

Varazdin Development and Entrepreneurship Agency and University North  
in cooperation with  
Russian State Social University  
Faculty of Management University of Warsaw  
Faculty of Law, Economics and Social Sciences Sale - Mohammed V University in Rabat  
Polytechnic of Medimurje in Cakovec



# Economic and Social Development

60<sup>th</sup> International Scientific Conference on Economic and Social Development –  
XX International Social Congress (ISC 2020)

## Book of Proceedings

Editors:

**Natalia Pochinok, Olga Bakhtina, Nicholas Recker**



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Moscow, 20-21 October 2020

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## **CONTENTS**

### **CHANGES TO SOCIAL PATTERNS OF BEHAVIOUR STIMULATED BY THE DEVELOPMENT OF ICT AND DIGITAL TRANSFORMATION .....1**

Samanta Kocijan, Ana Globocnik Zunac, Petra Ercegovac

### **ART INSPIRED HOTELS – COMPETITIVENESS CONTEXT AND MARKET POSITIONING.....10**

Tamara Floricic

### **EFFECT OF VISUAL MERCHANDISING ON CROATIAN CONSUMER IMPULSE BUYING BEHAVIOUR – SEM APPROACH.....26**

Rea Flegar, Damir Dobrinic, Iva Gregurec

### **THE IMPACT OF FISCAL AUTONOMY ON REGIONAL DEVELOPMENT IN THE REPUBLIC OF CROATIA.....39**

David Krmpotic, Marija Iles, Dina Bicvic

### **THE TAX ASPECT IN EARNINGS OF SOLE PROPRIETORS.....49**

Domagoj Cavric, Maja Buljat, Dario Lesic

### **BANKING SECTOR OF AZERBAIJAN: TRENDS, PROBLEMS, PROSPECTS.....59**

Zahid Farrux Mamedov, Mustafa A. Abbasbeyli, Elkhan N. Valiev, Emin N. Veysov

### **NEW STRATEGY FOR HIGHER EDUCATION FOR 2021-2030 IN BULGARIA AND CHALLENGES FOR ITS IMPLEMENTATION .....67**

Venelin Terziev

### **INDONESIAN PERSPECTIVE ON HAGIA SOPHIA .....76**

Mohammad Suryadi Syarif, Abdul Rahman A. Ghani, Jeanne Francoise

### **THE DIZZYING FREEDOM OF THE CAGELESS PRE-PARADIGM .....84**

Zoltan Baracscai, Andras Nemeth

### **STUDYING THE PERCEPTION OF THE EU MEMBERSHIP IMPLICATIONS ON CROATIA: A COMPARATIVE ANALYSIS.....92**

Petar Kurecic, Igor Klopotan, Damira Dukec

### **UNIVERSITY DEVELOPMENT STRATEGIES: COMMERCIALIZATION AND RESPONSES TO NEW CHALLENGES .....101**

Zahid Farrux Mamedov, Khalide Bayramova

### **THE PROMOTION OF DIGITAL COMMUNICATION CHANNELS BY THE TOURIST BOARD OF THE CITY OF ZAGREB .....109**

Diana Plantic Tadic, Hrvoje Ratkic, Lea Prevendar

### **THE ROLE OF FOREIGN DIRECT INVESTMENT IN TECHNOLOGY TRANSFER PROCESS AND ECONOMIC GROWTH: A THEORETICAL OVERVIEW .....120**

Petra Karanikic

## THE TAX ASPECT IN EARNINGS OF SOLE PROPRIETORS

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### ABSTRACT

*Sole proprietors represent one of the major factors in Croatia's economic development and the performance of proprietorship activities in the Republic of Croatia is regulated by the Sole Proprietorship Act. Unlike starting a company, the legal requirements for starting a sole proprietorship are somewhat simple, which makes this one of the entrepreneurs' key motivators to dive into the world of entrepreneurship by opening a sole proprietorship. Although they are small entrepreneurs, proprietors are the bearers of a large part of the national economy due to their production of goods and services, as well as providing employment opportunities for other persons in the labor market. Given the lower level of bureaucratization in business, they are far more adaptable and ready to respond quickly when faced with the numerous challenges of the modern market. The credibility of this statement is reflected in the current COVID-19 crisis, during which the cease of business has caused major market disruptions, such as the inability to get products shipped from distant suppliers as well as the termination of working positions in large scale systems, which has led entrepreneurs towards adapting their businesses in order to provide the necessary goods and services in their local market. The business adjustment consisted of changing product ranges and distribution services, which they have imaginatively and skillfully adapted to the newly developed situation. Given the aforementioned, it is clear that sole proprietors are an important factor in the national economy and as such should be met with approval. Therefore, I believe it is necessary to reduce pressure of national regulations and make it easier for them to do business.*

**Keywords:** *entrepreneurship, market and business, sole proprietorship*

### 1. INTRODUCTION

Establishing a business is often motivated by the desire of an individual to act independently and take responsibility for the success of the business, thus ensuring earnings in accordance with their arrangement. An entrepreneur copes with a greater challenge and increased responsibility for success or failure, which ultimately gives him a sense of satisfaction in building an independent business career. Performing trades in the Republic of Croatia is regulated by the Sole Proprietorship Act, which states that "a trade is an independent and permanent performance of permitted economic activities, under certain conditions, done by natural persons for the purpose of achieving income or profit generated by production, trade or services on the market. Any economic activity that is not prohibited by law is allowed in performance of said activities." The issue this final paper looks at is the uncertainty in business planning caused by frequent changes in tax policy by comparative analysis of the tax burden between 2010-2019 according to the applicable tax rates in a given period that the regulator puts on the proprietor.

In addition to the presented problem, the aim of this final paper is to explain the basic elements related to the sole proprietors' accounting and puts forward the elaboration and manner of filling in all of the accounting forms and records prescribed by law for the proprietors' accounting. This paper will look at business, legal regulation and accounting features with the application of legal regulations for craftsmen who earn income from self-employment. Special emphasis was placed on the tax aspect, taking the necessary actions that precede the preparation of the annual income tax return and its submission. This paper provides an insight into the tax burden that the regulator places on the sole proprietor and shows the problem of uncertainty in planning their business with these frequent changes in tax policy.

## **2. OVERVIEW OF PREVIOUS RESEARCH**

The progressiveness of income tax in Croatia is high compared to other countries. Understanding the importance of each individual element of the tax system in achieving progressivity can be useful in shaping tax reform. For example, if progressivity is achieved predominantly by personal deduction, as it is in Croatia, we can conclude that introducing only one tax rate per base would retain much of the current progressivity (Urban, 2006). Income tax shows up on the occasion of the inflow of income, and the payment of taxes in the phase of income generation affects the economic power of a natural person. Since taxation is based on an effort to capture economic capacity as accurately as possible, income tax could be defined as a general tax on the economic power expressed by earned income (Anđel, 1992:288). Although certain social goals are achieved, to a greater or lesser extent, by capturing the economic power of the taxpayer while respecting their certain personal characteristics, the primary goal of income tax is to collect revenue for the state treasury (fiscal goal). Finally, the right to income tax is by its characteristics an integral part of a special substantive tax law (Miljatović, 2007). Modern income tax laws are based on different principles that are important not only for tax-political application but also for legal application (Doralt, Ruppe, 2000:17-19). Certainly the most important principle and essence of the income tax system is the principle of taking into account personal economic strengths (Peterson, 2003): income, from a financial and legal point of view, is regarded as a particularly appropriate indicator of personal economic strength. Taking into account personal economic strength is one of the most important features of income tax. Lang believes that the postulate of equal taxation according to economic power leads to proportion, not progression. Progressive income tax does not serve equality, but redistribution. According to current knowledge, lower tax rates, a graded tariff with a maximum rate of 35 percent or even a flat tax with a tax rate of 25 percent achieve more tax fairness than a sharp tax progression, which in the end privileges only those who can afford a well-paid tax advisor or can withhold the entire tax by moving abroad (Lang, 2005:92). The principle of economic power as a maxim of fair distribution of the tax burden between natural persons in developed countries requires that individuals with the same economic power be treated equally with tax, and individuals with unequal economic power should be treated unequally (Blankenburg and Windisch, 2003). According to this principle, everyone should contribute to the collection of tax revenues in accordance with their individual economic strength. Individuals in the same position should be taxed the same, and individuals in a better economic starting position should be taxed higher. These two subcategories of the principle of economic power are known under the conceptual pair of horizontal and vertical justice (Beiser, 2001). If it is decided to keep the emphasis on the consumption concept, i.e. to focus taxation on labor income, then the existing system should be "cleansed" of elements that only complicate it and create an apparent image of justice. In order for a synthetic tax to survive, it is necessary to introduce a mandatory tax return or a simple tax solution. Another option would be to turn to the income concept. This would mean a comprehensive reform that would include other forms of taxation, but also economic policy in general.

The current economic crisis has highlighted a number of shortcomings in the consumer-oriented system, including a sharp drop in tax revenues. Given that the tax relief of labor is already being seriously discussed (primarily through endowments), the difference in lost tax revenues is only possible through the strengthening of the income tax. Given the tax structure, in the long run, such a trend is inevitable in Croatia (Šimović, 2012).

### **3. SOLE PROPRIETORS' AND FREELANCERS' ACCOUNTING**

Sole proprietors' and freelancers' accounting practices are based on simple bookkeeping, the main characteristic of which is the use of the "cash register principle" in recording business events, i.e. in recording receipts as income and expenditures as expenses. An exception to this principle is the acquisition of fixed assets in which expenses are recognized through depreciation in proportion to the useful "shelf-life" of the fore mentioned, just as with other entrepreneurs. Proprietors, as natural persons who perform work activities, are subject to legal regulations for the activity they perform and are obliged to keep business books. Based on the business books, by combining receipts and expenditures, reports for external users and income tax returns are compiled and submitted by the end of February of the current year for the previous year. When opening a sole proprietorship, according to the Sole Proprietors Act, " a natural person must meet the following general conditions:

- that a final court judgment, a decision on a misdemeanor or a decision of the Court of Honor of the Croatian Chamber of Trades and Crafts has not imposed a security measure or a protective measure prohibiting the performance of activities while the measure lasts;
- to have the right to use the space if this is necessary to perform the trade."

Furthermore, Article 9 of the same Act, in addition to the general conditions, prescribed special conditions that must be met by a natural person to open a business, namely:

- that they must have an appropriate level of expertise for related trades, namely: an exam on professional qualification, secondary education or a master's exam;
- that they must have specific medical fitness for trade occupations prescribed by particular laws;
- that they must have the prerogative of performing privileged trades from the competent ministry or other state body.

A person who does not meet the aforementioned requirements of the level of expertise, but meets the general requirements, should employ a full-time worker who meets the necessary conditions in order to perform the related trade. The related trade may also be performed by a person with a corresponding higher education or as an inventor under patent law. As an exception, for trades where the condition of passing the master's exam is mandatory, if they are opened with headquarters in areas of special care, in hilly and mountainous areas as well as on islands, they can be opened by persons who have completed appropriate secondary vocational education without having passed the master's exam, but with the obligation to take it within three years after the opening of the trade. When opening a trade, in addition to the conditions from the Sole Proprietorship Act, conditions from other legal regulations should be complied with, depending on the activity to be performed. When opening a trade, a written request is submitted as a form, "Application for entry in the trade register", in person or sent by mail to the County Office of Economy or the branch office of the City of Zagreb to the trade headquarters. A trade can also be registered through the online service "e-Obrt", which is an integral part of the e-Citizens system. During that process, the activity of the trade must be determined according to the "Decision on the National Classification of Work Activities 2007" - NKD 2007. The trade headquarters is considered to be the place or the address of the business premises or residence of the proprietor.

When the work activity is performed in other locations in addition to the headquarters, then these places are managed as separate plants. Based on the decision of the competent body, the proprietorship is entered in the Trade Register, which is publicly available. According to the Law on Trades, " for performing free, tied and privileged trades, a proprietor must have a proprietorship permit, while for performing privileged trades, a proprietor must also have a prerogative, or a permit. The trade may be terminated by deregistration or by force of law in accordance with Article 47 of the Trades and Crafts Act, which is determined by a decision of the competent body and deleted from the Trades and Crafts Register upon the execution of the decision." Self-employed proprietors, who keep simple books, record business events as receipts and expenditures that are determined on a cash basis according to their market value or price, which means that they are recognized after payments received or payments made. If receipts and expenditures are stated as turnover in goods, i.e. they are not paid or collected in cash, they are determined and recorded as receipts and expenditures in kind at the time of acquisition. Deviations from the cash principle occur in the acquisition of fixed assets when related expenses are recognized in a proportionate part of the useful "shelf-life" of fixed assets and are recorded in kind. Self-employed proprietors must keep business books and keep simple bookkeeping according to the cash register principle, from which the income from that activity is determined as the difference between business receipts and business expenses recorded in the Book of Receipts and Expenditures. If a tradesman is also a VAT payer, according to the Value Added Tax Act (Narodne Novine, nos. 73/13 to 121/19), VAT is calculated on the basis of invoices recorded in the Book of Outgoing Invoices, i.e. on receipts from performing craft activities (which are recorded in the Book of Receipts and Expenditures), as well as on receipts earned on the basis of other income (which are not recorded in the Book of Receipts and Expenditures). VAT is not calculated on receipts based on income from self-employment. Business books and records in the income tax system, which serve as a basis for the preparation of tax reports and determination of financial results, according to the Law and the Ordinance on Income Tax, are the following:

- the book of receipts and expenditures is a record of daily and total operating receipts and expenditures in the tax period;
- inventory of fixed assets used to determine the depreciation expenses of fixed assets;
- the turnover book is a record in which receipts collected in cash are entered at the end of the working day, and at the latest before the beginning of the next day;
- records of receivables and liabilities are records of all issued and received invoices, except those collected or paid in a way that has the characteristic of cash payment.

If craftsmen are liable to pay VAT, according to the Law on Value Added Tax, they should also keep the following business books and records:

- incoming invoice book;
- outgoing invoice book; and
- other records - records on the acquisition of goods and services within the EU, from third world countries and records for the domestic transfer of tax liability.

Proprietors in the VAT system are not obliged to provide data on receivables and liabilities, but if they keep the book of incoming and outgoing invoices according to paid or collected invoices, then they should also keep a record of claims and liabilities. Business receipts on the basis of self-employment, according to the Income Tax Act, are: all goods (money, goods, material rights, services, etc.) that the taxpayer received in the course of his tax activity in the tax period, and are determined by their market value, after receiving cash payments. Business receipts that are included in the income tax base (tax deductible receipts) are recorded in the Book of Receipts and Expenditures, depending on whether they are receipts in cash, on a gyro account



or in kind. According to Article 32 of the Income Tax Act, operating expenses on the basis of independent activities are considered to be as follows: all outflows of goods of the taxpayer during the tax period for the acquisition, insurance and preservation of business receipts that are directly related to the performance of activities, and are determined after payments on a cash basis. Operating expenses that are included in the income tax base (tax deductible expenses) are recorded in the Book of Receipts and Expenditures, depending on whether it is in cash, on a giro account, in kind or in the form of the non-tax-deductible expenses from Article 33 of the Act.

#### **4. INCOME TAX**

The basic regulations for determining and paying the income tax liability are the Income Tax Act (Narodne Novine, Nos. 115/16 to 32/20) and the Ordinance on Income Tax (Narodne Novine, Nos. 10/17 to 1). / 20.). In accordance with Article 1 of the Income Tax Act, income tax is increased by surtax, the introduction and amount of which are decided by local self-government units according to special laws. Income tax is determined according to the residence or habitual residence of the taxpayer in Croatia, and if he does not have a residence or habitual residence, it is determined according to the headquarters of the payer. According to the Income Tax Act, "self-employment income is the difference between operating income and operating expenses incurred in the tax period." Receipts and expenses are all business events that are recorded according to the cash principle in the Book of Receipts and Expenditures. These are all paid and collected receipts and expenditures in the same tax period, together with the write-off of fixed assets, i.e. depreciation expense, which is calculated on the basis of the Inventory of fixed assets. In order to determine the income, or the tax base, it is first necessary to determine the total operating receipts and total operating expenses in the same tax period, after which the Book of Receipts and Expenditures is concluded. Therefore, income is the difference between determined receipts and determined expenditures in the Book of Receipts and Expenditures. Thus, the determined income does not have to be same as the tax base on which the proprietor calculates income tax and surtax, because the Act and the Ordinance on Income Tax also regulate tax reliefs, which reduce the tax base, and as such apply to the determined income from the Book of Receipts and Expenditures.

##### **4.1. Taxpayer**

According to the Income Tax Act, "a taxpayer is a natural person who earns income", i.e. any natural person who performs an independent work activity. A taxpayer is any natural person who earns income in Croatia. This is not affected by whether the taxpayer has his habitual residence at home or abroad. No later than 8 days from the beginning and termination of activities in the competent branch office of the Tax Administration according to his residence or usual residence, the tradesman is obliged:

- to apply to the register of taxpayers, and
- to apply to the register of contributors.

From January 1, 2020, if a sole proprietor, a natural person who performs independent work activity, is a payer of income tax, performs registered work and determines income based on data from the Book of Receipts and Expenditures, such a person becomes a taxpayer of income tax at his own request, in accordance with Article 36, paragraph 1 of the Income Tax Act, or by "force of law" if in the previous tax period they achieved a total income of more than HRK 7,500,000.00, in accordance with Article 2, paragraph 4 of the Income Tax Act.

#### **4.2. Tax Period**

As a rule, the tax period for which income tax is determined and paid is a calendar year or only a part of the year in which the taxpayer operated. The annual tax return should always be filed as if it referred to the entire tax period.

#### **4.3. Income calculation**

Income from trades (as one of the sources of income) is determined according to the business books. According to the Income Tax Act, "income from self-employment is the difference between operating receipts and operating expenses incurred in the tax period." Receipts and expenditures are determined according to the cash principle and according to their market value after payments received / payments made. There must be an interdependence between operating receipts and operating expenditures, which means that the incurred expenditure should be reflected in the creation of future receipts. A self-employed proprietor who is a payer of income tax, i.e. performs a registered activity and determines income on the basis of data from the Book of Receipts and Expenditures, is obliged to submit an annual income tax return to the competent branch office of the Tax Administration, which they will submit on Form DOH no later than the end of February in the current year for the previous one.

#### **4.4. Tax base and personal deduction**

The tax base of a resident taxpayer is income from self-employment earned in the country and abroad, and of a non-resident earned in the country. In the annual income tax return, the tax base is determined by reduction of income by the amount of the basic personal deduction. The taxpayer's tax base is income from self-employment reduced by the amount of the basic personal deduction in the amount of HRK 4,000.00, on a monthly basis within the tax period for which income tax is determined. A resident may increase his basic personal deduction based on the basic deduction base in the amount of HRK 2,500.00 by applying the regulated coefficients for non-taxable parts of income in accordance with Article 14 of the Income Tax Act. Dependent immediate family members include spouses, children and parents of the taxpayer and all adults for whom the taxpayer is a guardian, provided that their annual income does not exceed HRK 15,000.00. The personal deduction of the taxpayer is increased for the amounts paid, up to the regulated mandatory health insurance contribution, as well as for the donation in the country, in kind and money transferred to the gyro account for the regulated purposes up to 2% of receipts determined by the annual tax return of the previous year.

#### **4.5. Contributions and tax rates sole proprietor**

Proprietors who perform self-employment as their only occupation are themselves obliged to calculate and pay contributions for personal insurance, as follows:

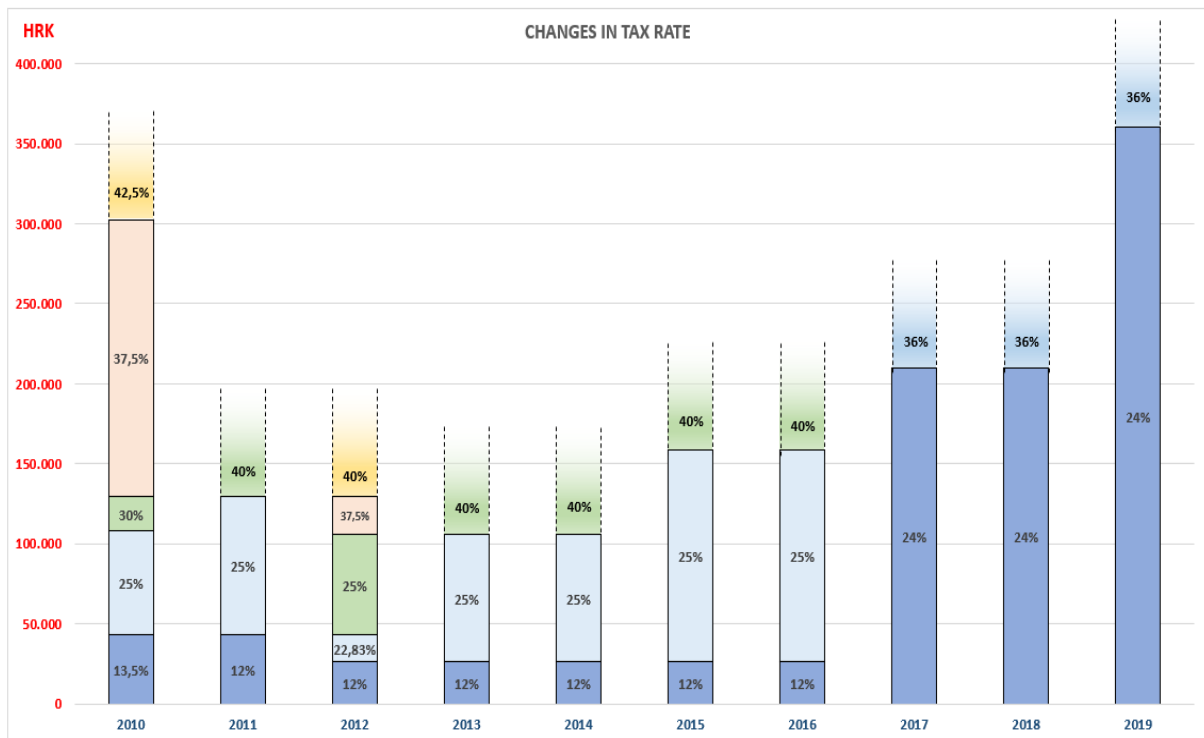
- contribution for pension insurance (15%);
- contribution for pension insurance based on individual capitalized savings (5%);
- health insurance contribution (16.5%).

Pursuant to the Contributions Act, contributions are calculated according to the monthly base rate for the calculation of contributions as a product of the average salary and coefficients. The proprietor pays the annual income tax according to the prescribed rates which, according to the Income Tax Act, are applied in relation to the tax base up to the base in the amount of HRK 360,000 at the rate of 24%, and for the base above HRK 360,000 at the rate of 36%.

### **5. CHANGES IN INCOME TAX IN THE PERIOD FROM 2010 TO 2019**

This paper will deal with a brief comparative analysis of the fictitious business results of proprietors subject to income tax with regard to changes in income tax rates and basic personal

deduction in order to compare the tax burden in the period from 2010 to 2019, or in the last ten years. The surtax tax rate for the City of Zagreb did not change during the entire period and amounted to 18%. Tax rates and tax bases in the specified tax period are shown in Chart 1.



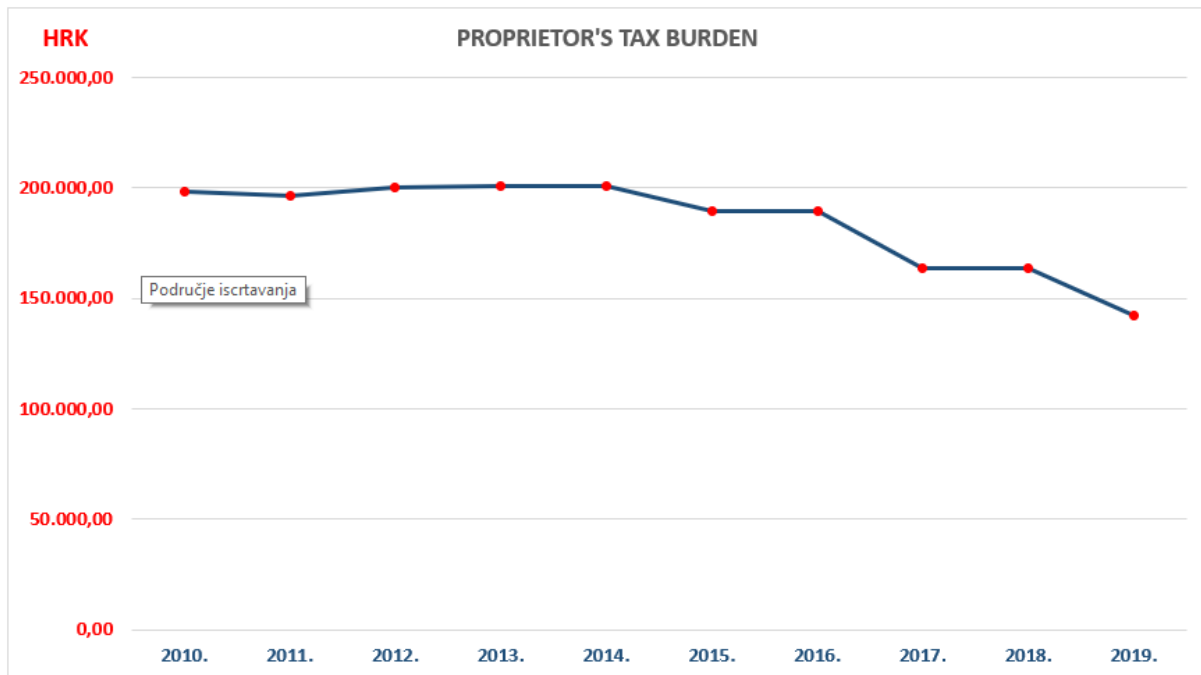
*Graph 1: Movement of tax rates with regard to the part of the tax base in the period from 2010 to 2019*  
(Source: Written by the author)

An example in this paper is a fictitious proprietor based in Zagreb, who earned an annual income from self-employment in the amount of HRK 500,000.00 and has no benefits other than the basic personal deduction. Based on this data, the annual tax liability for each year in the period from 2010 to 2019 will be calculated to compare the movement of the tax burden as shown in Table 1.

YEARS	2010.	2011.	2012.	2013.	2014.	2015.	2016.	2017.	2018.	2019.
INCOME	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00	500.000,00
PERSONAL ANNUAL DEDUCTION	21.600,00	21.600,00	25.600,00	26.400,00	26.400,00	31.200,00	31.200,00	45.600,00	45.600,00	45.600,00
TAX BASE	478.400,00	478.400,00	474.400,00	473.600,00	473.600,00	468.800,00	468.800,00	454.400,00	454.400,00	454.400,00
TOTAL ANNUAL TAX	168.112,00	166.304,00	169.523,44	170.168,00	170.168,00	160.328,00	160.328,00	138.384,00	138.384,00	120.384,00
ANNUAL SURTAX	30.260,16	29.934,72	30.514,22	30.630,24	30.630,24	28.859,04	28.859,04	24.909,12	24.909,12	21.669,12
ANNUAL TAX LIABILITY	198.372,16	196.238,72	200.037,66	200.798,24	200.798,24	189.187,04	189.187,04	163.293,12	163.293,12	142.053,12

*Table 1: Calculation of the tax burden on proprietors in the period from 2010 to 2019*  
(Source: Written by the author)

For a better visual comparison, the obtained results of annual tax liabilities are shown in the following chart:



*Graph 2: Movement of the tax burden of proprietors in the period from 2010 to 2019  
(Source: Written by the author)*

From the above data and trends in the tax burden of proprietors in the period from 2010 to 2019 (See Chart 2), there is a trend of decreasing in total tax burden from 2014, which was influenced by the increase in the basic personal deduction, and particularly the decrease in the number of tax rates, as well as the increase in the tax base at the lowest rate. The reduction in the number of tax rates itself greatly facilitates and simplifies the calculation of the tax liability. A closer examination of this data leads to the conclusion that changes in the tax system are very common and that such dynamics of tax policy are not good for the economy and long-term planning, although it is currently exhibiting a positive effect of reducing the tax burden.

## 6. CONCLUSION

Before starting a business venture, an entrepreneur must be aware of the legal norms imposed on him by the state in order to be ready in advance to meet all the requirements to avoid unnecessarily jeopardizing his business venture and investment, and thus his existence. Researching regulatory obligations within the Croatian bureaucracy is an immense task, so this paper provides potential entrepreneurs with an insight into the basic legal framework of their future business. After making the decision to open a business, a proprietor today has the opportunity to start the whole process in one place by using the e-citizen application. After finding the first clients and selling them goods and services, they would record business events in business books and records. The successful completion of the business year is followed by a new obligation to file an annual tax return. In order to further complicate this difficult process for tradesmen, regulators often resort to changes in tax policy, which imposes an additional burden on the already sufficiently expensive business by introducing new forms. The global market benefits large companies because they have opportunities for large investments in innovation, market research, promotion, etc. for which proprietors have neither enough knowledge nor capital nor employees.

The economic position of proprietors in the context of general globalization is becoming more complex every day, competition is increasing, and consumers are becoming more demanding. In such conditions of globalization, artisans serve local markets by filling the gaps left behind by large companies, but they still meet the needs of these large companies by delivering their products at the lowest prices. At the same time, they gain new customers by quickly applying innovations and being more adaptable to market changes. Taking into account all of the above as well as the fact that despite being small, proprietors still represent a significant factor in the national economy. Because they are a such an important factor in the national economy of each country and at the same time very "fragile", as they find it difficult to make a profit that would sustain them when hard times come, their way of doing business should be made easier just as they made our lives easier with their rapid reactions and adaptations to the new circumstances caused by the COVID-19 virus crisis. It would not be fair not to mention the reaction of the state in this crisis, which provided support to the most vulnerable to preserve jobs. Such a mutual and quick reaction indicates the right path for the further survival and development of sole proprietorships. Despite all the above advantages and disadvantages in the business of proprietors, without them our everyday life would be unthinkable; they do not create high technology, but provide us with a wide range of products and services that are needed in everyday life. Tax fairness achieved through a progressive system of income taxation, as well as the existence of numerous tax exemptions and tax privileges of another kind leads to a complex tax calculation procedure, which is subject to criticism from the point of view of cost-effectiveness of its collection. In order to reduce this kind of complexity, tax simplification can be expected within the traditional income tax system in the future. It can be expected that the simplification will be expressed through a partial reduction in the subjectivization of income tax (so-called personal income tax depersonalization), and a shift towards flat-rate and typifying the calculation and collection of income tax.

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