



BAZAAR ACCOUNTING AND  
MANAGEMENT ADVISORS LLC

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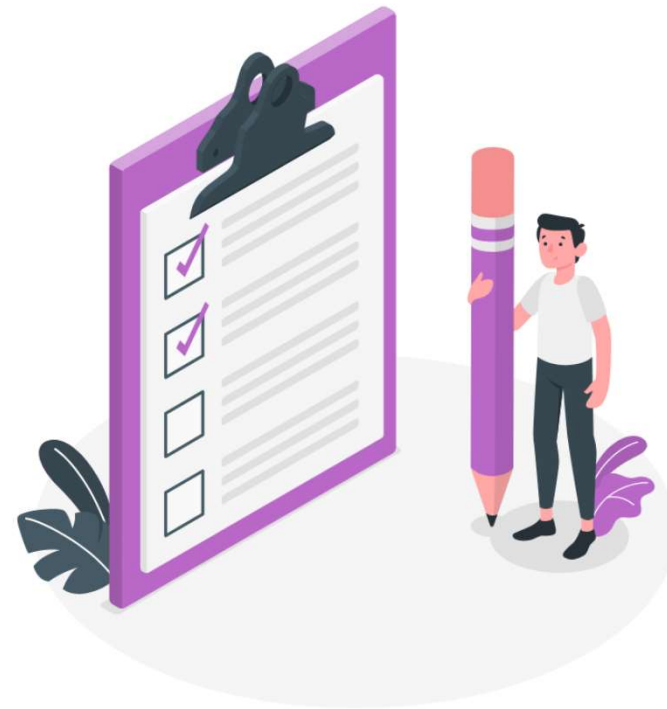
*Accounting Standards  
Interaction with Corporate Tax:*

# Replacing Equity Method with Cost Method of Accounting



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# Introduction

In November 2023, the Federal Tax Authority (FTA) has released **Corporate Tax Guide | CTGACSI – Accounting Standards and Interaction with Corporate Tax**, which provides guidance on the interaction of Accounting Standards with the newly-implemented Corporate Tax in the UAE.

It contains an overview of the accounting methods to be used and the required adjustments from the accounting income to arrive at the taxable income, in terms of the accounting methods applied.

This article will focus on paragraph **6.5 Cost Method of Accounting to replace Equity Method of Accounting** set out in CTGACSI. This mainly applies to parent companies holding Investments in Associate and Joint Ventures which are covered in IAS 28 of the International Financial Reporting Standards (IFRS).



# Which investments shall be recognized as Investments in Associates and Joint Ventures?

**IAS 28: Investments in Associates and Joint Ventures** defines the following terms as:



## **Associate**

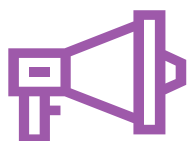
an entity over which the investor has significant influence.



## **Joint Venture**

an arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

Thus, if an entity has investments in associates, or has a joint control over an arrangement with another entity, as defined above, such investments shall be recognized as Investments in Associates or Investments in Joint Ventures in the books of the investor, and accounting guidelines set out in IAS 28 shall be applied.



### **What is *significant influence*?**

As per par. 5 of IAS 28, an *investor* has significant influence over an *investee* if the investor holds, directly or indirectly, 20 percent or more of the voting power of the investee. It is usually evidenced in one or more ways including but not limited to: representation in the board of directors, material transactions, participation in decision-making processes, etc.

# Accounting Methods

Under **IFRS**, parent companies (not in the context of a Tax Group) are allowed to account for investments in associates and joint ventures using the **equity method**, where the investor company records its proportionate share of the investee's financial results.

While under **Corporate Tax** guidelines, to avoid double taxation of the equity accounted investment's income, **cost method** should be used to account for these investments.



# Equity Method

In the *equity method* of accounting, the investment is initially recognized at cost, while movements and transactions related to the investment will affect the carrying amount as follows:

- Share in the ***profit/loss of the investee*** will be accounted in the investor's **profit/loss** and will **increase** the carrying amount of the investment;
- While ***dividends received*** from the investee will be treated as a **reduction** in the carrying amount of the investment in the investor's books.



# Equity Method – Illustrative Example

Company A paid AED 250,000 to Company B in exchange for 25% ownership of Company B. During the financial year, Company B reported a net income of AED 100,000, and declared dividends to investors, of which, AED 50,000 was paid to Company A.

The **carrying amount** of Company A's investment at year-end would be:

		Applicable journal entries would be:
Initial recognition:	AED 250,000	Dr. Investment in associate xxx Cr. Cash/Bank account xxx
Share in P/L:	AED 25,000	Dr. Investment in associate xxx Cr. Investment income xxx
Dividend payout:	(AED 50,000)	Dr. Cash/Bank account xxx Cr. Investment in associate xxx
At year-end:	<u>AED 225,000</u>	

In addition, Company A has reported a net operating income of AED 475,000 before any investment income. So, at the end of the year, the reported **accounting income** of Company A in their financial statements would be:

Net operating income:	AED 475,000
Investment income:	<u>AED 25,000</u>
Net accounting income:	AED 500,000



# Cost Method



In the application of equity method, the portion of the investee's profit/loss recognized in the investor's profit/loss may be taxed twice, as Corporate Tax is a direct tax on an entity's income.

To avoid double taxation of the equity accounted investment's income, the FTA requires for Cost Method to replace the Equity Method of accounting.

With this, treatment of the related transactions are as follows:

- Share in the ***profit/loss of the investee*** shall **not be included** in the investor's taxable income calculation;
- Instead, only ***dividends and other profit distributions*** (which may also qualify for exemption under Article 22 of the Corporate Tax Law) should be **recognized** for CT purposes.



# Cost Method – Illustrative Example

Company A paid AED 250,000 to Company B in exchange for 25% ownership of Company B. During the financial year, Company B reported a net income of AED 100,000, and declared dividends to investors, of which, AED 50,000 was paid to Company A.

In addition, Company A reported a net income of AED 500,000 in their financial statements, which includes their share in Company B's net income.

The computation of Company A's **taxable income** would include:

<b>Net accounting income:</b>	<b>AED 500,000</b>
<b>Share in P/L:</b>	<b>(AED 25,000)</b>
<b>Dividend payout:</b>	<b>AED 50,000</b>
<b>Net taxable income:</b>	<b>AED 525,000*</b>

*\*Before other adjustments and considerations as set out by the FTA Guidelines.*

# How we can assist you

- ✓ We can help in reviewing the financial statements if needed, ensuring they meet the required standards and are accurately reflected in the tax return.
- ✓ Our team can provide expert advice on the applicable adjustments to be made on the accounting income to determine the final net taxable income, and the total income tax payable.
- ✓ We can assist in identifying the documents required based on your tax profile and ensure they are correctly prepared and ready to submit to FTA. This includes gathering both mandatory and optional documents that may be relevant.
- ✓ We offer support in filing the tax return in the FTA portal and uploading the necessary documents, ensuring that all steps are completed properly and efficiently.



# Our Team



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# Contact Us

To discuss how we can support your business, please reach out to us via the following:



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