KTBA Karachi Tax Bar Association

25th OF 2024 KTBA ONE PAGER CASE LAW UPDATE (OCTOBER 31, 2024)

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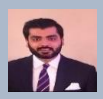

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Dear Members,

A brief update on a judgment by the Appellate Tribunal Inland Revenue, Peshawar on **"Input Disallowance is Prerogative of the Government. It is Not Allowed for Goods not Directly used in Taxable Supply"** is being shared with you for your knowledge. The order has been attached herewith the update.

This update is in line with the efforts undertaken by our **"CASE LAW UPDATE COMMITTEE"** to apprise our Bar members with important court decisions.

You are equally encouraged to share any important case law, which you feel that should be disseminated for the good of all members.

You may contact the Committee Convener Mr. Shams M. Ansari or at the Bar's numbers 021-99212222, 99211792 or email at info@karachitaxbar.com & ktba01@gmail.com

(Syed Zafar Ahmed)
President

(Asim Rizwani Sheikh)
Hon. General Secretary

25th OF 2024 KTBA ONE PAGER
CASE LAW UPDATE
(October 31, 2024)

INPUT DISALLOWANCE IS PREROGATIVE OF THE GOVERNMENT. INPUT NOT ALLOWED ON GOODS NOT DIRECTLY USED IN TAXABLE SUPPLY.

Appellate Authority: Appellate Tribunal Inland Revenue, PSH
Appellant: CIR (Corporate Zone), RTO, Peshawar.
Respondent: Gadoon Textile Mills Limited
Sections: 8(I)(h) & (i) of Sales Tax Act, 1990 and SRO 450 of 2013 dated May 27, 2013

Detailed Judgment was passed on October 10, 2024

Background: The respondent submitted a sales tax refund claim under Section 10 of the Sales Tax Act, 1990 (the Act). The STARR/CREST system raised certain objections based on which the assessing officer issued a show cause notice invoking provisions of Section 8(1)(h) and (i) of the Act read with SRO 450 of 2013. The notice questioned the validity of the refund pertaining to the input tax claimed on textile machinery, wires, cables, office equipment and steel pipes. The reply of the Respondent could not attain satisfaction of the assessing officer who confirmed the violations and rejected the sales tax refund of Rs. 454,809/-. The Commissioner Inland Revenue, Appeals (CIRA) vacated the impugned tax demand raised under the SRO 450 of 2013. Aggrieved, the department challenged the CIRA's order before the Appellate Tribunal Inland Revenue (ATIR).

Decision of the ATIR:
First Ruling of the ATIR:
Section 8 takes precedence over Section 7 due to the non-obstante clause:

The ATIR ruled that the non-obstante clause in Section 8(1) of the Act restricts input tax deductions for specific goods as identified in SRO 450 of 2013. The input tax pertaining to items that are not directly used in manufacturing of taxable supplies cannot be claimed in presence of an expressed bar on input adjustments under section 8(I) (h) &(i) of the Act. The ATIR clarified that items such as electric spare parts, wires, and cables do not qualify as goods for direct use in the production or manufacture of taxable good as the term "direct use" typically refers to the use of an item as a raw material, component or supply in the production process, as opposed to its use in a general or administrative sense.

The ATIR cited the AMZ Spinning case to reinforce that input tax adjustments could very much be denied for items integral to the production process.

Second Ruling of the ATIR:
It is the Legislature's Prerogative to Permit or to Deny any Input Tax Adjustments

The ATIR emphasized upon the legislative prerogative of the Federal Government to specify goods to prohibit input tax adjustments on its own discretion. Section 8(I)(b) of the Act highlights the mandate conferred upon the Federal Government to decide entitlement or disentitlement of input tax claims. The ATIR cited the ruling in Rajby Industries and affirmed that the restrictions imposed by the Federal Government fall within its lawful jurisdiction under the Act.

Conclusion:
The ATIR ruled in favor of the tax department affirming the rejection of sales tax refund claim. The ATIR emphasized that Section 8(1) of Act, with its non-obstante clause, takes precedence over Section 7, thereby restricting input tax deductions for specific goods outlined in SRO 450 of 2013 not directly used in the production of taxable supply is legal. The ATIR also highlighted the legislative authority of the Federal Government to designate goods eligible for input tax adjustments.

APPELLATE TRIBUNAL INLAND REVENUE, PESHAWAR,
(Single Bench)

STA No.76/PB/2018
(Tax Period- July-2016)

****

Commissioner I.R (Corporate Zone), RTO, Peshawar.	Appellant
Vs	
M/s Gadoon Textile Mills Ltd., Gadoon Amazai, Swabi.	Respondent

Appellant By:	Mr. Aziz ur Rehman, DR
Respondent By	Mr. Usman Gul, G.M
Date of Hearing:	10.10.2024
Date of Order:	10.10.2024

O R D E R

M. M. AKRAM (MEMBER): The titled appeal has been filed by the appellant department against the impugned Order in Appeal No.177/2018, dated 15.02.2018, passed by the learned Commissioner Inland Revenue (Appeals), Peshawar for the Tax Periods 07/2016 on the grounds as set forth in the memo of appeals.

2. The brief facts giving rise to the appeal are that the respondent, a company engaged in manufacturing cotton yarn with an industrial unit in Gadoon Amazai, Swabi, regularly files monthly sales tax returns. For the tax period of July 2016, the company submitted a sales tax refund claim under Section 10 of the Sales Tax Act, 1990. However, the STARR/CREST system raised objections based on Section 8(1)(h) & (i) of the Act, read in conjunction with SRO 450(1)/2013 dated May 27, 2013. The appellant department subsequently issued a show cause notice (C.No: T050716100004/32 dated April 26, 2017), alleging violations of Sections 4, 7, 8(1), 10, 26, and 73 of the Sales Tax Act, 1990, as well as SRO 450(1)/2013. The notice also questioned why the refund should not be rejected and why penal action should not be taken for these violations. After providing the respondent the opportunity to be heard and considering their explanations, the assessing officer issued Assessment Order No. 49/2017 dated

August 7, 2017, confirming the violations and rejecting the sales tax refund of Rs. 454,809. Dissatisfied with the decision, the company filed an appeal with the Commissioner Inland Revenue (Appeals). In the order dated February 15, 2018, the Commissioner vacated liabilities amounting to Rs. 348,725 under SRO 450(I)/2013. The appellant department, aggrieved by this decision, filed an appeal before the tribunal, challenging the order on various grounds.

3. The case was heard on 10.10.2024. Mr. Aziz ur Rehman, DR, represented the appellant department in the appeal, while Mr. Usman Gul, General Manager of Gadoon Textile Mills, appeared on behalf of the respondent/registered person. The learned DR strongly contended that a somewhat similar issue of input tax had recently been settled by the Hon'ble Supreme Court of Pakistan in the case titled ***M/s Rajby Industries, Karachi, etc. vs. Federation of Pakistan and others*** (CP No. 4700, 310-K to 314-K, 423-K to 426-K, 553-K, and 493-K of 2021) through an order dated June 1, 2022, which was decided in favor of the department. He further argued that the Peshawar High Court, in its decision on STR No. 49-P/2023, did not take into account this Supreme Court judgment. Additionally, concerning input tax under section 8(1)(h), the learned DR referred to an unreported judgment of the Sindh High Court in the case ***M/s Continental Biscuits, etc. vs. Federation of Pakistan & others*** (CP No. D-1916/2016). Considering the aforesaid judgments, the learned DR urged that the appeal filed by the department should be accepted.

4. In contrast, the learned AR for the respondent argued that the company had purchased electric spare parts for textile machinery, wires, cables, office equipment, steel pipes, etc, all of which were intended to be used in furtherance of taxable activities. He further pointed out that this issue had recently been settled by the Hon'ble Peshawar High Court in ***M/s Gadoon Textile Mills Ltd vs. Deputy Commissioner IR, RTO, Peshawar***, (STR No. 44-P/2023). In its order dated September 20, 2023, the court observed that items like electric

wires, pipes, and cables, when used in machinery or for the maintenance of machinery involved in production activities, should not be denied input tax adjustment. He, therefore, contended that the appeal filed by the department be dismissed.

5. We have heard the parties and examined the record. The main issue in the instant case pertains to the admissibility of input tax by the learned CIR(A) claimed on account of the purchase of electric spare parts for textile machinery, wires, cables, office equipment, steel, etc goods which are specifically prohibited under section 8(1)(h) & (i) of the Sales Tax Act, 1990 read with SRO.450(I)/2013 dated 27.05.2013. Since the primary activity of the respondent is the manufacturing and sale of textile yarn, these items were considered not to be directly used in the production of yarn. Before addressing this issue further, it is important to examine the framework of the Act.

SCHEME OF THE ACT

6. The Sales Tax Act, 1990, introduces an indirect tax levied, charged, and collected on imported goods or taxable supplies of goods. The supplier collects the tax on behalf of the government, but the ultimate burden falls on the consumer of the imported or taxable goods. Section 3 of the Act outlines the foundational principles of sales tax: first, the tax amount is based on the value of goods imported into Pakistan or taxable supplies made by a registered person; second, the tax becomes chargeable when goods are imported or when a registered person makes taxable supplies as part of a taxable activity; and third, the responsibility to pay the tax lies with the importer of goods or the supplier of taxable goods within Pakistan. The Sales Tax Act operates under a value-added tax (VAT) model, where sales tax is only paid on the value added at each stage of production or distribution. This system allows taxpayers to deduct the input tax they have paid on goods or services used in manufacturing, producing, or marketing their taxable goods from the output tax they owe on those goods. An

essential feature of the VAT model is the ability to credit input tax against output tax, with the final output tax ultimately borne by the end consumer, as outlined in section 7(1) of the Act. Under this provision, a registered person can deduct the input tax paid or payable during a tax period from the output tax due on taxable supplies for that period. According to section 2(14) of the Act, the tax paid at the time of purchases is known as the "Input Tax" and is adjustable against the "Output Tax" under section 2(20), which is charged on the sale of finished products. Thus, the Act allows a manufacturer to claim the input tax credit for sales tax paid or payable on purchases against the output tax owed on the sales of its products, enabling the calculation of the final tax liability under section 7.

ADJUSTMENT OF INPUT TAX

7. The Sales Tax Act provides a mechanism for adjusting input tax against output tax and allows for refunds if applicable. This mechanism is primarily governed by Sections 7 (Determination of Tax Liability) and 8 (Tax Credit Not Allowed). Section 7 (subject to Sections 8 and 8B) entitles a taxpayer to deduct input tax paid or payable for the purposes of making taxable supplies from the output tax owed for a specific tax period. While there are additional restrictions and mechanisms within Section 7, they are not relevant to the current matter. Importantly, the ability to adjust input tax or claim a refund is subject to the conditions set forth in Section 8. Section 8 imposes restrictions, specifying that a tax credit will not be allowed in certain circumstances. It prohibits a registered person from reclaiming or deducting input tax unless it is directly related to taxable supplies made or to be made. Additionally, the section prevents the deduction of input tax on goods specified by the Federal Government and other similar restrictions. The Hon'ble Supreme Court of Pakistan, in the case ***M/s Rajby Industries, Karachi, etc. vs. Federation of Pakistan and others***

(CP No. 4700, 310-K to 314-K, 423-K to 426-K, 553-K, and 493-K of 2021), in its order dated June 1, 2022, made the following observations:

> "10. It is worth mentioning that Section 8 triggers and stems from a "non-obstante clause which accentuates that notwithstanding anything contained in this Act, (STA 1990) a registered person shall not be entitled to reclaim or deduct input tax paid on the goods or services which are more particularly jotted down in clause (a) to (m). In the present case, clause (b) is quite relevant which is reproduced as under:-
>
> "(b) **any other goods for services) which the Federal Government may, by a notification in the official Gazette, specify.**" [Emphasis supplied)
>
> 11. The aforementioned section spotlights the mandate conferred upon the Federal Government to decide the entitlement or disentitlement with regard to reclamation or deduction of input tax by a notification in the official Gazette. It is clearly resonating that restrictions imposed for reclaiming input tax on packing material by way of the impugned S.R.O. was not illegal, unlawful, or without jurisdiction but it was within the realm and domain of powers vested in the Federal Government under Section 8 of the Sale Tax Act, 1990." (Emphasis supplied)

8. In this case, the subject goods were initially notified under section 8(1)(b) through SRO 490(I)/2004 dated June 12, 2004, later amended by SRO 450(I)/2013 dated May 27, 2013, and are now part of the Act under sections 8(1)(h) and 8(1)(i). The respondent's main argument is that the items in question are directly used to facilitate and enhance the manufacturing of the final product, making them an integral part of the taxable supply. Therefore, when section 7 and section 8 are read together, input tax adjustment should not have been denied under the provisions of sections 8(1)(h) and (i). However, I disagree with this contention, as the issue has already been settled by a learned Division Bench of the Hon'ble Sindh High Court in ***AMZ Spinning and Weaving Mills (Pvt) vs. Appellate Tribunal, Customs, Sales Tax and Federal Excise, Karachi*** (2006 PTD 2821). The court held that due to the non-obstante clause in section 8, it overrides and takes precedence over section 7, and the denial of input tax adjustment is based on section 8(1)(b). The purpose of enacting section 8(1)(b) was to deny input tax adjustment on certain items, even

if they are used in the production of taxable goods, as the Federal Government may choose not to extend such benefits to taxpayers. The principle from this judgment also applies to sections 8(1)(h) and (i), as previously, goods on which input tax adjustment was denied were notified under section 8(1)(b). Now, in addition to a notification (SRO 450) being issued, these goods have been specifically incorporated into sections 8(1)(h) and (i) of the Act. I believe it is within the Legislature's prerogative to permit or deny input tax adjustment. For clarity, sections 8(1)(h) and (i) are reproduced below:

> "**8. Tax credit not allowed.** – (1) Notwithstanding anything contained in this Act, a registered person shall not be entitled to reclaim or deduct input tax paid on –
>
> (a) the goods or services used or to be used for any purpose other than for taxable supplies made or to be made by him;
>
> (b) any other goods or services which the Federal Government may, by a notification in the official Gazette, specify;
>
> .....
>
> **(h)** goods used in, or permanently attached to, immoveable property, such as building and construction materials, paints, **electrical** and sanitary fittings, **pipes, wires, and cables,** but excluding pre-fabricated buildings and such goods acquired for sale or re-sale **or for direct use in the production or manufacture of taxable goods;**
>
> **(i)** vehicles falling in Chapter 87 of the First Schedule to the Customs Act, 1969 (IV of 1969), parts of such vehicles, electrical and gas appliances, furniture, furnishing, office equipment (excluding electronic case registers), but **excluding such goods acquired for sale or re-sale;**"[Underlined to supply emphasis]

It can be seen that the sentence used in section 8(1)(h) i.e. ***"Goods for direct use in the production or manufacture of taxable goods"*** refers to items that are used directly in the process of production or manufacturing a taxable

product. These goods may be used as raw materials, components, or supplies in the production of process, and are typically subject to taxes when they are sold or used in the production of taxable goods. For example, if a company manufactures shoes, the leather, thread, and other materials used to make the shoes would be considered "goods for direct use in the production or manufacture of taxable goods." These goods would be subject to tax when they are sold or used in the production process. On the other hand, items that are not directly used in the production or manufacture of taxable goods, such as office supplies, or equipment, would not be considered "goods for direct use in the production or manufacture of taxable goods."The expression "Direct use" generally refers to the use of an item in a manner that is immediately necessary or essential for a particular purpose. In the context of goods used in the production or manufacture of taxable goods, "direct use" typically refers to the use of an item as a raw material, component, or supply in the production process, as opposed to its use in a general or administrative sense.

9. The intent and purpose of 8(1)(h) & (i) of the Act and so also SRO.450(I)/2013 reflects that the Legislature has decided that these materials, which have been so notified, are not a direct constituent of a taxable supply, whereas, even otherwise it is settled in the case of AMZ Spinning cited supra that Input Tax Adjustment can even be denied on materials, which are a direct constituent of a taxable supply. Similarly, to begin with, the scope of section 8, we want to clarify that unlike section 7, which is a beneficial provision for conferring a right to deduct input tax, section 8 carries certain restrictions and contains the bar on the said right of adjustment. Among others, section 8 is a safeguard to prevent misuse of the right of input tax adjustment, especially with respect to goods not directly or integrally part of the taxable supply. Reference can be made to the case of ***Collector of Customs v.Sanghar Sugar Mills***, PLD 2007 SC 517, where the Hon'ble Supreme Court held as follows:-

> "*Section 7 of the Sales Tax Act, which is a beneficial section, entitles a registered person to deduct input tax, from output tax, however, section 8 provides certain eventualities and the powers of the Federal Government through a notification in the official Gazette specify the goods under which the input tax is not available and in this respect the Federal Government while exercising powers under the aforesaid section has issued notification prescribing the goods on which the adjustment of input tax was disallowed. This may be in order to forestall the possible misuse of the input adjustment against the procurement of such goods which are not direct constituents/ingredients of the finished goods or which have multiple usages as well and also in line with the provisions of section 8 that the goods were used not for the purpose of manufacture or production of taxable goods or taxable supplies. The refusal of input tax adjustment within the purview of the legal provision or legally competent notifications do not absolve the assets from the settled/due liability.*"[Underlined to supply emphasis]

10. The unreported judgment of the Sindh High Court in the case ***M/s Continental Biscuits, etc. vs. Federation of Pakistan & others***,(CP No. D-1916/2016), where the court, in its order dated November 24, 2020, observed that;

> " *We, respectfully do not agree with this part of the judgment of the Appellate Court in as much as the Appellate Court had already arrived at a contrary conclusion after relying upon the judgment of the Hon'ble Supreme Court in the case of Attock Cement (1999 PTD 1892. "9…….However, as already discussed above, such deduction is not admissible under section 8 if the Federal Government under a notification includes the accessories and spare parts in the goods within the meaning of section 8(1)(b) of the Act.") and therefore, in such circumstances in our considered view adjudicating authority cannot take a contrary view once the Supreme Court and the High Court have already arrived at a conclusion that any input tax adjustment under section 7 of the Act is subject to section 8 ibid. Therefore, the opinion of the learned Single Judge of the Lahore High Court in Nishat Mills (2020 PTD 101) is correct and applicable to the present facts before us."*

As reproduced above, there is an express bar on input adjustment with respect to wires, cables, bars, furniture, equipment, etc in clauses (h) and (i). The exception is where such goods are directly used in the manufacturing process or goods acquired for sale or re-sale respectively. It is a well-settled canon of statutory interpretation that redundancy cannot be attributed to the words of the statute to render them superfluous or nugatory. Each and every word of the statute has to be given effect. See ***Searle IV Solution v. Federation of Pakistan***, 2018 SCMR 1444; ***Pakistan Television Corporation v. CIR, Islamabad***, 2017 SCMR 1136; ***OGDCL v. FBR***, 2016 PTD 1675 [Islamabad]. The term *direct use* has been employed by the legislature in its wisdom to formulate a fiscal policy, which cannot be rendered meaningless by this forum. Being fortified with the view of the Hon'ble Supreme Court of Pakistan in the ***Sanghar Sugar Mills case (supra)***, binding in terms of Article 189 of the Constitution of Pakistan, 1973 I am unable to agree with the learned AR for the respondent. Therefore, the impugned order of the learned CIR(A) is modified to such an extent by declaring that the input tax claimed by the respondent and comes under the ambit of section 8(1)(h) & (i) is not admissible.

11. In light of the above, the department appeal is accepted.

(M. M. AKRAM)
JUDICIAL MEMBER