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State & Local Tax Advisory ■

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Sales Tax Complexities of Customer Loyalty Programs

These days almost every business has some type of loyalty or reward program. At the heart of these programs, a business is trying to reward or incentivize its customers for certain consumer behavior. Not surprisingly, the structure of these programs varies considerably, as does the sales tax treatment that may apply in the states in which the rewards are offered and redeemed. We addressed this issue in a recent article published in the *Journal of Taxation*. Specifically, we discussed the question of whether the value of the reward is considered part of the "sales price" such that it would be subject to the tax when the rewards are exchanged for free or discounted tangible personal property or taxable services.

Minnesota Department of Revenue Addresses Rewards Programs

In June 2015, Minnesota, a state that was discussed in our article, issued Sales Tax Fact Sheet 167, "Coupons, Discounts, Rewards, Rebates, and Other Forms of Payment." The fact sheet explains the sales taxation of eight different types of payments—coupons, discounts, rewards, rebates, trade-ins, gift cards and certificates, scrip and barter. The fact sheet provides a level of clarification around loyalty programs that was previously lacking.

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

While the clarity is helpful to those businesses providing rewards to Minnesota customers, the fact sheet also explains that if a taxable reward is bundled with a nontaxable reward, the entire reward is taxable unless the seller can provide documentation showing otherwise. This could be challenging for businesses that redeem rewards that as a matter of business practice are commingled and cannot be separated in a manner acceptable to the Department of Revenue.

Michigan Case Addresses Rewards Programs

On September 15, 2015, the Michigan Court of Appeals held in *Schoeneckers, Inc. v. Department of Treasury*, No. 321033 (Mich. Ct. App. Sept. 15, 2015) (unpublished), that the administrator of an employee rewards program is liable for sales tax on the retail value of the products it provides to its clients' employees when they redeem award points for merchandise.

The taxpayer in *Schoeneckers* administered rewards programs for employers. The taxpayer billed its clients based on the number of reward points issued to the clients' employees. The employees would then use the reward points to acquire merchandise from the taxpayer. The taxpayer purchased the merchandise free of tax, issuing a resale certificate. When the taxpayer distributed merchandise to the employees, the taxpayer remitted use tax based on the price it paid for the merchandise. However, the Michigan Department of Treasury argued that the correct measure of the tax was not the taxpayer's cost, but rather the value of the rewards points that the employees gave in exchange for the merchandise—i.e., the gross proceeds received from the taxpayer's clients for the points, which consisted of a payment for the items that could be redeemed and a fee for the administration of the program.

The sales taxation of the transaction was viewed within the context of the "incidental to service" test. Thus, the dispute in *Schoeneckers* boiled down to whether the rewards program in question constituted one transaction or two. Under *Catalina Marketing Sales v. Department of Treasury*, 678 N.W.2d 619 (Mich. 2004), providing tangible personal property "incidental to service" is not considered a retail sale. The taxpayer in *Schoeneckers* argued that its reward program, viewed as a whole, was a service provided to its employer-clients, and the merchandise dispensed to the customers was incidental to that service. Accordingly, it owed only use tax on the cost for removing the merchandise from its inventory.

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

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