Fast Food vs Fine Dining – The Tax Angle

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K. Vaitheeswaran, Advocate

There is a general feeling that India's Tax laws are complicated and peculiar tax questions arise only in the Indian Horizon. This is far from the truth as foreign precedents would show that when it comes to tax interpretations galore; classification disputes abound; the assesse loves a lower rate or no tax scenario whereas the tax authority prefers the opposite.

Fast Food Outlet in Poland

Imagine this. There is a franchisee of a chain of fast-food outlets which conducts its economic activity through a variety of retail methods and is primarily engaged in the sale of prepared meals and dishes, such as sandwiches, salads, chips, ice cream, etc. These products are served on a plastic tray with paper napkins and, for some products, plastic cutlery and/or a straw. The meals and dishes are prepared on the premises from semi-finished products, can be served hot or cold and are either consumed on the premises or taken away by the customers. Methods of carrying out business includes, sale either inside the restaurant, from the restaurant's outdoor/takeaway counters or inside shopping centres in designated restaurant areas.

The dispute arose when a VAT audit was conducted in 2016 which considered that all the activities of the appellant in the main proceedings should be classified as 'catering services', subject to the VAT rate of 8%, and not, as those activities had been declared, as 'supplies of prepared meals', to which the VAT rate of 5% applies.

The Second Appellate Court held that the Republic of Poland used the optional Provision under Article 98(2) of the EU VAT Directive, allowing member states to reduce the rate of VAT applicable to supplies of goods and services listed in Annex III to that directive.

The Referring Court (Second Appeals) also expressed its reservations on the inclusion of Article 98(2) of the Directive into Polish Law. The referring court emphasised that it is imperative to take into consideration all the sales practices as adopted by the applicant, in order to clearly distinguish between the supply of goods and the supply of services, pointing out that each of these methods has elements of both the former and the latter. The only difference, according to that court, is the extent of the infrastructure offered by the seller and the customers' expectations as to the importance of the elements of the supply of services.

Questions before the ECJ

The Referring Court thus framed three questions to be answered by the ECJ in order to provide clarity on the matter:

1. Does the concept of a "restaurant service" to which a reduced rate of VAT applies, cover the sale of prepared dishes under conditions such as those in the main proceedings, that is to say, in a situation where:

- the seller makes available to the buyer the infrastructure which enables him or her to consume the purchased meal on the premises (separate dining space, access to toilets);
- there is no specialised waiter service;
- there is no service in the strict sense;
- the ordering process is simplified and partly automated; and
- the customer's ability to customise the order is limited?

1. Is the way in which the dishes are prepared, consisting in, in particular, the heating of certain semi-finished products and the composing of prepared dishes from semi-finished products, relevant to answering the first question?
2. In order to answer the first question, is it sufficient that the customer is potentially able to use the infrastructure offered or is it also necessary to establish that, for the average customer, this element constitutes an essential part of the service provided?

Ruling of the ECJ:

The ECJ observed that the Option available under Article 98(2) allowing member nations to prescribe differential rates of taxes has been challenged and subsequently upheld by this Court by stating that *The purpose of the option open to Member States to provide for reduced rates of VAT is to make certain goods and services considered to be particularly necessary less expensive and, consequently, more accessible to the end consumer, who ultimately bears the tax (see, to that effect, judgment of 9 March 2017, Oxycure Belgium, C?573/15, EU:C:2017:189, paragraph 22 and the case-law cited). In accordance with the Court's settled case-law, it is for the Member States, subject to compliance with the principle of fiscal neutrality inherent in the common system of VAT, to determine more precisely which of the supplies of goods and services included in the categories of Annex III to the VAT Directive are subject to the reduced rate.*

In that regard, it should be noted that the VAT Directive establishes a common system of VAT based, inter alia, on a uniform definition of taxable transactions. In the case of a complex transaction, consisting of a series of closely linked elements and acts which objectively form a single inseparable economic transaction, it is apparent from the Court's settled case-law that, in order to determine whether that transaction is to be classified as a supply of goods or services, account must be taken of all the circumstances in which that transaction takes place in order to ascertain its characteristic and predominant elements (see, to that effect, judgment of 10 March 2011, Bog and Others, C?497/09, C?499/09, C?501/09 and C?502/09, EU:C:2011:135)

The Court herein considered even the minimal provision of services inherent in the supply of goods, such as display of the goods on the shelves or the issue of invoice, and held that *only those services which are distinct from those which necessarily accompany the marketing of goods may be taken into account for the purpose of assessing the share which the supply of*

services occupies in the totality of a complex transaction which also involves the supply of goods.

The Court finally held that the transactions under consideration falls squarely within the ambit of 'restaurant or catering services'/'foodstuffs', as prescribed under Annex III to the VAT Directive, however, this fact may not have any bearing on the reduced VAT rates as applicable by the member nation, as they are free to classify in the same category and to tax at a reduced rate, without formally distinguishing between supplies of goods and services.

The concept of 'restaurant and catering services' includes the supply of food **accompanied by sufficient support services** intended to enable the immediate consumption of that food by the end customer, which is a matter for the national court to determine. Where the end customer chooses not to benefit from the material and human resources made available by the taxable person to accompany the consumption of the food supplied, it must be concluded that no support services accompany the supply of that food.

The India Story

In the VAT regime, some States had a lower rate of VAT for hotels, restaurants, eating places etc and there was some degree of distinction between branded or unbranded goods. Whether the name of a hotel by itself makes the food sold as branded goods is still pending before the Madras High Court. When Restaurants were subjected to service tax by the Union, the Kerala High Court in the case of ***UOI Vs. Kerala Bar Hotels Association [TS-501-HC-2014(KER)-ST]***, struck down the levy as unconstitutional relying upon Article 366(29A) which declared it as a sale of goods. The Bombay High Court on the other hand upheld the levy in the case of ***Indian Hotels & Restaurant Association [TS-110-HC-2014(BOM)-ST].*** The Uttarakhand High Court in the case of ***Valley Hotel and Resorts Vs. CCT [TS-129-HC-2014(UTT)-VAT]*** has held that since service tax is being discharged on 40% of the value, VAT is not payable on 40%. The Chattisgarh High Court in the case of ***Hotel East Park Vs. UOI [TS-159-HC-2014(CHAT)-ST]*** held that when service tax was discharged on 40% or 60% of the value, VAT is not payable on the said amount.

GST was supposed to solve this dispute. In all fairness the Entry 6(b) treats supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other Article for human consumption or any drink (other than alcoholic liquor for human consumption), where such supply or service is for cash, deferred payment or other valuable consideration as a supply of services. In terms of Section 7(1A) of the CGST Act, activities or transactions which constitute a supply shall be treated either as supply of goods or supply of services as referred to in Schedule II. When supply of food has been expressly treated as a supply of service, there should be some degree of reluctance to explore whether there is a supply of goods in small outlets where the service element is negligible or discernible or not availed. However, the temptation to treat the transaction as a supply of goods as against a supply of service is basically on account of the fact that most of the pre-packed or packed beverages are supplied to the outlet at the GST rates applicable to goods and when the outlet charges 5% as a restaurant service, it is not entitled to ITC.

Even though AAR rulings are not binding precedents and even though they are not manned by judicial authorities, the rulings also indicate the confusion in the mind of the applicant or his consultant in asking certain questions. The Kerala AAR in the case of ***Square One Homemade Treats [TS-931-AAR-2019-NT]*** gave a ruling to the effect that, a restaurant is a place of business where food is prepared in the premises and served based on the orders received from the customer. In the instant case, it is a bakery where ready to eat items are sold and mere facility is provided to have it from the shop. Resale of food and bakery products does not fall under restaurant services.

The Uttarakhand AAAR in the case of ***Kundan Mishthan Bhandar*** gave a ruling to the effect that sale of sweets, namkeens, cold drinks and other edible items through restaurant will be treated as composite supply with restaurant supply being the principal supply. Sale of sweets, namkeens, cold drinks, and other edible items from sweet shop counter will be treated as supply of goods with applicable GST rates of the items being sold and ITC will be allowed on such supply. The Applicant should maintain separate records for restaurant and sweet shop.

The issue in India has become complex primarily on account of distortion of the GST system by providing a lower rate without the benefit of ITC. In most of these fast food chains, the role of a centralised kitchen is significant and generally, cooked food or pre packed food or semi cooked food or beverages are supplied to these outlets charging the GST rates applicable to goods. The outlet suffers increase in cost when the 5% rate is adopted for the output supply. The 5% rate is so popular that many outlets provide tables and chairs and other infrastructure to get the look and feel of a dine-in and enjoy the trappings of a restaurant service as set out in Notification No.11/2017.

The Madras High Court in the case of ***Chang Foods*** held that sale of puffs at a counter in a supermarket would not be sale in the eating house, even though the assessee had its frying unit therein. In the said case, the High Court observed that sale had taken place in the supermarkets premises which is not sale in a 'eating house' under Section 3-D in the Tamil Nadu General Sales Tax Act, 1959. The Court noted that the puffs were sold by the assessee only to the supermarket and not in any other eating house of the assessee.

Concluding Thoughts

Given the backdrop of the decision by the ECJ and the issue at stake for the various outlets, the following course correction is suggested:-

1. The 5% rate without ITC should be an option and there must be an alternate 12% or 8% rate with ITC.
2. Alternatively, an outlet must be permitted to charge the GST rates applicable to sale of pre-packed food, reheated cooked food and beverages and avail ITC.

3. If none of the above are implemented, restaurants should explore whether the 5% rate can be perceived as a concessional rate through a conditional exemption Notification since 11/2017 draws its power both from Section 9 and 11. The logical corollary would be the possibility of foregoing the conditional exemption; paying the full rate of 18% and availing ITC.

As a tail piece, COVID-19 has snatched away the pleasures of fine dining and dine-in and the public have adjusted to packed food that is delivered home. While only 5% is being charged, with a fall in sales on account of absence of footfalls, restaurants are struggling even more as they have to pay GST on the rentals, maintenance and other services which do not qualify for ITC. Hence, the sector is in need of some serious relief.