



REFORM OF INDIVIDUAL INCOME TAX AND POSITION OF  
ENTREPRENEURS

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The Fiscal Council of the Republic of Serbia published on 29 September 2022 the „Proposal of social and tax policy measures for reducing inequality and poverty risks in the Republic of Serbia“.

One of the proposed measures of tax policy for reducing inequality is doubling the limit of non-taxable salary amount, from RSD 19,300 to RSD 40,000 and introduction of non-taxable census of RSD 20,000 per month, to be granted for each household member – dependent. In order to maintain the existing level of budgetary funds, should this proposed reform of individual income tax be adopted, i.e. in order to prevent decrease of budgetary funds due to the reform, it is necessary to increase the salary tax rate from 10% to 15% in parallel with increase of non-taxable census and introduction of non-taxable census for household members-dependents.

The proposed measures correlate with the analysis published by the Fiscal Council on 1 July 2021 under the name „Two decades of individual income tax: Possibilities and need for system reform“. In this analysis, the Fiscal Council pointed out a legit remark regarding unequal tax treatment of different types of engagement (employment relationship, engagement through a service agreement or agreement on temporary and occasional activities, and other).

On the other hand, the analysis from the year 2021 does not address the matter of flat rate taxation almost at all, since it addresses it by only one paragraph where it states that the flat rate taxation option is too wide, and that this does not correspond with the good business practice principle.

The opinion of the Fiscal Council is that the tax equity principle may be compromised due to such policy, both observed in relations between citizens who pay regular taxes and contributions, and in relations among flat taxpayers who accrue significantly different levels of income.

In the analysis from the year 2021, the Fiscal Council underlines that the experts from IMF proposed, as one of the possibilities for improvement of fairness in this field, that the limit for flat rate taxation is reduced from six to two million dinars of annual turnover.

Also, and in order to avoid sudden change of conditions for a large number of taxpayers who are currently in flat tax rate system, the proposal is to introduce a “semi-flat tax rate“ system for tax payers with annual turnover between two and six million dinars. Such new taxation regime would represent a sort of compromise between the current flat tax rate taxation system and regular taxation, whereby the taxpayers would be obliged to keep simplified versions of business records and tax would be calculated on the basis of simplified rules (e.g. as percentage of turnover).

Even though there are no significant general remarks to the statement that the possibilities for flat rate taxation are set too widely, the most substantial issue of flat rate taxation is represented in the fact that the basic criteria, i.e. only criteria for flat rate taxation is the income, i.e. turnover of the tax payer.

Both the Fiscal Council and the IMF fail to identify the fundamental problem, i.e. the reason due to which entrepreneurs gravitate towards flat rate taxation, whenever possible. Fundamental reason for entrepreneurs to opt for flat rate taxation is not related to the amount of their income, but lies in the manner of treatment of expenses of entrepreneurs who are not in the flat tax rate system.

Namely, the income accrued by entrepreneurs through their business activity is used for two purposes: for covering of business expenses, but also for covering of personal (living) expenses, unlike the legal persons – companies who use the accrued income for covering of business expenses and realization of profit. However, the rules for recognition of expenditures are the same for entrepreneurs and for companies.

Therefore, the fundamental problem that leads to such broad application of flat rate taxation should not be searched for in the system of flat rate taxation, but in the tax treatment of entrepreneurs who do not use flat rate taxation system, i.e. in the manner and scope of their expenditures that may be recognized for the purposes of determining the tax base in cases when taxes are paid on the basis of actual (not flat rate) income. Namely, only expenses that are recognized in regard to companies are recognized to these entrepreneurs.

Such treatment of expenditures of entrepreneurs is not justified. In the same manner as the Fiscal Council points out and proposes that it is not justified to pose a different tax treatment of incomes of persons engaged by the service agreement, or by other form of engagement, from the one of the employees (in employment relationship), having in mind similar nature of these engagements from the perspective of the engaged person, we may pose a remark that it is not justified to treat expenses of entrepreneurs – natural persons and of companies in the same manner, having in mind different nature of these expenditures from the perspective of the income recipient.

If this issue is well thought out, it does not seem logical that the flat rate taxation system is based on flat income determined for the entrepreneur – even though the income of each entrepreneur is known and undisputable, while the expenses that entrepreneurs bear and which may be recognized (in regard to their actual expenses in connection to both business activities and living expenses) are not known, i.e. nobody takes them into consideration.

In other words, if the position of entrepreneurs - who are natural persons, on one hand, and they conduct business activities, on the other hand - would be recognized, and if specific rules for recognition of expenses (that would include living expenses) of entrepreneurs would be introduced, many entrepreneurs would abandon flat rate taxation system themselves.

For example, if we take that an average consumer basket amounts to a little over than RSD 86,000, as per the latest available data from July 2021, mere recognition of this amount as an expense would amount to a little over RSD 1,000,000 on annual level. When this amount would be applied to actual income of each entrepreneur, the entrepreneurs who accrue higher incomes would pay more taxes than the ones who accrue smaller income, while the tax relief for all of them would be obvious, thus the entrepreneurs would be motivated to leave the flat rate taxation system.

To summarize, having in mind that the income of entrepreneurs – natural persons, represents in its essence income from which the entrepreneurs cover their business expenses, as well as their living expenses, including the potential expenses of their dependents – household members, it is necessary to consider both types of these expenses when determining which expenses shall be recognized for taxation purposes.

This way, the proposal of the Fiscal Council to introduce reliefs (to natural persons) through additional non-taxable amounts for dependents – household members, could be applied to entrepreneurs as well (through additional amounts of recognized expenses), which would mean that this concept is applied fairly to all natural persons, whereby the tax discrimination of entrepreneurs, which is indisputably present in current tax policy principles, could be avoided thereof.

The costs of women entrepreneurs who decide to become mothers and have costs related to child delivery and costs which arose for those women, especially in the year when delivery occurs, could also be treated in special manner. In present atmosphere of noticeable tendency of encouraging awareness of position of entrepreneurs and present policy of inciting entrepreneurship (especially in connection with IT services provided by resident natural persons to foreign customers, which, at the same time, lowers the unemployment rate), such measure of fiscal and tax policy would be the first step in this direction.