The ABCs for a self-employed person

Table of contents

Business income and expenses **3**
Business income **3**
Expenses related to business **6**
Deduction of expenses and limitations thereon **9**
Expenses carried forward **10**

Business income and expenses

Income tax is charged on income derived from business, regardless of the time of its receipt. It is required to declare **all** income derived from business (both certified and non-certified).

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Business income

Business income is connected with independent economic activity.

BUSINESS INCOME IS:

- ✓ money received from the production, sale or intermediation of goods;
- ✓ income from the provision of services or other activities, including creative or scientific activity;
- ✓ financial benefits, scholarships and grants received in connection with business activity (including scholarships and grants paid from the state budget under the law and benefits received under the law);
- ✓ ARIB supports given to a self-employed person that are directly received by third parties but are supports to self-employed persons by their nature;

  Example
  In 2020, a self-employed person acquires a combine harvester on a lease basis at the price of 160,000 euros. The amount of self-financing for the self-employed person is 60,000 euros and in addition, he applies for an investment aid from ARIB for the additional investment. The amount of the support determined by ARIB (100,000 euros) is not transferred into the self-employed person's bank account, instead, it is directly transferred into the bank account of the lessor, reducing thereby the leasing obligation.
  This financial entry under the leasing contract is equalised in the accounting for taxation purposes with the receipt into the bank account and with the payment from the bank account.
  Thus, the ARIB support for the self-employed person (100,000 euros) must be indicated in the income – on the income tax return form E line „Benefits" and in expenses – line „Acquisition cost of fixed assets", i.e. the expenses made for the acquisition of fixed assets.

- ✓ any financial income received in the non-monetary form (except non-monetary benefits);

- **Example**
  Mr Karu rents out unrenovated rooms for 50 euros per month (renting out of rooms is his business income). Resulting from the contract, Mr Karu receives financial income in the amount of 30 euros in a month whereas the lessee is renovating the rented rooms instead of Mr Karu. The rest of the rent (20 euros) is offset against the renovation costs. In this case, the business income for Mr Karu is still 50 euros.

- income from rent or licence fees;
  If a taxpayer is registered as a self-employed person and the income received from rent or licence fees is her business income, such income is declared on form E. If the said income is not business income, it is declared on form A.
  On leasing or renting out their property or receiving licence fees, natural persons can make a choice whether the said activity is their business activity or not. Being a self-employed person, they can make deductions from the income received but they must pay social tax.
  If a self-employed person has entered the acquisition cost of the property to be leased or rented out into the expenses related to business, the property has not been taken into personal use and the market price of the property has not been added to the business income, the income received from the rent of such property is **always** business income.

- financial income (including interests paid by the bank, for depositing money in a special bank account);
  From 2018, income tax is charged on all interests paid by banks. If a bank has declared these interests in the tax return TSD and these data are pre-filled on form A of the income tax return, these already taxed interests shall not be declared on form E any more.

- An insurance indemnity paid in a case where the insured event occurred under non-life insurance conditions if the self-employed person has deducted the insurance premiums related to such insured event or the acquisition cost of the insured assets;

- the market price of the property taken into personal use;
  The income derived from the transfer of property or the market price of the property taken into personal use shall be considered business income if the acquisition cost or improvement costs made for the property have previously been entered into the expenses related to business.

- income received from business abroad;
  If a self-employed person earns business income in a foreign state through her permanent establishment situated in the foreign country, the income is not subject to income tax in Estonia. The income and incurred expenses are declared on form E in table 1 (choose 'V' as a method of taxation-exemption method). To apply tax exemption to such income in Estonia, the following conditions must be met:

  1. the business income has been earned through the self-employed person's permanent establishment situated in the foreign country,
  2. the income received abroad is taxed in the foreign country and this is certified,

- ✓ 3. the amount of income tax paid is indicated on the certificate.

- ✓ All other business income taxable on the basis of the Income Tax Act.
  For example, value added tax refunded by the Estonian Tax and Customs Board or settled by some other obligation shall be considered business income.

Business income may be received, *inter alia*, as a service fee on the basis of the contracts under the law of obligations (for example, a contract of purchase and sale, authorisation agreement, etc.).

Income is indicated together with value added tax on form E of the income tax return.

The accounting period for business income is the calendar year, regardless of how many months the self-employed person received income during the calendar year and whether he/she received income during engagement in business, suspension of business or after the termination of engagement in business. Thus, pursuant to the Income Tax Act, business income is taxed regardless of the time it is received.

WHAT IS NOT CONSIDERED AS BUSINESS INCOME

Whereas a natural person and a self-employed person is one and the same person, the income received by the natural person is not always considered business income of a self-employed person. Here, it is necessary to clarify for what a natural person receives income. Some examples of income which is not considered a natural person's business income:

- ✓ income from employment received from the employment or service relationship;
  In a situation where a natural person works at an employer, subordinates to the employer's leadership and control, and his/her working time and duties of employment are determined by the employer.

- ✓ income received from the transfer of securities belonging to the natural person;

- ✓ non-monetary benefits related to business and received pursuant to law (for example, a tractor granted to a farmer as a support);

- ✓ a loan taken whereas it is subject to the repayment;

- ✓ income received into a business account (not into the self-employed person's special account) in accordance with the Simplified Business Income Taxation Act. The owners of a business account have to bear in mind that they may not be engaged in the same or similar business activities as a self-employed person at the same time.

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Expenses related to business

WHAT ARE EXPENSES RELATED TO BUSINESS

Expenses are related to business if they have been incurred for the purposes of deriving income from taxable business or are necessary or appropriate for maintaining or developing such business and the relationship of the expenses with business is clearly justified, or if the expenses have been made for ensuring the occupational health and safety to the employees (in accordance with **subsection 13 (1) of the Occupational Health and Safety Act**).

In order to consider the expenses as expenses related to business, these must be:

- ✓ made by taxpayers themselves;
- ✓ made during the period of taxation when the expenses are deducted from the business income;
- ✓ certified;
- ✓ related to the business activity of the taxpayer, not to the business activity of anybody else.

EXPENSES RELATED TO BUSINESS ARE:

- ✓ acquisition of fixed assets for business activity (including any commissions and fees paid); fixed assets are assets that a self-employed person uses in production or provision of services for a longer period than one year (for example, land, buildings or civil engineering works, machinery, equipment, animals, patents, licences, etc.);
- ✓ costs for renovation and supplementation of fixed assets;
- ✓ property which is not fixed assets;
- ✓ goods acquired (including materials, raw material, fuel, energy, semi-finished products);
- ✓ services acquired (including rental charge paid for facilities used in business);

- ✓ wages, salaries or other remuneration that self-employed persons pay to their employees;
- ✓ social tax on payments made by self-employed persons to their own employees and unemployment insurance premiums of employers;
- ✓ fringe benefits granted by self-employed persons to their own employees, after payment of income tax and social tax thereon;
- ✓ social tax paid for the self-employed person's spouse participating in the self-employed person's business activities;
- ✓ other state taxes related to business (land tax, value added tax, customs duty, heavy goods vehicle tax, road toll) and local taxes (taxes established by local governments within their administrative territories, for example, sales tax, advertisement tax, entertainment tax, etc.);
- ✓ financial costs, interests paid on loans related to business or on other debt obligations (except interests paid on the basis of the Taxation Act);
- ✓ interest calculated and paid on the tax arrears to be paid in instalments pursuant to the Taxation Act after approval of the payment schedule (except interest calculated on the tax liability imposed by a notice of assessment);
- ✓ in-service training and re-training costs paid by the self-employed person for himself/herself or for the employees, if the existing professional, vocational or occupational knowledge was broadened or new skills needed in the business activities were acquired;

  Example
  A self-employed person participated in a training course on changes in the Accounting Act and acts concerning taxes and paid for the training himself. Whereas the self-employed person keeps his accounting himself, he enters the amount paid for the training into the business expenses.

- ✓ insurance premiums for the property used in the business activity;
- ✓ costs related to the transfer of the property used in the business activity;
- ✓ fees paid for licences, trading permits or activity licences, etc. used in business activity;
- ✓ social tax paid in a foreign state, if the self-employed person has submitted a certificate from the tax administration of the foreign state to the Estonian Tax and Customs Board (form A1/E101) indicating that he/she has the social insurance in the foreign state and the Estonian Social Tax Act is not applied for taxation by the social tax.

On form E, self-employed persons indicate the expenses related to business together with the value added tax paid.

WHICH EXPENSES ARE NOT RELATED TO BUSINESS

The expenses that are not considered business expenses and thus not deductible from business income are listed in the **Income Tax Act in § 34.** Such expenses are:

- ✓ income tax paid on business income (including advance payments of income tax);

- ✓ fines and penalty payments imposed on the basis of law and paid during the period of taxation, and interests paid on the basis of the Taxation Act;

  Example
  A self-employed person who provides transport services was fined for over speeding. This fine cannot be entered in the expenses related to the self-employed person's business.

- ✓ the cost of property seized from the taxpayer;

  Example
  A self-employed person sells at the market besides his own goods also cigarettes brought illegally into Estonia, for which he has paid to the mediator. The police confiscate the cigarettes. It is not allowed for the self-employed person to enter the amount paid for the cigarettes in the expenses related to business.

- ✓ environmental charges at a higher rate paid pursuant to the Environmental Charges Act and for the breach of the requirements provided by this Act or for the pollution of the environment, and the compensation for damage caused to the third person;

- ✓ expenses incurred on account of benefits not subject to income tax pursuant to the Income Tax Act;

- ✓ any loss from the transfer, at a price lower than the market price, of property to a person associated with the taxpayer, unless income tax on fringe benefits has been paid on such loss;

- ✓ any loss from the transfer, at a price higher than the market price, of property purchased from a person associated with the taxpayer;

- ✓ gratuities and bribes;

- ✓ social security taxes and contributions paid in Estonia or in a foreign country, if the objective of payment was to guarantee pension, health, maternity, unemployment, accident at work or occupational disease insurance to the person, if the Estonian Social Tax Act is applied upon taxation of business income by social tax;

- ✓ contributions to a mandatory funded pension;
- ✓ the amount paid for services to a natural person, which is taxed on the basis of the Simplified Business Income Taxation Act, i.e. through a business account;
- ✓ expenses incurred for receiving business income exempt from income tax (the income earned through a permanent establishment located in a foreign country and taxed in the foreign country) (the income declared in table 1 on form E and 'exemption method' chosen);
- ✓ calculated sickness benefit indicated in the Social Tax Act which is exempt from social tax.

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Deduction of expenses and limitations thereon

THE RIGHT TO DEDUCT EXPENSES

Self-employed persons (notaries and bailiffs included) are allowed to deduct all certified expenses incurred in relation to business during a period of taxation from their business income.

In the accounting for taxation purposes, source documents (documentary evidence) must meet the requirements provided for in **§ 7 of the Accounting Act**.

If expenses incurred are only partly related to business, only the part related to business may be deducted from business income.

If the person is not registered as a self-employed person, he/she has no right to make deductions from the business income.

It is allowed to deduct expenses incurred before the registration as a self-employed person as well, if they are related to the registration of the self-employed person, obtaining activity licences or registrations necessary for commencement of business activities.

LIMITATIONS ON DEDUCTION OF EXPENSES

On deduction of certain expenses from income, the limitations set out in the Income Tax Act should be taken into account (**§ 33 of the Income Tax Act**).

- ✓ Certified expenses incurred in connection with the provision of catering, accommodation, transportation or entertainment to guests and co-operation partners may be deducted from the business income in an amount not exceeding 2 per cent of the business income after the prior deduction of the expenses. In addition to 2 per cent, expenses made for entertaining guests may be deducted in the amount of up to 32 euros per calendar month.

- ✓ Expenses of goods transferred or services provided for the purposes of advertising may be deducted from the business income of a period of taxation if the value of the goods or services without value added tax is up to 10 euros.

- ✓ Expenses made by a self-employed person for improving his or her own health may be deducted to the extent of 100 euros in a quarter on the conditions provided for in **subsection 48 (5^5) of the Income Tax Act**. In other words, the conditions listed under the mentioned subsection apply to self-employed persons in the same way as to their employees.

- ✓ Certified expenses incurred in connection with personal meals of a self-employed person during temporary engagement in business in a foreign state may be deducted from the business income of a period of taxation, provided that prior to the engagement in the foreign state, the business was conducted in Estonia and after the engagement in the foreign state, the business will be continued in Estonia, or in other words, a substantial part of his/her business was conducted in Estonia (i.e. the smaller part than 25 per cent of the supply or the time of engagement is in a foreign state). During the first 15 days, the tax exempt limit is 50 euros per day, and beginning from the 16th day it is 32 euros per day.

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Expenses carried forward

If the total amount of the deductions allowed (specified in **subsections 32 (1)–(3) of the Income Tax Act**) exceeds the business income derived by a taxpayer during a period of taxation, the amount by

which expenses exceed business income (hereinafter expenses carried forward) may be deducted from business income during up to ten subsequent periods of taxationt (**§ 35 of the Income Tax Act**).

The period of carrying forward the expenses was extended from seven years to ten years beginning from the year 2018. The changeover to ten years takes place step by step:

- ✓ the expenses exceeding the income in 2018 may be carried forward up to 8 years,
- ✓ the expenses exceeding the income in 2019 may be carried forward up to 9 years,
- ✓ the expenses exceeding the income in 2020 may be carried forward up to 10 years.

On adjusting the business income by social tax, the amount of the social tax exceeding the taxable business income is also carried forward to the following periods on the basis of the rules of loss to be carried forward.

Example
The income before adjustment by the social tax is 385 euros. The self-employed person's minimum obligation of the social tax per year is 1,861.20 euros. The loss arising from the adjustment by the social tax is 1,476.20 euros (385 – 1,861.20 = –1,476.20) may be carried forward to the following years.

If the expenses to be carried forward incur during more than one period of taxation, such expenses should be recorded in accounting documents on a yearly basis in the order in which they incur. The records on the expenses carried forward are kept in table 3 on Form E of the income tax return.

If the amount of the expenses carried forward exceeds the business income during a period of taxation, the expenses carried forward are deducted partly from the business income, and the remaining part (or the part not deducted) should be carried forward to the following periods of taxation.

Example
In 2017, the self-employed person earned income in the amount of 10,000 euros. During the same period of taxation, the self-employed person made expenses related to business in the amount of 12,000 euros. The self-employed person declares the expenses exceeding the business income in the amount of 2,000 euros in 2017 as the amount of expenses to be carried forward. In 2018, the same self-employed person earns income in the amount of 5,000 euros and makes expenses 4,500 euros.
The self-employed person covers partly, in the amount of 500 euros, by the total net gain from business the expenses carried forward in 2017 (500 euros).
The part of the expenses (1,500 euros) not deducted from the income will be carried forward to the next period of taxation (for the year 2019). The total net gain of 2019 is 1,000 euros. With this amount, the self-employed person writes off the loss of 1,500 euros made and not yet used in 2017 by 1,000 euros, and the expenses in the amount of 500 euros, which have not been deducted from the income, are carried forward to the next taxable period, i.e. 2020.

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