TAT rules against the restriction of stock-in-trade to raw materials for the claim of input VAT

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KPMG Nigeria

On 10 February 2022, the Tax Appeal Tribunal (TAT or "the Tribunal") sitting in Lagos, ruled in *CHI Limited (CHI or "the Appellant")* and *Federal Inland Revenue Service (FIRS or "the Respondent")* that *stock-in-trade* as provided in section 17 of the Value Added Tax (VAT) Act for the purpose of determining input VAT allowable as a deduction from output VAT is not limited to raw materials, but includes the input VAT incurred on purchase of natural gas and diesel, short term spares and other manufacturing consumables.

Background of the Case

In September 2020, CHI wrote to the Tax Policy and Advisory Department of the FIRS requesting for permission to recover the input VAT incurred on the purchase of natural gas and diesel, short-term spares and other manufacturing consumables used in the manufacturing of its products against the output VAT charged on the sale of the products. The FIRS rejected the request on the basis that the expenses under consideration were production overheads and, therefore, did not qualify as stock-in-trade or raw materials for input VAT recovery purpose.

Dissatisfied with the FIRS' position, the Appellant sent a subsequent letter urging the FIRS to reconsider its position, but this was also rejected. Following the impasse, CHI filed an Appeal before the TAT seeking the following reliefs:

1. A declaration that the Respondent's construction or interpretation of section 17 of the VAT Act is wrong in law.
2. A declaration that the Respondent's decision that the Appellant cannot claim input VAT incurred on natural gas, short term spares and other consumables used in the direct production of its products in line with section 17 of the VAT Act is wrong in law.
3. A declaration that natural gas, short term spares and other consumable used by the Appellant in the production of its product constitute stock-in-trade.
4. A declaration that natural gas, short term spares and other consumables which form the Appellant's stock-in-trade are used in the direct production of its goods to the extent that they can be allocated to direct production.
5. An order directing the Respondent to henceforth grant the Appellant's claim of ₦173,433,562.14 input VAT incurred on natural gas used in direct production as well as input VAT incurred on short term spares and other consumables also used in the direct production of its products.
6. An order directing the Respondent to account for and refund all VAT that were wrongly collected by the Respondent.
7. An order for the payment of interest on all VAT wrongly collected by the Respondent.
8. An order restraining the respondent from imposing or insisting that VAT be imposed on natural gas.

CHI argued that the FIRS misinterpreted section 17(1) of the VAT Act by wrongly equating stock-in-trade to raw materials. Although stock-in-trade was not defined by the VAT Act, the legislature did not intend for stock-in-trade to mean only raw materials, otherwise, it would have used raw materials in the section instead of stock-in-trade. Stock-in-trade, based on its definition in multiple dictionaries, has a broader meaning that includes inventory, overhead, capital assets and raw materials. Therefore, it cannot be interpreted to mean only raw materials.

Further, the FIRS' position that the relevant costs are overheads and are not eligible for input VAT recovery based on Section 17(2) of the VAT Act is incorrect given that the section uses the phrase *"which otherwise can be expended through the income statement (profit and loss accounts)"* in qualifying the ineligible overhead costs. Thus, overhead costs which cannot be expended through the income statement and are used in direct production of a new product qualify as stock-in-trade for input VAT recovery as provided in section 17(1).

Based on the above, the Appellant is entitled to recover the input VAT incurred on natural gas, spares, and consumables which were directly linked to its finished products from the output VAT charged on the products. The Appellant also stated that that the *2020 VAT Modification Order* in force at

the time exempted natural gas from VAT and, as such, the Appellant should not have been subject to VAT on the gas it purchased.

The FIRS, however, argued that the ordinary meaning of legal terms could not be determined by the dictionary, and asserted that the provisions of the Act were clear and unambiguous and required no interpretation by the TAT. According to the Respondent, allowable goods must form part of the raw materials used directly to produce a new product. Therefore, the allowable input VAT claimable by CHI, a fruit beverage and dairy producer, must be limited to its raw materials, i.e., fruit concentrates and other ingredients used in the direct production of fruit juice. Further, the FIRS opined that the definitions provided by multiple dictionaries were skewed and out of semantic context citing, in its defense, the TAT ruling in *Nigerian Breweries Plc v FIRS.* (2019)[1] , where the Court equated stock-in-trade with raw materials.

Finally, the FIRS argued against the assertion that natural gas is exempted under the *2020 VAT Modification Order,* stating that the Order was unconstitutional based on the judgement of the Federal High Court in *Registered Trustees of Hotel Owners and Managers Association of Lagos Vs Attorney-General of the Federation* where it was decided that the Minister of Finance lacks the power to amend an Act of the National Assembly.

Issues for Determination

Based on the prayers and arguments submitted by the parties, the TAT adopted the Appellant's issue for determination as follows:

Whether, having regard to the provisions of Sections 16 and 17 of the VAT Act, the Appellant is not entitled to recover, from output VAT, the input VAT it incurred on natural gas, short term supplies and consumables which are used directly to produce goods (on which output VAT is charged)?

TAT's Decision

After considering the arguments of both parties, the TAT held that:

(i). the FIRS was incorrect to equate raw materials to stock-in-trade. Given that laws are constructed strictly, the lawmakers cannot be assumed to have used the term *"stock-in-trade"* haphazardly.

(ii). since the VAT Act did not define stock-in-trade, it is proper to resort to the dictionary definitions for guidance. The Tribunal also dismissed the FIRS' position that sought to denigrate the importance of dictionaries in the interpretation of the provisions of statutes.

Based on the definitions provided by the *Black's Law Dictionary and Words & Phrases Legally Defined*, the TAT noted that the phrase *"stock-in-trade"* includes *"resources or assets used to operate a business".* Hence, the phrase is more encompassing and broader in scope than raw material. For a manufacturing business, stock-in-trade includes tools, supplies, production equipment as well as raw materials, work-in-progress and finished goods.

(iii). the natural gas, short term spares and other manufacturing consumables used in the production of the new products form part of CHI's stock-in-trade to the extent that they have a direct and immediate link with the new products. Therefore, CHI is entitled to recover the input VAT incurred on the relevant costs from the output VAT charged on the sale of the new products.

(iv). there is an intersection between stock-in-trade and overhead. While stock-in-trade may include production overhead, not all overheads are stock-in-trade. Therefore, a company may recover the input VAT incurred on overhead against it output VAT provided that it meets the requirements specified in section 17(1) of the VAT Act, that is, the overhead constitutes the stock-in-trade used in the direct production process of new products on which output VAT is charged; and it is not to be expensed via income statement or relates to a capital expenditure which should be capitalised along with the cost of the asset.

Finally, the TAT granted reliefs 1 to 4 and 6 in favour of the Appellant, but modified relief 5 as an order directing the FIRS to allow CHI to claim the input VAT incurred on the relevant costs under dispute. The TAT refused reliefs 7 and 8.

Comments

The TAT decision will have significant implications on the VAT returns filed by taxpayers, especially manufacturing companies. The judgement changes the long-held basis for interpretation of qualifying items under section 17 of the VAT Act for input VAT recovery. The VAT principle underscores that the ultimate burden of the tax should be borne by the final consumer, therefore, companies are entitled, as much as possible, to recover the input VAT incurred in the process of production.

The judgment also provides precedent for what would constitute stock-in-trade for manufacturing companies. The practice and position of the FIRS had been to equate stock-in-trade to only raw materials used in the production process while treating other direct costs as overheads, which do not qualify for input VAT recovery. This position has been implemented by most manufacturing companies until now.

However, the TAT's judgment has now clarified that stock-in-trade extends beyond raw materials and includes tools,

1 Appeal number: TAT/LZ/VAT/020/2016

supplies and production equipment, work in progress and finished goods to the extent that they have a direct link with the production of a new product on which output VAT is charged.

Interestingly, in the case between *Nigerian Breweries v FIRS* (Appeal No.: TAT/LZ/VAT/020/2016) referenced by the FIRS in its argument, the TAT had stated that stock-in-trade equates to raw materials when it pronounced as follows:

"…it is pretty clear and unambiguous that, the intendment of the crafters of Section 17(1) of the VAT Act, as regards the use of the term "stock-in-trade," is to the extent that, such stock- in-trade, as a matter of fact, approximates an input raw material, that is eventually converted into finished products…"

However, it is important to note that while the current appeal relates to the eligibility of direct overhead costs for input VAT recovery, the crux of the matter in *Nigerian Breweries v FIRS* case was whether fixed assets purchased for use in production of goods for sale constitute stock-in-trade for the purpose of input VAT recovery. Clearly, the provisions of Section 17(2)(b) of the VAT Act already resolves the question by precluding VAT incurred on any capital item and asset from input VAT recovery. Specifically, Section 17(2)(b) of the VAT Act provides that *"any capital item and asset which is to be capitalized along with the cost of the capital item shall not be allowed as a deduction from output VAT."* Therefore, the basis of the TAT's decision was different given the issues under dispute in that case.

The judgment may lead to a number of companies reviewing their previously filed returns to determine if they may have underclaimed their input VAT and thus need to file revised returns to reflect their actual position.

Another interesting development from the case is the FIRS' argument that the *VAT Modification Order* is illegal based on the Federal High Court's decision that the Minister lacks authority to revise laws of the Federation in the case between *Registered Trustees of Hotel Owners and Managers Association of Lagos Vs Attorney-General of the Federation of the Federation & Minister of Finance* (please read our newsletter *Issue No. 9.7 of September 2020* for details of the judgement). The above position contradicts FIRS' current practice given that they still implement the provisions of the *VAT (Modification) Order,* 2021 and similar Orders issued by the Minister.

Finally, the judgement reiterates the importance of taxpayers challenging the tax authorities on the appropriate interpretation of the provisions of the law. It is hoped that the positive outcome of this case will encourage taxpayers to seek an administrative or judicial review of the interpretation of tax laws by the Tribunal or the courts, when they are dissatisfied with the position of the tax authorities.

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