TC03249

Appeal number: TC/2009/14551, TC/2010/09137 & TC/2012/00711

VAT – OUTPUT TAX –provider of standard rated tuition programme set up subsidiary to provide worksheets as zero rated supplies - whether subsidiary made zero rated supplies of worksheets - yes – whether supplies of worksheets part of single standard rated supply of services - no - whether contractual arrangements sham - no – whether contractual arrangements abusive practice - no - appeals allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

KUMON EDUCATIONAL U.K. CO LTD
KUMON BOOK SERVICES (UK) LIMITED

Appellants

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: JUDGE GREG SINFIELD
MRS C E FARQUHARSON

Sitting in public in London on 11 - 15 March 2013 and after consideration of the parties' further written submissions on 22 and 30 July 2013

Mr David Milne QC and Ms Sadiya Choudhury, instructed by Greenback Alan LLP, for the Appellants

Mrs Melanie Hall QC and Mr Alan Bates, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Kumon Educational U.K. Co., Limited ("KE") provides education in Maths and English to children in the UK based on a teaching programme called the Kumon Method via a network of self-employed instructors.

2. Until 1 November 2005, KE granted a licence to instructors to exploit the Kumon Method and provided worksheets for the instructors' students in return for a single inclusive royalty payment per student. This was treated as a single supply of services. KE charged and accounted for VAT at the standard rate on the royalty payments that it received.

3. From 1 November 2005, KE continued to grant the instructors a licence to use the Kumon Method and a subsidiary of KE, Kumon Book Services (UK) Limited ("KBS"), provided the worksheets to the instructors in return for a separate fee. KE accounted for VAT at the standard rate on the royalty payment. KBS treated supplies of the worksheets as chargeable to VAT at the zero rate. The aggregate amount paid by the instructors to KE and KBS was materially the same as the instructors had previously paid to KE alone.

4. In March 2009, the Respondents ("HMRC") decided that, notwithstanding the changes from 1 November 2005, KBS should not be regarded as making zero rated supplies of the worksheets. HMRC considered that there was no free-standing zero rated supply of the worksheets. The worksheets were merely a part of an artificially divided teaching programme. On the basis of that analysis, HMRC decided that KE continued to make a standard rated supply of the right to use the Kumon Method, which included the worksheets. HMRC assessed KE for VAT on the consideration paid by the instructors to KBS for the worksheets. In case their primary analysis was shown to be wrong, HMRC also issued alternative assessments, for identical amounts, to KBS on the basis that KBS was liable to account for VAT at the standard rate on the consideration received by it from the instructors. The amount of VAT at stake is £6.94 million.

5. KE and KBS now appeal against the assessments. The only question for determination is whether KBS made a zero rated supply of worksheets but this requires several issues to be considered.

6. For the reasons set out below, we have concluded that KBS made zero rated supplies of the worksheets and those supplies should not be regarded as elements of a single supply by KE of the right to use the Kumon Method. Accordingly, our decision is that the appeals by KE and KBS are allowed.

Legislation

7. There was no dispute between the parties that, during the period under consideration, Article 28(2)(a) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes

– Common system of value added tax: uniform basis of assessment, and Article 110 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (together "the VAT Directives") allowed the UK to apply VAT at a zero rate to the supply of books, booklets and leaflets.

8. Section 30 of the VAT Act 1994 ("the VATA") provides that a supply of goods or services is zero rated if the goods or services are of a description specified in Schedule 8 to the VATA. Item 1 of Group 3 of Schedule 8 specifies "Books, booklets, brochures, pamphlets and leaflets". HMRC accepted that the worksheets, which were provided in bound sets, were books or booklets within item 1 of Group 3.

9. Note (1) to Group 3 of Schedule 8 to the VATA provides that item 1 "include[s] the supply of the services described in paragraph 1(1) of Schedule 4 in respect of goods comprised in the items". Paragraph 1(1) of Schedule 4 provides that any transfer of the whole property in goods is a supply of goods but the transfer of the possession of goods is a supply of services.

10. With effect from 19 July 2011, Notes (2) and (3) to Group 3 provide as follows:

> "(2) Items 1 to 6 do not include goods in circumstances where
>
> (a) the supply of the goods is connected with a supply of services, and
>
> (b) those connected supplies are made by different suppliers.
>
> (3) For the purposes of Note (2) a supply of goods is connected with a supply of services if, had those two supplies been made by a single supplier
>
> (a) they would have been treated as a single supply of services, and
>
> (b) that single supply would have been a taxable supply (other than a zero rated supply) or an exempt supply."

11. KE and KBS accept that they are within Notes (2) and (3) to Group 3 and that the supplies of worksheets by KBS on or after 19 July 2011 are chargeable to VAT at the standard rate.

Summary of submissions

12. Mr David Mine QC, who appeared with Ms Sadiya Choudhury for the Appellants, submitted that KBS made zero rated supplies of worksheets to the instructors under the new arrangements introduced with effect from 1 November 2005. Mr Milne relied on the decision of Court of Appeal in *Telewest Communications plc v Customs and Excise Commissioners* [2005] EWCA Civ 102, [2005] STC 481 ("*Telewest*") as establishing that separate supplies by separate companies could not be regarded as a single supply. This was so even though, as KE and KBS admitted, the new arrangements were introduced primarily to achieve a VAT saving.

13. Mrs Melanie Hall QC, who appeared with Mr Alan Bates for HMRC, submitted that the new arrangements were ineffective for one or more of four reasons, namely:

(1) there was no supply of the worksheets by KBS to the instructors because the instructors never acquired any right to dispose of the worksheets as owner;

(2) there was a single supply of services, namely the right to use the Kumon Method, under the Licence Agreement between KE and the instructors and the Worksheet Sales Agreement between KBS and the instructors and no separate supply of the worksheets;

(3) the creation of two separate agreements under the new arrangements was a sham and they could be ignored; and/or

(4) the new arrangements were an abusive practice which resulted in the accrual of a tax advantage that was contrary to the purpose of the VAT Directives and the legislation transposing them into UK law so that the arrangements must be redefined so as to re-establish the situation that prevailed under the old arrangements.

14. Mrs Hall submitted that the VAT outcome of each of the above was the same, namely that the instructors receive, or are to be regarded as receiving, a single standard rated supply of the right to use the Kumon Method. It was HMRC's case that the worksheets formed an essential and inextricable part of the Kumon Method and were the principal means by which tuition was delivered. When viewed from the perspective of KE, KBS, the instructors or their students, the tuition and the worksheets had no economic or commercial function in isolation from each other.

15. Mrs Hall contended that this case was distinguishable from *Telewest* and, if it were not so distinguishable, then she submitted that *Telewest* was no longer good law and/or binding on this tribunal in the light of subsequent case law of the Court of Justice of the European Union ("CJEU"). Further, Mrs Hall submitted that *Telewest* could not be applied in cases of sham and abuse.

Issues

16. The issues in this appeal are as follows:

(1) did KBS supply worksheets to the instructors?

(2) if so, was the supply of the worksheets a separate supply or an element of a single supply of the Kumon Method?

(3) if there was a separate supply of the worksheets, as a matter of general VAT law, did

(a) the doctrine of sham; or

(b) the principle of the prohibition of abusive practices,

require the arrangements to be redefined as a single supply?

Although there is an inevitable overlap in the evidence and arguments, we consider the issues separately.

Burden of proof

17. It was common ground that the burden of proving the existence of a sham rests on HMRC where they make such an allegation. If any support is needed for this proposition, it can be found in *Hitch and others v Stone* [2001] EWCA Civ 63, [2001] STC 214 ("*Hitch v Stone*") at [32] where Arden LJ observed without comment that the Special Commissioners had noted that the burden of showing that any document was a sham was a heavy one and lay on the Crown.

18. HMRC also bear the burden of proof in relation to the allegation of an abusive practice. This is clear from *Lower Mill Estate Ltd v HMRC* [2010] UKUT 463 (TCC), [2011] STC 636 ("*Lower Mill*") where the Upper Tribunal said, at [137], that the onus is on HMRC to establish that there is an abuse.

19. In relation to all other issues in this appeal, the burden of proof rests on KE and KBS.

Evidence

20. Mr Takeshi Ichino and Mr Hiroshi Nakamura provided witness statements on behalf of the Appellants. Mr Ichino is currently a director of Kumon Educational Japan Co., Ltd, ("Kumon Japan"). He was formerly General Manager of Regional Headquarters (Europe and Africa). He was the leader of the Kumon VAT Task Force responsible for setting up KBS in 2005 and became its first Managing Director. Mr Nakamura was the Vice President and director of KE and KBS from August 2009. Mr Ichino and Mr Nakamura gave oral evidence. Their witness statements were admitted as evidence in chief and they were cross-examined. We found both Mr Ichino and Mr Nakamura to be honest and truthful witnesses and we have accepted their evidence.

21. Mr Jaswinder Singh Sian of Greenback Alan LLP ("GA"), accountants, also produced a witness statement on behalf of the Appellants which was admitted as evidence in chief. There were no witnesses on behalf of HMRC. The parties also produced 12 bundles of documents.

Facts

22. On the basis of the witness evidence and documents, we find the material facts to be as set out below.

The Kumon Method

23. The Kumon Method was developed in Japan in 1958. It is a teaching programme that provides supplementary education in Maths and English to children via a network of self-employed instructors, who set up their own Study Centres from which they operate their own businesses, based on the Kumon Method.

24. The Kumon Institute of Education ("KIE"), which is the ultimate Japanese holding company of the Kumon group of companies, granted KE a master licence for

the promotion of the Kumon Method in the UK. The original licence was granted by KIE to KE in 1991 and it has been revised several times. Under its agreement with KIE dated 1 June 1998, KE paid 5% of its gross revenues (comprising tuition, registration and licence fees) to KIE.

25. In 2005, Kumon operated study centres in 44 countries and over 3.7 million children worldwide studied using the Kumon Method. In 2009, there were approximately 500 study centres in the UK where self-employed instructors provided face to face tuition to their students using the Kumon Method.

26. One of the key features of the Kumon Method is the use of worksheets which are specially printed materials developed and licensed by KIE. The worksheets are at the heart of the Kumon Method. The worksheets are in book format and students enter their answers directly into them. The instructors provide the students with the worksheets. The worksheets are not available through any retail or other outlet in the UK (although they are sold in some other countries).

27. At the study centre, students complete one or more worksheets and receive guidance, tuition and assistance from the instructors who might also mark their work. The worksheets are designed for self-learning. If a student does not understand the tasks in the worksheets then they are assisted by the instructor. In between attendances at the study centres, the students are given homework in the form of worksheets which are marked by their parents using an answer book provided by the instructor. More than 70 per cent of the Kumon worksheets completed by students are completed at home, away from the centre and the instructor. The core elements of the Kumon Method are independent study away from the centre using the worksheets on a daily basis and repeated practice until a topic has been mastered. None of the core elements of the method is achievable without the worksheets.

Arrangements before November 2005

28. KE promoted the Kumon Method in the UK to potential instructors. Individuals who were interested in becoming instructors attended an information session and undertake a short test in Maths and English. If both parties wished to proceed, the would-be instructor paid a deposit of £200, which would form part of the consideration for the licence to use the Kumon Method, and KE undertook background checks.

29. An instructor's training took place over the course of one year. The initial training took 3 days with a break of 4 to 5 weeks and then a further 2 days. At the end of the initial training, the new instructor paid the balance of the licence fee of £200 and KE granted the instructor the right to use the Kumon Method and instruct students under a licence agreement as a provisional licence holder. Provisional licence holders were allowed to open a study centre which their students typically attended once a week during the evening for half an hour per subject. The instructors paid KE a one-off registration fee when a student enrolled to study Maths or English and ongoing monthly royalty fees for each subject studied by the student.

30. KE provided training and ongoing support to the instructors under the terms of the licence agreement in the form of seminars, workshops and conferences, some of which instructors were required to attend.

31. When a provisional licence holder had been an active instructor for 12 months and provided they had at least 20 Maths and English students, they were eligible to become full licence holders. In order to become a full licence holder, an eligible provisional licence holder had to complete an additional 2 days training, assignments and proficiency tests. No further licence fee was payable by the instructor on becoming a full licence holder. The one-off registration fees and monthly royalty fees that KE charged instructors holding a full licence were slightly lower than the fees charged by KE to instructors who were provisional licence holders.

32. Before 1 November 2005, all supplies to the instructors were made by KE. The worksheets were not priced separately and no separate fee was payable by the instructors for the use of the worksheets. KE billed instructors monthly for the royalty fees. KE charged and accounted for VAT at the standard rate on on all fees charged to instructors on the basis that it was making a single standard rated supply of the right to use the Kumon Method.

VAT saving proposal

33. In December 1999, GA prepared a report for KE proposing arrangements to achieve a more efficient structure in the UK for VAT purposes and also to consider centralising printing operations in Spain. The proposed VAT efficient structure was that a new company should be set up to supply the worksheets in the UK rather than them being supplied by KE. The report stated that the supply of worksheets in isolation would be chargeable to VAT at the zero rate rather than standard rated as part of the supply of the right to use the Kumon Method by KE. KIE reviewed GA's proposal and decided not to pursue it as KE did not have the capability to implement it at that time.

34. Mr Ichino said that he studied GA's proposal both before and after he was assigned to KE. He discussed the proposal with GA and other advisers at various meetings in 2004 - 2005. A KIE Board report, dated 30 January 2005, set out the tax advantages of the new arrangements. The paper included calculations showing the projected VAT savings per student and in aggregate. The projected VAT saving for the fiscal year 2006 was just over £1 million.

35. In 2005, Mr Ichino formed, and was the leader of, the Kumon VAT Task Force responsible for setting up KBS. The VAT Task Force Plan set out the tasks that had to be achieved in order to implement GA's proposal. The tasks included the following:

> "Obtain letter re zero rated worksheets for Newco from HMCE
>
> …
>
> Full explanation to the tax authorities."

Preparations for changes to arrangements from 1 November 2005

36. KBS was incorporated in April 2005. The shares in KBS were owned 80% by KE and 20% by Kumon Publishing Co Limited ("KPC"). KPC was a Japanese-incorporated company and subsidiary of KIE. KPC sold Kumon practice books, which were similar to the books of worksheets, to the public in Japan and in North America. KBS was separately registered for VAT. KE and KBS were not treated as members of a VAT group. It was common ground that the main reason for setting up KBS was to save tax.

37. KE made presentations about the new arrangements (described below) to its staff and to the Instructors Advisory Committee, a representative group of instructors, in April and May 2005. KE made further presentations about the new arrangements to many more instructors at six regional meetings in June 2005. We were shown a draft of the presentation slides. It was not suggested that it differed materially, if at all, from the presentations that were actually given.

38. One of the early slides stated as follows :

> "A new UK subsidiary company
>
> 1. Establishment of a new subsidiary of [KE] that will import Kumon related books and sell at bookshops.
>
> 2. Kumon can take advantage of the correct (zero) VAT rate for its books and save cost. Some of the cost savings are directly passed on to Instructors and the rest are used for the future expansion of the Kumon system."

The 'books' referred to in the slide were the worksheets which were grouped as books or booklets.

39. The slides stated that the establishment of a new subsidiary required amendments to the Licence Agreement between KE and the instructors as well as the introduction of a new Worksheet Sales Agreement between the instructors and the new subsidiary, KBS. A slide explained the establishment of a new subsidiary as follows:

> "Kumon Book Services (UK) Limited has been established to import and sell (through bookshops) Kumon related books.
>
> The books are <u>not</u> a replacement for the Kumon Method delivered at your Study Centres."

In the early stages of consideration of the VAT saving proposal, KE intended that KBS would sell books to bookshops in the UK but that never happened.

40. A further slide explained that KBS would own and supply the worksheets and other chargeable items, eg answer books, flash cards, magnetic number boards and stationery, to the instructors. It said that the non-chargeable items, such as diagnostic and achievement tests and answers, test certificates and administration items, would continue to be owned by KE but would be distributed by KBS. Those items would be supplied to instructors only and would not be sold through bookshops.

41. Notwithstanding the changes to the identity of the supplier of the goods, a slide stated that the delivery method and staff involved would remain the same and the transition would be seamless.

42. Another slide explained how the benefit of the new arrangements would be shared as follows:

> "Kumon will benefit from the zero rated VAT status of its books.
>
> Some of this benefit will be passed on to Instructors in the form of a discount of 50 pence per student, per subject, per month from November 2005 to 31 October 2007.
>
> The remaining benefit will be used for the future expansion and improvement of the Kumon franchise system."

43. Another slide explained why there would be separate agreements as follows:

> "As supply is coming from two separate companies ([KE] and Kumon Book Services) separate Agreements are necessary.
>
> One Agreement cannot exist without the other."

44. The slides made clear that the total monthly amount payable by instructors holding a full licence would be unchanged at £18 per student per subject. Under the revised arrangements, KE would invoice the instructors £6 per student per subject each month in respect of the royalty fee. Each month, KBS would invoice the instructors £12 per student per subject in respect of the worksheets. KE would collect both amounts, acting as agent of KBS in respect of the worksheet charge.

45. At and after the meetings, KE received a number of questions from the instructors about the new Licence Agreement and Worksheet Sales Agreement. KE produced a document setting out the questions and answers to them, including the following:

Ref	Question	Answer
11	*Why have we got the 50p subsidy for only two years?*	Our standard planning horizon is 1 year. As this is a major project we have forecast the savings for a longer period. We are confident that in the current political and economic climate we can achieve the savings for a 2 year period and we are happy to commit to the subsidy for this duration. We are optimistic that we will be able to achieve savings beyond this time scale and to continue to provide some form of direct benefit to our Instructors but do not want to make any commitment beyond 2 years at this stage.
	How can we order in the same way if [KE] owns the Non-Chargeable Items and KBS the Worksheets and Chargeable Items?	KBS will purchase, store and distribute the Non-Chargeable Items on behalf of [KE]. You will submit the same order form as now, to KBS, for all items.

59	*I am concerned that legally the Course and the Method are in the one Contract and the Worksheets in another. I cannot run the course without the Worksheets*	There have to be 2 separate contracts as you are dealing with two separate legal entities ([KE] and KBS). KBS is fully accountable to [KE] so commitment and support remain unchanged. …
60	*But do we still have a voice?*	Yes, the contacts give you the right that if you have a dispute with [KE]/KBS you can still report your grievance through the normal channels.
61	*The contracts feel like a fait accompli. What happens if we disagree and don't sign?*	The LAs you have received are the final versions. The purpose of the Regional Meetings … is to address your questions. If you do not sign the new Agreements you will cease to be a Kumon Instructor. …
63	*Has it been considered that Instructors may not sign the Agreement?*	The new Agreement is based on the existing contract and the aim is not to have unreasonable clauses. There is nothing revolutionary or surprising in the LA.
67	*Has the establishment of a separate subsidiary company (KBS) been considered before?*	Yes, this was considered in the past but at the time the decision was taken not to proceed.
68	*Is anything that Kumon produces available to anyone other than Instructors?*	Worksheets will only ever be supplied to Instructors (ie not directly to the public). Kumon Publishing (a separate Kumon Group company) are currently selling workbooks in Japan (for the last 28 years) and in North America (for the past year). The American English versions on sale in the US are available in the UK through Amazon but Kumon Publishing currently has no firm plan to sell British English versions in the UK.

Sub-licence between KE and KBS

46. On 2 September 2005, KE granted KBS a sub-licence which gave KBS the right to use certain trademarks etc so that KBS could supply instructors with worksheets and merchandise. In consideration for the licence, KBS agreed to pay KE a licence fee of 60% of its gross profit each year. Gross profit was defined as arising only from the sale of worksheets and chargeable items, less associated costs.

Management agreement between KE and KBS

47. KBS had no employees and KE provided all necessary management services and staff to KBS. On 2 September 2005, KE and KBS entered into an agreement ("the Management Agreement") under which KE provided certain services to KBS in return for a monthly fee.

48. The services included assisting with developing new materials, purchasing, warehousing, stock-control, handling orders, invoicing, fee collection, and accounts. KE charged VAT at the standard rate on all supplies made to KBS under the Management Agreement.

49. The management fee was set initially at £100,000 per month, subject to six-monthly reviews. KE invoiced KBS monthly for the management charge. Each month KE offset the worksheet fees it collected on behalf of KBS (see below) against the management fee due, with the balance either paid to or due from KBS.

Amended agreement between KIE and KE

50. An agreement, dated 1 November 2005, amended the licence agreement dated 1 June 1998 between KIE and KE relating to the Kumon Method. The amended agreement acknowledged the new role played by KBS in the arrangements and set the fee payable by KE to KIE at 5% of the combined income of KE and KBS.

New agreements with instructors

51. With effect from 1 November 2005, instructors were required to enter into two agreements, one with KE and another with KBS, instead of entering into a single agreement with KE. Save for the discount of 50p per student, per subject, the combined monthly amount payable by the instructors to KE and KBS under the new arrangements after 31 October 2005 was the same as the amount that had been payable under the single agreement with KE up to that date.

Licence Agreement between KE and instructors

52. KE granted a licence ("the Licence Agreement") to individual instructors to use the Kumon Method. The Licence Agreement did not include the supply of the worksheets used in the Kumon Method. It was not possible for instructors to enter into the Licence Agreement with KE without, at the same time, entering into the Worksheet Sales Agreement with KBS.

53. Under the terms of the Licence Agreement, instructors paid KE an initial licence fee of £400 and further licence fees of £200 for each additional study centre opened. The instructors also paid KE one-off registration fees of £7.50 each time a student enrolled to study a subject. Provisional licence holders paid KE a monthly royalty fee of £6.75 per student per subject. Fully qualified instructors paid a monthly royalty fee of £6.00 per student per subject. Both the instructor and KE had the right to terminate the Licence Agreement. KE charged and accounted for VAT on the licence fee and monthly fees paid by the instructors at the standard rate.

Worksheet Sales Agreement between KBS and instructors

54. The instructors purchased the worksheets, as well as other merchandise (such as stationery), from KBS under an agreement ("the Worksheet Sales Agreement") between KBS and the individual instructor. The instructors paid KBS a monthly

Worksheet Fee for the worksheets which was based on the number of students studying a subject.

55. Under the terms of the Worksheet Sales Agreement, provisional instructors paid a monthly Worksheet Fee of £13.50 per student per subject. Fully qualified instructors paid a monthly Worksheet Fee of £12 per student per subject. As the Worksheet Fee was calculated by reference to the number of students and subjects, it was payable even if no worksheets were ordered in a month, eg because the instructor had sufficient worksheets from previous orders.

56. Clause 2.8 of the Worksheet Sales Agreement provided:

> "Any worksheets provided by [KBS] to the Instructor under this agreement will remain at all times the property of [KBS] until such worksheets are used by a Course Participant, at which time ownership of the worksheets shall pass from [KBS] to the Instructor."

57. KBS bought the worksheets from the various printers. KBS treated the supply of the worksheets to the instructors as zero rated for VAT purposes.

No supply

58. Mrs Hall contended that KBS never made any supply of the worksheets to the instructors because the instructors never acquired any right to dispose of the worksheets as owner. Mrs Hall referred to a number of cases on the meaning of supply of goods, including Case C-25/03 *Finanzamt Bergisch Gladbach v HE* [2005] ECR I-3123 at [64] of the judgment and Case C-40/09 *Astra Zeneca UK Limited v HMRC*) [2010] STC 2298, at [24] - [26] of the judgment.

59. There was no dispute that, under article 5 of the Sixth VAT Directive, a supply of goods means the transfer of the right to dispose of tangible property as owner. Mrs Hall submitted that the instructors did not acquire any such right either under the Licence Agreement or under the Worksheet Sales Agreement. Mrs Hall's submission was that clause 2.8 of the Worksheet Sales Agreement provided that the worksheets remained the property of KBS at all times until they were used by a student, when property transferred to the instructors. Mrs Hall contended that this meant that the instructors never had both possession and ownership of the worksheets.

60. Essentially, Mrs Hall's submission was that there was no supply by KBS to the instructors because the instructors were never able to make a supply of the worksheets as a supply of goods. It seemed to us that the instructors must have had the right to dispose of the worksheets as owner, even if only for a scintilla of time, because Clause 2.8 of the Worksheet Sales Agreement provided that ownership of the worksheets passed from KBS to the instructor when the worksheet was used by the student. The right to dispose of tangible property as owner does not require the putative supplier to have possession or title, only the ability to dispose of it as if he were the owner of the property – see Case C-320/88 *Staatsecretaris van Financiën v Shipping and Forwarding Enterprise Safe BV* [1991] STC 627 at [7] and Case C-494/12 *Dixons Retail plc v HMRC* at [20] – [21].

61. It is not necessary for us to decide that KBS made a supply of the worksheets as a supply of goods, however, as the transfer of the possession of the worksheets is a supply of services and such supplies are within the scope of the zero rating provisions. Note (1) to Group 3 of Schedule 8 to the VATA provides that item 1 "include[s] the supply of the services described in paragraph 1(1) of Schedule 4 in respect of goods comprised in the items". Paragraph 1(1) of Schedule 4 provides that any transfer of the whole property in goods is a supply of goods but the transfer of the possession of goods is a supply of services. Even if Mrs Hall's submission that there was no supply of goods were correct, there was still a supply of the worksheets when possession of the worksheets passed to the instructors as a supply of services which fell within the zero rating provisions.

62. Our decision on this issue is that, subject to the other issues discussed below, supplies of the worksheets fell within the description "Books, booklets, brochures, pamphlets and leaflets" in item 1 of Group 3 of Schedule 8 and were accordingly zero rated whether they were goods or services.

Single supply

63. As is now well-established, the CJEU recognises two distinct types of single composite supply, namely:

> (1) where one or more supplies constitute a principal supply and the other supply or supplies constitute one or more ancillary supplies which do not constitute for customers an end in themselves but a means of better enjoying the principal service supplied (see Case C-349/96 *Card Protection Plan Limited v Customs and Excise Commissioners* [1999] STC 270 ("*CPP*") at [30]); and
>
> (2) where two or more elements or acts supplied by the taxable person are so closely linked that they form, objectively, a single, indivisible economic supply, which it would be artificial to split (see Case C-41/04 *Levob Verzekeringen and OV Bank v Staatssecretaris van Financien* [2006] STC 766 ("*Levob*") at [22]).

64. The CJEU's decision in *Levob* was anticipated by the House of Lords in *College of Estate Management v Customs and Excise Commissioners* [2005] STC 1597 ("*College of Estate Management*"). In that case, the College provided distance-learning courses in the fields of property management and construction. HMRC contended that the College made a single supply of exempt educational services to its students whereas the College argued that it made a zero rated supply of goods (i.e. the written course materials) that was separate from the exempt supply of the rest of the educational services. The House of Lords agreed with the tribunal's findings that the printed materials were not an end in themselves and even though the means of educating the students relied, principally, on the provision of written materials, the College was providing overall a supply of education (see [23] and [31] of the judgment). This was despite the fact that the supply of the written materials was not "ancillary" to the supply of education in the *CPP* sense. The fact that a particular supply was not "ancillary" to a principal supply did not of itself make it a separate supply for VAT purposes. Even before the decision in *College of Estate*

Management, KE had accepted that its supplies to instructors were single supplies and that they were chargeable to VAT at the standard rate.

65. The cases of *CPP*, *Levob* and *College of Estate Management* all concerned the supply of multiple services or goods and services by a single taxable person. The issue in those cases was whether the taxable person made a single composite supply or two or more independent supplies. In *Telewest*, the issue was whether separate supplies by separate companies could be regarded as a single supply by one or both of them for VAT purposes. In February 2005, the Court of Appeal in *Telewest* held that the supplies by the two separate companies, not being members of a VAT group, could not be treated as a single supply. With effect from 1 November 2005, KE put in place the arrangements, described above, to split the supplies to instructors between KE and KBS. The new arrangements relied on *Telewest*.

66. Telewest was a cable television company. Customers subscribed to Telewest's television service by contracting with one of its regional companies. Both the television service and a TV listings magazine showing the broadcast programmes were supplied to the customers by the regional companies. Telewest accounted for VAT on the charge to customers for the television service but not on the amount charged for the magazine which it regarded as a zero rated supply. In *British Sky Broadcasting Plc v Customs and Excise Commissioners* (1999) V & DR 283 ("*BSkyB*"), the VAT and Duties Tribunal, applying *CPP*, decided that the provision of a television service and a listings magazine were a single supply chargeable to VAT at the standard rate.

67. Following the *BSkyB* case, Telewest established a wholly owned subsidiary, Telewest Communications (Publications) Limited ("Publications"). Publications entered into an agency agreement with the regional companies under which it agreed to provide a copy of the monthly listings magazine to each customer. Existing customers were informed that Publications would now provide them with the magazine and there would be no change in the customer's obligation to pay. New customers were informed that, if they agreed to subscribe for television services, they also agreed to the supply of the magazine as part of those services.

68. HMRC considered that Telewest should account for VAT at the standard rate on the full amount paid by the customers of the regional companies for both the television services and the magazine. They considered that there was only one relevant contract, i.e. a contract between the customer and the regional company for the supply of a package consisting of the television service and the magazine. Telewest appealed on the grounds that there were two separate contracts: one between the regional company and the customer for the supply of the television service, which was standard-rated, and one between the customer and Publications for the supply of a magazine, which was zero rated.

69. The Tribunal and the High Court agreed with HMRC that there was a single standard rated supply by Telewest. The Court of Appeal allowed Telewest's appeal. It held that there was no authority for the proposition that the concept of principal and ancillary contracts in *CPP* could apply where there was more than one supplier, nor

that where one supply could be said to be ancillary to another, even though they were made by separate suppliers, both supplies had to share the same tax treatment. It further held that supplies by two separate suppliers could not be treated as principal and ancillary supplies.

70. In *Telewest* in the Court of Appeal, Sir Christopher Staughton found that the appeal succeeded on an analysis of the contractual position, ie each company made a separate supply to the customers, subject to any arguments on VAT law. The contractual position is not in issue in this case. There were separate contracts, namely the Licence Agreement and the Worksheet Sales Agreement, entered into by separate companies, KE and KBS respectively, and, subject to arguments about sham (discussed below), HMRC did not challenge the effectiveness of the contracts. There was no suggestion in *Telewest* that the contracts were a sham.

71. In the Court of Appeal in *Telewest*, Arden LJ considered the VAT law issues. HMRC put forward three arguments based on VAT law, namely that:

(1) *CPP* applies even where, unlike in *CPP*, there is more than one supplier so that there is a single supply where one supply was ancillary to the principal supply of services by Telewest ("the *CPP* argument");

(2) the two contracts were linked, in that a customer could not subscribe for the television service without taking the magazine as well, so that they did not give rise to two independent VAT supplies ("the package argument"); and

(3) the VAT treatment should be determined by reference to the economic reality, which was that Publications and Telewest were a single supplier, rather than the domestic contract law analysis ("the artificiality argument").

Arden LJ rejected all three arguments.

72. In relation to the package argument, Arden LJ held at [66] and [69] that Case C404/99 *Commission v France*, [2001] ECR 1-2667, relied on by HMRC, did not support the proposition that linked transactions should be treated as a single supply.

73. In relation to the *CPP* argument, at [71] and [74], Arden LJ held that there was no suggestion in *CPP* that the concept of principal and ancillary contracts could apply where there is more than one supplier and the case did not support the submission that the two contracts in *Telewest* should not be treated as separate supplies. At [74] of her judgment, Arden LJ held:

> "In the *CPP* case at [29] the Court of Justice emphasised that a single supply from an economic point of view should not be artificially split so as to distort the functioning of the VAT system. [Counsel for HMRC] submits that to treat the supply by Telewest and the supply by Publications as separate supplies amounts to artificially dividing them into separate transactions. I do not consider that the *CPP* case supports the submission that the two contracts should not be treated as separate supplies. The passage relied upon is dealing with the situation where it is sought to analyse a single supply with two or more elements. I agree with the judge's conclusions at [96] of his judgment that there is

> nothing in the *CPP* case 'to justify the proposition that where [there are two separate contracts] the supply made by the one supplier, Publications, takes the tax treatment applicable to the supply made by the other'."

74. In [75] - [79], Arden LJ rejected the submissions based on other cases which were not relied on before us. Accordingly, Arden LJ refused to extend *CPP* to apply to a situation where there are two suppliers so as to treat their supplies as a single supply.

75. On the issue of artificiality, Arden LJ rejected the argument that the Court should look at the economic reality and ignore the changes in the arrangements for the supply of the listings magazine as artificial steps. As Arden LJ pointed out in [81], there was no evidence of value shifting or that Publications was a mere cipher and no suggestion of fraud or abuse. It was in that context that Arden LJ observed at [82]:

> "In my judgment, there is an objection in principle in this field of law to taxing transactions according to their economic reality. The economic reality of a transaction is antithetical to legal certainty. If VAT is payable according to economic reality, the seller will not know what VAT to account for, and the purchaser will not know what VAT to pay. The system for the collection of VAT would no longer be straightforward. Accordingly, there seem to me strong policy reasons against the course which [counsel for HMRC] invites us to take. The principle of legal certainty is one recognised and applied by the Court of Justice in this field."

76. This approach was explained further by Arden LJ in [87] as follows:

> "The mere fact that the court seeks to find the commercial reality of a transaction does not mean that it would seek to apply the economic reality of the transaction. The economic reality of the transaction may have nothing to do with either the essential features of what the parties agreed or the legal structure of their transaction. Moreover, as this court said in *Tesco plc v Customs and Excise Commissioners* [2003] EWCA Civ 1367, [2003] STC 1561 at [159]: 'Economic *purpose* is not the same as economic *effect*' [159] (emphasis added in original)."

77. The decision in *Telewest* was considered by the Upper Tribunal in *Lower Mill*. Lower Mill Estate Limited ("LME") was a developer of holiday homes. LME owned freehold land with the benefit of planning permission for up to 575 residential homes which were subject to residence restrictions and were intended as second or holiday homes. Accordingly, supplies of such homes were chargeable to VAT at the standard rate. LME granted 999 year leases of plots for houses to customers. The leases were subject to VAT at the standard rate. The customers also entered into agreements with Conservation Builders Limited ("CBL") to construct a holiday or second home on each such plot. The supply of such construction services was zero rated for VAT purposes. At all material times, LME and CBL were owned by the same person. HMRC considered that the leases and agreements to build houses should be treated as effecting single supplies of completed holiday homes and the total amount paid by the customers should be subject to VAT at the standard rate. The First-tier Tribunal

rejected that argument (but held that the transactions concerned were an abuse which we discuss below).

78. In the Upper Tribunal, HMRC renewed its submissions, made before the First-tier Tribunal, that there was a single supply. HMRC contended that cases decided by the CJEU since the Court of Appeal's decision in *Telewest*, namely *Levob* and Case C-425/06 *Ministero dell'Economia e delle Finanze v Part Service Srl* [2008] STC 3132 ("*Part Service*"), showed that there was a single supply and that analysis was not affected by the fact that different elements were supplied by different persons.

79. In *Part Service*, two companies belonging to the same financial group were involved together in leasing transactions, mostly in relation to motor vehicles. One company entered into a lease, with an option to purchase, with a customer in consideration of lease payments with a surety for the amount not covered by the lease payments with both covered by an unlimited security. At the same time, the other company entered into an agreement with the customer under which it insured the vehicle and guaranteed the customer's obligations to the first company by financing the surety and security. The first company charged and accounted for VAT on the payments under the lease whereas the payments under the insurance, finance and guarantee contract were treated as exempt. The Italian tax authority considered that VAT was due on the total payments made by the customer. The Italian court referred two questions to the CJEU, both of which referred to the concept of abuse of rights.

80. Having referred to *CPP* and *Levob*, the CJEU in *Part Service* stated at [54] – [55]:

> "It is for the national court to assess if, the contractual structure of the transaction notwithstanding, the evidence put before the court discloses the characteristics of a single transaction.
>
> In that context, it may find it necessary to extend its analysis by seeking evidence of indications of the existence of an abusive practice, which is the concept with which the question referred is concerned."

The CJEU then discussed whether there had been an abusive practice before, as it usually does, leaving the national court to determine whether the transactions were abusive (see [63]).

81. The Upper Tribunal in *Lower Mill* rejected HMRC's submissions that there was a single supply in [43] – [47] of the decision. The Upper Tribunal concluded that the correct treatment for VAT purposes, absent abuse and on the basis that the contracts were genuine and not a sham, was that there were separate taxable supplies by LME (of leases of building plots) and by CBL (of building services). The Upper Tribunal held that *Telewest* provided a conclusive answer to HMRC's contentions and that it remained good law notwithstanding *Part Service*. The Upper Tribunal explained its view on the latter point at [44] as follows:

> "We do not consider that subsequent case-law has made the position doubtful. In our judgment the decision of the Court of Justice in *Part Service* provides no basis for reconsideration of the decision in

> *Telewest*. Although that case did concern separate supplies by separate suppliers, and although reference was appropriately made to *CPP* and *Levob*, we do not read the judgment as extending in any way the jurisprudence apart from abuse. It is to be noted that at [53] in *Part Service* the Court of Justice referred to a single supply by the taxable person to the customer rather than to a possible single supply by two taxable persons. The ruling of the Court of Justice was directed at abuse. If it had intended its words to be taken as extending the principles discussed in *CPP* and *Levob* so as to enable, in an appropriate case, two supplies by separate suppliers to be treated as a single supply, we would have expected them to say so, especially in the light of the need for some guidance about how the value of the supply would then be apportioned between the two separate suppliers. The Court of Justice regularly reframes questions referred. If the Court had considered that there was a relevant possibility that there were on general principles single supplies albeit by separate taxable persons under separate contracts, we are confident that the Court would have said so before going on to consider the question of abusive practice."

82. We are bound by the decision of the Upper Tribunal in *Lower Mill Estate* that *Telewest* remains good law after *Part Service*. In any event, we agree with the Upper Tribunal's view, expressed in [44], that *Part Service* did not extend the concept of a single composite supply in *CPP* and *Levob* other than in cases of abuse. In [55] of *Part Service*, the CJEU did no more than state that the national court could find that there was a single supply, even where the contractual structure indicated that there were separate supplies, but only by extending its inquiry to ascertain whether (and find that) there was abuse. We infer from [54] and [55] that the CJEU in *Part Service* did not consider that, in the absence of abuse, it was possible to treat supplies by separate persons as a single supply.

83. We now consider whether there was a single supply of services or separate supplies of the right to use the Kumon Method and the worksheets. We approach this issue on the basis that there was no abusive practice and that the arrangements were not a sham. The issues of abuse and sham are discussed separately below.

84. Mrs Hall submitted that, in *Telewest*, the characteristics of the goods and services made it possible for them to be enjoyed separately whereas neither element in this case could be enjoyed without the other because of the integrated nature of the Kumon Method which meant that each element could not be used without the other. We do not agree with this proposition. Mr Ichino's evidence was that the worksheets were essential to the Kumon Method but he also stated that Kumon Publishing sold Kumon practice books in Japan and North America. The contents of those books resembled the worksheets. No such books were sold officially in the UK although the questions and answers document described at *[45]* above shows that the US books were available in the UK through Amazon. The evidence shows that there was, early in the consideration of the new arrangements, an intention that KBS would sell worksheets or similar products such as practice books separately although this never happened. We consider that the fact that practice books were sold elsewhere and the proposal, never acted upon, to sell worksheets or practice books in the UK establishes that the worksheets had a value in their own right. We consider that the fact that KBS

took steps, discussed above, to ensure that it retained title to the worksheets until they were used by the students showed that there was a concern that instructors could use or even sell the worksheets independently. On the basis of the evidence, we find that there was nothing in the nature of the products that meant that they could not be supplied separately, even though we accept that the right to use the Kumon Method and the worksheets were intended to be used by the instructors together.

85. Mrs Hall also submitted that, unlike in *Telewest* where the regional companies relinquished the obligation to supply the listings magazine, KE continued to have an obligation to supply the worksheets after the new arrangements were introduced. The Licence Agreement did not contain a specific provision requiring KE to supply the worksheets but Mrs Hall submitted that the agreement must be read as including an obligation to provide the worksheets otherwise the Kumon Method could not work. Although the Kumon Method, which was licensed to the instructors by KE, required the instructors to be supplied with worksheets, we do not accept that that meant that KE was obliged to provide the worksheets itself. We agree that it was important, perhaps essential, to KE that the instructors would be provided with worksheets but that did not prevent another entity, such as KBS or any other person, being the supplier.

86. We do not accept that the situation of KE and KBS can be distinguished from that in *Telewest* in any material way for the reasons given above. Following *Telewest* and *Lower Mill*, as we must, we hold that the supplies by two suppliers under two contracts cannot be a single supply for VAT purposes. Our decision is that the correct analysis of the transactions in this case for VAT purposes is that KE and KBS made separate supplies to the instructors: KE supplied the right to use the Kumon Method under the Licence Agreement and KBS supplied worksheets under the Worksheet Sales Agreement.

87. Our conclusion that the supplies of the worksheets are separate supplies by KBS and are not part of a single supply of the right to use the Kumon Method by KE is predicated on the assumption that the arrangements are neither a sham nor an abusive practice. We now turn to consider those issues.

Sham

88. HMRC contended that the creation of a separate Worksheet Sales Agreement under the new arrangements was a sham. Mrs Hall submitted that taxpayers could not bring themselves within the *Telewest* principle by entering into separate contracts, even with separate suppliers, if those arrangements were a sham. As a sham, the Worksheet Sales Agreement did not create any rights or obligations that were separate from the Licence Agreement and, therefore, there was no independent supply of the worksheets.

89. We must consider the meaning of "sham", whether the arrangements introduced by KE and KBS with effect from 1 November 2005 were a sham and, if so, what effect that has on the VAT treatment of the transactions.

90. Sham is a purely domestic law concept developed by the courts. In *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786, Diplock LJ said in a much quoted passage at page 802:

> "It is I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities, that for acts or omissions to be a 'sham' with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating."

It is clear that a sham exists where the parties intend that their real contractual relationship should be something other than what is stated in the contract between them – see also *McNicholas Construction Co Ltd v Customs and Excise Commissioners* [2000] STC 553 at [34].

91. The doctrine of sham was also considered in *National Westminster Bank plc v Jones & ors* [2001] 1 BCLC 98 Neuberger J (as he then was) stated at [39]

> "Both principle and the authorities indicate that the court is slow to find that an agreement is a sham, and that, before the court can reach such a conclusion, it must be satisfied that the purported agreement is no more than a piece of paper which the parties have signed with no intention of its having any effect, save that of deceiving a third party and/or the court into believing that the purported agreement is genuine."

92. The doctrine of sham was examined in a tax context by the Court of Appeal in *Hitch v Stone*. *Hitch v Stone* concerned a complex scheme to enable taxpayers to avoid capital gains tax on land with a substantial development value. The scheme sought to convert capital sums into income and involved the taxpayers entering into an agreement with two companies, controlled by the tax adviser who had devised the scheme. The agreement provided for the grant of a lease of the land to one of the companies ("C"). The scheme also involved an assignment by C of its interest in part of the land to another company controlled by the tax adviser. There was also a deed which, among other things, created a lease over the remaining part of the land in favour of C. The Inland Revenue took the view that the agreements were shams and assessed the taxpayers. The taxpayers appealed. The Special Commissioners found that the first agreement was a sham and, in consequence, the assignment and parts of the deed were also shams. That decision was overturned on appeal and the Inland Revenue appealed to the Court of Appeal.

93. In *Hitch v Stone* in the Court of Appeal, Arden LJ summarised the approach to the issue of whether something is a sham as follows at [63] to [69]:

"63. The particular type of sham transaction with which we are concerned is that described by Diplock LJ in *Snook*. It is of the essence of this type of sham transaction that the parties to a transaction intend to create one set of rights and obligations but do acts or enter into documents which they intend should give third parties, in this case the Revenue, or the court, the appearance of creating different rights and obligations. The passage from Diplock LJ's judgment set out above has been applied in many subsequent decisions and treated as encapsulating the legal concept of this type of sham. …

64. An inquiry as to whether an act or document is a sham requires careful analysis of the facts and the following points emerge from the authorities.

65. First, in the case of a document, the court is not restricted to examining the four corners of the document. It may examine external evidence. This will include the parties' explanations and circumstantial evidence such as evidence of the subsequent conduct of the parties.

66. Second, as the passage from *Snook* makes clear, the test of intention is subjective. The parties must have intended to create different rights and obligations from those appearing from (say) the relevant document, and in addition they must have intended to give a false impression of those rights and obligations to third parties.

67. Third, the fact that the act or document is un-commercial, or even artificial, does not mean that it is a sham. A distinction is to be drawn between the situation where parties make an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship.

68. Fourth, the fact that parties subsequently depart from an agreement does not necessarily mean that they never intended the agreement to be effective and binding. The proper conclusion to draw may be that they agreed to vary their agreement and that they have become bound by the agreement as varied: see for example *Garnac Grain Co. Inc. v H M F Faure and Fairclough Ltd* [1966] 1 QB 650.

69. Fifth, the intention must be a common intention: see *Snook's* case, above."

94. Arden LJ stated at [85] of *Hitch v Stone*:

"85. I have already noted that it is an established requirement of a sham transaction that the parties should have the common intention that it should not take effect according to its tenor and in addition that a false impression should be given to third parties. But this point raises one of the issues of law that has arisen in this case: common to whom? Mr Price [for the taxpayers] submits that the intention must be common to all the parties to a document save in very exceptional circumstances, which he does not define and which he submits it is not appropriate to define since they were not applicable in this case. Thus,

> on his submission, all the parties had to have a common intention, and hence the 1984 Deed was incapable on the facts as found by the Special Commissioners of being a sham. He refers to this as the "all or nothing" principle. Mr Vallance [for the Revenue] submits that this is not a necessary requirement of a sham, and does not apply where (as here) the document implemented more than one transaction. In principle I accept Mr Vallance's submission. In *Snook's* case Diplock LJ was concerned with the situation where the document implemented a single transaction, and his words must be read in the context of the case before him. In any event, the effect of Mr Price's submission is that the court will be precluded from finding that a document is a sham because it includes an additional provision which is intended to be effective. This might deprive the doctrine of sham of any operation in a situation which is logically indistinguishable from the situation where the doctrine of sham already applies. In my judgment, the law does not require that in every situation every party to the act or document should be a party to the sham. I accordingly reject Mr Price's submission save that I accept that the case where a document is properly held to be only in part a sham will be the exception rather than the rule, and will occur only where the document reflects a transaction divisible into separate parts."

95. In our view, the passages quoted from *Snook*, *National Westminster Bank* and *Hitch v Stone* show that the parties must intend that the documents or acts cause third parties, including HMRC or a court, to believe that legal rights and obligations have been created while the parties themselves intend that different rights or obligations or no such rights or obligations shall apply.

96. More recently the issue was considered in *Autoclenz Ltd v Belcher* [2009] EWCA Civ 1046; [2010] IRLR 70, which was a case concerning employment status. In the Court of Appeal, Smith LJ said at [49]:

> "Where one party was relying on the genuineness of an express term and the other party was disputing it, there was no need to show that there had been a common intention to mislead. That was particularly so in a contract in the employment field where it was not uncommon to find that the 'employer' was in a position to dictate the written terms and the other party was obliged to sign the document or not get the work. In such a case, there was no need to show an intention to mislead anyone; it was enough that the written term did not represent the intentions or expectations of the parties."

97. *Autoclenz* went to the Supreme Court where Lord Clarke who gave the only judgment, having referred to Diplock LJ's statement in *Snook*, said at [23]:

> "23. I would accept the submission made on behalf of the claimants that, although [*Snook*] is authority for the proposition that if two parties conspire to misrepresent their true contract to a third party, the court is free to disregard the false arrangement, it is not authority for the proposition that this form of misrepresentation is the only circumstance in which the court may disregard a written term which is not part of the true agreement. That can be seen in the context of landlord and tenant

from *Street v Mountford* [1985] AC 809 and *Antoniades v Villiers* [1990] 1 AC 417, especially per Lord Bridge at p 454, Lord Ackner at p 466, Lord Oliver at p 467 and Lord Jauncey at p 477. See also in the housing context *Bankway Properties Ltd v Pensfold-Dunsford* [2001] 1 WLR 1369 per Arden LJ at paras 42 to 44."

98. Lord Clarke reviewed previous decisions in relation to the issue of sham in an employment law context and held as follows:

"29. … The question in every case is, as Aikens LJ put it at para 88 quoted above, what was the true agreement between the parties. I do not perceive any distinction between his approach and the approaches of Elias J in *Kalwak*, of Smith LJ and Sedley LJ in [*Protectacoat Firthglow Limited v. Szilagyi* [2009] EWCA Civ 98 (*"Szilagyi")]* and this case and of Aikens LJ in this case.

30. In para 57 of *Kalwak* (set out above) Elias J quoted Peter Gibson LJ's reference to the importance of looking at the reality of the obligations and in para 58 to the reality of the situation. In this case Smith LJ quoted (at para 51) para 50 of her judgment in *Szilagyi*:

> 'The kernel of all these dicta is that the court or tribunal has to consider whether or not the words of the written contract represent the true intentions or expectations of the parties, not only at the inception of the contract but, if appropriate, as time goes by.'

…

32. Aikens LJ stressed at paras 90 to 92 the importance of identifying what were the actual legal obligations of the parties. He expressly agreed with Smith LJ's analysis of the legal position in *Szilagyi* and in paras 47 to 53 in this case. In addition, he correctly warned against focusing on the "true intentions" or "true expectations" of the parties because of the risk of concentrating too much on what were the private intentions of the parties. He added:

> "What the parties privately intended or expected (either before or after the contract was agreed) may be evidence of what, objectively discerned, was actually agreed between the parties: see Lord Hoffmann's speech in the *Chartbrook* case at [64] to [65]. But ultimately what matters is only what was agreed, either as set out in the written terms or, if it is alleged those terms are not accurate, what is proved to be their actual agreement at the time the contract was concluded. I accept, of course, that the agreement may not be express; it may be implied. But the court or tribunal's task is still to ascertain what was agreed."

I agree."

99. Lord Clarke also observed at [35]:

"… the relative bargaining power of the parties must be taken into account in deciding whether the terms of any written agreement in truth represent what was agreed and the true agreement will often have to be gleaned from all the circumstances of the case, of which the

> written agreement is only a part. This may be described as a purposive approach to the problem. If so, I am content with that description."

100. On the basis of the authorities quoted above, we consider that an act or document is a sham if it represents that certain legal rights and obligations have been created between persons when those persons intend that different rights or obligations or no such rights or obligations shall apply. Where an act or document is a sham, the court or tribunal must disregard the false arrangement, determine the true agreement between the parties and give effect to the real rights and obligations.

101. The fact that an agreement may have been wholly artificial and have no commercial purpose does not mean that it was a sham (see [67] of Arden LJ's judgment in *Hitch v Stone* quoted above and [15] of Lindsay J's judgment in *Weald Leasing* quoted below).

102. We accept that, in the context of employment status cases, there is no need to show a common intention to mislead but it must be remembered that those cases are concerned with a situation where one party seeks to rely on the wording of a contract while another person disputes it. In this case, Mrs Hall submitted that KE and KBS attempted to mislead HMRC. At the hearing, Mrs Hall accepted that the evidence did not support HMRC's case on sham based on purely the content of the Worksheet Sales Agreement. HMRC's case on sham was that the new arrangements, introduced with effect from 1 November 2005, viewed as a whole had the appearance of creating legal rights and obligations between the parties that were different from the actual legal rights and obligations which the parties intended to create. Mrs Hall submitted that the Worksheet Sales Agreement was intended to give the appearance of a free-standing independent agreement for a supply of goods when it was not because it was inseparable from and integral to the Kumon Method. The Worksheet Sales Agreement and the Licence Agreement created a false impression of being separate agreements and, therefore, they were shams. Mrs Hall contended that the true relationship between KE, KBS and the instructors from 1 November 2005 was the same as it had been before in that the Kumon Method was licensed to the instructors for use by them in teaching their students and the provision of the worksheets was an integral part of the Kumon Method. Mrs Hall pointed out that, save for the discount of 50p per student, the instructors paid the same monthly amount to KE and KBS under the new agreements as they had paid to KE under the single agreement before the change. The conduct of the parties after the change in the arrangements was not consistent with the creation or operation of a free-standing contract for the sale of the worksheets. Similarly, the Licence Agreement did not confer rights that could be used independently of the worksheets, which is why it was not possible to enter into one agreement without the other.

103. The documents that we have seen set out the contractual position. The issue is whether the documents and acts of the parties represented the true intentions or expectations of the parties. We conclude on the evidence that the parties in this appeal, ie KE, KBS and the instructors, intended the arrangements introduced with effect from 1 November 2005 to have effect in accordance with the new agreements and that the parties acted in accordance with those agreements. The explanations of the new arrangements given to the instructors at presentations and the questions and

answers documents produced in response to the instructors' comments show that all parties were eager to understand the true effect of the new arrangements. The instructors were clearly concerned about the possible impact of the changes, specifically the introduction of KBS and a new agreement, but there is nothing in the answers provided by KE to the instructors to indicate that the parties did not intend that the new agreements should take effect as drafted and in accordance with their terms. Similarly, the subsequent conduct of the parties is consistent with the provisions of the agreements: KBS provided the worksheets to the instructors who paid KBS, via KE, for them as set out in the Worksheet Sales Agreement; KE provided the services to the instructors under the Licence Agreement and the instructors paid fees to KE in return. In our view, HMRC have not established on the evidence that there was any intention by KE and KBS (or the instructors) to mislead HMRC about the true effect of the arrangements. Accordingly, we find that the arrangements were not a sham.

104. HMRC also relied on "deceit" in the letters from GA, as accountants for KE and KBS, to HMRC after the new arrangements had been introduced. We reject this submission as misconceived. Those letters were not part of the agreements and did not purport to create any legal rights or obligations between KE, KBS and the instructors. The letters contained representations, on behalf of KE and KBS, about the legal effect and VAT consequences of the agreements. The letters from GA did not affect the content of the agreements and, thus, could not make the agreements shams.

105. Mrs Hall also submitted that, although it is a purely domestic law concept, a sham created with the sole aim of obtaining a tax advantage is an abusive practice contrary to the purpose of the VAT Directives. We agree with that submission. It is entirely consistent with the CJEU's statement in [46] of *Newey* quoted at [*136*] below. Although a sham intended to avoid tax is an abuse, our conclusion that the arrangements in this case were not a sham does not dispose of the issue of abusive practice. We consider that the principle of the prohibition of abusive practices is wider than the doctrine of sham.

Abusive practice

106. HMRC's case was that new arrangements from 1 November 2005 were an abuse which resulted in the accrual of a tax advantage that was contrary to the purpose of the VAT Directives and the legislation transposing them into UK law. Mrs Hall submitted that if the arrangements were an abuse then they must be redefined to re-establish the situation that prevailed under the old arrangements.

107. If there is an abuse then the formal contractual analysis may not lead to the correct VAT treatment and the transactions may need to be redefined. We start by considering the meaning of the principle of the prohibition of abusive practices and how it has been applied by the courts and then consider its application to the facts of this case.

108. The CJEU first applied the principle of the prohibition of abusive practices in the context of VAT in Case C-255/02 *Halifax plc and Others v HMCE* [2006] STC 919 ("*Halifax*"). The CJEU observed, at [71], that preventing possible tax evasion, avoidance and abuse was an objective recognised and encouraged by the Sixth VAT Directive. The CJEU noted, at [73], that taxable persons may choose to structure their business so as to limit their tax liability. The Sixth VAT Directive does not require a taxable person to choose the structure which involves paying the highest amount of VAT. The CJEU then gave the following guidance on the application of the principle prohibiting abusive practices in relation to VAT at [74] and [75]:

> "74 In view of the foregoing considerations, it would appear that, in the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.
>
> 75 Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed in point 89 of his Opinion, the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages."

109. The CJEU gave further guidance at [80] and [81] of its judgment:

> "80 To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.
>
> 81 As regards the second element, whereby the transactions concerned must essentially seek to obtain a tax advantage, it must be borne in mind that it is the responsibility of the national court to determine the real substance and significance of the transactions concerned. In so doing, it may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden"

110. The CJEU summarised the position in relation to abusive practice at [86]:

> "86. For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from

> a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage."

111. The CJEU concluded at [98] that, where an abusive practice has been found to exist, the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.

112. The abusive practice in *Halifax* did not involve disaggregation of a supply into separate supplies. That issue came before the CJEU in *Part Service* which we have already discussed at [*78] – [80*] above. In *Part Service*, the CJEU held that there could be an abuse where two companies entered into separate contracts with a single customer for leasing, financing, insurance and intermediation in relation to the leasing of a motor car. The CJEU held in [59] - [60] that such transactions could be contrary to the provisions of the Sixth Directive as they would allow an exemption in respect of the services other than leasing which would be contrary to the objective that tax should be charged on all the consideration received from the customer. It is clear from [25] of the judgment that the Supreme Court of Cassation, in its second question to the CJEU, had compared the arrangements in *Part Service* to the concept of "an ordinary leasing contract" and the CJEU stated at [27] that a financing transaction was "regarded in economic practice and in national case law as an essential component of a leasing contract". In the light of those passages in the judgment, the Upper Tribunal in *Lower Mill*, at [69] to [74], took the view that, as a matter of Italian law, there must have been some objectively identifiable normal commercial operations under which there would be found to be a single supply of the different supplies which existed on the facts. At [74], the Upper Tribunal stated:

> "[74] Paragraphs 59 and 60 might be seen as lending support to the view that it is a proper approach to apply national law to establish the 'real' nature of the transactions (much as one would in a conventional tax-avoidance scheme in accordance with purely domestic law). But it must be recognised that the court was answering the question referred in the context of an identified normal commercial arrangement namely 'a single contract of leasing [which] in accordance with the practice and interpretation of national case law would include the financing'."

113. We did not understand Mrs Hall to submit that, as a matter of UK law and economic practice, there is a category of standard rated tuition incorporating the provision of study materials which is a single supply. Mr Milne submitted that *Part Service* did not assist HMRC's case because *Part Service* concerned a supply which appeared to be treated as a single supply under Italian law even though it was divided under separate contracts in that case. We accept Mr Milne's submission that, in contrast to *Part Service* but as in *Lower Mill*, there is no objectively identifiable normal commercial operation which would be a single supply of the supplies by KE and KBS in this case. As Mr Milne contended, in the absence of such a single supply, *Part Service* does not take matters any further than *Halifax*.

114. The ability of a taxable person to choose to structure transactions so as to reduce his or her VAT liability, as noted by the CJEU in [73] of *Halifax*, was further referred to in two cases that considered the principle prohibiting abusive practices on

references from the UK. The first was Case C-277/09 *HMRC v RBS Deutschland Holdings GmbH* [2011] STC 345. The case concerned the taxpayer's right to deduct input tax in relation to a leasing transaction where no output tax had been accounted for as a result of differences in the place of supply rules between the UK and Germany. The CJEU confirmed that the right to deduct input tax was not dependent on there being a payment of output tax and went on to consider whether the deduction was precluded on the grounds that an abusive practice existed. The CJEU held that it was not so precluded, stating at [52] - [54]:

> "52. In those circumstances, the fact that services were supplied to a company established in one member state by a company established in another member state, and that the terms of the transactions carried out were chosen on the basis of factors specific to the economic operators concerned, cannot be regarded as constituting an abuse of rights. RBSD in fact provided the services at issue in the course of a genuine economic activity.
>
> 53. It is important to add that taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their economic activities and for the purposes of limiting their tax burdens.
>
> 54. The court has held that a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the neutral system of VAT (see *Customs and Excise Comrs v Cantor Fitzgerald International* (Case C-108/99) [2001] STC 1453, [2001] ECR I-7257, para 33). In that connection, the court has made clear that, where it is possible for the taxable person to choose from among a number of transactions, he may choose to structure his business in such a way as to limit his tax liability (see *Halifax* (para 73))."

115. The second case was Case C-103/09 *HMRC v Weald Leasing Ltd* [2011] STC 596. In that case, an insurance group purchased assets and leased them through a subsidiary, Weald Leasing, and an unconnected third party. The effect of the lease arrangement was to defer irrecoverable VAT that would have been incurred by the insurance group if it had purchased the business assets. The lease rentals were set below open market value thus extending the period of deferral. The reason for inserting the third party into the structure was to prevent HMRC from being able to impose market value on the lease rentals under paragraph 1 of Schedule 6 to the VATA. The CJEU was asked whether the transactions gave rise to a tax advantage contrary to the Sixth VAT Directive and whether they constituted an abusive practice if the person did not engage in them in the course of normal commercial operations. The CJEU held, at [33], that leasing transactions came within the scope of the Sixth Directive and the tax advantage that arose did not in itself constitute a tax advantage contrary to the purpose of those provisions. The CJEU's ruling was subject to the point that the contractual terms of the leases, particularly the level of rentals, corresponded to arm's length terms and that the involvement of the third party was not such as to preclude the application of the provisions of Schedule 6 to the VATA. The latter points were left for the national court to determine.

116. In *Halifax*, the CJEU clearly held that the principle prohibiting abusive practices applies in the context of VAT. The principle applies where, first, transactions, even if formally compliant with legislation, result in the accrual of a tax advantage which is contrary to the purpose of the VAT Directives and the national legislation transposing them; and, secondly, the principal aim of the transactions, established by reference to objective factors, is to obtain a tax advantage. If the transactions may have some explanation other than obtaining a tax advantage then the principle does not apply to prohibit that result. The CJEU acknowledged that a taxable person may choose to structure transactions so as to limit the VAT liability.

117. If an abusive practice is found to exist, the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the abusive transactions. The exercise is one of redefinition of the transactions constituting the abusive practice in order to remove the fiscal advantage sought to be obtained by the abusive practice and ensure that the transactions are subject to VAT in the same way as they would have been in the absence of the abusive practice. Any advantage obtained by the abusive practice is recoverable from the person who received it but the redefinition must not result in the imposition of a penalty.

118. KE and KBS accepted that the essential aim of the inclusion of KBS in the new arrangements for the supply of worksheets to instructors was to obtain a tax advantage for VAT purposes. Mr Milne submitted that the tax advantage derived from the new arrangements was not contrary to the purposes of the VAT Directives as zero rating a supply of printed matter is permitted under those provisions and the new arrangements allowed KBS to make zero rated supplies. Mr Milne submitted that KE and KBS were entitled to structure their business so as to limit their tax liability. They were not required to choose to enter into a transaction which involved them paying the highest amount of VAT. Mr Milne, adopting the words of the CJEU in *RBS Deutschland* at [54], contended that KE and KBS had chosen the organisational structure and form of transaction which they considered to be the most appropriate for their economic activities and for the purpose of limiting their tax burdens. That did not in itself constitute abuse. KE and KBS both carried out genuine economic activities and actually made the supplies in issue to the instructors. As the activities in question were genuine, the arrangements were not artificial and reflected economic reality.

119. Mrs Hall submitted that the *Halifax* principle applied to the new arrangements introduced by KE and KBS from 1 November 2005. KE and KBS had conceded that the essential aim of the new arrangements was to secure a tax advantage, namely the zero rating of supplies of the worksheets, and so the second limb of *Halifax* was satisfied. Mrs Hall contended that the tax advantage, ie the zero rating of the supply of the worksheets, was contrary to purpose of the VAT Directives because:

(1) the new arrangements did not reflect economic reality; and

(2) the supplies under the old arrangements were identical to the supplies under the new arrangements and to treat them differently contravened the principle of fiscal neutrality.

120. In relation to economic reality, Mrs Hall submitted that the new arrangements were devoid of economic reality in the sense that they would not have been agreed to in an open market place with open and fair competition between parties operating at arm's length. Mrs Hall contended that the features of the new arrangements were as devoid of economic reality as the rental levels in *Weald Leasing*, which were fixed regardless of the life of the asset. The price paid for the worksheets was fixed by reference to the numbers of students and subjects regardless of how many, if any, worksheets were actually supplied. The arrangements were not based on commercial or economic considerations but were tax-based and therefore commercially hollow. It was HMRC's case that the economic and commercial reality is determined by looking at the way that the Kumon Method was delivered to students by the instructors. The Kumon Method and the worksheets were intrinsically and inseparably linked. The instructors could not deliver the Kumon Method without the worksheets.

121. Mrs Hall submitted that there was no commercial justification for the new arrangements and that, following their introduction, nothing of any substance changed only the formal contracts (and some corresponding changes in ownership and title) which were entered into for the sole purpose of securing a VAT advantage. HMRC's case was that the interposition of KBS was a purely artificial device for obtaining a tax advantage and did not represent the reality.

122. We do not accept Mrs Hall's submissions on this point. It is not correct, in our view, to say that nothing of any substance changed on 1 November 2005. First, as HMRC acknowledge, the contracts changed and the effect of that change is that KE and KBS had different obligations from 1 November than they had before. Even from the point of view of the instructors there were some changes as a result of the new agreements although the effect of the changes on the instructors was kept to a minimum. Secondly, we do not accept that the fact that KBS was interposed in order to save tax, even in the context of minimising the impact of the change on instructors, means that the arrangements were artificial. In *Weald Leasing* in the High Court, [2008] EWHC 30 (Ch), [2008] STC 1601, Lindsay J at [15] agreed with counsel for HMRC's description of the arrangements of the scheme as being 'commercially hollow' but said that:

> "The transactions, being, as I have mentioned, intended by the parties thereto to take effect according to their letter, were not shams but, despite the attempts to confer the outer appearances of familiar commercial arrangements, they were artificial in the sense of being such as, but for their having the essential aim of obtaining tax advantage, they would never have been made in any commercial context."

123. In *Taxpayer Audit and Assessment v Cigarette Company of Jamaica Ltd (Jamaica)* [2012] UKPC 9, [2012] STC 1045 in the Privy Council, Lord Walker considered the meaning of artificial and observed that:

> "21. It is common ground between counsel that in section 16(1) [of the Jamaican Income Tax Act] 'artificial' has a meaning different from, and wider than, "fictitious" (the latter expression approximating in

meaning to 'sham'). Counsel accepted that authoritative guidance has been given (in relation to an earlier provision in the same terms as section 16) by Lord Diplock in *Seramco Ltd Superannuation Fund Trustees v Income Tax Commissioner* [1977] AC 287, 298:

> ''Artificial' is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsmen of the subsection is pleonastic, that is, a mere synonym for 'fictitious'. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. 'Artificial' as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed. Judicial exegesis should be confined to what is necessary for the decision of the particular case. Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as 'artificial' within the ordinary meaning of that word.'
>
> As Lord Diplock indicates, context is very important. In relation to a natural, tangible object (such as silk, or leather, or even a human limb) it is not a matter of degree: either an object is artificial, or it is not. But a transaction is an abstract construct. Every transaction is in a sense artificial in that it is put together by two or more parties in order to create or alter legal rights and obligations as between them. While mindful of Lord Diplock's warning against too much judicial exegesis the Board consider that in this context a transaction is 'artificial' if it has, as compared with normal transactions of an ostensibly similar type, features that are abnormal and appear to be part of a plan. They are the sort of features of which a well-informed bystander might say, 'This simply would not happen in the real world.' Recognising a transaction as artificial in this sense is an evaluative exercise calling for legal experience and judgment. It is certainly not an ordinary question of primary fact, as Mr McCall acknowledged in abandoning one of the main points in his written case."

124. We do not accept HMRC's submissions that the new arrangements were not at arm's length and therefore lacked economic and commercial reality. Unlike the situation in *Weald Leasing*, where the parties were associated companies and the third party company was controlled by the insurance group's tax adviser, the Appellants and the instructors were genuinely at arm's length. On the basis of the evidence of the presentations made and questions and answers document produced in advance of the introduction of the new arrangements, we find that KE was concerned that the instructors might not agree to the new agreements and the instructors were concerned about the possible impact of the changes. We recognise that the bargaining positions

of the two parties were unequal but that is not uncommon and the instructors could, if they did not like the revised arrangements, have refused to enter into the new agreements. Although a choice between accepting a supplier's new terms of business or ceasing to do business altogether may seem stark, it is not uncommon for a customer to be in such a position and, in our view, it does not indicate that the new terms are artificial or uncommercial.

125. Mrs Hall contended that the instructors would not have agreed to the new arrangements in the open market but also, in relation to fiscal neutrality, submitted that the new agreements did not materially change anything. We find those submissions to be inconsistent. If the new arrangements changed nothing then they remain as commercially and economically real as the old arrangements and we did not understand Mrs Hall to contend that the old arrangements were devoid of reality. We do not consider that the pricing mechanism for the worksheets indicates any artificiality or a lack of commerciality. Under the old arrangements, the instructors paid the monthly licence fee regardless of how many worksheets were provided in any month and the new arrangements continue that system of charging but with KBS rather than KE providing the worksheets in return for a monthly fee based on the number of students and subjects. In our view, there is nothing in the terms of the agreements to suggest that they were not genuine commercial agreements.

126. In relation to fiscal neutrality, Mrs Hall submitted that the agreements were artificial distinctions and the differences between the old arrangements and the new arrangements were insignificant. HMRC's case was that the old arrangements and the new arrangements were essentially the same and yet under the old arrangements VAT was paid on the whole of the licence fee whereas, under the new arrangements, less VAT was paid and that was contrary to the principle of fiscal neutrality. Mrs Hall relied on Joined Cases C-259/10 and C-260/10 *HMRC v The Rank Group plc* [2012] STC 23 where the CJEU said at [44]:

> "Two supplies of services are therefore similar where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable and where the differences between them do not have a significant influence on the decision of the average consumer to use one such service or the other."

127. We do not accept this submission. The principle of fiscal neutrality is concerned with ensuring that supplies of similar goods and services, which are thus in competition with each other, are treated the same way for VAT purposes. The CJEU clearly stated in Case C-117/11 *Purple Parking and Airparks Services v HMRC* [2012] STC 1680, at [39] that

> "… the treatment of several services as a single supply for the purposes of VAT necessarily leads to tax treatment different from that that those services would have received if they had been supplied separately … Accordingly, a complex supply of services consisting of several elements is not automatically similar to the supply of those elements separately".

This passage shows that the principle of fiscal neutrality does not require that a transaction consisting of more than one element should be treated in the same way as independent supplies of the same elements or vice versa.

128. On 20 June 2013, the CJEU released its judgment in Case C-653/11 *HMRC v Paul Newey trading as Ocean Finance* ("*Newey*"). Both parties made written submissions on the decision in *Newey* after the hearing of this case. In summary, the facts of *Newey* were as follows.

129. Mr Newey was a loan broker, established in the UK, who made exempt supplies. As a consequence, Mr Newey was unable to recover VAT charged on advertising services supplied to him. In order to avoid the irrecoverable VAT, Mr Newey incorporated a company ('Alabaster') in Jersey and granted that company the right to use the business name Ocean Finance. Mr Newey was the sole shareholder of Alabaster. Mr Newey played no part in the management of Alabaster which had a full-time employee and part-time directors in Jersey who were responsible for managing and exercising the powers of the company.

130. Alabaster entered into broking contracts with the lenders. The lenders paid broking commissions to Alabaster and not to Mr Newey. Alabaster entered into a services agreement with Mr Newey for the supply of processing services for the loan broking business services. Those services were provided by Mr Newey's employees in the UK. Under that agreement, Mr Newey had the power to negotiate the terms of the broking contracts between Alabaster and the lenders. In return for providing the processing services, Alabaster paid Mr Newey fees of 50%, later 60%, of its gross commissions, plus certain expenses or disbursements.

131. In practice, potential borrowers contacted Mr Newey's employees in the UK directly. They processed each file and sent the applications which satisfied the credit eligibility criteria to Alabaster's directors in Jersey for authorisation. The approval process generally took around one hour to complete and no request for authorisation was ever refused.

132. The advertising aimed at potential borrowers was critical to the loan broking business and represented a considerable part of the costs borne by Alabaster. Alabaster entered into a contract with an unconnected company ('Wallace Barnaby'), also established in Jersey, for the provision of advertising services. Wallace Barnaby obtained the advertising services from an advertising agency established in the UK. No VAT was chargeable on the supply of the advertising services by the UK advertising agency to Wallace Barnaby or the services supplied by Wallace Barnaby to Alabaster.

133. Mr Newey, although not able to use the advertising services or liable to pay for them, had the power to approve the content of the advertisements. He did this at meetings with one of the UK advertising agency's employees in the UK. Following the meetings, the employee made recommendations to Wallace Barnaby which, in turn, made recommendations to Alabaster. In practice, none of the recommendations was ever rejected.

134. HMRC assessed Mr Newey to recover the VAT on the advertising services on the basis that, for VAT purposes, the advertising services were supplied to Mr Newey in the UK and therefore subject to UK VAT and the loan broking services were supplied by Mr Newey in the UK. Alternatively, HMRC contended that the arrangements were an abuse and must be redefined. Mr Newey appealed against that assessment. The First-tier Tribunal (Tax Chamber) allowed the appeal. HMRC appealed to the Upper Tribunal (Tax and Chancery) which referred six questions to the CJEU.

135. As it often does, the CJEU reformulated the questions referred into a single question, namely: "whether contractual terms are decisive for the purposes of identifying the supplier and the recipient in a 'supply of services' transaction … and, if the answer is in the negative, under what circumstances those terms may be recharacterised." The CJEU answered the reformulated question at [52] as follows:

> "52 … contractual terms, even though they constitute a factor to be taken into consideration, are not decisive for the purposes of identifying the supplier and the recipient of a 'supply of services' … They may in particular be disregarded if it becomes apparent that they do not reflect economic and commercial reality, but constitute a wholly artificial arrangement which does not reflect economic reality and was set up with the sole aim of obtaining a tax advantage, which it is for the national court to determine."

136. The CJEU set out the approach to contractual terms at [42] – [45] as follows:

> "42 As regards in particular the importance of contractual terms in categorising a transaction as a taxable transaction, it is necessary to bear in mind the case-law of the Court according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT (see, to that effect, Joined Cases C-53/09 and C-55/09 *Loyalty Management UK and Baxi Group* [2010] ECR I-9187, paragraphs 39 and 40 and the case-law cited).
>
> 43 Given that the contractual position normally reflects the economic and commercial reality of the transactions and in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration when the supplier and the recipient in a 'supply of services' transaction within the meaning of Articles 2(1) and 6(1) of the Sixth Directive have to be identified.
>
> 44 It may, however, become apparent that, sometimes, certain contractual terms do not wholly reflect the economic and commercial reality of the transactions.
>
> 45 That is the case in particular if it becomes apparent that those contractual terms constitute a purely artificial arrangement which does not correspond with the economic and commercial reality of the transactions.
>
> 46 The Court has held on various occasions that preventing possible tax evasion, avoidance and abuse is an objective recognised and

> encouraged by the Sixth Directive (see *Halifax and Others*, paragraph 71 and the case-law cited) and that the effect of the principle that the abuse of rights is prohibited is to bar wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage …"

137. The CJEU left the national court to decide, by means of an analysis of all the circumstances, whether the contractual terms genuinely reflected economic reality. The CJEU gave some specific guidance in [48] where it explained that:

> "… taking into account the economic reality of the business relationships between, on the one hand, Mr Newey, Alabaster and the lenders and, on the other hand, Mr Newey, Alabaster and Wallace Barnaby, as apparent from the order for reference and, in particular, the matters of fact mentioned by the Upper Tribunal (Tax and Chancery Chamber) in the third question, it is conceivable that the effective use and enjoyment of the services at issue in the main proceedings took place in the United Kingdom and that Mr Newey profited therefrom."

138. The matters of fact referred to by the Upper Tribunal in its third question were

> (1) Whether the person who makes the supply as a matter of contract is under the overall control of another person?
>
> (2) Whether the business knowledge, commercial relationship and experience rests with a person other than that which enters into the contract?
>
> (3) Whether all or most of the decisive elements in the supply are performed by a person other than that which enters into the contract?
>
> (4) Whether the commercial risk of financial and reputational loss arising from the supply rests with someone other than that which enters into the contracts?
>
> (5) Whether the person making the supply, as a matter of contract, sub-contracts decisive elements necessary for such supply to a person controlling that first person and such sub-contracting arrangements lack certain commercial features?

139. In relation to the supplies of loan broking services in *Newey*, Alabaster was under the control of Mr Newey and it appears from the CJEU's recital of the facts that the business knowledge, commercial relationship and experience rested with Mr Newey or his employees in the UK. The CJEU noted that Alabaster did not process applications for loans but sub-contracted the work to Mr Newey. Mr Newey and his employees performed all the processing tasks for the loan broking business undertaken by Alabaster, including negotiating the terms of the contracts between Alabaster and the lenders. The CJEU pointed out that the potential borrowers, although they contracted with Alabaster, contacted Mr Newey's employees in the UK directly and those employees processed the applications which were always approved by Alabaster, generally quickly. In [48], the CJEU appears to state that the national court might conceivably find that the loan broking service supplied to the lenders took place in the UK and that Mr Newey was the supplier of those services.

140. In relation to the supplies of advertising services in *Newey*, Wallace Barnaby sub-contracted the services to the UK advertising agency. The CJEU noted that Mr Newey, who was not a party to the contract, had the power to approve the content of the advertisements and that he met regularly with an employee of the UK advertising agency supplying the advertising services. The recommendations that arose from those meetings were passed back to Alabaster via Wallace Barnaby and, in practice, none was ever rejected. Again, in [48], the CJEU appears to state that the national court might conceivably find that the advertising services were supplied to Mr Newey in the UK.

141. The CJEU stated, in [49] and [50] of *Newey*, that if the contractual terms do not genuinely reflect economic and commercial reality then, applying *Halifax*, those terms must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.

142. The issues in *Newey* were who was the supplier of the loan broking services and who was the recipient of the supplies of advertising services. Although the issue did not arise in *Newey*, we consider that the CJEU's approach in that case is equally applicable when determining the nature of supplies i.e. whether a supply of worksheets should be considered to be a supply of the Kumon Method.

143. In approaching the question of whether or not there is an abusive practice, we accept that we must not look at individual transactions in isolation but must look at the new arrangements as a whole and ask whether the outcome of those new arrangements is contrary to the purpose of the VAT Directives and the national legislation implementing them.

144. In accordance with the CJEU's approach in *Newey*, we have regard to the terms of the various agreements between the parties described above but we do not treat them as conclusive in determining the identity of the supplier or the nature of the supply. In particular, if we consider that the agreements put in place from 1 November 2005 were a wholly artificial arrangement that did not reflect the economic and commercial reality of the relationship with the instructors, it being accepted that the purpose of the arrangements was to save tax, we must disregard those agreements and determine the identity of the supplier and the nature of the supplies by reference to the economic and commercial reality of the transactions. It follows that we must first determine what is meant by economic and commercial reality and then decide whether the agreements of 1 November 2005 reflected that reality.

145. We consider that the meaning of economic and commercial reality in *Newey* can be discerned from the factors which the CJEU took into account in considering whether the contracts in that case were a wholly artificial arrangement that did not reflect the economic reality of the business relationships. The contracts in *Newey* formally provided that Alabaster supplied loan broking services to the lenders and that advertising services were supplied by the UK advertising agency to Wallace Barnaby and, in turn, by Wallace Barnaby to Alabaster. As stated above, the CJEU indicated that the national court might conceivably find that the services were supplied other than as the contracts provided. In reaching that view, the CJEU referred to the

business relationship between Mr Newey and the other parties. In our view, the CJEU must have had in mind the facts which it extracted from the order for reference. The CJEU noted that, although there was no contract between the lenders and Mr Newey, Mr Newey negotiated the terms of the contract between those lenders and Alabaster and he also received 50%, later 60%, of the commission payable to Alabaster under such contracts. Also, although Alabaster was the supplier of loan broking services under the contracts, potential borrowers contacted Mr Newey or his employees in order to make loan applications. Alabaster had to approve the loan applications but Mr Newey's employees checked whether the relevant criteria were met and informed Alabaster which never refused a request for authorisation. Similarly, although Alabaster entered into an agreement with Wallace Barnaby for advertising services and Wallace Barnaby subcontracted to the UK advertising agency, it was Mr Newey who approved and appeared to authorise the advertising through meetings with an employee of the UK agency in the UK. The points made by Mr Newey at those meetings were relayed to Alabaster which never rejected any recommendation.

146. On the basis of the facts singled out by the CJEU in its judgment, it appears that what actually happened in *Newey* was not consistent with what the contracts provided should happen. Although the contracts for loan broking services were between the lenders and Alabaster, they were negotiated by Mr Newey. The contracts provided that Alabaster would provide the loan broking services but, in practice, the services were carried out by Mr Newey and his employees in the UK with Alabaster merely 'rubber stamping' the applications. The importance of the role played by Mr Newey was shown by the fact that he received a large part of the commission. In relation to the advertising services, the contracts did not reflect the influence of and benefit to Mr Newey. In short, the contractual terms did not reflect the reality of what happened. To borrow the words of Arden LJ in *Telewest*, Alabaster and Wallace Burnaby were mere ciphers.

147. It seems to us that, in [48] of *Newey*, the CJEU indicates that, in a case such as *Newey*, economic and commercial reality, ie who really made and received supplies of services, are determined by considering matters such as where the services were used and enjoyed and who benefited from them. The factors are not bright line tests but, as the CJEU makes clear in [49], matters that the national court should take into account as part of an analysis of all the circumstances of the case. It must also be borne in mind that the matters mentioned by the CJEU were chosen in the light of the facts of and issues in *Newey* and different matters may be relevant in other cases.

148. Mrs Hall submitted that the CJEU's judgment in *Newey*, in particular [50], showed that entering into contractual terms which do not reflect economic reality is itself an abusive practice. We think that submission goes too far. The CJEU in *Newey* made two points. First, in [42], the economic and commercial reality of the transactions, such as who are the supplier and the recipient of a supply of services in reality, must be considered when determining the VAT status or treatment of transactions. Secondly, in [46], wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage are an abusive practice.

149. Mrs Hall submitted that, following the CJEU's judgment in *Newey*, the judgment of Arden LJ in *Telewest* can no longer be regarded as good law. We do not accept that submission. It may be right that economic reality plays a greater part in determining the correct application of the VAT rules than Arden LJ allowed in [82] of *Telewest* but she specifically acknowledged the role of commercial reality in analysing transactions for VAT purposes at [87]. The CJEU in *Newey* referred to the economic and commercial reality of transactions. In our view, the differences, if such they be, between the labels used by Arden LJ in *Telewest* and the CJEU in *Newey* are not such as to allow us to disregard *Telewest* in relation to the issue of artificiality in determining whether supplies made by two persons should be regarded as a single supplies or cause us to revisit our conclusion at [*87*] above that the supplies of the right to use the Kumon Method by KE and of the worksheets by KBS are separate supplies.

150. We find that the agreements put in place on 1 November 2005 formally provided that KE would grant a licence to use the Kumon Method to the instructors and KBS would supply the worksheets to the instructors. What happened thereafter was consistent with the agreements. Unlike in *Newey*, there was no evidence in this case that supplies were made by or to persons who were not parties to the agreements. We have already held that, whether as goods or services, KBS made and the instructors received supplies of the worksheets. KBS did not sub-contract the supply of the worksheets but actually supplied them to the instructors. KBS relied on KE to provide all necessary management services and staff, particularly in relation to charging and collection of the fees for the worksheets, under a Management Agreement but we do not regard that as establishing that the agreements were a wholly artificial arrangement that did not reflect the economic reality of the business relationships between KE, KBS and the instructors. In our view, the evidence shows that the transactions under the agreements put in place on 1 November 2005 were not wholly artificial arrangements and reflected economic and commercial reality of the supplies made by and between KE, KBS and the instructors. We conclude that HMRC have failed to establish that the new arrangements from 1 November 2005 under which KBS supplied worksheets to the instructors were an abusive practice.

Alternative assessments

151. As stated at the beginning of this decision, as well as assessing KE, HMRC also issued alternative assessments, for identical amounts, to KBS in case their arguments on their primary analysis were unsuccessful. The alternative assessments were on the basis that KBS was liable to account for VAT at the standard rate on the consideration received by it from the instructors. HMRC issued the assessments to KBS on the alternative basis that if there were two supplies, then the supply by KBS was a standard rated supply. The essence of what the instructors paid for was a teaching programme which they had been trained to use in their business. The worksheets were an indissociable part of that programme. HMRC relied upon the principles established by *CPP*, *Levob* and *Part Service*.

152. This alternative submission was not the subject of any argument at the hearing although it was not abandoned. We do not see how these cases help the alternative

case which is a question of classification of KBS's supply not single/multiple supplies. If, as we have found, the Worksheet Sales Agreement is not a sham or an abuse and KBS makes supplies of the worksheets to the instructors then we do not see how those supplies could be reclassified as supplies of a teaching system. We consider that the most natural classification of the supplies of worksheets is as "books, booklets …" within Group 3 of Schedule 8 to the VATA.

Decision

153. For the reasons given above, our decision is that the supplies of the worksheets by KBS should not be regarded as elements of a single supply by KE of the right to use the Kumon Method. Our conclusion is that KBS made zero rated supplies of the worksheets. It follows that KE's and KBS's appeals are allowed.

Rights of appeal

154. 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.

GREG SINFIELD
TRIBUNAL JUDGE

RELEASE DATE: 20 January 2014