

SELF EMPLOYED
&
VAT



Revenue Management Division
MFEM

Avarua, Rarotonga
Cook Islands

Ph: (682) 29365
Fax (682) 29465

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A Introduction

Value Added Tax - What is it?

VAT is a tax on spending. It is ultimately paid and borne by the final consumers of goods and services and is designed to tax their spending evenly and fairly. It is not a tax on the sellers of goods; they will simply collect the VAT on behalf of the Government.

VAT will neither favour nor discriminate against individual suppliers. The tax will be charged on virtually all goods and services whether supplied by government, business, or non-profit organisations. It is not a tax on profits and therefore profit making intentions do not come into consideration.

If you are self employed, you may be liable to register for VAT and will have certain new liabilities and responsibilities.

The booklet is designed to explain the impact of VAT on you and to provide specific information to assist you in understanding VAT and in deciding whether or not to register.

How VAT works?

In effect, VAT works in two steps:

- A registered person, eg. an electrician whose turnover is more than \$30,000 per annum, pays VAT tax on all the goods and services purchased for business use. But a credit can be claimed for this tax - therefore no VAT is borne by the electrician.
- The electrician includes 12.5% VAT in the price of all goods and services supplied and pays this amount minus the VAT on

purchases to the Revenue Management Division of MFEM (RMD) - therefore the VAT is all charged to the buyers/recipients of the goods and services.

So, every dollar you pay in VAT can be recovered if you are registered. For example, the electrician may buy light fittings, bulbs and electrical wire from a supplier for \$48 and pays that price plus \$6 VAT to the supplier.

The electrician then installs the light fittings as part of a contract with a client. He sends an invoice to the client for full contract price of \$144 plus VAT of \$18. The electrician collects this \$18 from the client, deducts the \$6 already paid to the supplier and sends the balance (ie \$12 to the RMD). However, the electrician does not have to wait until the sales invoice is paid before a credit can be claimed for the VAT on purchases on the light fittings and all other purchases, ie the credit can be claimed in the return period during which the purchases are made.

In practise, the electrician would have a number of other expenses relating to the business, eg tools, petrol, overhead expenses and would deduct all the VAT paid on these expenses from the VAT collected on sales.

Because a credit can be claimed for VAT paid on purchases, all VAT is passed on through the production and distribution chain, and only the final consumer of the goods and services actually bears the tax. Like all other private consumers, the electrician and other self-employed persons will, of course, bear the cost of VAT on all purchases made for private use.

B Registering for VAT

Who should register?

In determining whether or not they must register for VAT, self-employed persons will need to assess the nature of their activity, ie whether or not their sales are taxable, and the annual value of the sales of their goods and services. Almost all self-employed persons will probably be involved in making 'taxable' sales, ie goods and services supplied in the course of an activity (excluding hobbies or occupation as an employee) that is carried on regularly or continuously. However, income received from investments (interests, dividends, etc.) do not form part of a 'taxable activity'.

The features of a taxable activity are:

- it must be continuous or regular;
- goods and services must be sold in the future for a consideration;
- the activity can be carried on by a business, trade, manufacturer, profession, vocation, association or a club;
- profit making intentions are not relevant;

If you are unsure whether your activity is a taxable activity rather than a hobby, the RMD will assess your situation for you. If your activity is a taxable activity, and

- your turnover is not more than \$30,000 per annum, you have the option of registering or not registering for VAT
- your turnover is more than \$30,000 per annum, you must register for VAT and become a 'registered person'.

Advantage of registering

You can claim a credit or refund for the VAT which you pay on purchases, eg stationery, equipment, electricity, etc. used in your business. If you do not register, VAT will increase your costs. So you may have to put your prices up. This will not matter if you are selling to other non-registered persons, ie the general public, because your prices will be similar to or less than those of self-employed persons who register and include VAT in their prices.

It will matter, however, if you are selling to registered persons because they can claim a credit for VAT paid on their purchases, ie your sale. If you are not registered your prices may be higher to them than the prices of someone who is registered. For example, if you are a commercial artist and they wish to claim a credit for VAT on artwork you do for them. They can only do so if you are registered and charge VAT on your invoice.

Since VAT is a single rate and applies to virtually all goods and services, the calculation is relatively simple.

Disadvantage of registering

The disadvantages of registering are;

- That you will have to keep records of VAT and account for the tax to the RMD.
- You must account for VAT on assets held or kept if you cease to be registered.

Summary

If your turnover is under \$30,000 per annum, the decision as to whether you register or not depends largely on whether you sell to registered or non-registered persons.

If you sell mainly to non-registered persons, your prices will probably be cheaper than those of a registered person selling a similar service or product and you will therefore be able to remain competitive without the necessity of completing a VAT return. This will be so particularly if a large content of your selling price is the value of your own labour. You will probably be best not to register.

If you sell to registered persons, it comes down to a trade-off between the increase in costs you would have to face and the possibility of becoming uncompetitive if you opt out, and the cost of producing a VAT return each month if you opt in.

Example:

A typist who runs a typing service may presently receive \$20,000 per annum in return for services and have the following expenses in relation to the services.

	\$
Heat, Light and Power	500
Vehicle Expenses	1,200
Subscriptions	30
Publicity	400
Photocopying	250
Accountant Fees	150
Total	2,530

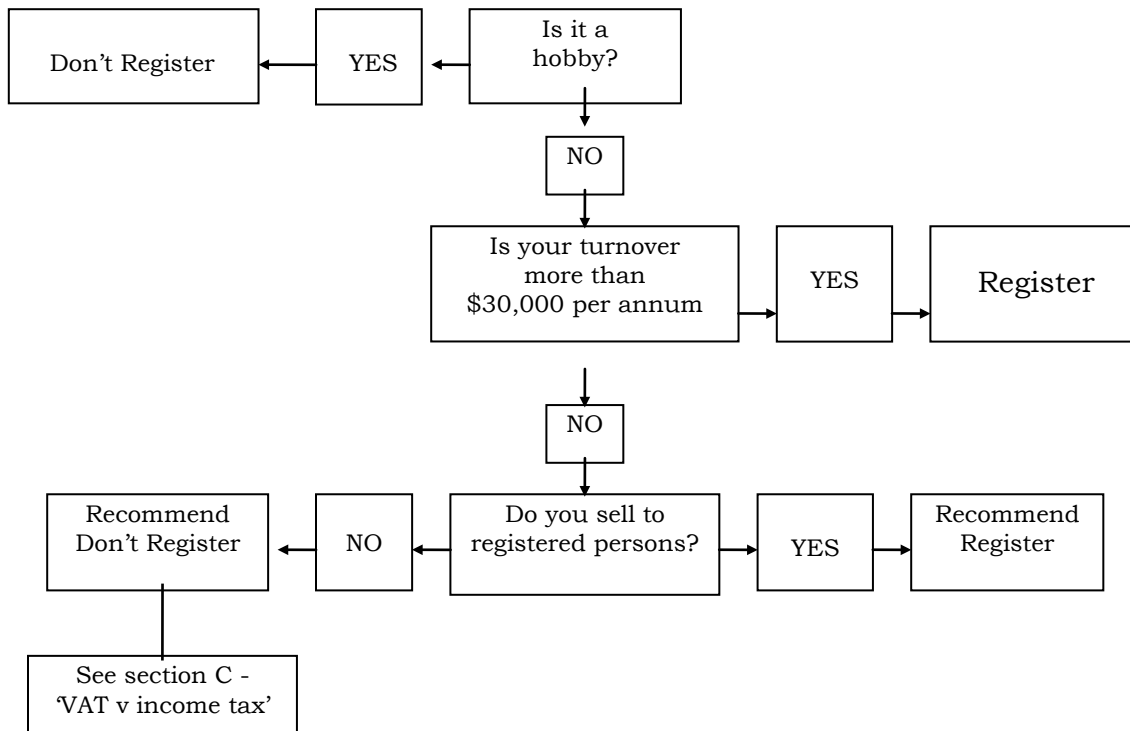
If you do not register:

- You would pay VAT on all your purchases but won't be able to claim a credit for the VAT paid.
- You would have to put up your prices to recover the extra costs or absorb them in your existing price structure. You would need to put up your prices by \$316.25 (or 12.5% of \$2530)

If you do register:

- You would be required to account to the RMD for VAT. You may need to increase your prices to cover the difference between the current turnover tax rate (equivalent to 11.1%) and the VAT.
- You would pay VAT on all your purchases but can claim a credit for the VAT paid.
- Your net cash position would be the same as at present but you would have to complete a VAT return each month. You do not have to produce accounts or a profit statement. It is simply a matter of adding up the VAT on your sales invoices (or dividing your total sales including VAT by 9) and deducting from the amount the VAT on your purchase invoices.

Should you register?



C VAT Vs income tax

The basic income tax provisions remain in place - you will pay less of it.

If you are registered:

- VAT is not a tax on your income. You are collecting taxes on someone else's spending. VAT will not generally increase your business costs.
- You do not claim expenses as such in your VAT return, but you can claim a credit for VAT paid on your purchases, eg business cards, petrol, materials. You can claim expenses (excluding the VAT) against your income in your income tax calculation in exactly the same way as before.
- Depreciation is not relevant for VAT purposes. You will pay VAT on capital purchases (eg plant and equipment) but again you may claim a credit for the VAT paid. You may claim depreciation for income tax purposes on the VAT exclusive price of an asset.
- VAT must be accounted for in the period during which the sale is made or service supplied. You have collected tax on behalf of the Government, and it must be returned to them monthly.
- You do not have to match expenditure to income - you can claim a credit for VAT on your purchases as soon as you pay for them, even if the item is still in stock when you complete your VAT return.

- Your VAT return is completely separate from your income tax return and VAT on all expenses is claimed as a credit in your VAT return. The VAT transactions are completed in each return period - for most registered persons there will be no end-of-year adjustments nor matching to income tax returns. However, if you or your accountant find that you have inadvertently omitted to claim some VAT on purchases, an adjustment can be made in a subsequent VAT return.

If you are not registered:

- VAT will be a tax on your spending, both personal and business. You will in fact be a final consumer of goods and services and cannot claim a credit for VAT paid on purchases used in your business.
- You may then claim the full cost of your expenses including VAT when calculating your income for income tax purposes.
- You may claim depreciation on the total cost including VAT paid for a capital asset.

D Who is self employed?

Anyone who is engaged, employed, or has an occupation under a contract of service does not have to register for VAT if that is his or her only source of income. Most people in this category are employees subject to PAYE.

Self-employed persons generally have no tax deducted at source on their income. Most of these people will be required to register for VAT if their annual turnover exceeds \$30,000.

In determining whether a contract of service exists the following points are considered:

- 1) Has the principal the right to control how, where, when and who is to carry out the work?
- 2) To what extent is the person an integral part of the principals business activities?
- 3) The extent to which a person is carrying on their own business. Are they exposed to normal business risks such as loss of capital, equipment, shortage of work, capital and labour overheads, liability for faulty workmanship?
- 4) In general, the provisions of any contract that may exist.

If you are unsure as to whether or not you are employed under a contract of service contact the RMD and discuss it with them.

Service or Labour only contracts

VAT is a tax on spending. When this involves the sale of goods, there is little difficulty in identifying the goods and applying the tax to the sale price. All services are also subject to VAT, but because there is no physical commodity, the transactions and their value

may not be so clearly defined as in the case of the sale of goods.

You may be selling your labour only as a service direct to the public (eg a labour contractor) or to an agency (eg. a draughts person on contract to an engineering firm). The situation here is the same for VAT as if you were producing physical goods. If you are registered, you will be required to account to the RMD for VAT on the sale of your services or on your contract price. If your contract is for \$1,000, the VAT will be \$125 making the final tax-inclusive price \$1,125. The VAT content of the price will therefore be 1/9th. The easiest way of determining the tax content of any price is to divide the total by 9. The principle is exactly the same whether there is a sale of goods or labour (ie services).

If you work through an agent, the agent will charge you VAT on his or her commission if the agent is registered. You may claim a credit for this VAT if you are also registered.

Agents

If you are acting as an agent or selling something on behalf of someone else, you charge VAT only on your agency fees or the commission you receive. It is the total of these which you should consider for the purposes of the \$30,000 threshold.

Partnerships

If your only business activity is as a member of a partnership you should not register as the partnership itself will be treated as a separate entity for VAT purposes and will generally be required to register.

E Equipment and records

The introduction of VAT will not mean that you will have to change your current method of recording sales and purchases. As business records are already kept for income tax

purposes, it should be possible to complete the VAT return form with little change to existing book-keeping systems.

Invoices

Sales to the general public will not require any special documentation.

Sales to other registered persons, on the other hand, will require a tax invoice to be issued in order that the other registered person may claim a credit for the VAT paid on the transaction, eg if you do contract work for a company, the company is entitled to ask you for a tax invoice indicating that the VAT has been charged on the contract price. The Tax Invoice is evidence that you have accounted to the RMD for the VAT and the company may claim a credit for the same amount. All registered self-employed persons will need to modify their existing invoices so that they become 'tax invoices' after the 1 July 1997 if they sell to other registered persons.

The following rules apply in relation to the issue of tax invoices:

- No tax invoice is required for sales of less than \$50 (including VAT).
- If the amount of the sale is greater than \$50 (including VAT), the tax invoice must show:

- the words tax invoice in a prominent place;
- an individual serialised invoice number;
- the name, RMD number and address of the supplier;
- the name of the recipient;
- the date;
- a description of the goods and services supplied;
- the quantity or volume of the goods or services
- either the VAT inclusive price and a statement that it includes a charge for the tax; or the price excluding tax; the tax and the price including tax.

Note that you must also keep tax invoices to support your claims for VAT paid on goods and services over \$50 that you buy yourself. However, the tax invoices do not need to be sent to RMD with each return.

Sample invoice

The following sample tax invoice is intended as a guide only. It is designed to show how the information required for tax invoices may be included in the types of invoice format currently in use in the business sector.

Raro Bottles Ltd		Tax Invoice 123	
		Date <u>1-11-97</u>	
to: <u>KARIKA VIDEO</u>		RMD Registration No:	
<u>RAROTONGA</u>		0 0 0 0 0	
Quantity:	Description:		
40	VAIORA (raspberry)	1, 000	00
VAT Charged:		125	00
Total		1, 125	00

VAT need not be shown separately, if the tax invoice indicates clearly that VAT is included in the total.

F VAT on purchases/expenses

Use of home as studio/workshop/office

If you must register or if you decide to register, you may claim a credit for VAT on all the goods which you purchase for your business. In most cases, such purchases will be clearly identifiable and the VAT credit will be easy to calculate. However, sometimes it may not be so clear-cut.

For example, you may use your home as a studio, workshop or office. VAT may be claimed automatically on purchases if the goods or services purchased are being used exclusively to produce a taxable sale. This means that the VAT on a desk, furniture or stationery, purchased specifically for a studio or office or for business use may be claimed as a credit.

Similarly, a credit can be claimed for VAT on floor coverings, paint, wallpaper, etc. in the room used as a studio, workshop or office.

Use of a private car

If a registered person buys a vehicle and considers that a portion of the VAT paid on that vehicle should be deducted as a credit, the person must make an apportionment for the purchase in the monthly return. The person must be able to provide grounds for the basis of their apportionment to RMD if requested. I.e. a log book.

G Transitional arrangements

Credit for sales tax

A full credit will be given to registered persons for the turnover tax content of trading stock and stationery held at 30 June 1997. A credit will not be given for turnover tax on:

- Goods which are part of a business's capital assets; or
- Hired goods or goods available for hire; or
- Second-hand goods

The claim may be made in any one return before the month ended 30 September 1997. RMD must be satisfied that turnover tax has been paid on goods for which a claim is made.

Pricing

Repricing during the transition period will need to take account of the removal of turnover tax on goods subject to turnover tax because of VAT.

Price tags

To avoid confusion all goods on display or advertised to the public must show an all-up

price. There are several ways of showing prices to customers but in each case the total price (including VAT) must be shown.

Sales spanning introduction

Special provisions exist for situations where the invoicing, payment for and delivery of goods and services spans the VAT introduction date. In cases where:

- Invoicing and/or payment occurs before 1 July 1997 but delivery of the goods and services takes place after that date, eg a mail order item, the goods and services will be taxable because VAT is charged at the time of delivery.
- Invoicing and/or payment occurs on or after 1 July 1997, but delivery of the goods and services takes place before that date, eg trading stock delivered before 1 July which is invoiced on 20 July, no VAT will be payable because the goods were delivered before VAT came into force.

H Guide to VAT return

Guide to VAT return preparation

Labour only contracts

VAT on sale/income calculation	
Contract Price (including 12.5% VAT)	9,000
Divide by 9	VAT
	1,000

VAT on purchases/expenses calculation	
* Purchases for business use, eg Equipment, etc.	
Overhead expenses, eg Stationery, petrol, advertising, etc.	4500
Divide by 9	500
	VAT
	500

Final calculation	
VAT on sales	1000
Less VAT on purchases	500
VAT payable to RMD	500

- VAT would be calculated by adding up the VAT on all tax invoices held for that period.

Further assistance/information

If you require further assistance in administering VAT as part of your business, the Revenue Management Division will be pleased to help you.