

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.

Year #	Year	cash received to date (B)	B/\$1100 = C	1-C=D	Reserve = D *Gross Profit
1	2012	\$220	0.2	0.8	\$800
2	2013	440	0.4	0.6	600
3	2014	660	0.6	0.4	400
4	2015	880	0.8	0.2	-
5	2016	1100	1	0	-

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**:

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

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

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 owing 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.