# The ABCs for a sole proprietor

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# Personal property and property used for business

## DISTINCTION BETWEEN PERSONAL PROPERTY AND PROPERTY USED FOR BUSINESS PURPOSES

- During engagement in business, the property in personal use must be separated from the property used for business purposes.

- If spouses' joint property is concerned, it is important in whose name the property has been acquired. Sole proprietors have the right to deduct certified expenses made by themselves only from their business income, although the expenditure may have been made on the account of the spouses' joint property and the property acquired belongs into the joint property. Therefore, the spouse's name who is the sole proprietor must be indicated on the expense receipt certifying the expenditure related to business indicated as the person making the expenditure.

- Income received from transfer of securities is not charged as business income but as gains from the transfer of a natural person's property and must be declared on Form A of the income tax return for natural person.

Often the property is related to business only partly. Depending on the property, it may be relatively simple to divide it into legal shares according to the application and find the size of the part used just in business.

**Example**
An operator uses one room (surface area 12 $m^2$) as a working room from its apartment (total surface area 63 $m^2$). The working room is used in business only, i.e. it is not used for personal purposes. Thus, the proportion of the use of the apartment in business is 19 per cent (12 ÷ 63 x 100). If the operator makes repairs in the whole apartment, it is possible to enter 19 per cent of the expenses incurred for the repairs of the apartment into the expenses related to business (according to the proportion of the working room of the total surface area of the apartment).
If the rooms not used for business activities are repaired, the expenses incurred may not be indicated in the expenses related to business.
If the repairs are done only in the room used for business, all the expenses incurred for the repairs are considered the expenses related to business.

In several cases, sole proprietors use their property both in business and for own personal use and the property cannot be divided into legal shares. In such cases, sole proprietors themselves must determine the part of any property to be used in business.

- ✓ First, all assets and goods used exclusively for business purposes must be separated. Such properties and goods may be tools, materials, semi-finished products, etc.

- Then, it is required to separate the assets and goods which the sole proprietor uses in addition to business also for own personal use (the proportions between the business activities and personal use must be determined).

**Example**
A sole proprietor uses its automobile both for private journeys and for business purposes. He/she keeps records of journeys made for business purposes. The total distance run during the period is 50 000 km from where, according to the records kept on driving, 10 000 km had been run for business purposes. Thus, 20 per cent of the expenses incurred for the automobile may be deducted from the expenses related to business (10 000 ÷ 50 000 × 100).

The proportion of the use of the automobile for business purposes may be calculated on the basis of some other method as well.

- Finally, the proportions of the assets and goods used both by the sole proprietor and his/her family members in personal use in addition to the use for business purposes must be determined.

**Example**
A sole proprietor acquired a computer, which is used in business activity 45 per cent of the working time according to the calculations. The sole proprietor's spouse and children use the computer during the rest of the time, i.e. it is in use for activities other than business.
The sole proprietor deducted 45 per cent of the acquisition cost of the computer from the business income. It is also allowed to deduct 45 per cent of the additional expenses incurred for the computer from the business income (extensions in the hardware, new computer programs, etc.). Upon acquiring a program for the computer, it should be specified whether the program is necessary for the sole proprietor's business and if so, then to what extent. If a sole proprietor offering accounting services acquires a new accounting program, this will be business-related expenditure. Purchasing a new computer game for the sole proprietor's children is not business-related expenditure.

# Transfer of property used in business

### TAXATION OF INCOME RECEIVED FROM TRANSFER OF PROPERTY USED IN BUSINESS

If sole proprietors transfer their business-related property the acquisition cost of which has previously been entered in the expenses either partly or in full, the selling price (or the market price of some other property received through the exchange of property) of this property is considered business income and is subject to income tax.

**Example**
A sole proprietor sold a drill acquired for business purposes for the amount of 192 euros, which he had purchased for 3500 kroons in 2010 (223.69 euros). He had entered the purchase price of the drill in the expenses related to business. He indicated the amount received from the sale (192 euros) in the expenses related to business (line 1.1.4 on Form E).

If the acquisition cost of assets or goods are entered in expenses partially, the income received from the transfer or the return on sales should be indicated in the sole proprietor's income in the same proportion as the acquisition cost entered in the expenses.

**Example**
A sole proprietor acquired a smoke oven for 1278 euros. Being aware that the oven will be used for own personal use as well, the proportion of the use in business was determined as 75 per cent, so 75 per cent (958.50 euros) of the acquisition cost was entered in the expenses related to business.
The same oven was then sold for 1182 euros. 75 per cent of the sales revenue received (in the same proportion as used on purchasing), i.e. 886.50 euros (1182 x 75 ÷ 100) was added to the business income.

Likewise, based on **subsections 48 and 49 of the Income Tax Act**, sole proprietors may increase the acquisition cost of the taxed property by the amount subject to income tax during the taxable period when the property is transferred or put into use for own consumption.

**Example**
A sole proprietor buys a printing press for a market price, i.e. 15 000 euros from a legal person and pays for it 5 000 euros. The company has paid 20/80 income tax on the remaining 10 000 euros. Later, the sole proprietor decides to sell this asset for 30 000 euros. The taxable income upon transfer or use for personal consumption of such an asset is found as follows.
Upon the acquisition of the asset, the sole proprietor entered 5 000 euros in business-related expenses. In the event of transfer (or putting into use for personal consumption) of the asset, the selling/market price would be decreased by 10 000 euros and 20 000 euros (30 000 – 10 000) would be entered in the expenses related to business.

# Personal consumption of business assets

### TAXATION IN CASES WHERE BUSINESS ASSETS ARE PUT INTO USE FOR OWN CONSUMPTION

If sole proprietors decide to put into use for own consumption the business assets, the acquisition cost of which they have entered in business expenses whether partly or in full, this is equated with the transfer of property and the market price of the property is declared as business income. Any property taken into personal use must be declared as business income regardless of the fact whether it is fixed or current assets, immovable or movable property.

Personal use of business assets means the use of the assets for purposes other than business. Personal use of business assets arises, if either the person himself/herself uses the assets for other purposes than business or the assets have been given for use to somebody else.

It is possible to put business assets into use for own consumption either during engagement in business, in the case of suspension of business activities or when terminating engagement in business.

If business assets are taken into personal use, it is the market price of the assets, not the acquisition cost, that must be added to business income. The market price is added to business income during the taxable period of which the assets are taken into personal use or when the use of the assets for business purposes is terminated.

**Example**
An asset with a cost of 639 euros has been entered in the business expenses. At the time when the assets are put into use for personal consumption, the market price of the asset is 479 euros. Therefore, 479 euros should be added to the business income.

Taking into personal consumption is not the case if:

- ✓ the property is made available to third parties in return for rent as business income. In this case, the charge received should be added to business income (line 1.1.2 of Form E).

- ✓ the use of assets in business is terminated as a result of destruction, deterioration, theft, rendering unusable, etc. and there is evidence thereof.
  In this case, write-off is necessary and evidence must be accompanied by a write-off or certified statement drawn up by the sole proprietor.

- ✓ Assets belonging to the sole proprietor's enterprise are transferred or bequeathed to a person who will continue the business of the enterprise. This means that a sole proprietor may transfer his or her assets (both non-monetary and money in a special account) to any person (another sole proprietor, company) provided that the person continues the sole proprietor's business activities.

# Transfer of dwelling used for business

## TAXATION OF GAINS RECEIVED FROM TRANSFER OF A DWELLING USED AS THE PLACE OF RESIDENCE AND PARTLY FOR BUSINESS PURPOSES

The income received from transfer of the immovable the essential part of which is a dwelling is not considered a natural person’s taxable income if the person used the transferable dwelling up to the transfer as his/her place of residence.

If a natural person has used his/her dwelling partly for business purposes and entered a part of the acquisition cost of the dwelling into the expenses related to business, the corresponding part of the income received from the transfer of this dwelling is taxed.

If a sole proprietor has terminated the use of the dwelling in business and added the market price of the part entered into business expenses to the business income or has terminated the use of the dwelling in business long time ago and used it as his/her actual place of residence, then the gains received from the transfer of the dwelling are exempt from taxes in full.

**Example 1**
A sole proprietor resided permanently in an apartment the total surface area of which was 100 $m^2$. Thereby she used 70 $m^2$ of it as her dwelling and 30 $m^2$ for business purposes. The acquisition cost of the apartment was 700 000 kroons in 2009 (44 738.15 euros). The sole proprietor **did not enter** the part of the acquisition cost of the property used for business in her business expenses. The sole proprietor as a natural person sells the apartment for 63 912 euros, using the services of a real-estate agent and paying brokerage in the amount of 639 euros.
The person received gains from the transfer of the property in the amount of 63 912 – 44 738.15 - 639 = 18 534.85 euros. 70 per cent of the income (18 534.85 euros) is exempt from taxes, i.e. this part of the dwelling which the sole proprietor used as her actual dwelling. The remaining 30 per cent (18 534.85 x 30% = 5560.45 euros) is taxed as the income from the sale of the natural person’s property because the sole proprietor used a part of the dwelling in business up to the transfer.
The gains from the transfer of the natural person’s property is declared on Form A of income tax return for natural person.

Based on the information in Example 1, the gains from the transfer of the property is declared on Form A in table 6.3 as follows:

Transfer of other property

| Type of property | Address | Acquisition cost and expenses related to transfer | Sales price |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Sales of apartment (30%) | Harju County Rae rural municipality Jüri small town Ehituse 3-2 | 13 421.45 (44 738.15 x 30%) + 191.70<br><br>191.70 (639 x 30%) | 19 173.60 (63 912 x 30%) |

**Example 2**

Let us take Example 1 for a basis, where the sole proprietor resided permanently in an apartment with the total surface area of 100 $m^2$. Thereby she used 70 $m^2$ of it as her own dwelling and 30 $m^2$ for business purposes. The acquisition cost of the apartment was 44 738.15 euros. In this example, **the sole proprietor has entered** the part of the acquisition cost of the apartment used for business purposes into the expenses related to business (44 738.15 x 30% = 13 421.45).
The sole proprietor as a natural person sold the apartment for 63 912 euros, using the service of a real-estate agent, for which he paid 639 euros. As a sole proprietor, he received the gains from the transfer amounting to 19 173.60 euros (63 912 × 30% = 19 173.60). The income received (19 173.60 euros) must be declared on Form E, line 1.1.4 (Income from transfer of property used in business). The sole proprietor may enter the expenses for the services of the real-estate agent in the amount of 191.70 (639 x 30% = 191.70) in Form E, line 1.2.11 (Other expenses).