



**TC04291**

**Appeal number: TC/2014/00064**

*VAT – franchise of educational teaching method– rewards paid to franchisee instructors– whether contingent discount reducing VAT on franchise fee – whether payment for separate supply – HELD – reward enhancement of basic supply – artificial to separate from services supplied under franchise agreement – reward is contingent discount – appeal allowed.*

**FIRST-TIER TRIBUNAL  
TAX CHAMBER**

**KUMON EDUCATIONAL UK COMPANY LTD                      Appellant**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY’S                      Respondents  
REVENUE & CUSTOMS**

**TRIBUNAL: JUDGE RACHEL SHORT  
MRS GILL HUNTER**

**Sitting in public at Royal Courts of Justice, the Strand London on 18 December  
2014**

**Leslie Allen of Mishcon de Reya for the Appellant**

**John Nicholson Higher Officer of HMRC, instructed by the General Counsel  
and Solicitor to HM Revenue and Customs, for the Respondents**

## DECISION

1. This appeal concerns HMRC's refusal to make a repayment of output VAT to the Appellant in an amount of £36,053. The Appellant made a voluntary disclosure claim on 19 December 2012 being over declared output VAT on payments made to the Appellant's teaching instructors. HMRC notified the Appellant on 25 April 2013 that it was refusing its repayment claim and confirmed that view in its review letter of 9 September 2013. The Appellant attempted to come to some agreement with HMRC but no agreement was reached. The Appellant appealed to this Tribunal on 18 December 2013. HMRC accepted by letter of 14 November 2013 that the time limit for the Appellant to make its appeal should be extended so that its appeal could be treated as made in time.

2. The VAT in issue relates to reward payments made to instructors employed by the Appellant in the UK. The VAT treatment of the reward payments depends on whether, as argued by the Appellant the reward payments take the form of a contingent discount deductible from the franchise payments made by the instructors to the Appellant or whether, as argued by HMRC, the payments are in consideration of a separate supply made by the instructors to the Appellant.

20 *The Law.*

3. The relevant legislation is set out at s 19 Value Added Tax Act 1994 ("VATA 1994"):

(1) *For the purposes of this Act the value of any supply of goods or services shall, except as otherwise provided by or under this Act, be determined in accordance with this section and Schedule 6 .....*

(2) *If the supply is for a consideration in money its value shall be taken to be such amount as, with the addition of the VAT chargeable, is equal to the consideration.*

(3) *If the supply is for a consideration not consisting or not wholly consisting of money, its value shall be taken to be such amount in money as, with the addition of the VAT chargeable, is equivalent to the consideration.*

(4) *Where a supply of goods or services is not the only matter to which a consideration in money relates, the supply shall be deemed to be for such part of the consideration as is properly attributable to it.*

(5) .....

### *Background Facts*

4. The Appellant is a provider of educational services to five to seventeen year olds and is an international business with a significant operation in the UK. Its business model is to offer franchises of its teaching methods to individual instructors

5 who pay a licence fee based primarily on a set amount per pupil for access to these teaching methods. In return for that payment (the “Franchise Fee”) they receive training, access to information about Kumon’s teaching methods, workbooks and support from a local Kumon representative. Fees are payable by instructors to Kumon two months in arrears. Each instructor operates from one site.

10 5. On an annual basis (in November) instructors are assessed on their performance for the previous year and are entitled to receive a “reward” based on a points system which is dependent on a number of different factors relating to their performance as instructors and the success of their teaching site. Details of this reward system are set out in the Kumon Operations Manual which is given to each new instructor.

6. It has been assumed for these purposes that the payments made by the instructors to the Appellant can properly be treated as royalty payments relating to intellectual property rights owned by the Appellant. No submissions were made by either party about the characterisation of these payments.

15 7. The parties agreed that there were no factual matters in dispute between them.

#### *Evidence*

20 8. The Tribunal was provided with copies of the Kumon Operations Manual which included at Section 11 details of the Centre Development Programme “CDP”. The CDP section of the operations manual set out how the “rewards” were calculated which were payable under the CDP programme and the rationale for the programme itself:

*“Once you are fully licensed, your main focus should be on continuously developing your centre. Key tools in maintaining an adequate level of ongoing professional development are CDP and KQS (Kumon Quality Standards)”*

25 9. The payment of CDP rewards was based on three criteria; “Quantity” Number of students and number of students retained (ii) “Quality” Number of student attaining higher levels of achievement and (iii) “Programme Knowledge” The instructor’s own technical level of training.

30 10. We also saw the Licence Agreement (the example which we saw was dated August 2009) entered into by instructors with Kumon. The Kumon document described two different fees which were payable to Kumon by the instructor:

*“Fees – means the royalty based on the registration fee and monthly subject fee payable by the Course Participants to paid by the Instructor to Kumon UK pursuant to this Agreement as set out in Appendix 1”*

35 *“Licence Fee – means the fee payable by the Instructor prior to the Commencement Date as set out in Appendix 1”*

Appendix 1 set out (i) the Licence Fee payable per study centre (ii) the registration fee payable per student (iii) the monthly royalty payable per student

per subject and (iv) a fee payable for the establishment of a Centre Promotion Account payable per study centre.

11. The Licence Agreement set out both Kumon's obligations to the instructors, at Clause 2 - to provide information about their teaching methods and also obligations of the instructors, at Clause 3 – to promote the potential of students participating in their courses, improve their own teaching skills and knowledge of the programmes and promoting the Kumon method.

12. The Tribunal was provided with a witness statement dated 15 September 2014 of Mr Anu Beligoda, Finance Coordinator of the Appellant which was taken as read and heard oral evidence from Mr Beligoda.

13. Mr Beligoda described how instructors were hired and trained by Kumon, paying an initial licence fee of £200, then going through a 6 month training programme before paying a further £200 and signing their licence agreement with Kumon under which the Franchise Fees were payable. The price paid to Kumon each month as a royalty was based on the number of students at a particular centre and was a fixed amount per student (approximately 50% of the fee charged by the instructor to the student).

14. All instructors were given a copy of Kumon's operational manual during their training and this included an explanation of the CDP. At the relevant time payments under the CDP were made by issuing a credit note to instructors which would be paid directly into their bank account. (This practice has since been changed and reward payments are now deducted from future Franchise Fees). Mr Beligoda said that of about 700 instructors employed each year by Kumon, about 150 would receive reward payments under the CDP.

#### 25 *Appellant's Arguments.*

15. The Appellant argued that the rewards given to instructors were linked to the Franchise Fee and therefore fell within the definition of a "contingent discount" set out in VAT Notice 700 at 7.3.2(c):

30 *"Contingent Discounts: If you offer a discount on condition that something happens later (for example on condition that the customer buys more from you) then the tax value is based on the full amount paid. If the customer later earns the discount, the tax value is then reduced and you can adjust the amount of tax by issuing a credit note".*

16. In substance the reward was linked to the service provided by Kumon to the instructors, allowing them to expand student numbers. The reward was based on the success of the franchise.

17. Taking account of the authorities in this area the Tribunal should take a commercial approach to determining whether these payments could be treated as a contingent discount (see for example *Empire Stores v Commissioners of Customs and Excise Case C- 33/93*). The Tribunal should avoid any artificial dissection of supplies

made as made clear in the *Pippa-Dee* decision (*Customs & Excise v Pippa-Dee Parties Ltd* [1981] STC 495). The Appellant relied in particular on the decision of Judge Berner in *Everest* where a payment was treated as a discount for VAT purposes even though it was earned by reference to a supply made by a third party (being loan finance for house improvements). (*Everest Limited v HMRC* [2010] UKFTT 5 621(TC)).

18. According to the Appellant, it was made clear in the documents provided to the instructors that the reward was given as a discount against the Franchise Fee payable; this was set out very clearly in the CDP document. The criteria for determining the reward might be complex, but the level of the discount was ascertainable. 10

19. The Appellant also relied on the analysis of consideration for supplies provided in the *Naturally Yours Cosmetic* case in which the value of supplies of cosmetic cream at a discount was taken to be the discounted cash value of the goods plus the value of the retailer's undertaking to procure hostesses to sell its goods. The Appellant argued that as was accepted in that case, there was a link between the instructors' obligations to Kumon and the rewards given to them; Kumon lowered the price of its services (the Franchise Fee) to reflect the value of services provided by a successful franchisee. There was a direct link between the reward and the royalties paid by the franchisees. (*Naturally Yours Cosmetics Ltd v Customs & Excise Commissioners* 15 [1988] STC 879). 20

20. From the Appellant's perspective there was only one supply in this case, being the provision of intellectual property by Kumon to its instructors for which a royalty in the form of the Franchise Fee was payable. The number of students taught by each instructor was a fundamental element of the Franchise Fee and it was also fundamental to the level of any reward paid. The reward should be treated for VAT purposes as a contingent discount against the Franchise Fee and Kumon should be obliged to account for VAT only on the net amount of the Franchise Fee actually paid. 25

#### *HMRC's Arguments*

21. HMRC argued that there was no direct link between the rewards paid to certain instructors and the Franchise Fee. As stated in their letter of 25 April 2013 to the Appellant "*the reward had no relationship to the fees paid by the franchisee*". The rewards paid as set out in the CDP document were linked to supplies which were not part of the Franchise Fee and included services which were not part of the Licence Agreement, for example the quality of the teaching provided, as well as just student numbers. 30 35

22. HMRC suggested that the *Everest* decision could be distinguished from the facts here because in that case it was clear that a 10% discount would always be received whereas there was no set discount amount in Kumon's CDP document. The reward did not reduce the Franchise Fee by a set percentage or a set amount and was not referred to as a discount. Nor was it clear on these facts whether the reward was a discount set against a Franchise Fee which had already accrued or against future payment obligations. HMRC referred to the *Lex Services* case to support their position 40

that if the reward is to be treated as a discount against the Franchise Fee, that needs to be very clearly set out in the terms of the documents. (*Lex Services plc v HMRC* [2003] UKHL 67)

23. In HMRC's view the fundamental question was whether the discount represented any reduction in the value of the supplies to which the Franchise Fee related, to which they said the answer was no. The Appellant was attempting to re-characterise something which was actually a separate supply into something which could be treated as a discount. There was no evidence of a reduction in the value of the supply made by Kumon to the instructors as a result of the reward payments.

#### 10 *Decision*

##### *General Approach*

24. Our conclusion is based on an approach which starts from the premise that the form in which a payment is made for services should not affect its treatment for VAT purposes. We have not taken the fact that the reward payments were not deducted from the Franchise Fee but were paid as a separate credit to instructors as significant. Nor do we think that a lack of a uniform method for calculating the payment means that it cannot be treated as a discount, as suggested by HMRC; we take the court's comment in the *Lex* decision about the need for clarity if a discount is to be applied to go not to clarity of calculation but clarity of intention in stating that something is intended to operate as a discount.

25. Unlike in many of the authorities cited to us this case involves a supply (or supplies) made only between two parties. No third party is involved in the generation of the rewards paid to instructors therefore it must either operate as a reduction in the fee paid for the services provided by Kumon or as consideration for a separate supply made by the instructors to Kumon.

##### *Facts Found*

26. On the basis of the evidence provided the Tribunal found the following facts:

- (1) The rewards given to instructors were not described in any of the Kumon documentation which we saw as a discount.
- 30 (2) The basis for calculating the reward payable to an instructor was complicated but was based on clear criteria and was ascertainable in any given case.
- (3) The right to be paid a reward was not included in the Licence Agreement under which the Franchise Fee was paid but was stated in the Kumon Operations Manual which all instructors were given.
- 35 (4) The Operations Manual was a detailed document which provided information about the instructors' obligations as part of their franchise agreement with Kumon and was a fundamental part of their agreement with Kumon.

(5) The Franchise Fee payable by the instructors to Kumon under the Licence Agreements were dependent in part on the number of students which that instructor had at their study centre and was derived from the payments which the instructors received from their students.

- 5 (6) The Licence Agreements conferred obligations on Kumon to provide information about their teaching methods but also obligations on the instructors to promote the Kumon method.

*Were the supplies linked for VAT purposes?*

10 27. We cannot agree with HMRC's position that the reward payments were completely separate from the supplies made by Kumon in return for the Franchise Fee payable by the instructors. Those services as detailed in the Licence Agreement obliged Kumon to provide the right to use, and information about, its teaching methods to enable the instructors to take on students and pass on to Kumon a standard  
15 fee for each student which they taught. It was part of that agreement that the instructors had obligations towards Kumon; to promote the Kumon method and improve their own teaching skills. We do not think that these obligations can be realistically separated from the commercial bargain on which the Franchise Fee was based.

20 28. It is correct that the reward payments included specific performance criteria which were not set out in detail in the Licence Agreement (the quality of teaching, for example). However some elements of the reward payment were linked to elements of the Franchise Fee (the number of students and the retention of students) while the others were an extension of the basic obligation of instructors under the Licence  
25 Agreement; not just to teach the Kumon method, but to teach it to a particularly high standard.

29. None of the cases cited to us considered whether actions of a customer which added value to the supply for which it was paying its supplier should be treated as a separate supply or as merely changing the value of the existing supply.

30 30. The Appellant referred to the *Naturally Yours Cosmetics* case in support of its argument that the supplies made by the instructors were linked to the supplies made by Kumon and so therefore should be treated as a reduction in the consideration for that supply. However in that case it was decided that there was a separate supply made by the consultants to their supplier, (the undertaking to procure hostesses)  
35 which had to be added to the value of the consideration. The mere fact that services are linked does not mean that a separate supply cannot be identified for VAT purposes.

*Was the reward consideration for a supply made by the instructors?*

40 31. We have taken as the best test here that set out in the *Everest* case; is the payment here for the mere fulfilment of a contingency or are there additional actions

of a third party (in that case the customer, in our case the instructors) which give rise to a supply.

5           “a distinction must be drawn between the mere satisfaction of a contingency and the actions of a customer that amount to a service by the customer to a supplier”.

32. In that case it was held that the satisfaction of a contingency can include a behavioural shift by a customer and it was said that in order to identify a separate supply it must be possible to identify a separate economic activity being carried out by the customer. It was accepted in the *Everest* case that there would be a spectrum of cases involving different levels of activity by a customer which might or might not amount to the making of a separate supply

33. Our conclusion on these facts is that the reward paid to the instructors is for enhancing the basic service for which they paid a Franchise Fee to Kumon. We think that this is best viewed as an enhancement of that basic service rather than a separate supply and is closer to cases in which a discount is given for bulk purchases than to cases in which activities unconnected with the service being provided are undertaken by the customer (such as *Naturally Yours Cosmetics* and *Empire Stores*).

34. There is, to that extent, a direct link between the activities for which the reward was payable and the services provided for which the Franchise Fee was payable. We think this is demonstrated particularly by the statements made in the Kumon operations manual which suggested that the Centre Development Programme was a significant part of all instructors’ roles for Kumon; “*your main focus should be on continuously developing your centre*”; it was not an additional extra which some instructors could decide to participate in and others not, but was core to their role as Kumon’s franchisee.

*Has the value of the Appellant’s supply been reduced?*

35. HMRC approached the issues by asking whether, looking at the transaction as a whole, the actions of the instructors which led to the payment of a reward altered the value of the supply made by the Appellant in providing its intellectual property rights under the Licence Agreements. We consider that this is in essence asking the same question as was addressed in the *Everest* case, but analysing the supply from the perspective of the supplier rather than the customer. HMRC did not refer to any authorities in support of this approach.

36. That leads to the question of what activities were being undertaken by the instructors to earn their rewards. We think that the best description of this is that those activities were an enhancement to their basic obligations as Kumon’s franchisees, better quality teaching, improved student retention and higher student numbers. The reward was based on a number of components:

5 (1) An increase in student numbers and an increased retention rate. By procuring and keeping more students and receiving a reward for that, the instructors were in effect being allowed to pay less per head for each student. It seems to us that this is core to their activities for which the Franchise Fee is paid and this can relatively easily be treated as reducing the value of the service provided by Kumon.

10 (2) An improved level of teaching (more students obtaining higher level qualifications and teachers having done more technical training). By providing higher standards of teaching, instructors were providing an enhanced level of service as Kumon's franchisees. Kumon were putting themselves in the position of receiving the same level of franchise payment for better teaching services. The instructors have provided improved quality rather than improved quantity to Kumon for the same return. This is more difficult to analyse as a reduction in the value of the supply made by Kumon, but we do not consider that changes in the quality of the activities of the instructors should be treated differently than changes in the quantity of students which they instructed, or that to do so would be to artificially dissect aspects of these transactions which are commercially all components of one agreement.

20 *Considering all the circumstances of the transaction*

25 37. The Tribunal has considered its obligations not to "artificially dissect supplies" and it is telling in this regard that HMRC when asked were not able to provide a description of what the separate supply to which they alleged the rewards related actually was. The Tribunal has considered whether it is possible to categorise the activities of the instructors which gave rise to the reward payments as a separate supply made by the instructors to Kumon, but in our view on any approach what the instructors "supplied" derived from their obligations under the Licence Agreements and it is not commercially realistic to view this as a separate supply.

30 38. For these reasons we have concluded that the rewards paid by Kumon to its instructors should be treated as a contingent discount, deductible for VAT purposes from the value of the Franchise Fee charged to the instructors and the Appellant's VAT reclaim for these periods should be allowed.

35 39. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

5

**RACHEL SHORT  
TRIBUNAL JUDGE**

**RELEASE DATE: 17 February 2015**