RESERVES FOR TAX PURPOSES

Reserve for Installment Sales/ Uncollected Proceeds (Long Term Receivables) -

This reserve applies to situations where

- Real property is sold (i.e. land inventory); or
- Where any portion of an accounts receivable is not due until at least 2 years (i.e. installment sales)

Reserve Formula:

\[
Reserve = 1 - \frac{\text{total cash received to date}}{\text{contract price i.e. total sales}} * \text{Gross Profit}
\]

A Reserve is allowed in **the year of sale, year 2 and year 3**; however, on the **fourth year the remaining profit needs to be included in income**.

**Example:**

A good that’s costs $100 is sold for $1,100 in 2012. The amount is receivable over 5 years in equal amounts ($220 per year) starting in 2012. Therefore, per the solution, no reserve is allowed in year 4 and year 5.

**Previous year reserves are always added back; and current year reserves deducted:**

Note in 2013, $800 would be added back to income and you would take a deduction of $600. Basically this means that since you collected $220 during the year (also 20% of the sales) you include 20% of the gross profit in income ($1,000*20% = $200)

In 2015 you add back the $400 claimed in 2014 and take no reserves.

<table>
<thead>
<tr>
<th>Year #</th>
<th>Year</th>
<th>cash received to date (B)</th>
<th>B/$1100 = C</th>
<th>1-C=D</th>
<th>Reserve = D *Gross Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2012</td>
<td>$220</td>
<td>0.2</td>
<td>0.8</td>
<td>$800</td>
</tr>
<tr>
<td>2</td>
<td>2013</td>
<td>440</td>
<td>0.4</td>
<td>0.6</td>
<td>600</td>
</tr>
<tr>
<td>3</td>
<td>2014</td>
<td>660</td>
<td>0.6</td>
<td>0.4</td>
<td>400</td>
</tr>
<tr>
<td>4</td>
<td>2015</td>
<td>880</td>
<td>0.8</td>
<td>0.2</td>
<td>-</td>
</tr>
<tr>
<td>5</td>
<td>2016</td>
<td>1100</td>
<td>1</td>
<td>0</td>
<td>-</td>
</tr>
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</table>
Capital Gains Reserve

This reserve is used in situations where you sold a property and realized a capital gain; however, some of the proceeds are yet to be collected. CRA gives this reserves, because to pay taxes on a gain, you need to collect the amounts owing first.

Reserve Formula:

The capital gains reserve is the lesser of:

$$A = \text{Reasonable Reserve} = Gain \times \frac{\text{amount not yet collected}}{\text{total proceeds of disposition}}$$

$$B = Gain \times \frac{4 - \# \text{ of years past since disposition}}{5}$$

Example:

A land with an ACB of $100 is sold for $2100 in 2012. The amount is due equally ($210 over 10 years starting in 2012).

Reserve in 2012 (current year) is the lesser of

A = 2000 * ((2100-210)/2100)) = 2000*0.90 = $1,800
B = 2000 * (4-0)/5 = 2000*4/5 = $1,600

Therefore, the reserve in 2012 should be $1600.

In 2013, $1600 is added back to income and a reserve for 2013 is deducted using the formula above.

Reserves for Bad Debts

- A reserve can be taken on all debts owning to the taxpayer, that are established to have become bad debts in the year.
- You need to assess each account (debt) one by one, to determine what the yearend reserve should be for bad debts.
  - For accounting, if you are using the aging method to calculate the Allowance for Doubtful Accounts, the reserve for tax purposes and the reserve for accounting purposes may be similar.
  - However, if for accounting you are using the % of sales method to come up with the bad debts expense; your accounting reserve (i.e. the Allowance for doubtful account) will likely not be the same as the tax reserve for bad debts.
- Previous year reserves for bad debts is added back to income; and the current end of year reserve for bad debts is deducted
Reserve for goods and services undelivered or unrendered at year end

- This is a reserve where cash is received up front; however, the goods and services are not provided till after the tax year end. Therefore, this is a **reserve for unearned revenues**.
- Often the total impact on income is the same for both tax and accounting purposes; but CRA makes you add back your accounting unearned revenue and take a tax reserve which usually works out to the same amount (and end up cancelling each other out).

Example #1

You get a 3 month contract with a price of $50,000 and you get the $50,000 up front on December 1 2010. It is now December 31, 2010 the taxation year end and you have done 1/3rd of the services; yet 2/3 has yet to be done.

- For accounting purposes you would have realized revenues of $16,667 ($50,000*1/3) and would have unearned revenues (liabilities) = $33,333

**For tax purposes**

- You need to add $33,333 to accounting income (i.e. your financial statement reserve)
- You then deduct the tax reserve
  - Tax reserve = upfront payment less the value of service unrendered at year end = $50,000 - 50000* 1/3 = 33,333

- As you can see, in this case, the amount of accounting reserve (the unearned revenues) = the tax reserve (value of service unrendered). The accounting and the tax treatment are the same. The effect on income under both cases is 16,667.

Example #2:

You get a 3 month contract with a price of $100,000 and you get $50,000 up front on December 1 2010. It is now December 31, 2010 the taxation year end and you have done 1/3rd of the services; yet 2/3 has yet to be done.

- For accounting purposes your revenues will be $100,000*1/3 = $33,333 and your unearned revenues (accounting reserves) will be $50,000 – 33,333 = 16,667

**For tax purposes**

- You need to add back the financial statement reserve = $16,667
- You then take a tax reserve = upfront payment less the value of service unrendered = 50,000 – 100,000 * 1/3 = 16,667

- Again, in this case, the accounting and the tax reserves are the same and cancel each other out. Basically, the effect on income under both cases is $33,333.