

VAT DUTIES & INDIRECT TAX LAW

WHO SUPPLIES WHAT IN A LOYALTY REWARD SCHEME

CASES C-53/09 AND 55/09 HMRC v LOYALTY MANAGEMENT UK LTD AND BAXI GROUP LTD

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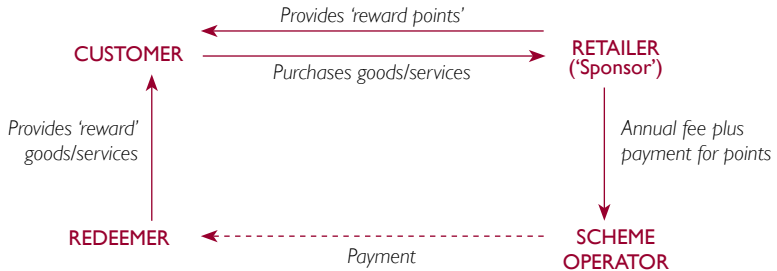
A loyalty reward scheme is an increasingly common marketing device used by retailers to encourage their customers to continue to use them for their purchases. The retailer gives the customer a card, and when the customer makes purchases from that retailer they receive a certain number of 'reward points' in proportion to the amount they have spent. When the customer has accumulated sufficient points, these can be exchanged for 'reward' goods or services.

Underlying a fairly simple marketing concept is a structure of interlinked transactions the VAT treatment of which has caused considerable confusion and difference of opinion. In its judgment in Cases C-53/09 and 55/09 HMRC v Loyalty Management UK Ltd and Baxi Group Ltd (judgment of 7 October 2010) the Court of Justice of the European Union ('CJEU') has clarified that payments which are made to the company which supplies the reward goods/services are third party consideration for the company supplying those rewards to customers.

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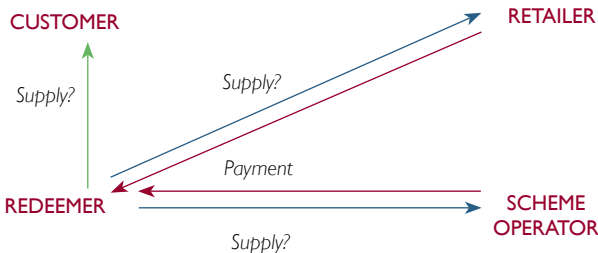
The basic structure of a loyalty reward scheme is as follows:



ISSUES IN THE CASE

The CJEU considered two joined cases, both on references for a preliminary ruling by the House of Lords. *Loyalty Management UK Ltd* ('LMUK') concerned the 'Nectar Card' scheme, and *Baxi Group Ltd* ('Baxi') concerned a scheme operated by a manufacturer of boilers who offered rewards to installers. The schemes were slightly different in structure: in *LMUK* the structure included a Scheme Operator, LMUK, and various Redeemers. In *Baxi* one company, called '@1', acted as both the Scheme Operator and as the Redeemer who offered reward goods/services to customers.

Both cases concerned the question of what the payments made to the Redeemer are consideration for. In particular, whether the payments are consideration for services supplied by the Redeemer to the person making the payment, or consideration for the reward goods/services supplied by the Redeemer to the Customer:



In both cases, the person making the payment to the Redeemer (the Scheme Operator in *LMUK* and the Retailer in *Baxi*) sought to deduct input VAT on the payments, on the basis that the payments were made as consideration for the services supplied to it.

HMRC contended that neither should be permitted to deduct input VAT, as the payments to the Redeemers were in fact consideration provided by a third party (the person making the payment) for goods/services supplied by the Redeemer to the Customers.

THE CJEU'S ANALYSIS

The CJEU accepted HMRC's analysis of the transactions at issue, and held that the payments made to Redeemers are third party consideration for the supplies made by Redeemers to Customers.

(1) The Redeemers supply goods/services to Customers

The CJEU held that although reward schemes are intended to encourage Customers to make their future purchases from the same Retailer who gave them the reward points, the economic reality of the situation is that it is the Redeemer who supplies the Customers with their rewards. That supply of rewards by the Redeemer to the Customers is a 'supply of goods' for the purposes of Article 5(1) Sixth Directive, or a 'supply of services' for the purposes of Article 6(1).

(2) The supply by the Redeemers is a separate transaction from the sale of goods/services by the Retailer

The CJEU held that there are in fact two separate transactions which take place in the operation of the scheme (paragraph 55); the transaction between the Customer and the Retailer is separate from the transaction between the Customer and the Redeemer:

The Court noted that when the Customer purchases their goods/services from the Retailer, they pay the same price irrespective of whether they get reward points or not – for example, a person who shops in Sainsburys will pay the same price for their groceries even if they do not have a Nectar Card and receive reward points for their purchase.

Following the decision in *Case C-48/97 Kuwait Petroleum* [1999] ECR I-2323, at [31], the sale of the goods/services to Customers is therefore a separate transaction from the supply of loyalty rewards in exchange for reward points.

Although not explicit in the judgment, the implication of this part of the analysis must be that one cannot treat the Customer as having provided consideration for the reward goods/

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service. When he pays his purchase price to the Retailer, that payment is consideration for the goods/services he has purchased, and no part of that is consideration for the reward points – and ultimately the reward goods/services - he receives.

(3) The payments to the Redeemers are consideration for the Redeemers' supplies to Customers

Applying the test laid down in Case 102/86 *Apple and Pear Development Council* [1988] ECR I 443, the CJEU accepted that the transactions between the Redeemers and the Customers were carried out for consideration, that consideration being the payments made to Redeemers by the third party Scheme Operator / Retailer:

In *LMUK* the structure of the scheme was such that Redeemers only received payment from LMUK where they made supplies of loyalty rewards to Customers. Redeemers would supply their goods/services to the Customers, and then issue an invoice to LMUK. The amount invoiced to LMUK would be based on a fixed amount for each point redeemed for the goods/services. As such, there was a 'direct link' between the Redeemers' supplies to customers, and the payments by the Scheme Operator to the Redeemers (paragraph 57).

In *Baxi* the CJEU went on to consider whether the payments to the Redeemer could be split into different elements. The payment structure in *Baxi* was such that the Redeemer received the retail price for the reward goods/service, rather than a payment linked to the number of points surrendered by the Customer. As it purchased the reward goods at a wholesale price, the payment made to thus included a margin of profit. Baxi had argued that the payments it makes to @I correspond to advertising services, and HMRC had accepted that deductions could be made on the basis of those parts of the payments which represented a profit margin for @I.

The CJEU agreed that Baxi's payments could be divided into two elements. It held that the payment of the wholesale purchase price at which @I had acquired the reward goods is consideration for the reward goods/services supplied by @I to the Customers. There is a 'direct link' between the supply made and the payment received. The payment of an additional profit margin, however, was held to be consideration for the advertising services supplied to the Retailer, Baxi. As such, Baxi could deduct input VAT paid on this part of the transaction (paragraph 63).

The CJEU noted that LMUK had not argued that its payments to the Redeemers could be split in the same way as in *Baxi*, but that it would be a matter for the Supreme Court to determine whether it could be (paragraph 64).

CONCLUSIONS

In practical terms, the ruling may well mean that operators of these schemes elect to adjust their payment structures in future, so that a larger proportion of the payments they make to Redeemers are fixed amounts for services such as advertising and administration, and the proportion which is paid for the reward goods is smaller.

In legal terms it raises the larger question of whether (and if so to what extent) the House of Lords' judgment in *CEC v Redrow Group plc* [1999] STC at 161 requires to be revisited. In particular, their Lordships' conclusion that one must consider the transaction from the perspective of the taxpayer, since "*Questions such as who benefits from the service or who is the consumer of it are not helpful*" (per Lord Hope at 166), and ask "*did he obtain anything—anything at all—used or to be used for the purposes of his business in return for that payment?*" (per Lord Millet, at 171), appears open to doubt. Though that judgment had concluded that the benefit obtained by the taxpayer "*may equally well consist of the right to have goods delivered or services rendered to a third party. The grant of such a right is itself a supply of services.*" (per Lord Millet at 171) the CJEU's conclusion in this case suggests that that analysis is not correct. In future it seems that one must indeed ask who benefits from the service, in order to determine what supply is in issue, and what transaction a particular payment is consideration for.

Nicholas Paines QC and Christopher Vajda QC appeared for HMRC
Raymond Hill appeared for the United Kingdom