeemed gift card balances. In certain States in America these unredeemed balances will be classified as abandoned property (Norvell & Horky, 2018:401).

According to Diamond (2011:978) real and tangible unclaimed or abandoned personal property will, under the American doctrine, revert back to the State, provided specific legislation has been enacted. Modern American unclaimed property laws have developed to also include unclaimed intangible property (Diamond, 2011:979). This unclaimed intangible property includes unredeemed gift cards. However, there is some difficulty regarding the practical application of the existing State laws to unredeemed gift cards as it lacks clarity, which makes reporting difficult (Diamond, 2011:979). This also causes high stakes of non-compliance.

These laws have been primarily developed for the State to merely hold the unclaimed property in perpetuity until the rightful owner claims it back (Diamond, 2011:979). The main purpose of these escheat laws is thus to return abandoned property to the rightful owner (Kile Jr. & Wall, 2008:76). The name and address of the holder of the gift card is never disclosed to the retailer who issues the gift card, because consumer privacy concerns are addressed by the anonymity of the sale (Diamond, 2011:983). This makes it impossible to trace the unredeemed gift card back to the ultimate holder defeating the purpose of the unclaimed property laws.

These are some of the reasons why certain states in the USA exempt gift cards from the escheatment laws while other states are merely silent on the matter (Horne, 2007a:192). In South Africa there seems to be no specific legislation dealing with unclaimed intangible property similar to those in the USA. It is thus fair to conclude that any unredeemed gift card value in South Africa is kept by the retailer who originally sold the gift card.

It could be argued that unredeemed gift card balances are not a windfall gain for the supplier of the gift card as there has been active productive activities that resulted in business expenditure for developing and providing gift cards to customers (Diamond, 2011:985). Per opinion, this could be a justification for the fact that unredeemed gift card balances should be kept by the retailer who issued the gift card and that fees should be charged on the long outstanding gift card balances to recover some of the business expenditure.

## 2.7 Costs associated with gift cards for retailer and consumer

The cost for a retailer associated with gift card programs should be considered. There are significant production costs to manufacture and administrate the gift cards (Norvell & Horky, 2018:399). With certain closed-loop gift cards the purchaser fully pays for the gift card before giving it to the recipient, which means no margin is lost by the retailer. In contrast, a promotional gift card, which is in essence a discount, store credit is given away by the retailer without any compensation (Norvell & Horky, 2018:400). The retailer thus ends up carrying the cost of the goods redeemed by the holder of a promotional gift card.

Dormancy fees are charged on gift cards when the consumer fails to use the gift card for a certain period (Thomas & Dillenbeck, 2004:54). According to the Bidvest Bank (2020) website dormancy fees are charged at a rate of R31 per month in South Africa if a bank account becomes dormant (no activity for at least 6 months). This fee is in nature a service fee used to recoup some of the costs incurred by the company to operate the gift card program (Thomas & Dillenbeck, 2004:54). Open-loop gift cards are most vulnerable to dormancy fees as the issuer is usually a financial institution that earns a substantial profit from unused gift card balances – in contrast to normal retailers, there is no incentive for a financial institution to attract customers by using gift cards to encourage the purchase of merchandise (Ammons *et al.*, 2012:2). The standard interchange fees that apply to a normal debit or credit card will also apply to an open-loop gift card (Ammons *et al.*, 2012:2).

The above implies that it is mainly financial institutions that charges these types of fees on the open-loop gift cards which is mainly issued by them or in collaboration with them. According to the Ombudsman for Banking Services (2018) in South Africa, a financial institution is entitled to charge monthly fees on an account that becomes dormant on the condition that prior notice is given to the customer that the balance on the account will be depleted by these fees.

As open-loop gift cards can be redeemed at many stores, similar to a debit or credit card, the redemption of the gift card will be more similar to the way cash would have been spent (Felső & Soetevent, 2014:285). However, because of the restraining nature of a closed-loop gift card the redemption rate could possibly be affected. To avoid losing the entire value of the gift card received, consumers will approach secondary markets to sell the gift cards (Offenberg, 2007:232).

## 2.8 Secondary markets

Secondary markets exist where recipients sell the gift cards given to them for a price less than face value paid by the giver, as no sentimental value is attached to the gift card (Ng, 2013:1301). The buyer of the gift card on a secondary market usually wants to pay less than the price available at a retail outlet, while the seller wants to get rid of the unwanted gift card (Ng, 2013:1301). This causes a welfare loss to occur, where the welfare loss equals the difference between the value at which the gift card was bought by the gift-giver and the amount the gift card is sold for on the secondary market (Offenberg, 2007:232). According to Ng (2013:1301) gift cards from specialized stores are often sold at a higher discount while gift cards from stores with a bigger range of products are sold at a lower discount. This could be because the value of a gift card that can be spent at a variety of retailers might approximate the value of cash.

There has been significant growth in gift card exchange companies, for example GiftCardSwapping.com, Monster Card and Cardpool, which allows for unwanted gift cards to be sold for as much as 92% of the face value (Norvell & Horky, 2018:401). According to Offenberg (2007:232) the average discount at which the gift cards is sold usually approximates 15% of the initial value. This is before considering the shipping fees that is usually paid by the seller of the gift card on the secondary market (Offenberg, 2007:232). The existence of these gift card exchange companies significantly lowers the breakage rate (the amount of value on a gift card that is unspent by the recipient) for retailers, as it provides a platform to trade unwanted gift cards for cash (Norvell & Horky, 2018:401).

## 2.9 Accounting treatment of gift cards

Understanding the accounting treatment of gift cards could shed some light on the commercial nature thereof and should thus be considered to achieve the objective. The accounting standard that covers gift card related transactions is IFRS 15 – *Revenue from contracts with customers*.

IFRS 15 (2014) states the following: “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.” Revenue will thus be recognised as or when goods or services are transferred to a customer. The transaction price paid by the customer will be allocated to all the performance obligations of the company identified as part of the contract (PWC, 2017:10). The question that arises is thus

when and what amount of revenue should be recognised for prepaid and promotional gift cards as goods are not necessarily immediately transferred when the gift card is issued.

According to PWC (2017:6) when a customer prepays for a gift card, cash is exchanged for a right to receive goods or services in the future when the gift card is presented to the retailer. This non-refundable gift card should be accounted for by the retailer as a contract liability on initial purchase as no goods or services promised has been transferred yet (PWC, 2017:6). This promise to deliver goods or services in the future creates a performance obligation and when the customer subsequently redeems the gift card value by exchanging it for the goods or services, the performance obligation is met by the retailer, resulting in the liability to be derecognised and revenue to be recognised (PWC, 2017:6).

When a consumer receives a promotional gift card, according to PWC (2018), there should be considered whether the company is party to a binding contract with the customer, whether the contract gives rise to a material right for additional goods or services or whether there is consideration payable to the customer by the retailer. When a company is not party to a binding contract or the contract does not give rise to a material right for additional goods or services for the customer, there is no performance obligation that needs to be met by the company and in effect no liability to defer the recognition of revenue. As promotional gift cards have numerous variations and differing restrictions (Ernstberger *et al.*, 2012:191), these terms need to be considered when determining the financial accounting impact.

Discount gift cards, like a coupon where, for example, the holder of the gift card is entitled to a discount on a purchase that exceeds a specific monetary threshold, are not considered to create a binding contract with a customer before the required condition for redemption is met (PWC, 2018:25). This is because a contract should create an enforceable right for the customer to receive the goods and an obligation for the company to transfer the goods - neither of these rights and obligations are created before the condition is satisfied. Therefore, no liability is recognised in the financial statements of the company. Revenue will be reduced with the amount of the discount when the gift card is redeemed and the condition for redemption satisfied.

Earned gift cards, issued by the retailer after the customer purchased goods or services that met certain requirements, are usually considered to be a separate performance obligation (PWC, 2018). This is because a material right is created that provides the customer with the option to purchase additional goods or services that would not normally have been awarded to the customer without meeting the purchase requirements (PWC, 2018). The total transaction

price of the goods sold will then, based on standalone selling price, be allocated to the separate performance obligations (PWC, 2017:10) which include the earned gift card and the goods sold. A contract liability will be recognised for the future redemption of the gift card and revenue will be recognised for the actual goods or services sold to earn the gift card – the revenue for the earned gift card will be recognised at the time when redeemed.

Breakage occurs when customers do not exercise the rights to the gift cards' value (PWC, 2017:6), meaning the gift card remains unredeemed or expires. For accounting purposes, the breakage estimated to be included in the contract liability will be recognised as revenue in the same pattern as the actual gift card value that is redeemed by the customer or, if the company is unable to estimate the amount of breakage that is likely to occur, the revenue will be recognised when the probability of the customer redeeming the gift card becomes remote (PWC, 2017:6 & BDO, 2017).

## **2.10 Summary**

The commercial nature of vouchers has been extensively described in this chapter to achieve a comprehensive understanding thereof. The different types and characteristics of gift cards were investigated, and two main types of gift cards were identified. A lot of sub-categories and permutations of how these gift cards can be used flowed from these two main categories of gift cards. After these numerous permutations of gift cards were investigated, it was confirmed that there are considerable benefits in using gift cards from both the retailer's and the customer's perspective.

However, it was determined that despite these benefits for the consumer, non-redemption of gift cards still occur. The causes, effects and other considerations regarding non-redemption or expiration of vouchers have been thoroughly described. It has also been established that secondary markets exist in an attempt to mitigate the welfare loss of non-redemption. Incremental costs associated with a gift card program for a company were explained and the fact that the consumer will likely pay dormancy fees on failure to redeem the gift card value was identified. The accounting treatment of gift cards and related transactions were included in the chapter to add value and help clarify the commercial nature from an accounting perspective. In Chapter 3 the commercial nature of gift cards will be used as basis for a critical analysis of the South African VAT legislation.

## **Chapter 3**

### **3 Critical analysis of current South African VAT legislation to determine how vouchers are taxed**

#### **3.1 Introduction**

The current South African VAT legislation will be analysed in this chapter to achieve a comprehensive understanding about the VAT consequences of vouchers and related transactions. It will be determined whether the South African VAT legislation is clear and comprehensive. The general VAT principles that are applicable to voucher related transactions will be stated and discussed, after which the parts of the VAT legislation relating specifically to vouchers will be identified. Hereafter, the VAT consequences of the different types of gift cards and gift card related transactions, as discussed in the chapter 2, will be analysed and applied to the identified legislation. This approach will enable the identification of possible shortfalls in the current VAT legislation.

#### **3.2 General VAT principles**

As discussed in chapter 1, VAT is a broad, consumption-based taxation. According to Le Minh (2007:204) VAT is imposed on goods and services used in final domestic or private consumption. Van Oord (2015:50) states that VAT should be levied on the broadest base possible and should approximate the economic base of consumption without taxing production. Certain types of consumption, however, is excluded from the tax base of VAT by applying two slightly differing methods – exemptions from VAT and the zero-rating of certain supplies of goods and services (Van Oord, 2015:50).

The exemption from VAT implies that no output tax is charged by a vendor in relation to certain supplies of goods and services made to customers. This also means that no input VAT can be claimed on the production of the goods (Van Oord, 2015:50). The effect on the VAT base will depend on where in the production chain the exemption occurs (Le Minh, 2007:204). The tax base will shrink if the exemption takes effect at the point of sale to the consumer at the end of the supply chain, as the South African Revenue Service (SARS) then loses the output tax (Le Minh, 2007:204). However, if the exemption occurs somewhere within the production chain, the manufacturer making the supply is unable to claim the input VAT during the production phase resulting in a cascading effect in the next phase of the value chain which will broaden the tax base (Le Minh, 2007:204). Items, for example in the financial services sector, are hard

to tax and are thus exempted for equity, practicality and efficiency reasons (Van Oord, 2015:50).

The zero-rating of certain supplies of goods and services means that output tax is charged at a nil rate, meaning a zero-rated supply is still a taxable supply (Van Oord, 2015:50). The effect is that input tax can still be claimed during the production phase of the goods or services with the result that no additional burden is placed on manufacturers with regards to unclaimable VAT, as is the case with exemptions (Le Minh, 2007:204). If a supply of goods or services is not exempted or zero-rated, the general VAT rules regarding the levy of output tax will apply.

Output tax is charged in accordance with section 7(1)(a) of the Value-added Tax Act stating the following:

there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax— (a) on the supply by any vendor of goods or services supplied by him on or after the commencement date in the course or furtherance of any enterprise carried on by him;

There are many aspects of section 7(1)(a) of the Value-added Tax Act that needs to be defined for a better understanding of the requirements for when output tax should be levied.

Foremost, one needs to understand the term “supply” since it is the action that triggers the levy of output tax. According to the Value-added Tax Act the definition of “supply” includes:

the performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of “supply” shall be construed accordingly;

This is thus a very broad definition and basically encompasses any good or service changing hands. Section 1 of the Value-added Tax Act also defines “sale”, which forms part of “supply”, as “an agreement of purchase and sale and includes any transaction or act whereby or in consequence of which ownership of goods passes or is to pass from one person to another”. It would also be important to determine when a “supply” of goods or services is deemed to be made by a vendor as this will establish when output tax is payable to SARS. Section 9 of the Value-added Tax Act deems a “supply” to be made at the earlier of the date of issue of an invoice for the applicable goods or services, or the time of any receipt of consideration by the vendor in respect of that supply.

In addition to the above rules regarding whether a “supply” is made, it is important to identify when that “supply” is deemed to take place. This will determine when the output tax should be levied. Section 9 of the Value-added Tax Act prescribes the terms of the time of a supply and states the following:

a supply of goods or services shall ... be deemed to take place at the time an invoice is issued by the supplier or the recipient in respect of that supply or the time any payment of consideration is received by the supplier in respect of that supply, whichever time is earlier.

The general rule thus deems a “supply” to be made at the event that happens the earliest between invoice date or payment date.

Furthermore, the term “vendor” needs to be defined, as this will indicate to whom section 7(1)(a) applies. According to the Value-added Tax Act “vendor” means any person who is required to be registered under the Value-added Tax Act. It is stipulated in Section 23(1)(a) that if “at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R1 million” the person needs to be registered for VAT.

Another requirement is that the vendor needs to carry on an “enterprise”. According to the Value-added Tax Act “enterprise” means, “in the case of any vendor, any enterprise or activity which is carried on continuously or regularly by any person in the Republic ... and in the course or furtherance of which goods or services are supplied to any other person for a consideration, whether or not for profit” It can thus be expected that “enterprise” refers to any ongoing activity or trade practised by a vendor, which could include either the sale of goods or the rendering of services for consideration.

The identification of “goods” and “services” supplied by the vendor will be an important indicator of whether output tax should be levied. The VAT is meant to be levied on consumption, which implies the usage of “goods” or “services”. According to section 1 of the Value-Added Tax Act “goods” can be defined as “corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity”. However, this definition specifically excludes “money” which is defined in the Value-added Tax Act as:

coins (other than coins made wholly or mainly from a precious metal other than silver)  
... and any paper currency which under the said Act is a legal tender; ... any bill of

exchange, promissory note, bank draft, postal order or money order, except when disposed of or imported as a collector's piece, investment article or item of numismatic interest.

The definition of "enterprise" also excludes any right under a mortgage bond or anything similar and any stamp/card with a money value issued by the State for the payment of any tax. In contrast, "services" are defined by Value-Added Tax Act as "anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods". Services thus tend to be incorporeal in nature where goods are corporeal.

A part of the definition of enterprise also requires that a "consideration" be paid for the supply of goods or services. According to the Value-added Tax Act "consideration" that is made:

in relation to the supply of goods or services to any person, includes any payment made or to be made ... whether in money or otherwise ... in respect of ... the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain: Provided that a deposit ... whether refundable or not, given in respect of a supply of goods or services shall not be considered as payment made for the supply unless and until the supplier applies the deposit as consideration for the supply or such deposit is forfeited.

This definition is thus also considered to be wide and unspecific and can include anything exchanged with monetary value to receive goods or services. The general rule for the value of goods or services supplied is thus the actual consideration payable to the supplier or, if the consideration is not money, the market value thereof. It should also be noted that when no "consideration" is payable in exchange for the supply of goods or services, section 10(23) of the Value-added Tax Act determines that "the value of that supply shall be deemed to be nil" if in the course of furthering of the enterprise. There will thus be no output tax payable when the above is applicable.

A seller of goods or services will charge output VAT on a supply of goods or services, which will be included in the invoice amount, when all the above requirements and definitions are adhered to. The purchaser of these goods or services will only be able to claim back the input VAT on the purchases against his own sales if the goods or services were purchased to produce the subsequent sales (Van Oord, 2015:83). Section 1 of the Value-added Tax Act

defines “input tax” in relation to a vendor as “tax charged under section 7 and payable in terms of that section by a supplier on the supply of goods or services made by that supplier to the vendor ... where the goods or services concerned are acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies”. This enables SARS to tax the “value added” in each stage of production until the goods or services reach the end-consumers who are unable to claim back an input-tax credit like a normal manufacturer, as the goods or services are for private use.

The above discussion summarizes the general application and working of the Value-added Tax Act. It needs to be considered whether voucher/gift card related transactions will be subject to these general VAT rules. This evaluation will include determining whether these different transactions would qualify as a normal supply of goods or services for a consideration in the course of the enterprise. This will depend on the terms and conditions of the different voucher/gift card related transactions.

There is, however, special provisions regarding the transactions where it is difficult to apply the general VAT rules. One of these instances is the clarification or the determination of the value of the supply of vouchers.

### **3.3 Voucher specific VAT legislation**

According to Arends and Kolkman (2016) until the Council of the European Union adopted a directive on the VAT treatment of vouchers, no clear rules with regards to the VAT treatment existed across the Member States. This “uncertainty” with regards to the voucher VAT legislation increases the risk of mismatches in national VAT legislation leading to double taxation, non-taxation, uncertainty on tax compliance obligations or other negative consequences (Arends & Kolkman, 2016). Lutz (2007:3) states that “even though a number of European Court of Justice Cases have provided useful guidance on the matter, the principles stated by the Court seem difficult to put in practise since the current rules are not adapted to the evolution of some vouchers”. The implementation of the Council directive is thus to harmonize the VAT treatment of vouchers within the European Union and to provide more clarity.

The Council Directive issued by the Council of the European Union (2016:3) defines a “single-purpose voucher” as “a voucher where the place of supply of the goods or services to which the voucher relates, and the VAT due on those goods or services, are known at the time of issue of the voucher”. While a “multi-purpose voucher” is “a voucher, other than a single-purpose voucher”. According to Kokolia and Katrinaki (2015:291) a “chargeable event” occurs

when a single-purpose voucher is issued but for a multi-purpose voucher the “chargeable event” only occurs when it is actually redeemed.

This treatment is consistent with the BUPA Hospitals Ltd and Goldsborough Developments Ltd vs Commissioners of Customs & Excise (2006) case. It was ruled by the European Court of Justice (ECJ) that:

in order for the tax to become chargeable where an amount is paid on account without the supply or service having been provided, all the relevant information concerning the chargeable event, namely the future delivery or future performance, must already be known and therefore, in particular, when the payment on account is made the goods or services must be precisely identified.

They concluded that “payments on account of supplies of goods or services that have not yet been clearly identified cannot be subject to VAT”.

The VAT treatment of promotional discount vouchers was addressed in the Elida Gibbs Ltd vs Commissioners of Customs and Excise (1996) case. It was stated that “the taxable amount serving as a basis for the VAT to be collected by the tax authorities cannot exceed the consideration actually paid by the final consumer which is the basis for calculating the VAT ultimately borne by him”. It causes that “the taxable amount attributable to the manufacturer as a taxable person must be the amount corresponding to the price at which he sold the goods to the wholesalers or retailers, less the value of those coupons”.

These court cases are only two examples of how the gift card VAT legislation started to evolve in the United Kingdom. South Africa has similar voucher specific VAT legislation that is contained in the Value-added Tax Act, however, there is no formal definition of a “voucher” or related sub-categories like in the Council directive issued by the Council of the European Union. The South African Value-added Tax Act relies on three specific sections to clarify the type of voucher and the value of the supply thereof.

Section 10 of the Value-added Tax Act addresses the special rules for the value of certain supplies of goods or services where the application of the general VAT rules become unable to address certain aspects of the transaction. Even though the general VAT rules are still applicable to voucher related transactions, there are additional specific legislation regarding the value of vouchers which is addressed in section 10(18), section 10(19) and section 10(20) of the Value-Added Tax Act.

When looking at the three voucher specific sections in the Value-Added Tax Act, the VAT effect at the time of issuance of a gift card to a consumer and the VAT effect at the time of redemption of a gift card by a consumer needs to be considered. When redemption from a merchant other than the original issuing merchant occurs, any related reimbursement should also be kept in mind. The issue of a gift card and the subsequent redemption of a gift card are also the first two stages in the Three-stage model, with reimbursement - if applicable - the third and final stage. This model will be applied to different voucher related transactions to determine the applicable VAT effect in section 3.5 and 3.6 of this study. The three voucher related sections in the Value-Added Tax Act will now be discussed in more detail.

Section 10(18) of the Value-added Tax Act addresses the value of a purchased voucher, where any good or service is available in exchange in the future, on the date of actual purchase of the voucher. Section 10(18) specifically states the following:

where a right to receive goods or services to the extent of a monetary value stated on any token, voucher or stamp ... is granted for a consideration in money, the supply of such token, voucher or stamp is disregarded for the purposes of this Act, except to the extent (if any) that such consideration exceeds such monetary value.

From the above legislation the impact of the phrase “goods or services to the extent of a monetary value” should be highlighted. This implies that the goods or services to be received by the gift card redeemer at date of redemption is unknown at date of issue of the gift card, because any goods or services are redeemable for the monetary value on the card (South African Revenue Service, 2014:2). Therefore, the issue of the gift card will not be deemed “supplied” to a buyer on the actual date of issue, but rather on date of redemption when the goods or services exchanged for the gift card becomes known. The effect is that no output tax will be levied at the date of issue of the gift card, but rather at the date of redemption (Van Zyl, 2013:236).

In contrast to section 10(18), section 10(19) addresses the value of voucher related transactions for specific goods or services indicated on the voucher on the date of actual redemption of the good or service. According to Section 10(19) of the Value-added Tax Act:

where any token, voucher or stamp ... is issued for a consideration in money and the holder thereof is entitled on the surrender thereof to receive goods or services specified on such token, voucher or stamp or which by usage or arrangement entitles the holder to specified goods or services, without any further charge, the value of the supply of

the goods or services made upon the surrender of such token, voucher or stamp is regarded as nil.

The following phrase should be highlighted in this piece of legislation to identify the type of voucher issued: “goods or services specified on such token”. This indicates that on date of issue of the voucher, the goods or services to be redeemed on a later date is already known when the gift card is issued (South African Revenue Service, 2014:3). It is thus possible to already levy output tax on date of issue as all the variables is known. Output tax will thus not be levied at that point in time when the actual goods or services are redeemed (Van Zyl, 2013:236). The purpose of section 10(19) is thus to deem the value of the supply to be nil at the date of redemption of the gift card value (South African Revenue Service, 2014:3).

Both section 10(18) and section 10(19) refer to voucher related transactions where a consideration was paid to acquire the voucher. It should be considered, however, that when consideration is paid to acquire a voucher that is not restricted with regards to redemption, the substance of the transaction could be closer to the exchange of currency, which means the transaction might qualify as a financial service. This causes section 10(18) and 10(19) not to apply – the transaction will be exempt from VAT (refer to part 3.5 of this chapter). Section 10(20) refers to the value of voucher related transactions where no consideration was payable by the recipient to acquire the voucher in the first place.

According to section 10(20) of the Value-added Tax Act:

where any token, voucher or stamp is issued by any vendor for no consideration and the holder thereof is entitled on surrender thereof to another person, being the supplier of goods or services, to a discount on the price of goods or services supplied to the holder, the consideration in money for the supply of such goods or services shall be deemed to include the monetary value stated on such token, voucher or stamp: Provided that such monetary value shall be deemed to include tax.

The issuing merchant thus received no consideration for issuing the gift card – no output tax can thus be applicable at the issuing stage of the voucher because to levy output tax a consideration needs to be received in terms of section 7(1)(a) of the Value-added Tax Act. It is clear from the above legislation that the “no consideration” requirement is not the only triggering requirement for section 10(20) to be applicable. It is also required that the voucher should be issued by and redeemed from different persons. The issuing merchant and the merchant the gift card is redeemed from should thus be different (South African Revenue

Service, 2014:3). Section 10(20) dictates that the value of the supply for the person providing the goods or services to the customer redeeming the voucher, is the full amount of consideration without excluding the discount as per voucher (South African Revenue Service, 2014:3). Output tax is thus payable by the merchant issuing the goods or services on the entire value of the goods or services – the discount should not be deducted (Van Zyl, 2013:243).

Another part in the Value-added Tax Act that deals with this type of voucher transaction and thus links with section 10(20) is section 16(3) that outlines the stipulations for a possible input tax credit for the party that originally issued the voucher.

Section 16(3) of the Value-added Tax Act states that:

the amount of tax payable in respect of a tax period shall be calculated by deducting from the sum of the amounts of output tax of the vendor which are attributable to that period ... the following amounts, namely ... an amount equal to the tax fraction of any payment made by the vendor during the tax period in respect of the redemption with him, or his agent, of the monetary value of any token, voucher or stamp contemplated in section 10 (20), to a supplier of goods or services who has granted a discount on the surrender to him of such token, voucher or stamp by a recipient of a supply of goods or services if those goods or services are not charged with tax at the rate of zero per cent under section 11.

The original issuer (vendor) of the voucher is thus allowed an input tax credit if a reimbursement for the said voucher value was provided to the retailer who supplied the actual goods or services to the customer on redemption of the voucher (South African Revenue Service, 2014:3).

The question now arises as to what the VAT effect would be at issue and redemption when a voucher is issued at no consideration and redeemed from the same supplier. The consequences of this type of transaction will be discussed in section 3.6.2.1 and section 3.6.1.1 of this study.

These special value rules regarding vouchers in the Value-added Tax Act only address specific parts of the entire voucher transactions, which extends from original issue to eventual redemption, at a specific point in time. It can thus be noted that the general VAT rules will be applicable to the other stages of a voucher transaction. The application of these rules to

different types of vouchers and the related transactions will be analysed further and discussed in detail.

### **3.4 Application to different types of vouchers**

The application of the VAT legislation to the different voucher related transactions identified in chapter 2 will be broken down into the different stages of the Three-stage model described in chapter 2. This will enable a better understanding of the effect of VAT on each party in each stage of a voucher related transaction. It will be assumed that all merchants in this Three-stage model analysis is registered vendors. Open-loop gift cards and closed-loop gift cards will be analysed separately.

The breakage consequences of each different type of gift card will also be considered separately. It will be important to distinguish between actual expiration of a gift card and gift cards that only remain long outstanding but has not yet expired. The reason for this is that there seems to be a difference between when the rights to the value of the gift card are transferred from the holder to the original issuing merchant. On actual expiration the rights to the value of the gift card is transferred to the original issuing merchant as stated in the terms and conditions of the gift card while there seems to be no transfer of rights on only a long outstanding gift card, even if the chances of redemption by the holder is slim. When a gift card expires, the issuer may be entitled to the proceeds without fulfilling any obligation attached to the gift card (Hennes & Schenck, 2014:561), the rational being that the value is voluntary forfeited which is not the merchant's failure (Horne & Bendle 2016:167). It will need to be determined when or if any output tax is payable on breakage.

### **3.5 Open-loop gift cards**

As described in chapter 2, open-loop gift cards can be redeemed from any merchant for any available goods or services and are usually issued by financial institutions. It was also noted that open-loop gift cards are nearly as spendable as cash and are expected to be used in the same way cash would be used. A financial institution will thus be used in the Three-stage model below as the gift card issuing merchant.

The following diagrams will illustrate the transactional flow of the open-loop gift card. For this type of gift card, the Three-stage model will be adapted and analysed to determine whether there are any VAT consequences. Breakage considerations regarding VAT will be discussed after the transactional flow analysis.

## Stage 1

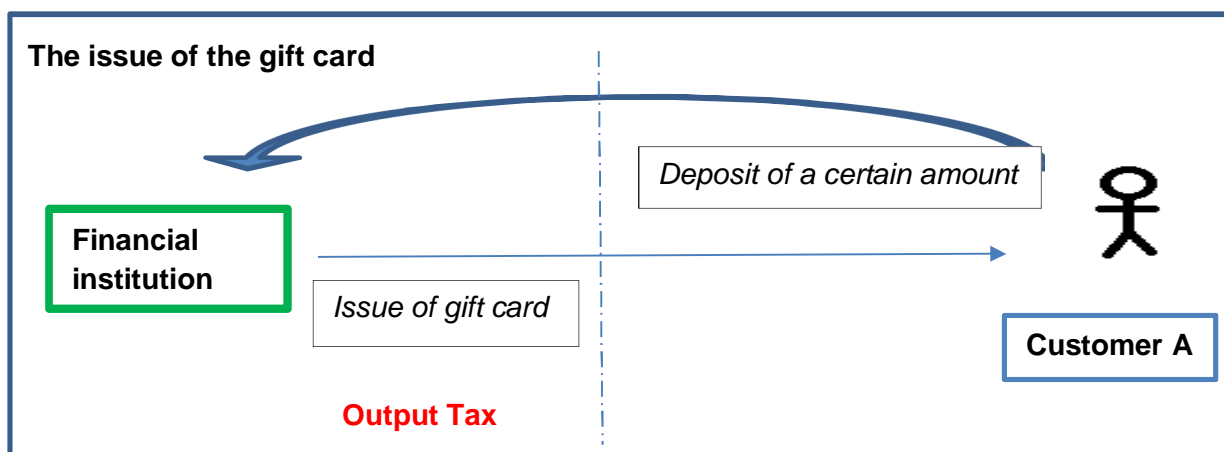


Figure 4.1 – Stage 1

Source: Compiled by researcher from accumulated data

During stage 1 of this open-loop gift card transaction, a financial institution issues a gift card in exchange for a certain amount of cash. It needs to be determined if the issue of the gift card constitutes a “supply” of “goods” or “services” in the course of the financial institution’s “enterprise”.

As discussed in chapter 2, the transaction is in essence very similar to a debit or credit card, where currency is exchanged for crediting a specific account at the financial institution which relates to Customer A. This credit will be used to pay for the desired item at any merchant with the available payment facilities to accept the gift card – which is usually very often. The financial institution is thus making available a facility in the form of temporarily retaining the currency that was exchanged for the gift card which will immediately be paid to the merchant from whom the gift card is redeemed. The financial institution is thus supplying a “service”.

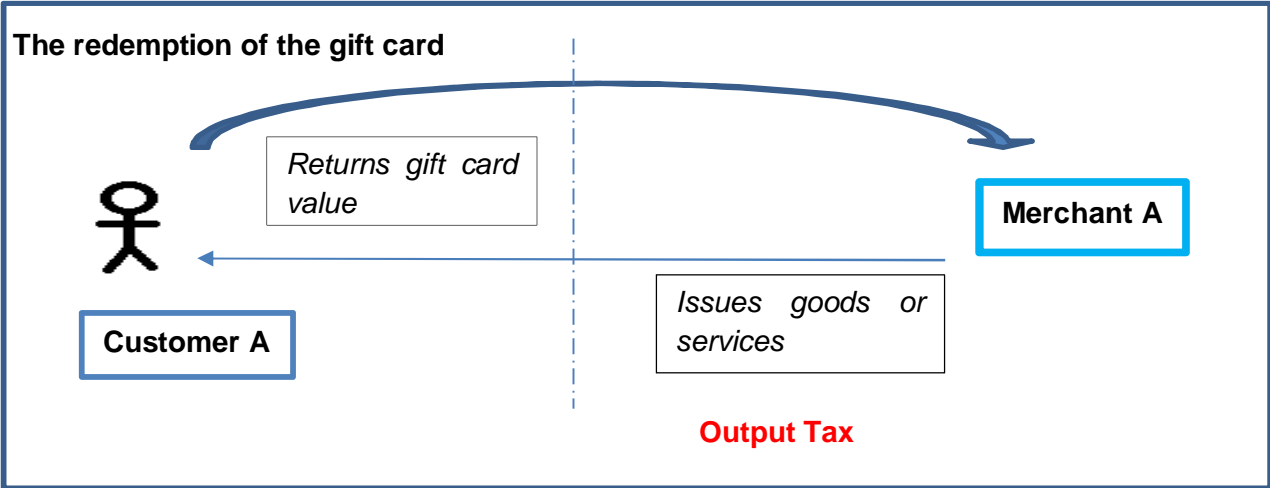
In terms of the Value-added Tax Act the definition of “financial services” are deemed to be activities as specified in section 2 of the Value-added Tax Act. Section 2 of the Value-added Tax Act includes the following in the definition of “financial services”: “The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise)”. When money is thus exchanged for crediting an account with the value of the money exchanged, the transaction will constitute an “exchange of currency” and qualify as a “financial service”. This definition also explicitly excludes “...to the extent that the consideration payable in respect thereof is any fee, commission, merchant’s discount or similar charge, excluding any discount cost” from the definition of “financial services”.

The service the financial institution is providing Customer A can be argued to be a “financial service” as the core of the transaction is exchanging currency by crediting the gift card account for future use. The supply of any financial service is exempt from VAT in terms of section 12(a) of the Value-added Tax Act. The financial institution will thus not be liable for any output tax on the supply of the financial service to Customer A.

However, it should be noted that any fees paid by Customer A, similar to bank charges, to facilitate the transaction will be subject to output tax as this type of services are specifically excluded from the “financial services” definition.

Stage 1 of the gift card transaction will be followed by stage 2, which will involve the redemption of the gift card.

**Stage 2**



*Figure 4.2 – Stage 2*  
*Source: Compiled by researcher from accumulated data*

During stage 2 of the transaction the gift card will be redeemed by Customer A at any merchant with the available facilities to accept the gift card. Customer A will apply the available credit stored on the gift card in exchange for goods or services at the particular merchant (Merchant A in this scenario). It needs to be determined whether Merchant A is liable for output tax.

Output tax will be levied in terms of section 7(1)(a) of the Value-added Tax Act when there is a “supply” of “goods” or “services” made in the course of an “enterprise”. Since Merchant A transfers the ownership of the items in exchange for the value stored on the gift card, there is a “sale” which will constitute a “supply”. The items received by Customer A will constitute corporeal movable things – “goods” (or “services” if incorporeal).

Merchant A will immediately receive payment for these goods or services when the gift card account at the financial institution is debited with the value spent by Customer A. A “consideration” in money is thus received by Merchant A in a way very similar to a debit or credit card payment. Receiving “consideration” for the supply of goods or services is one of the requirements of a transaction being in the course of an “enterprise”. The transaction will thus be considered in the course of Merchant A’s “enterprise”. The value of the supply to Customer A would be the amount received in money by Merchant A in exchange for the goods or services supplied. Output tax should thus be levied on the goods or services supplied to Customer A if those goods or services supplied are not zero rated or exempt supplies.

Because the consideration payable by Customer A in exchange for the goods or services seems to be immediately transferred to Merchant A when the gift card value is applied, like with a normal debit or credit card transaction, there will be no stage 3 applicable in the transactional flow of an open loop gift card.

### **3.5.1 Breakage consequences**

As discussed in chapter 2, when the open-loop gift card is not redeemed, or if the value is long outstanding, financial institutions seem to charge dormancy fees on the remaining balance to recoup the value. This can be considered a charge or a fee for services rendered, similar to a bank charge - which does not qualify as an exempt financial service. Output tax should thus be charged on the amount received by the financial institution with regards to dormancy fees.

If the gift card expires before redemption, the entire value will be kept by the financial institution who issued the gift card. The customer who had the right to spend the value of the gift card, lost that right when the terms and conditions of the gift card transaction was not met – specifically the terms regarding the allowed redemption period. It should be considered whether the financial institution is liable to pay output tax on the retention of the gift card balance that expired.

For output tax to be levied there needs to be a “supply” of “goods” or “services” in the course of an “enterprise”. It could be argued that the financial institution provided a service for the period specified in the term and conditions of the gift card by making available the facility of safe access to the amount loaded onto the gift card at any merchant preferred by Customer A at any time. This is on the condition that the gift card value should be spent within a specified period. If the value is used within this period, no consideration, other than transactional fees, is payable. If the value is not redeemed within that specified period, the remaining gift card

balance will be applied by the financial institution as consideration for services rendered – either by applying dormancy fees to consume the whole value or by simply applying the balance due to actual expiration. While the service was supplied throughout the period specified in the terms and conditions, the value of the supply and the timing of payment thereof can only be determined when the gift card value is applied by the consumer or when the gift card value expires.

While the crediting of the gift card account on initial issue of the gift card could be considered a financial service (Lutz, 2007:16), which is exempt from VAT, the retainment of the balance of the gift card value by the financial institution could be considered a charge or a fee with a nature similar to a bank charge. This would thus not be considered an exempt supply. Output tax should therefore be levied, because there was a supply of a service for a consideration.

### **3.6 Closed-loop gift cards**

As discussed in chapter 2, closed-loop gift cards can be divided into the two categories namely: product specific gift cards, where only specific goods stated on the gift card can be redeemed, and retailer specific gift cards, where a holder of the gift card can redeem the value for any item or service available at a particular merchant or group of merchants. The VAT consequences of both these categories will be analysed separately.

#### **3.6.1 VAT consequences - Retailer specific gift cards**

Retailer specific gift cards can only be redeemed at the merchants specified in the terms and conditions of the gift card. However, any goods or services available at these specified merchants may be redeemed by the consumer in exchange for the value of the gift card. This type of gift cards is sub-divided into two categories: Promotional gift cards and purchased gift cards.

##### **3.6.1.1 Retailer specific promotional gift cards**

The Three-stage model is adapted as follows to be specifically applicable to the transactional flow of promotional gift cards redeemable at specified merchants for any available item or service available for sale. The consumer received this type of gift card for free after a condition was met and can spend it as partial payment for any available item at the merchant.

The below diagrams will illustrate the flow of the retail specific promotional gift card transaction in the three main transactional stages identified in chapter 2.

## Stage 1

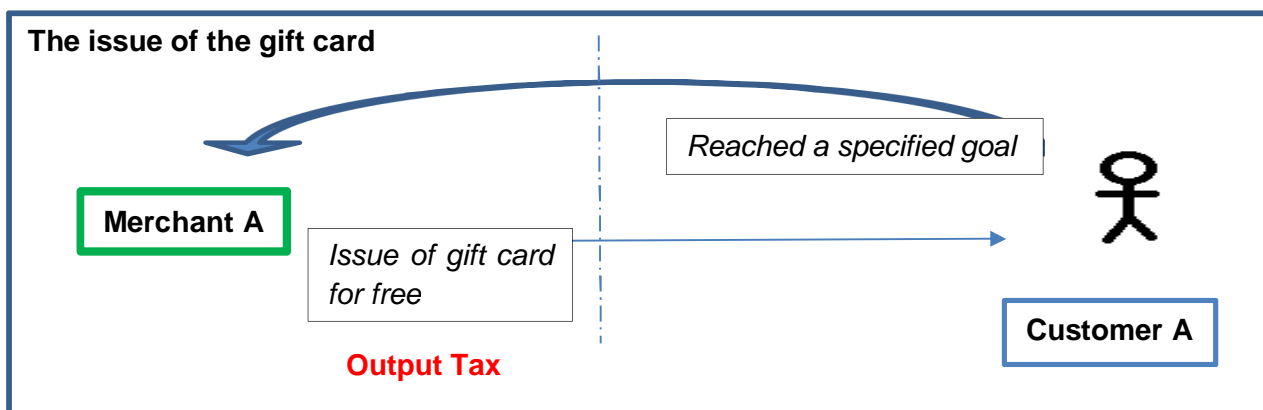


Figure 5.1 – Stage 1

Source: Compiled by researcher from accumulated data

During stage 1 there are two parties partaking in the transaction – Merchant A issues the promotional gift card, which is redeemable as part of the payment for any item or service available at the supplier noted on the gift card, and Customer A who receives the gift card. To be awarded the free “earned” gift card, Customer A met a goal, for example a pre-determined purchasing goal. This scenario, however, can be applicable to any other action taken by the customer which will result in the free receipt of a gift card – this free gift card received can be an “earned”, “discount” or “gift” gift card and will reduce the amount payable for a purchase. The VAT consequences during stage 1 of this transaction now need to be determined.

In terms of section 7(1)(a) of the Value-added Tax Act, for output tax to be levied there needs to be a supply of goods or services by a vendor in the course of an enterprise. If it is assumed that all merchants are registered vendors, then there only needs to be determined whether the issue of the gift card is a “supply” of “goods” or “services” and whether it was issued in the course of an “enterprise”.

The issue of the gift card is a “supply” of a “service” by Merchant A as the right to a reduced price on redemption of the gift card is granted to Customer A. However, the definition of “enterprise” according to the Value-added Tax Act requires a consideration to be received in return for the services supplied. According to the South African Revenue Service (2013) Interpretation Note no. 70 “consideration” per the “enterprise” definition should not be narrowly interpreted – one should regard the activities of the merchant as a whole. Even though Customer A did not provide any consideration in return for the issue of the free gift card, one can still consider the issue of the free gift card by Merchant A in the course of the enterprise. Section 10(23) of the Value-added Tax Act states that the value of a supply made for no

consideration is deemed to be nil if the supply is made in the furtherance of an enterprise. No output tax will thus be levied on the issue of the free gift card by Merchant A.

As Customer A is the final consumer of the goods or services and will supply the gift card as payment for items reserved for private use, no input tax is claimable by Customer A. When Customer A decides to redeem the free gift card, the transaction flows into stage 2.

Stage 2 can have two basic variations which will be discussed separately below in stage 2(a) and stage 2(b). Stage 2(a) occurs when the gift card is redeemed from a different merchant than the original issuing merchant while stage 2(b) occurs when the merchant who originally issued the gift card are the same merchant from who the gift card is redeemed.

**Stage 2(a) – Redemption from a different merchant than the issuer**

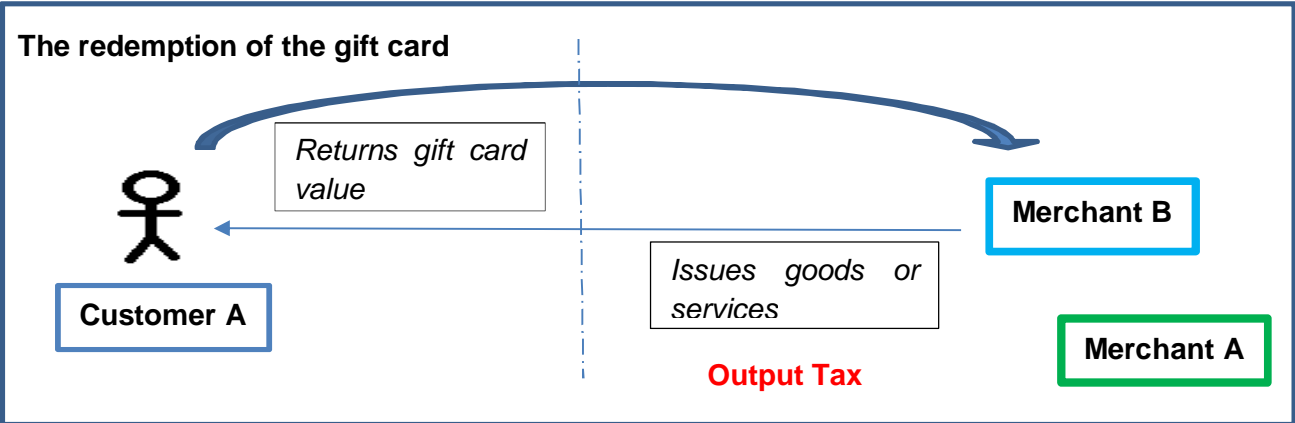


Figure 5.2 – Stage 2(a)

Source: Compiled by researcher from accumulated data

During stage 2 Customer A redeems the free gift card value from one of the allowed merchants stated in the terms and conditions of the promotional gift card, for any available goods or services. As Merchant B did not issue the free gift card originally (was issued by merchant A), it needs to be considered whether Merchant B made a “supply” of goods or services to Customer A in the course of an “enterprise” and, if so, what the value of the supply would be.

As the ownership of the items issued by Merchant B transfers to Customer A, there seems to be a “sale” as defined by the Value-added Tax Act. The definition of “supply” in terms of the Value-added Tax Act includes a sales transaction. There can thus be concluded that the issue of the goods or services to Customer A constitutes a “supply” by Merchant B.

Merchant B will receive the gift card as payment or partial payment by Customer A for the supply of goods or services. It can be argued that as Merchant B receives the right to the value

of the gift card, which is redeemable from the original issuer (Merchant A), in return for the goods or services supplied, the exchange can constitute “consideration”. The supply of these items is thus in the course of the “enterprise”, and output tax should be levied on the supply.

The question now becomes what the value of the supply should be that output tax is levied on, as the gift card was received by Merchant A instead of actual money. It should be noted that the gift card value will be recovered by Merchant B from the initial gift card issuer, Merchant A, (discussed during Stage 3). The fact that the gift card value will be recovered is the determining factor in the question regarding the value of the supply.

Section 10(20) of the Value-added Tax Act states that when a gift card that was originally issued for no consideration and is redeemed from a merchant other than the original issuer, the value of the supply for the merchant who actually supplies the goods or services will be the total value of the goods or services without deducting the gift card value from the sales price. This is due to the fact that the value of the gift card will be reimbursed by the merchant who originally issued the gift card. As this is the case for Merchant B, output tax will be levied on the full value of the goods or services supplied to Customer A, without deducting the gift card value. The VAT consequences for the reimbursement of the gift card value from Merchant A, the initial issuer, will be discussed in stage 3 in the flow of the gift card transaction.

This scenario will slightly change when the promotional gift card is directly redeemed from the initial issuer, in this case from Merchant A – see illustration.

**Stage 2(b) – Redeemed from initial issuing merchant**

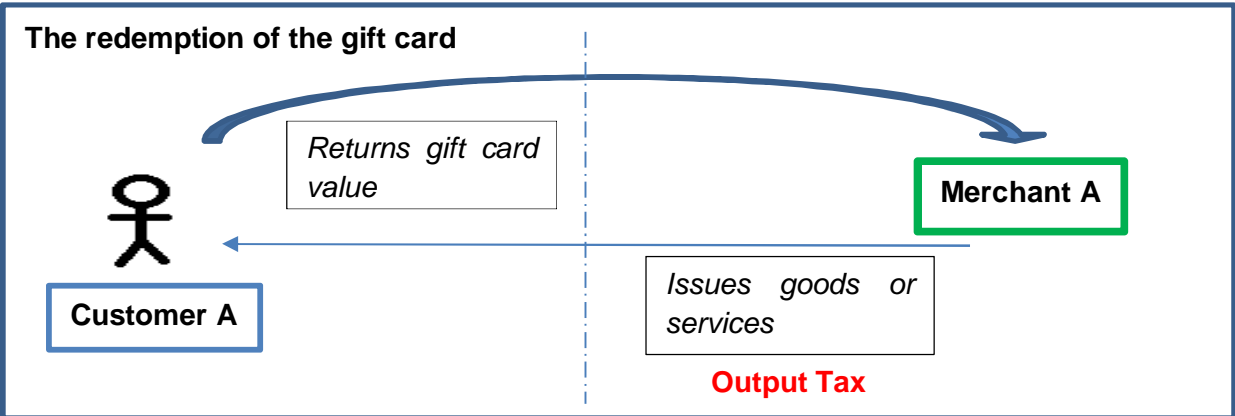


Figure 5.3 – Stage 2(b)

Source: Compiled by researcher from accumulated data

Like stage 2(a), the sale of the goods or services to Customer A is still considered a “supply” in the course of an enterprise. However, as the gift card value applied by Customer A as partial payment for the goods or services will not be redeemed from another merchant when received, the value of the supply on which output tax is levied will be different than in stage 2(a). “Consideration” as defined in the Value-added Tax Act, includes any payment made in money or otherwise. The gift card returned to Merchant A has no further monetary value after it is returned by Customer A as the value is not redeemable elsewhere – unlike in stage 2(a) where the value was still redeemable from the issuing merchant. The gift card value that is applied as partial payment should thus be excluded from the amount perceived as consideration for the goods or services (Lutz, 2007:23). Output tax will thus be levied on the value of the goods or services excluding the gift card value applied as partial payment. It should be noted that there will be no stage 3 applicable for this variation of the scenario, as the value of the gift card will not be redeemable from another merchant.

**Stage 3**

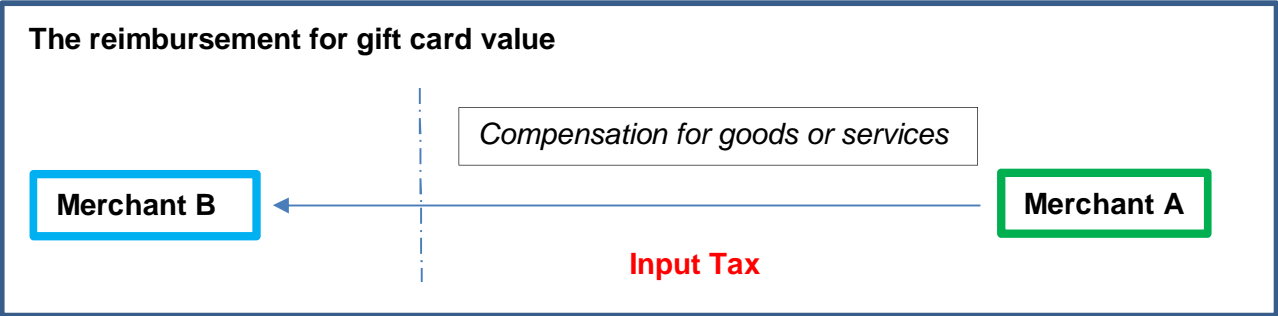


Figure 5.4 – Stage 3  
 Source: Compiled by researcher from accumulated data

During stage 3 of the gift card transaction flow the issuer merchant (Merchant A) reimburses the seller merchant (Merchant B) for the value of the gift cards redeemed by customers. There would usually be an agreement between participating merchants when the gift cards are redeemable from a merchant other than the issuer of the gift card. This agreement will include a stipulation that requires reimbursement (refer to section 2.3 of this study). It should be considered whether Merchant B will be liable for any output tax on the amount received for the reimbursement and whether Merchant A would be able to claim any input tax on the compensation for goods and services issued by Merchant B.

To determine if Merchant B is liable for output VAT, there needs to be established whether a “supply” of “goods” or “services” is made to Merchant A and what those goods or services

constitutes. The reimbursement paid to Merchant B is for the goods or services Merchant B supplied to Customer A in Merchant A's stead, meaning Merchant A did not supply the goods or services, that should have technically been supplied by them – Merchant A had the obligation to fulfil the right granted by the issue of the gift card. However, Merchant B fulfilled the obligation to deliver any goods or services in exchange for the gift card.

This could be considered a supply of a “service” from Merchant B to Merchant A because Merchant B made available an advantage to Merchant A in the form of supplying goods or services to Customer A while not receiving the full consideration due as the result of the redemption of the gift card issued by Merchant A. The actual goods or services have thus been delivered to Customer A and not to Merchant A.

Merchant A only reimburses an amount that is equivalent to the amount of value that was lost by Merchant B during the supply of goods or services to Customer A. The value reimbursed is thus limited to the actual gift cards redeemed. Merchant B does thus not charge an additional amount for the service of supplying goods to Customer A in Merchant A's stead. Merchant B already paid output tax on the supply of the goods or services to Customer A when the gift card was redeemed. At that stage this output tax was levied on the goods' full value, which was not actually received in cash because of the exchange of the gift card. No additional output tax should thus be levied for the reimbursement of the gift card value received by Merchant A. The value of the supply of the service from Merchant B to Merchant A, without considering the reimbursement for the value of the goods supplied to Customer A, is also nil as no additional amount is charged for this service rendered. No additional output tax is thus payable.

Merchant A, however, should be able to claim an input tax credit on the payment made to Merchant B for a service that was received in the course of Merchant A's enterprise. The reimbursement for the goods or services made to Merchant B will be claimable in terms of section 16(3) of the Value-added Tax Act. This section states that when a voucher is issued for no consideration and redeemed from a merchant other than the original issuer, the original issuer can claim an input tax credit for the value of the voucher. This, however, is only applicable if the supplier merchant was reimbursed for the goods or services supplied in the issuer merchant's stead. This amount that is reimbursed to Merchant B for the goods sold in Merchant A's stead could be considered a cost incurred in the course of the enterprise.

### **3.6.1.1.1 Breakage consequences**

Merchant A, who originally issued the promotional gift cards for no consideration, will need to consider whether there are any VAT consequences when the promotional gift cards expire or are long outstanding.

Long outstanding retailer specific promotional gift cards will have no additional consequences as there are no additional transfers of any rights or value, even if the redemption of the gift card by the holder becomes remote. This differs from the rationale behind the accounting treatment of breakage, where it is estimated how many gift cards will be redeemed and then taken into account when recorded into the financial records. In contrast, for the VAT consequences, this will only be taken into account when there is an actual transference of value – a supply. The gift card value is voluntarily forfeited which is not the merchant's failure (Horne & Bendle 2016:167). According to Horne (2013:1) money lost on gift cards constitute lost consumer value. When a gift card goes expires, the issuer may be entitled to the proceeds without fulfilling any obligation attached to the gift card (Hennes & Schenck, 2014:561). There will be a transference of value when the gift card is actually redeemed after it was long outstanding or possibly when it expires.

Retailer specific promotional gift cards that expired before redemption by a customer will have no additional VAT consequences as the gift cards were originally issued for no consideration. There was thus no retention of any amount by the original merchant – in this scenario Merchant A. As there is no consideration retained by Merchant A and no goods or services supplied in return for the value lost by Customer A, both parties are still in the exact same financial position as before the issue of the gift card.

### **3.6.1.2 Retailer specific purchased gift card**

The Three-stage model is adapted in the following diagrams to apply to the transactional flow of purchased gift cards that is redeemable at specified merchants for any available item or service available for sale. The consumer purchased this type of gift card for cash. This type of gift card cannot be considered “financial services”, which are defined by section 2 of the Value-added Tax Act as “The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise)”, similarly to an open-loop gift card because there are restrictions as to where the gift card might be redeemed. Open-loop gift cards are much more spendable (Yao & Chen, 2014:491), meaning it is more closely related to cash compared to a closed-loop gift card.

## Stage 1

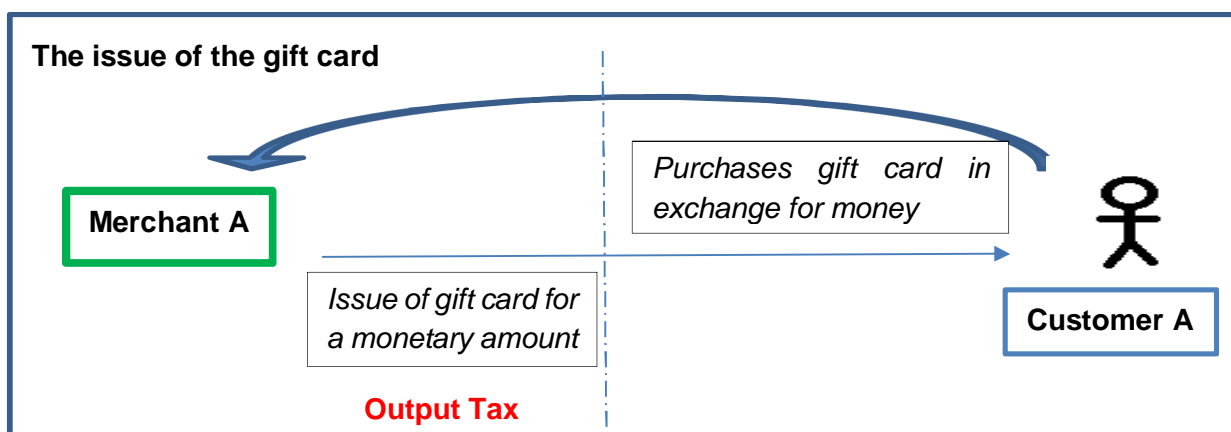


Figure 6.1 – Stage 1

Source: Compiled by researcher from accumulated data

Stage 1 of this type of gift card transaction involves a merchant (Merchant A) issuing a gift card to a customer (Customer A) in exchange for an amount payable in advance. The gift card can then be redeemed by the holder up until the date specified in the terms and conditions. This type of gift card differs from the open-loop gift card issued by a financial institution because there are restrictions with regards to redemption – the merchants where the gift card can be redeemed are prespecified. It should be noted that the gift card can specify that redemption is applicable from a different merchant than the original issuer (Merchant A). The VAT consequences for Merchant A who issues the gift card will need to be determined for stage 1. Customer A will not be able to claim any input tax as defined in the Value-added Tax Act as the goods or services purchased will not be used for taxable supplies.

Output tax will be levied in terms of the Value-added Tax Act when there is a “supply” of “goods” or “services” in the course of furtherance of an “enterprise”. Merchant A seems to sell the right to receive any good or service, limited to the gift card value, in the future on redemption. This can thus be considered the “supply” of a “service” by Merchant A. For the supply to be in the course of furtherance of Merchant A’s “enterprise”, the service needs to be supplied for a “consideration” as defined in the Value-added Tax Act. The definition of consideration explicitly excludes a deposit that has not yet been applied as payment for goods or services. A “deposit” is defined by the Cambridge Dictionary (2019a):

to pay someone an amount of money when you make an agreement with that person to pay for or buy something, that either will be returned to you later, if the agreed arrangement is kept, or that forms part of the total payment.

The amount paid by Customer A to receive the gift card value could thus be considered a non-refundable “deposit” that will be applied as payment or partial payment to buy something unknown in the future. The amount paid by Customer A for the gift card value can thus not yet be considered “consideration” as it was not yet applied to receive the ownership of a specified item.

In addition to the above, section 10(18) of the Value-added Tax Act deems the value of the supply made by Merchant A on the date of the issue of the gift card to be nil. This could be as a result of the fact that it is still unknown for which available goods or services the gift card will be redeemed in the future (South African Revenue Service, 2014:2). The possibility exists that the gift card will be redeemed for a zero rated or exempt item available at the merchant, which will have no VAT implications. This could be a partial explanation for the deferral of the output tax collection which will take place in stage 2. There are thus no VAT consequences during stage 1 of the transaction.

Stage 2(a) occurs when the gift card is redeemed from a different merchant than the original issuing merchant while stage 2(b) occurs when the merchant who originally issued the gift card are the same merchant from who the gift card is redeemed.

**Stage 2(a) – Redemption from a different merchant than the issuer**

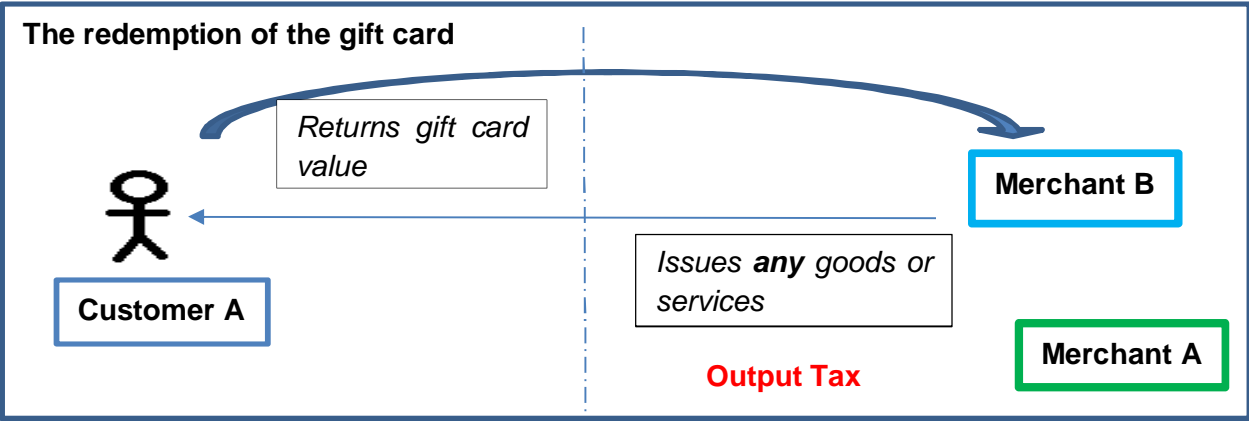


Figure 6.2 – Stage 2(a)

Source: Compiled by researcher from accumulated data

During stage 2(a) of the purchased gift card transaction Customer A redeems the gift card value for any goods or services available at the Merchant B, who has an agreement with Merchant A to supply the goods or services in Merchant A’s stead for a reimbursement of the gift card value redeemed. It should be considered if Merchant B is liable to pay output tax on the goods or services issued to Customer A. Customer A applied the amount “deposited” at

Merchant A as consideration to receive the goods or services from Merchant B. As Merchant B transfers the ownership of goods or services to Customer A in exchange for the gift card value (which is redeemable from Merchant A during stage 3 of the transaction), a sale thus took place. This will thus constitute a “supply”, triggering output tax consequences for Merchant B. As the nature of the goods or services becomes known at the time of redemption of the gift card, it can also be established whether the supply of the goods or services is standard rated, zero rated or an exempt supply.

There is no specific section in the Value-added Tax Act that addresses the value rule for a purchased gift card transaction where the value is redeemable at a merchant other than the original issuer (VAT consequences for Merchant B at redemption) like with a promotional gift card. The general rules will thus be considered to determine the value on which the output tax should be levied. The general rule for a consideration received in exchange for goods or services is that the market value of the exchanged item will constitute the value of the supply for VAT purposes. Customer A applies gift card value, which was initially prepaid to Merchant A, in exchange for the goods or services from Merchant B. The gift card value constitutes a right to receive reimbursement of the actual monetary value from Merchant A, the original issuer of the gift card. The market value of the gift card for Merchant B is thus the value that is refundable by Merchant A. The output tax will thus be levied on the entire gift card value received in return for the goods or services issued by Merchant B, if the item purchased by Customer A is not exempt or zero rated. If the item is exempt from tax or zero rated, no output tax will be payable by Merchant B.

The gift card could also be redeemed from Merchant A, the original issuer, instead of a secondary merchant. The following is an illustration of this scenario.

**Stage 2(b) – Redeemed from initial issuing merchant**

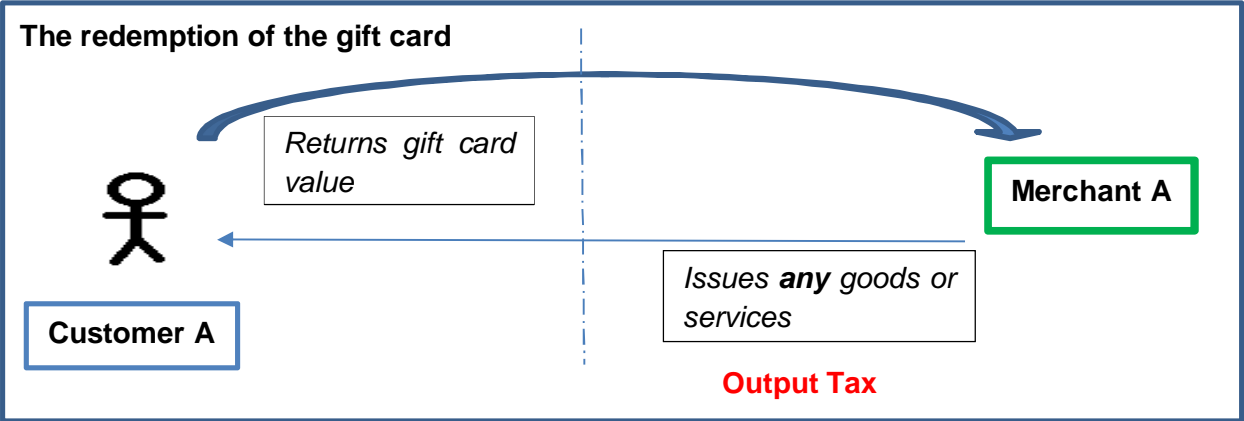


Figure 6.3 – Stage 2(b)

Source: Compiled by researcher from accumulated data

During stage 2(b) Customer A redeems the gift card value from the original issuer of the gift card, Merchant A. As customer A now applies the pre-paid value of the gift card to pay for the identified goods or services, it can be considered “consideration” – the ownership of the goods or services transferred to Customer A.

Merchant A already received the pre-paid value of the gift card during stage 1, however, the output tax will only be payable during stage 2 when the gift card is redeemed from Merchant A, enabling the identification of the goods or services receivable by Customer A. This will determine the nature of the items sold – whether a standard rate, zero rate or an exemption from VAT apply. Output tax will be levied accordingly on the total value of the gift card applied as “consideration”.

It should be noted that because the goods or services were redeemed from the original issuing merchant (Merchant A in this scenario), stage 3 will not follow stage 2(b). Stage 3 will, however, be applicable to stage 2(a). The figure relating to stage 3 will follow on the next page.

### Stage 3

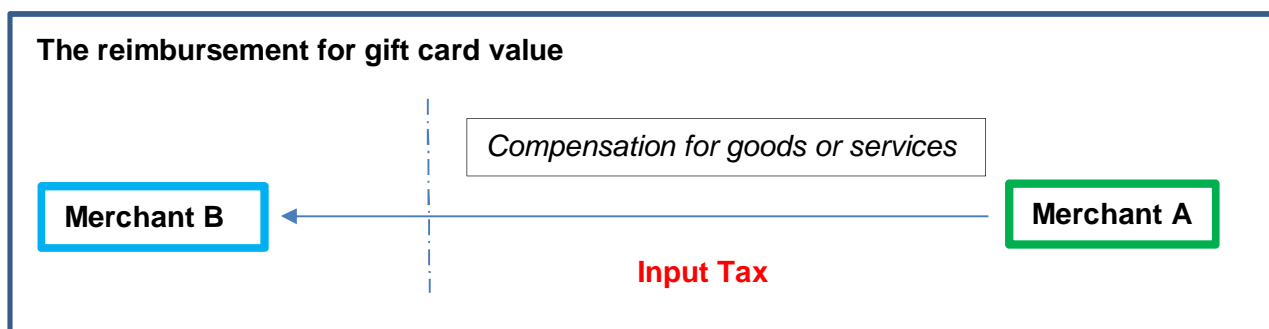


Figure 6.4 – Stage 3

Source: Compiled by researcher from accumulated data

In stage 3 Merchant A will reimburse Merchant B for the goods or services supplied to Customer A who redeemed the gift card value. Customer A pre-paid the value of the gift card to Merchant A, who never supplied the goods or services in return. Customer A redeemed the gift card value from Merchant B. It needs to be determined whether Merchant B “supplied” a “service” to Merchant A by supplying the goods or services to Customer A in Merchant A’s stead. Furthermore, if a taxable supply is made to Merchant A, any applicable input tax implications for Merchant A will need to be considered.

The core difference between the purchased gift card in this scenario and a promotional gift card transaction in the previous scenario lies in the fact that Customer A paid for the value of the purchased gift card where the promotional gift card was received without any additional cost to Customer A – Merchant A eventually carried the additional cost. This means in the current scenario Merchant A has no additional expense when reimbursing the value of the gift card that was redeemed at Merchant B. Customer A already “deposited” the value of the gift card at Merchant A for redemption in the future. In simple terms, the money “deposited” by Customer A at Merchant A is now transferred from Merchant A to Merchant B, because Merchant B, instead of Merchant A, provided Customer A with the goods or services.

The effect is that Merchant A received no additional advantage from Merchant B who sold the goods or services to Customer A. There was thus no “supply” of a “service” from Merchant B to Merchant A with regards to the repayment of the “deposit”. Merchant B is thus not liable for output tax – output tax was already paid on the entire value of the goods or services supplied to Customer A during stage 2.

As Merchant A did not receive a service in return from Merchant B when the transfer of the “deposit” was made as a reimbursement for the goods or services supplied to Customer A, no input tax credit will be claimable by Merchant A.

However, as Merchant B receives the advantage of more products being sold as a result of the redemption of the gift card issued by Merchant A, there may be a stipulation in the contract between Merchant A and B, enabling Merchant A to keep a percentage of the “deposit” paid for the gift card on issue when the goods or services are actually redeemed at Merchant B. This will constitute a “supply” of a “service” by Merchant A, who would be liable to pay output tax on the percentage of the value retained, to Merchant B, who would be able to claim input tax on the value that was retained by Merchant A.

#### **3.6.1.2.1 Breakage consequences**

Merchant A originally sold the retailer specific purchased gift card and would thus need to consider whether there are any VAT consequences with regards to possible non-redemption and eventual expiration of the gift card.

The problem with a retailer specific purchased gift card is that there is no levy of output tax when the gift card was issued by Merchant A to Customer A as explained in stage 1. This causes Merchant A to be in possession of the non-refundable consideration for the future purchases by Customer A, even though the consideration is considered not to be applied yet as the nature of the goods or services to be redeemed by Customer A remains unknown.

As discussed in chapter 2, the chances of a gift card being redeemed becomes slimmer as the time passes after original issue. However, the fact that a gift card value is long outstanding does not mean the customer who originally purchased the gift card value loses the right to redeem the value before the actual expiration date. The effect is that when a gift card is only long outstanding, there is not yet any transfer of value or right between the merchant and the customer to result in triggering a “supply” for output tax consequences. There is also no stipulation in terms of section 8 of the Value-added Tax Act that deems a “supply” to take place after it becomes improbable that the gift card value will be redeemed by the customer even though actual expiration did not yet take place.

There are thus currently no output tax consequences on long outstanding retailer specific purchased gift card values even though it could be argued that there should be output tax consequences when redemption by the consumer becomes improbable. As discussed in

chapter 2, the Consumer Protection Act stipulates that this period for redemption will not be less than three years. It can thus be argued that the probability of a gift card, with a redemption period longer than three years, being redeemed after the three-year period will be slim. It should thus be considered whether there can be assumed that after a three-year period without the redemption of the gift card, that the intention of the consumer is not to redeem the gift card in the future, causing the non-refundable value of the gift card to be transferred to the issuing merchant.

However, on the expiration of a retailer specific purchased gift card the consumer loses the right to the value of the gift card because the terms and conditions, stipulating that redemption should take place within a specified period, was not met. This means that 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.

When the gift card expires the original issuing merchant will retain the value of the gift card as consideration for granting the consumer the right to redeem any goods or services within the period stipulated in the terms and conditions, which already qualified as the “supply” of a “service” during stage 1 of the transactional flow. There should be considered whether this value of the gift card that was received in exchange for the right to receive any goods or services available at the participating merchants should now be subject to output tax.

The “deposit” made by Customer A in exchange for this right during stage 1 of the transactional flow can be considered applied on expiration because the “deposit” is non-refundable, and this right will no longer be exercised by the consumer. This “deposit” can now qualify as “consideration” for the right that was received by Customer A in stage 1 to redeem the gift card for any goods or services at a specified merchant or group of merchants, which means output tax should be levied.

Another problem that is created if output tax is levied on expiration, is the fact that the applicable VAT rate is not determined because the nature of the goods or services (standard rated, zero rated or exempt) that would have been redeemable was never identified. This is because the retailer specific purchased gift card would have been redeemable for any product available at the participating merchants specified in the terms and conditions. No value rule for this situation exists in section 10 of the Value-added Tax Act.

### **3.6.2 VAT consequences - Product specific gift cards**

Product specific gift cards can be only redeemed for goods or services that are specified on the gift card. This type of gift card can also be divided into the similar sub-categories as the retailer specific gift cards namely: Promotional and purchased gift cards.

#### **3.6.2.1 Product specific promotional gift card**

A product specific promotional gift card is very similar to a retail specific promotional gift card. The only difference is that the redemption of this gift card is limited to a specific item at the applicable retailer, making this type of gift card more restricted than a retailer specific promotional gift card. The product specific promotional gift card can also be received for free when a condition is met. This will also enable the receiving consumer to redeem the value as partial payment for a specific item, with the initial issuer carrying the cost.

The VAT treatment of this type of gift card will thus be the same as the VAT treatment for a retailer specific promotional gift card with section 10(20) and section 16(3) applicable. This is so, since a product specific promotional gift card is still issued for no consideration providing a “discount” to the holder on a purchase.

The breakage consequences of a product specific promotional gift card will also be similar to that of a retail specific promotional gift card, where there are no additional VAT consequences on expiration or on long outstanding gift cards.

#### **3.6.2.2 Product specific purchased gift card**

The Three-stage model is adapted in the below illustrations to apply to the transactional flow of purchased gift cards that is redeemable for specified goods or services. The consumer purchased this type of gift card for cash.

## Stage 1

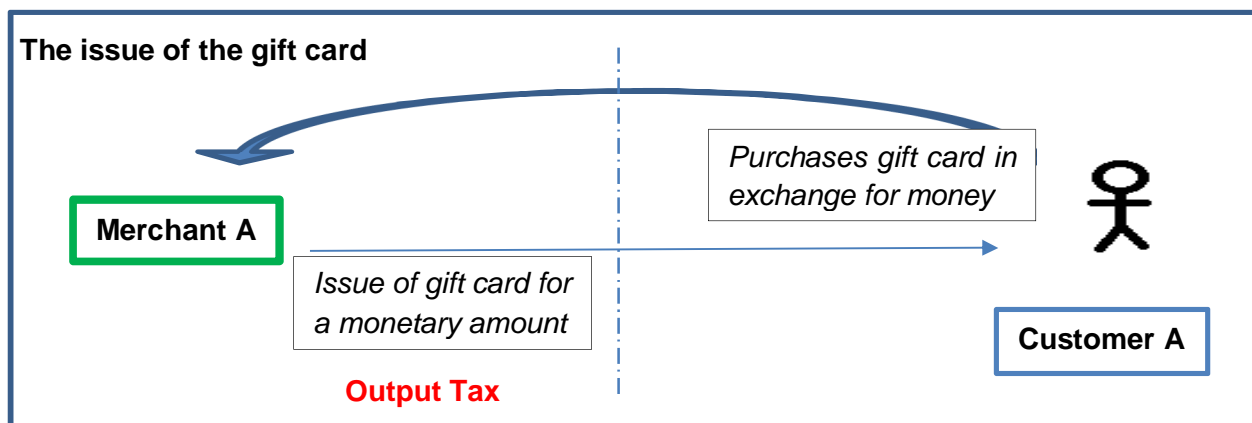


Figure 7.1 – Stage 1

Source: Compiled by researcher from accumulated data

During stage 1 of the gift card transaction, Customer A will purchase a gift card from Merchant A with a right to receive specified goods or services on redemption thereof. This right can be exercised by the holder of the gift card at any time during the period specified in the terms and conditions depending on the availability of the product or service. The VAT consequences need to be determined for Merchant A on the issue of the gift card. As Customer A is the end-consumer of the product, meaning the product will be applied for private use, no input tax is claimable by Customer A.

Merchant A will be liable for output tax when a “supply” of “goods” or “services” is made by a vendor in the course of an “enterprise”. Merchant A transferred the right to the ownership of specific goods (or services), as stipulated in the terms and conditions of the gift card, to Customer A when the gift card was purchased. This will thus qualify as a “supply” of “goods” because a “real right” in an identified “corporeal movable thing” was awarded to Customer A that will be “actually received” when the gift card is redeemed. The nature of the goods or services is thus already known on the date of sale of this type of gift card. This is the important difference between a purchased product specific and a purchased retailer specific gift card, where the goods or services redeemable still remain unknown at this stage of the transaction.

The right to these identified goods or services are received in return for an amount which was pre-paid by Customer A. As the goods or services that will be received on redemption of the gift card is predetermined, the pre-payment can be already be deemed “consideration” that was applied to purchase the goods or services specified in the gift card terms and conditions. The “supply” can thus be considered in the course of the “enterprise” of which the receipt of “consideration” for the supply is a requirement.

Furthermore, the general time of supply rules in the Value-added Tax Act, as stated in section 9, require output tax to be levied at the earlier of invoice date or payment date. An invoice will be made out on the date the actual goods are transferred to Customer A (stage 2). However, the payment for these goods are already received and applied on the date the gift card is received by Customer A as proof of the pre-payment. If it is possible to determine the VAT rate, output tax should thus be levied on the supply.

Unlike with a retailer specific purchased gift card, the goods or services that will be received on redemption of the purchased product specific gift card is already identified by Customer A in stage 1 of the transaction. It can thus be determined whether those goods or services required on future redemption will be standard rated, zero rated or exempt from VAT. This will enable the levying of output tax, as all the requirements of section 7(1)(a) are met. Merchant A will thus be liable to pay output VAT on the issue of the gift card value.

The redemption of the gift card from a merchant other than the original issuer will be considered in stage 2(a) and the redemption of the gift card from the original issuing merchant in stage 2(b).

**Stage 2(a) – Redemption from a different merchant than the issuer**

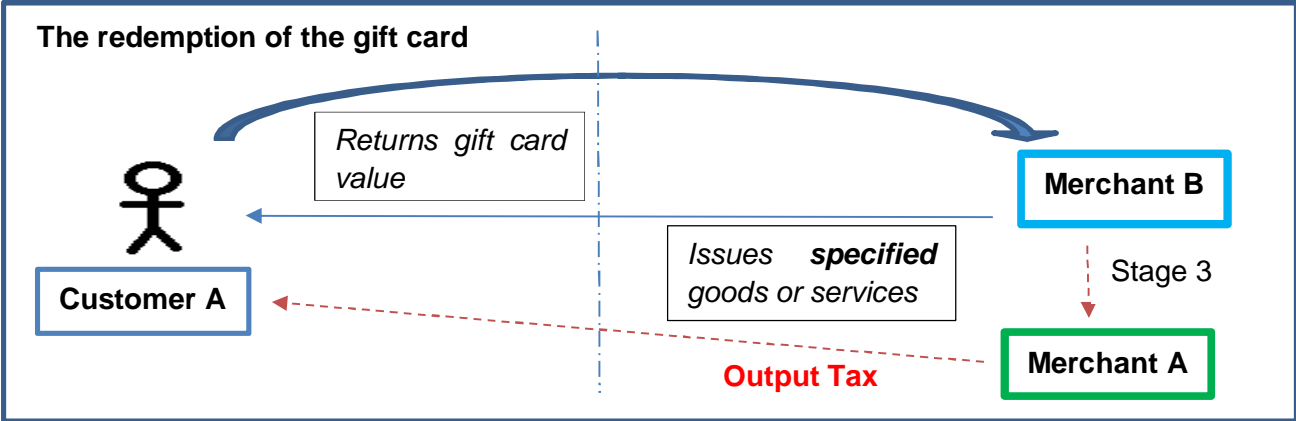


Figure 7.2 – Stage 2(a)  
 Source: Compiled by researcher from accumulated data

During stage 2(a) Customer A redeems the goods or services specified in the gift card terms and conditions from Merchant B, who is not the original issuer of the gift card. An agreement would exist between Merchant A and Merchant B stipulating that Merchant B will supply the goods or services that is redeemable by the consumers in exchange for the payment from Merchant A for these goods or services subsequent to the redemption of the gift card by

Customer A. It should be considered whether this issue of goods or services to Customer A constitutes a “supply” of “goods” or “services” in the course of an “enterprise” which will trigger the levy of output tax.

Merchant B physically transfers the actual goods to Customer A in exchange for the gift card. There is thus a “supply” of “goods” or “services” as the goods changed hands from Merchant B to Customer A. Yet, it should be questioned whether the supply of the goods or services by Merchant B was not in essence made to Merchant A rather than to Customer A. Merchant A has the liability to provide the specified goods or services because the consideration received from Customer A was already applied by Customer A to receive the right to these specified goods or services. It seems that Merchant B only delivers the pre-specified goods or services to Customer A while the liability to provide these goods or services still lies with Merchant A. Merchant A then pays Merchant B for the goods or services supplied to Customer A as per agreement. It is thus concluded that the “supply” of the goods or services by Merchant B is actually indirectly made to Merchant A and not to Customer A. The effect of this indirect “supply” between Merchant A and Merchant B will be discussed during stage 3 of the gift card transactional flow.

Merchant A fulfilled its obligation to deliver these specified goods or services to Customer A via the delivery by Merchant B. Merchant A already paid output tax on the supply of the real right to the goods or services to Customer A during stage 1. Since Merchant A now simply fulfils its obligation to Customer A to provide the specified goods or services, there is no new supply made to Customer A.

Section 10(19) of the Value-added Tax Act provides the value rule for the supply to Customer A when the promise to receive the actual goods are fulfilled by Merchant A (via Merchant B), stating that on the surrender of the product specific purchased gift card, the value of the supply of goods or services are deemed to be nil. There is thus no new liability for any output tax on the supply of goods or services to Customer A. This prevents the levying of output tax on the same value twice.

The effect of the reimbursement of the cost of the goods or services issued to Customer A will be considered in stage 3 of the transactional flow.

**Stage 2(b) – Redeemed from initial issuing merchant**

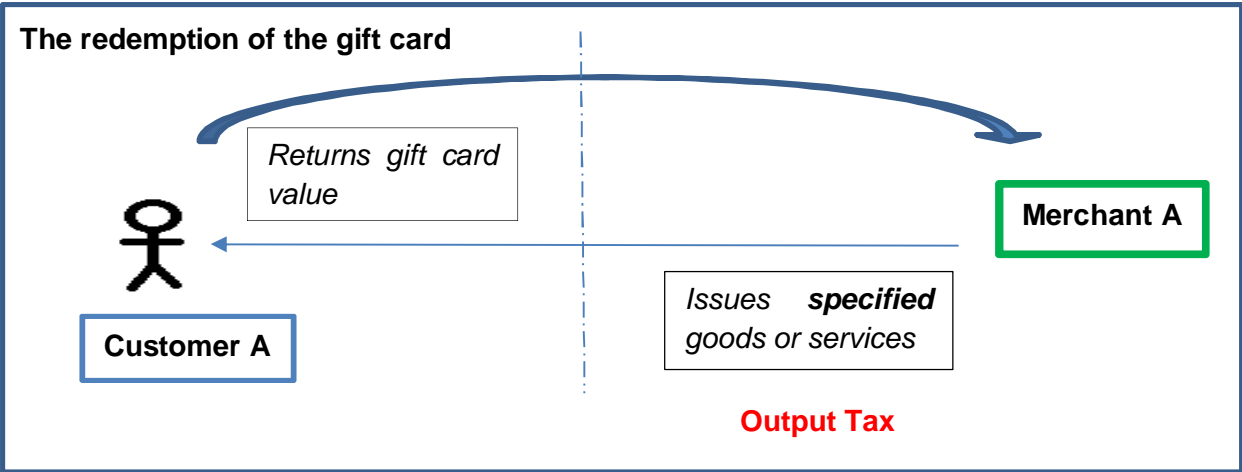


Figure 7.3 – Stage 2(b)

Source: Compiled by researcher from accumulated data

Stage 2(b) is a more simplified version of stage 2(a). Instead of the gift card being redeemed at another merchant, during stage 2(b) the gift card is redeemed from the original issuing merchant (Merchant A). It should be considered whether output tax is payable by Merchant A on the issue of the goods or services.

Output tax should be levied when there is a “supply” of “goods” or “services”. Like in stage 2(a), there seems to be a transfer of the actual goods or services required by the gift card to Customer A. There is thus a supply of the specified goods or services by Merchant A. However, the output tax has already been levied when the gift card was issued. To prevent output tax from being levied twice on the same value, section 10(19) determines that the value of the supply of purchased product specific gift cards on redemption by the holder equal is to nil. The effect is that no additional output tax will be levied.

As there are no other merchant that requires reimbursement from the issuing merchant (Merchant A), stage 3 of the transactional flow is not applicable to stage 2(b).

### Stage 3

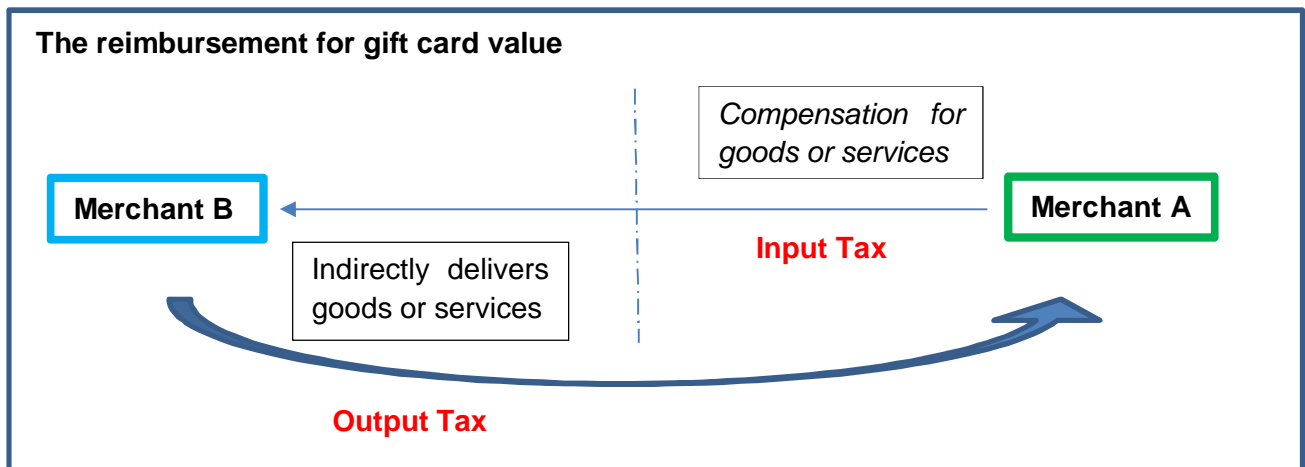


Figure 7.4 – Stage 3

Source: Compiled by researcher from accumulated data

During stage 3 of the transaction, the gift card issuing merchant (Merchant A) reimburses the merchant from who the gift card was redeemed (Merchant B). There needs to be determined whether Merchant B made a “supply” to Merchant A with “goods” or “services” as part of the “enterprise” when the actual goods or services was delivered to Customer A.

Like with a retailer specific purchased gift card, that was redeemed at a merchant other than the gift card issuing merchant, the goods or services were received by Customer A from Merchant B to fulfil Merchant A’s obligation to provide the goods or services promised. The goods or services were thus supplied by Merchant B to the consumer on request of Merchant A, who will then in turn reimburse Merchant B for the value of the gift card that was redeemed.

The difference between this scenario’s stage 3 and stage 3 of a retail specific purchased gift card lies in the fact that the amount received by Merchant A during stage 1 of the product specific gift card transactional flow was already applied as “consideration” causing output tax to already be levied by Merchant A on the issue of the gift card in stage 1. This ensures that Merchant A must deliver the specified goods or services promised. Yet, Merchant B fulfilled this promise by delivering the goods or services to Customer A and thus indirectly supplied the goods or services to Merchant A who will pay the full consideration in return.

The problem is that because it was Merchant B that actually transferred the goods or services to Customer A and then reclaimed the consideration in money from Merchant A for the supply, the final output tax liability should be with Merchant B and not with Merchant A – Merchant B

received the advantage of selling more products as a result of the issue of the gift card while Merchant A is in the same position as prior to the gift card issue in stage 1.

Merchant B will issue an invoice to Merchant A reclaiming the value of the goods or services delivered to Customer A. The effect is that Merchant A needs to pay Merchant B for the entire gift card value redeemed by Customer A which includes the value of the output tax that was also already paid by Merchant A on the entire value of the gift card during stage 1. As Merchant B will be liable for output tax in terms of section 7(1)(a) of the Value-added Tax Act – the “supply” of the specified “goods” or “services” delivered to Customer A was indirectly made to Merchant A, because the delivery extinguished Merchant A’s liability to provide the specified goods or services to Customer A and was then paid by Merchant A as per the agreement – Merchant A will be able to claim the input tax on the supply when the specified goods or services is paid for (or invoiced by Merchant B – whichever is earlier).

In some instances, Merchant A will charge Merchant B a fee for the fact that Merchant B received the advantage of selling the goods or services by way of the gift card issued by Merchant A for which full repayment is received. This will qualify as the “supply” of a “service” by Merchant A to Merchant B in the course of the “enterprise” meaning there will be VAT consequences. This fee will be deducted by Merchant B from the invoice amount paid by Merchant A for the specified goods or services delivered to Customer A. Merchant B will thus only pay output tax on the value of the goods or services delivered on behalf of Merchant A after deducting the fee payable for the advantage. Merchant A will thus only be able to claim input tax on the amount as per invoice received from Merchant B where the fee was already deducted.

#### **3.6.2.2.1 Breakage consequences**

Merchant A was the original issuer, who received the consideration from Customer A for the right to the specified goods or services as per the terms and conditions of the gift card. It is thus Merchant A that would need to consider the VAT consequences of long outstanding and expired gift cards.

The consideration received by Merchant A for the purchase of specific goods or services were already subject to output tax during stage 1 of the gift card transaction. This will influence the argument about whether output tax should be levied when breakage occurs. The consideration paid by Customer A to acquire the gift card was thus already deemed to be applied as payment for the specific goods or services during stage 1 of the transaction. If this gift card thus remains

long outstanding, with the probability of redemption low, or expires, no value is transferred to Merchant A as consideration for the right to specific goods or services, because this was already done on the original issue of the gift card during stage 1. The total output tax was thus already paid to the SARS irrespective of whether the gift card is redeemed or not. Non-redemption of long outstanding product specific purchased gift cards or expired product specific purchased gift cards will thus have no additional output tax consequences.

### **3.7 Summary**

In this chapter the South African VAT legislation was analysed to determine how it applies to voucher related transactions and whether it is clear and comprehensive. The Cambridge Dictionary (2019b) defines “comprehensive” as “including everything that is necessary; complete”. The Cambridge Dictionary (2019c) defines “clear” as “easy to understand”. These definitions imply that to meet the objective of the study, it needs to be established whether the legislation is complete and clearly addresses the different stages of voucher/gift card related transactions. This was done by identifying and explaining the general VAT principles applicable to voucher related transactions. The VAT legislation specifically relating to vouchers was also identified and clarified.

The different types of vouchers (gift cards) that were identified in chapter 2 were analysed individually and measured against the general VAT legislation to determine the workings thereof. It was identified where the special voucher related VAT legislation fit and to which types of vouchers these sections could apply. The different voucher types were analysed through applying a Three-stage model, that was identified to be applicable to the voucher related transactional flow. This model was adapted for each different type of voucher. There after the application of the Value-added Tax Act was considered. It was noted that there are many different types of voucher related transactions with differing VAT consequences. The different stages of a voucher related transaction seem to be addressed in the Value-added Tax Act – mainly with general principles. There are, however, three sections in the Value-added Tax Act that specifically address the value rules with regards to certain stages of different types of voucher related transactions.

Overall, the Value-added Tax Act seems to be clear and comprehensive on the treatment of voucher related transactions during the different stages of a voucher related transaction. However, a shortfall was noted when a retailer specific purchased gift card is subject to breakage. The nature of the transaction was deemed to be similar to that of a non-refundable deposit on issue of the gift card. When this gift card expires or remains long-outstanding with

the possibility of redemption becoming remote there seems to be uncertainty with regards to the VAT treatment. There seems to be no guidance on when output tax should be levied by the issuing merchant or at what rate – refer to chapter 4 for a more detailed discussion. Further study on this shortfall is advised.

## **Chapter 4**

### **4 Summary and conclusion**

In this chapter, the study will be summarised and it will be concluded whether the objectives were reached. The outcomes of the objectives set in chapter 1 will be discussed and key findings will be highlighted. It will then be concluded whether the main question of the study was answered.

#### **4.1 General background**

In chapter 1 it was highlighted that VAT is a consumption-based taxation that is levied on the value added in each stage of the production and distribution process. It was also established that the final consumer carries the burden of the VAT. It had to be established whether the issue and redemption of voucher/gift card transactions qualify as consumption by a customer which would have possible VAT consequences.

In the general overview of vouchers discussed in Chapter 1, it was noted that vouchers come in many different forms and are classifiable into multiple categories. It was also noted that the gift card market has shown significant growth from previous years, which could partially be due to technological developments in the field. The increase in the gift card sales could also result in an increased non-redemption or “breakage” rate which means lost consumer value. It is thus necessary to consider the VAT consequences of voucher/gift card related transactions to determine whether the current VAT legislation is sufficient to address these changes.

The question that was answered during the course of the study is as follows: Is the current South African VAT legislation regarding vouchers clear and comprehensive on the treatment of the different voucher related transactions, and if not, what are the shortfalls?

To answer the overall question, one main objective was formulated from the research question with two supporting secondary objectives. The main objective was to analyse the South African VAT legislation to determine whether the VAT treatment of vouchers is clearly and comprehensively addressed, and if not, how these shortfalls might impact the application of the VAT legislation to voucher related transactions. The study planned to reach the by formulating two secondary objectives that was set and answered in two separate chapters.

The legal doctrinal research used in this study was mainly utilised in the form of a critical analysis of the voucher-related VAT legislation. The letter of the applicable VAT legislation was

applied to the context and scenarios identified during the literature review to identify the characteristics and categories of the different types of vouchers. The study relied on theoretical sources of information.

#### **4.2 First secondary objective**

The first secondary objective (addressed in chapter 2) described the commercial nature and functioning of the different types of vouchers, the classification thereof, the possible permutations of voucher transactions, and any related non-redemption in the retail sector. This objective was set because the understanding of the commercial nature and functioning of voucher/gift card transactions in the retail sector are paramount in determining any possible VAT related consequences when an analysis of legislation is done.

It was identified in chapter 2 that voucher/gift card transactions can be divided into two main categories namely open-loop or closed-loop gift cards. It was concluded that the main difference between the two categories lies in the fact that open-loop gift cards are a more liquid type of gift card (very similar to currency) than closed-loop gift cards. Open loop-gift cards can be redeemed from any merchant with the facilities to accept the card, where redemption of closed-loop gift cards is limited to the specific retailers listed in the terms and conditions.

The category “closed-loop gift cards” can further be subdivided into the two categories, retailer specific and product specific gift cards. It was noted that retailer specific gift cards can be redeemed in the form of any goods or service available at the participating merchants listed in the terms and conditions of the gift card, while product specific gift cards can only be redeemed for a specific good or service listed in the terms and conditions. These two sub-categories of closed-loop gift cards can either be issued by a merchant for free as a promotional tool, which have numerous different forms, or purchased from the merchant by a customer.

It was also established that within all the different gift card related transactions the core of the transactional flow stays the same and can be divided into three stages – the issue of a gift card by a specific merchant, the redemption of the gift card by the customer and the reimbursement of the gift card value from the gift card issuing merchant to the merchant from whom actual redemption takes place. These stages can be adapted to be applicable to the purchased gift card and the different variations of promotional gift cards. However, it was established that these stages might vary depending on the terms and conditions of the transaction, the intention of the issuer and the preference of the recipient.

Chapter 2 also described the circumstances of expiration or non-redemption of gift cards. This is known in the industry as breakage. When a purchased gift card remains unredeemed or expires (which is not allowed before a period of at least 3 years) the value is retained by the original issuing merchant. This means that the consumer loses value. The value is lost because the holder of the gift card forfeited this value voluntarily. This ensures that the original issuing merchant is entitled to the proceeds without fulfilling any obligation attached to the gift card. There is no specific required period that must pass according to the Consumer Protection Act 68 of 2008 before a promotional gift card can expire. Additionally, it was noted that when a gift card remains long outstanding that in some instances the issuing merchant starts to charge dormancy fees – open-loop gift cards are most vulnerable to this type of fees. To avoid gift card breakage, consumers use secondary markets to sell unwanted gift cards at a price less than face value.

The accounting treatment of the different types of gifts cards/vouchers was also discussed in chapter 2 to provide an overview of the commercial substance of voucher related transactions. When a customer prepays for a gift card, a performance obligation is created for the merchant that needs to be satisfied before revenue can be recognized. It was noted that it should be considered whether the issue of a promotional gift card creates a binding contract with a customer or whether a material right is given to the customer that causes a performance obligation for the merchant before recognition. The estimated breakage was recognized in the accounting records as revenue in the same pattern as the actual gift card value that was redeemed.

From the above, it is clear that the objective of chapter 2, to describe the commercial nature of voucher/gift card transactions, was met. The gift cards were classified according to the main characteristics - which give rise to different transactional permutations, the commercial nature of each type was described, and core stages of a voucher/gift card transaction was identified to apply to the different permutations of the gift card transaction. The related non-redemption of vouchers/gift cards was also investigated to determine the circumstances related thereto. These observations in chapter 2 were used as context and basis for the critical analysis of the VAT legislation that was done in chapter 3 to achieve the second secondary objective.

#### **4.3 Second secondary objective**

The second secondary objective was to analyse the current South African VAT legislation to determine how and why the different types of vouchers are taxed in certain ways and whether the application regarding the voucher VAT legislation is clear and comprehensive.

In chapter 3 the general VAT legislation that is applicable to voucher/gift card related transactions were identified and briefly discussed. This general legislation includes the basic principles of when and on which items VAT is levied. Furthermore, the voucher specific VAT legislation was also identified and explained in order to enable the application to the context of the voucher/gift card related transactions identified in chapter 2.

The Three-stage model, representing the transactional flow of a gift card transaction (identified in chapter 2), was adjusted for each of the main voucher/gift card categories and sub-categories to fit the characteristics and nature of the different permutations of the voucher/gift card transactions. The VAT consequences for each of these categories of voucher/gift card transactions were analysed separately per stage. This included the VAT consequences of breakage.

The issue of open-loop gift cards seems to have no VAT consequences, as it could be argued that an “exchange of currency” occurred when the financial institution credited the gift card with the specific value that was received in money from the customer. Since this transaction qualifies as a financial service there will be no VAT consequences because the transaction is exempt. When the open-loop gift card is redeemed the transaction will function similar to a debit or credit card transaction, where the funds are transferred to the seller merchant at point of sale. The merchant who actually transfers the goods to the customer will thus pay output tax on the supply of goods or services and not the financial institution who issued the gift card.

When a voucher/gift card remains long outstanding, dormancy fees will be charged on the value of the gift card, which will be subject to output tax. This was conclusion was reached since dormancy fees have a similar nature to bank charges, which is a fee charged, and explicitly excluded from the definition of a financial service. When the gift card expires, it was concluded that output tax should also be levied, because the financial institution becomes entitled to the gift card value after the redemption period terms of the arrangement was not adhered to by the customer. This transfer of value can be regarded as consideration received by the financial institution for the right that was initially granted to the gift card holder to redeem the value of the gift card in the period specified in the terms and conditions. It was established that this transfer of value could be considered fee based, similar to bank charges, which is not a financial service and not exempt from VAT – output tax should thus be levied.

The VAT consequences on the issue of closed-loop gift cards depend on whether the voucher/gift card is retailer specific or product specific, and whether the gift card/voucher is purchased or promotional in nature. Product specific and retailer specific promotional gift cards

work very similarly. The only difference is that a product specific promotional gift card has stricter conditions for redemption – limiting the redeemer to specific goods or services. It was established that a promotional gift card had no VAT consequences on date of issue as there was no consideration received by the issuing merchant for the issue of the voucher/gift card. It was thus concluded that the issuing merchant is not be liable to pay any output tax on the issue of a promotional gift card.

On redemption of a promotional gift card, it should be considered whether the gift card is redeemed from the same issuing merchant or from another selling merchant. If it is redeemed from another selling merchant, that selling merchant will pay output tax on the entire value of the goods or services redeemed by the customer. The selling merchant will then be reimbursed by the gift card issuing merchant for the value of the gift card that was redeemed. It was established that the gift card issuing merchant will then be able to claim input tax on this value reimbursed to the selling merchant. If the gift card is redeemed from the same issuing merchant, it was concluded that the value of the goods redeemed will be reduced with the value of the gift card, similar to a discount, with output tax payable on the difference. It was also established in chapter 3 that there will be no VAT consequences with regards to breakage of a promotional gift card, because the gift card was originally issued for no consideration.

When a gift card is retailer specific and purchased it is fair to conclude that there will be no output tax consequences on the issue thereof, because it can be argued that the “deposit” is not yet applied as consideration for a specific item – it is unknown whether the goods that will be redeemed in the future will be taxable or not. When the gift card is redeemed by the customer from the same issuing merchant, it was noted that there will be output tax leviable on the entire value of the goods or services redeemed. If the goods or services are redeemed from another seller merchant, it was shown that output tax will still be payable on the entire value of the goods or services, which include the partial payment with the gift card. When the original issuing merchant reimburses the selling merchant for the gift card value, it is concluded that no input tax will be claimable on the reimbursement.

Breakage, the non-redemption or expiration, of retailer specific purchased gift cards seems to create problems with regards to the application of the VAT legislation. It was established that the longer the gift card remains outstanding, the slimmer the chances of redemption becomes. There is no special deemed time of supply rule in the Value-added Tax Act that addresses this problem. The general rules also seem unable to address this problem as there is no actual supply being made – the intention of the gift card holder is the only indicator that value is

transferred to the initial issuer. When actual expiration takes place output tax should be levied on the gift card value transferred to the gift card issuing merchant. However, according to the analysis performed, a problem with regards to the value of the supply is created, as the nature of the supply (taxable or non-taxable) still remains unknown. Further study is proposed on the above problems that were identified.

When a gift card is product specific and purchased, output tax will be levied on the issue of the gift card because the amount in consideration received is already applied to a specified good or service of which the taxable nature is known. On redemption of the gift card by the customer it was established that there will be no additional output tax levied on the supply of goods or services to the customer. However, if another selling merchant supplied the pre-specified goods or services on behalf, and on request of the gift card issuing merchant, it is concluded that a supply was indirectly made by the selling merchant to the gift card issuing merchant. This causes the supply made by the selling merchant to be subject to output tax, while the issuing merchant will be able to claim input tax on the repayment of the goods or services that was delivered by the seller merchant to the customer. This argument allows to put both merchants in the correct VAT position, where the selling merchant eventually pays the final output tax to the SARS. It was further established that there will be no additional VAT consequences for non-redemption or expiration of product specific purchased vouchers/gift cards as the output tax was already levied on original issue.

The objective of chapter 3, which was to analyse the VAT legislation with regards to the identified voucher/gift card related transactions, was met when the VAT consequences of each voucher/gift card category was separately analysed and discussed according to the three stages present in voucher related transactions. The problems with the application of the VAT legislation were identified. It includes the lack of clarity with regards to a time of supply rule addressing non-redemption of a retailer specific purchased gift card. There is no actual “supply” triggered even though the intention of the user indicates a transfer of value. Another issue is the value of the supply when non-redemption or expiration of a retailer specific purchased gift card occurs – the nature of the goods or services redeemable remains unknown, it is thus impossible to determine whether output tax should be charged at standard rate, zero rate or if the supply is exempt.

When the applicable VAT legislation (that was identified in chapter 3) was applied by doing a critical analysis thereof, in the context of the commercial substance of the voucher/gift card related transactions (identified in chapter 2), the results contributed to forming the overall

conclusion and answered the research question. This will be addressed in the following section.

#### **4.4 Conclusion on main objective and the answer to the research question**

The research question, “Is the current South African VAT legislation regarding vouchers clear and comprehensive on the treatment of the different voucher related transactions, and if not, what are the shortfalls?”, was answered by concluding on the primary objective of the study. The main objective was to analyse the South African VAT legislation to determine whether the VAT treatment of vouchers are clearly and comprehensively addressed, and if not, how these shortfalls might impact the application of the VAT legislation on voucher related transactions.

The primary objective was met after addressing the first and second secondary objectives. It became clear that because the commercial circumstances for each voucher/gift card category differ, the application of the VAT legislation is more complicated. After the critical analysis of the VAT legislation was done in chapter 3, it was identified that the issue and redemption of the vouchers/gift cards generally do not create a problem for the application of the VAT legislation. This is because the general VAT rules, together with the voucher specific legislation, are clear and comprehensive enough to address these stages of voucher/gift card related transactions.

However, when non-redemption or expiration of retailer specific purchased gift cards occur, the VAT legislation might not be clear and comprehensive enough. The nature of the transaction was deemed to be similar to that of a non-refundable deposit on issue of the gift card. When this gift card expires or remains long-outstanding with the possibility of redemption becoming remote there seems to be uncertainty with regards to the VAT treatment. There seems to be a need for a time of supply rule with regards to long outstanding retailer specific purchased gift cards because, in substance, the possibility of redemption of the deposited value is remote. There is also need of a value of supply rule that addresses the amount regarded as a standard rated supply as opposed to the exempted or zero-rated part – the goods or services were not identified in the terms and conditions of the voucher/gift card, it remains unknown which part of the supply is taxable or not taxable. This conclusion reached the primary objective.

When the primary objective was reached, the research question was also satisfied. In conclusion, to answer the research question: Is the current South African VAT legislation regarding vouchers clear and comprehensive on the treatment of the different voucher related

transactions, and if not, what are the shortfalls? It was established that the current South African VAT legislation regarding vouchers are clear and comprehensive on the treatment of the different voucher related transactions, with the exception of non-redemption and expiration of retailer specific purchased gift cards.

#### **4.5 Recommendation for future research**

It is recommended that in the future, research should be performed on how to address the shortfalls identified in this study – time and value of supply in case of non-redemption and value of supply in the case of actual expiration of retailer specific purchased gift cards. The issue of gift cards became a very popular sales boosting tool used by merchants in the current years (as evident from the discussion in chapter 1). The effect is that even though revenue is increased, non-redemption or expiration of gift cards is also higher. If no solution is found for the time and value of supply when non-redemption or expiration occur for retailer specific purchased gift cards that was issued by a merchant, it could mean that the SARS is losing part of the revenue that is due.

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