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# Tax alert

Estonia, Issue 32, September 2017



### *Tax Alert September 2017*

The Parliament has started proceedings to amend the Social Tax Act and Income Tax Act, which were initiated by the Government and set to become effective in the main part on 1 January 2018.

The main objective of the draft law is to incentivise carrying out business as a self-employed person. The rules for taxing a self-employed person's business income with income and social tax are to be amended. Most proposals aim to create a similar legislative and tax environment for self-employed persons as for companies and some hope to expand the tax incentives and social guarantees applicable to employees for the self-employed persons as well.

Below we provide an overview of the more important amendments.

### *Lowering the cap of social tax*

Under existing rules, the ceiling for the social tax liability calculated on a self-employed person's business income is based on the minimum salary in a calendar year multiplied by 15. The maximum social tax liability for a self-employed person in 2017 is EUR 27,918 ( $15 \times 12 \times 470$ , where 470 is the minimum full-time wage), in 2016 this amounted to EUR 25,542. The maximum liability in 2017 equals the social tax due on annual income of EUR 84,600 (gross) ( $84,600 \times 33\% = 27,918$ ). Therefore a self-employed person's business income should be more than EUR 7,050 per month ( $84,600/12$ ), to consider the amount exceeding that to be capital

income, not subject to social tax. The number of self-employed persons with this kind of business income is probably low.

The social tax cap is an attempt to divide the business income of a self-employed person into active and passive income – with the latter only being subject to income tax. This kind of rule for splitting business income to active and capital income has been in force already since 1994, but it does not adequately reflect actual active and passive income, especially in previous years when the minimum wage has increased far more rapidly compared to the average salary.

At the time of setting the cap on social tax, the minimum wage formed 17% of the average wage meaning that the maximum liability was calculated on a 2.5-times average salary, then in 2016 the respective proportion amounted to 38%, meaning that the cap was equivalent to the average salary times 6.

Since a better rule for splitting the active and passive business income of a self-employed person has not been invented, the authors of the draft law decided to simply reduce the multiplier to popularise the form of business as a self-employed person: 15 times monthly minimum wage will be replaced with a monthly minimum times 10 which is approximately 3.7 times average salary and the exceeding part is only taxed with income tax. This makes the maximum social tax liability in 2018 for a self-employed person EUR 18,612 ( $10 \times 12 \times 470 = 56,400 \times 33\%$ ), provided that the minimum monthly wage is 470 euros. According to the authors of

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the draft law, lowering the cap even more would significantly raise the risk of abuse, as employers would be influenced to form the employment relationship as business activities to cut the social tax cost.

### ***Social tax minimum liability will not arise for self-employed persons who are students***

There is a minimum of social tax payable which applies to self-employed persons and is calculated on the basis of a monthly salary of EUR 430 (in 2017). The minimum social tax liability in 2017 was 1702.80 euros ( $12 \times 430 \times 33\%$ ). This amount would become payable, if the business activities were loss making. Similarly to employees, certain self-employed persons are also exempted from paying the minimum social tax liability and the draft law extends this benefit to both under-aged and young people over 18, who are mainly engaged in studying (students, university students except for a doctoral student receiving financial aid). As a result of the amendments, these self-employed persons will not have the obligation to fulfil the minimum social tax liability and they will be able to pay social tax on actually earned business income.

The draft law will make the social tax minimum liability and the rules for calculating advance payments more flexible. That applies both to the event of temporary inability to work and starting with working in the middle of a calendar month.

### ***Self-employed person and sports club***

Currently a self-employed person is unable to deduct costs related to advancing his or her own health from business income (i.e. and entrance fee to a sports club). As of 1 January 2018 expenses incurred for the benefit of employees' health of up to EUR 100 in one quarter are excluded from fringe benefits taxation. To ensure equal treatment, the draft law expands the same exemption to self-employed persons, if the costs satisfy the conditions set forth in ITA § 48 (5<sup>5</sup>) (comes into effect 1 January 2018). If in one quarter no costs for health promotion are incurred, then the right of deduction is not carried forward to the next quarter.

### ***Self-employed person daily allowance***

Under applicable rules, a self-employed person is unable to pay tax exempt daily allowances to himself/herself when going on business trips abroad. However, ITA § 13 (3) (1) provides an employer with the right to pay tax exempt daily allowance when sending an employee on business trips abroad. The draft law aims at implementing a regulation under which a self-employed person is able to deduct documented costs related to meals from its business income and in line with the limits set under ITA § 13 (3)(1), if the business trip is of temporary nature.

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### *Self-employed person and the deductibility of promotional gifts*

Under current legislation, a self-employed person is not allowed to deduct costs related to making advertising or promotional gifts. The draft law does away with unequal treatment compared to companies and the tax exemption covering gifts for the purpose of advertising is extended to self-employed persons and will similarly be limited to the gift's value (value without VAT is 10 euros).

### *Loss carry-forward of a self-employed person*

Currently a self-employed person has the possibility to deduct costs exceeding the business income from the business income of up to 7 ensuing taxation periods. The draft law seeks to prolong the loss carry-forward period to 10 years. After ten years from making the cost, it can no longer be carried forward and the part that has not been deducted from business income will be lost. In order to avoid the retrospective and unfounded effect of the amendments, respective implementing provisions are added to the ITA.

### *The first reporting of loans issued to related parties*

ITA § 61 (55) – the transitory provision of reporting loans granted to related parties, is amended.

The said provision regards resident companies (not applicable to self-employed persons). As a result, by 20 April 2018, all resident companies must submit a respective form INF, provided by the Minister of Finance, the first declaration is to cover loans issued in the first quarter of 2018 as well as loans issued after 1 July 2017 and loans equivalent to those.

This amendment in turn is related to changes coming into force on 1 January 2018 and regarding income tax liability on loans issued to related parties if the circumstances surrounding the transaction indicate that it could be a hidden profit distribution (a substitute to the initially planned pledge income tax – for further reading, please see June 2017 Tax Alert).