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MCCSR Interpretation Bulletin

Subject: **Adjusted Deferred and Unrealized Gains and Losses Included in Capital**

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This bulletin describes how tax and disposition costs on deferred and unrealized gains/losses should be treated for MCCSR purposes. It provides illustrations under both the tax payable and deferred tax accounting methods.

Life insurance companies may include net deferred gains/losses and unrealized gains/losses in MCCSR capital, however, adjustments must be made to reflect:

- estimated disposition costs, and
- future income taxes that will be incurred when gains/losses are realized or amortized into income.

Tier 1 capital is adjusted as follows:

- add deferred gains/(losses) net of tax adjustments (illustrations 1 and 2), and
- deduct the tax and disposition costs on the amortized portion of unrealized gains/(losses) (illustrations 3 and 4).

Tier 2 capital is adjusted as follows:

- add the unamortized portion of unrealized gains net of tax and disposition costs (illustrations 3 to 5).

For gains/losses on which no taxes have been paid, life insurance companies must assume a 45% tax rate.

Deferred Gains and Losses (Illustrations 1 and 2)

Illustration 1

For stocks, real estate and bonds sold before 1995, gains are amortized into income and tax is paid when the gain is realized.

Assumptions:

150 gain;
15 year amortization into income;
Company's tax rate: 30%;
Disposition cost is 2% of gain.

TPA means tax payable accounting; DTA means deferred tax accounting.

Impact on retained earnings		**TPA**	**DTA**	**OSFI 87 ref**
i)	Gain	150	150	
ii)	Deferred gain	140	140	
iii)	Tax payable (30% x 150)	45	45	
iv)	Deferred tax (debit) (30% x 140)	n/a	-42	
v)	Retained earnings (i-ii-iii-iv)	-35	7	

MCCSR Treatment

	Tier 1 adjustment			
vi)	Deferred gain	140	140	
vii)	45% x portion of gains not taxed (45% x 0)	0	0	
viii)	Deferred taxes	n/a	42	
ix)	Disposition cost[1]	0	0	
x)	Adjusted net deferred gains (vi-viii)	140	98	Page 20020 lines 007, 008, 011
	Net gains included in capital (v + x)	105	105	

[1] Since deferred gains relate to assets that have been sold, disposition costs are already expensed; therefore, no adjustment is needed.

Illustration 2

Tax is paid as deferred gains are amortized into income. This, for example, is how gains on bonds sold after 1994 are treated.

Assumptions:

150 gain;
15 year amortization into income;
Company's tax rate: 30%
Disposition cost is 2% of gain.

TPA means tax payable accounting; DTA means deferred tax accounting.

Impact on retained earnings		**TPA**	**DTA**	**OSFI 87 ref**
i)	Gain	150	150	
ii)	Deferred gain	140	140	
iii)	Tax payable (30% (150 - 140))	3	3	
iv)	Deferred tax (debit)	0	0	
v)	Retained earnings (i-ii-iii-iv)	7	7	
MCCSR Treatment				
	Tier 1 adjustment			
vi)	Deferred gain	140	140	
vii)	45% x portion not taxed (45%x140)	63	63	
viii)	Deferred taxes (credit)	n/a	0	
ix)	Disposition cost	0	0	
x)	Adjusted net deferred gains (vi-vii-viii-ix)	77	77	Page 20020, line 011
	Net gains included in capital (v + x)	84	84	

Unrealized Gains and Losses (Illustrations 3 to 5)

Illustration 3

Tax is paid on realization; unrealized gains are amortized into income. This, for example, is how gains on stocks accruing before 1995 are treated.

Assumptions:

200 unrealized gain;
15% annual amortization into income;
Company's tax rate: 30%;
Disposition cost is 2% of gain.

TPA means tax payable accounting; DTA means deferred tax accounting.

Impact on retained earnings		**TPA**	**DTA**	**OSFI 87 ref**
i)	Amortized gain (15% x 200)	30.0	30.0	
ii)	Tax payable	0.0	0.0	
iii)	Deferred tax (debit) (30 x 30%)	0.0	9.0	
iv)	Retained earnings (i-ii-iii)	30.0	21.0	
MCCSR Treatment				
	Tier 1 adjustment:			
v)	Amortized gains: taxes not expensed (45% x 30)	13.5	0.0	
vi)	Disposition costs: (2% x 30)	0.6	0.6	
vii)	Deduction from tier 1 capital (v+vi)	14.1	0.6	20.020 line 024
viii)	Tier 1 capital (iv-vii)	15.9	20.4	
	Tier 2 adjustment:			
ix)	Unrealized unamortized gain (200 - 30)	170.0	170	
x)	45% x portion not taxed (45%x170)	76.5	76.5	
xi)	Deferred taxes (credit)	n/a	0.0	
xii)	Disposition cost (2% x 170)	3.4	3.4	
xiii)	Adjusted unrealized gains (ix-x-xi-xii)	90.1	90.1	Page 20030, lines 056, 058
	Net unrealized gains included in capital (ix + xiii)	106.0	110.5	

Illustration 4

Tax is paid on marked to market basis; unrealized gains are amortized into income. This, for example, is how gains on stocks accruing after 1994 are treated.

Assumptions:

200 unrealized gain;
15% annual amortization into income;
Company's tax rate: 30%
Disposition cost is 2% of gain.

TPA means tax payable accounting; DTA means deferred tax accounting.

	Impact on retained earnings	**TPA**	**DTA**	**OSFI 87 ref**
i)	Amortized gain (15% x 200)	30	30	
ii)	Tax payable (30% x 200)	60	60	
iii)	Deferred tax (debit) (30% x (200-30))	0	-51	
iv)	Retained earnings (i-ii-iii)	-30	21	
	MCCSR Treatment			
	Tier 1 adjustment:			
v)	Amortized gains: taxes not expensed (45% x 0)	0	0	
vi)	Disposition costs: (2% x 30))	0.6	0.6	
vii)	Deduction from tier 1 capital (v+vi)	0.6	0.6	20.020 line 024
viii)	Tier 1 capital (iv-viii)	-30.6	20.4	
	Tier 2 adjustment:			
ix)	Unrealized unamortized gain (200 - 30)	170	170	
x)	45% x portion not taxed (45%x0)	0	0	
xi)	Deferred taxes (credit) (30% x 170)	n/a	51	
xii)	Disposition cost (2% x 170)	3.4	3.4	
xiii)	Adjusted unrealized gains (ix-x-xi-xii)	166.6	115.6	Page 20030, lines 060, 061
	Net unrealized gains included in capital (viii + xiii)	136	136	

Illustration 5

Tax is paid on realization; unrealized gains are not amortized into income. This, for example, is how gains on bonds are treated.

Assumptions:

200 unrealized gain;
Company's tax rate: 30%
Disposition cost is 2% of gain.

TPA means tax payable accounting; DTA means deferred tax accounting.

Impact on retained earnings		**TPA**	**DTA**	**OSFI 87 ref**
i)	Amortized gain	0	0	
ii)	Tax payable	0	0	
iii)	Deferred tax (debit)	0	0	
iv)	Retained earnings (i-ii-iii)	0	0	
MCCSR Treatment				
	Tier 2 adjustments			
v)	Unrealized unamortized gain	200	200	
vi)	45% x portion not taxed	90	90	
vii)	Deferred taxes (credit)	n/a	0	
viii)	Disposition cost	4	4	
ix)	Adjusted unrealized gains (v-vi-vii-viii)	106	106	Page 20030, line 062
	Net unrealized gains included in capital (iv + ix)	106	106	