A Review of the CHI Limited Case and Its Impact on Discos' Claim of Input VAT

Overview of the Nigeria's Power Sector

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The ability to claim input Value Added Tax (VAT) has been a contentious issue in the power sector since privatization. The issue started with whether electricity can be classified as a good and or service and the impact the classification may have on the ability of companies in the sector to make any input VAT claim. This issue has indirectly been resolved in favor of the fact that electricity is a good. We used the term indirectly because of the manner of the resolution.

The VAT (Modification) Order 2021 provided some clarity on the application of VAT across the value chain which then formed a basis for addressing the issue. The Order modified the First Schedule to the VAT Act by expanding the list of exempt goods to include gas supplied to Generating Companies (GenCos), electricity generated by GenCos and supplied to Nigerian Bulk Electricity Trading Company (NBET), and electricity transmitted by the Transmission Company of Nigeria (TCN) to Distribution Companies (DisCos).

The inclusion of electricity supplied to the list of exempt goods in the VAT Act should put to rest the argument as to whether it is a good or a service. It is a good, at least according to the VAT Act. You must be a good before you can be an exempt good.

However, this has not resolved all the input VAT issues which impacts the sector. In fact, it can be argued that this has opened discussions on another issue. However, to understand the new issue, it is important we first consider the provision of the law on the claim of input VAT and the details of a relevant case.

Review of the Nigerian VAT Provisions

Companies can, under the Nigerian VAT Act, offset their allowable input VAT against output VAT before remitting the balance to the Federal Inland Revenue Service (FIRS). However, for input VAT to qualify as allowable for offset against output VAT, it must be related to:

1. Goods purchased or imported directly for resale, or

2. Goods that form the stock-in-trade used for the direct production of any new product on which the output tax is charged.

The above conditions have one thing in common - goods. Therefore, unless the input VAT was incurred on "goods", it should not qualify as an allowable input VAT that can be offset against output VAT. Also, the output on which the input VAT can be recovered must be charged and collected on "goods". Therefore, if either the input or output VAT is charged on a service, the input VAT cannot be recovered against the output VAT collected.

Fortunately, the goods question has been resolved.

Key Highlights of the CHI Limited Case

The Tax Appeal Tribunal (TAT) sitting in Lagos ruled, in February 2022, in the case of CHI Limited (CHI) vs FIRS, that stock-in-trade as provided in Section 17 of the 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. CHI had challenged the FIRS' interpretation of Section 17(1) of the VAT Act that the allowable input VAT claimable by the Company, a fruit beverage and diary producer, is limited to raw materials. CHI contended that its allowable input VAT includes VAT incurred on its stock-in-trade such as natural gas, spares, and consumables which were directly linked to its finished products.

The TAT in making its decisions provided some valuable clarifications on the issue. It noted that the concept of stock-in-trade extends beyond inventory and encompasses all tools, equipment, materials, and other consumables used ***in the direct production of a new product on which output VAT is charged.*** The TAT relied on the definitions provided by the Black's Law Dictionary and Words & Phrases Legally Defined, for additional clarification on the term "stock-in-trade" and this includes "resources or assets used to operate a business".

Hence, the TAT concluded that the phrase is more encompassing and broader in scope than raw material, and for a manufacturing business, stock-in-trade includes tools, supplies, production equipment as well as raw materials, work-in-progress and finished goods.

DisCos and the Manufacturing Debate

The above case appears straight forward for GenCos. There is little debate about the actual generating activity and the fact that it is akin to manufacturing as the GenCos use gas, a raw material, several complex machines and turn it into electricity which is a new product, different from the gas.

However, this argument is not very straightforward when it comes to DisCos. Some would even say that there should be no argument whatsoever because DisCos are trading companies which buy and sell a good – electricity. Therefore, there is no nexus between their operations and the CHI case. But is this true?

The Black's Law Dictionary 9th Edition defines manufacture as "the production of articles for use from raw or prepared materials by giving such materials new forms, qualities, properties or combinations, whether by hand labour or machine".

It appears from the above definition that for a process to qualify as manufacturing, the new product must be different from the input resources or transformed into a new and different product as a result of the manufacturing process.

DisCos, though, will argue that they meet these criteria. Yes, it is electricity they receive from the TCN, but can they pass the electricity in the form and quality in which it is received to your homes, factories, and offices? Will consumers be able to utilize the electricity in that form? The answer clearly is No! Unless we are willing to deal with potential fire outbreaks and destruction to high value equipment. Also, the process of converting the power to usable form in our homes, factories and offices is not straight forward. A mix of complex equipment, transformers, substations, and the likes are involved in this process. It is therefore arguable that a DisCo cannot be solely described as a trading company. They are also a manufacturing entity.

Others have argued that yes, the DisCos get involved in a significant conversion process but at the end of the day, power is power. There is no new product.

Conclusion

It is no longer news that the Nigerian Electricity Supply Industry (NESI) is plagued with several challenges that has continued to impact its liquidity. This has also had a significant impact on the ability of the players to invest in the development of the network that is urgently required to scale and transform the industry. As you would expect, the brunt of these challenges is felt by customers and by extension the entire country as it is impossible to drive meaningful economic growth without constant and reliable power.

It is therefore important for the NESI to consider any opportunity to generate much needed extra cash for investment purposes. DisCos and GenCos spend significant sums on items that may qualify as stock in trade. GenCos would have to begin to engage their tax advisers to assist to conduct a review of their records and determine the items that would qualify for the claim of input VAT and probably file a claim for any input VAT lost in the past.

DisCos though, would need to obtain clarity on their ability to claim, given the issue stated above and see how much they can unlock for further investments in their network.

For further enquiries on the above and information on how KPMG can assist you, please contact:

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