the current year's net premium payments (*i.e.*, gross premium payments minus return premium payments and reinsurance premium payments) for that contract. The percentage varies, depending on the type of Specified Contract in question, according to a schedule set forth in Section 848(c)(1).

8. Although framed in terms of requiring a portion of a life insurance company's general expenses to be capitalized an amortized, Section 848 in effect accelerates the realization of income from Specified Contracts for federal income tax purposes, and therefore, the payment of taxes on the income generated by those contracts. When the time value of money is taken into account, this has the economic consequence of increasing the tax burden borne by the Company that is attributable to such contracts. Because the amount of general deductions that must be capitalized and amortized is measured by premium payments paid for Specified Contracts, an increased tax burden results from the receipt of those premium payments.

9. The Contracts to which Applicants wish to apply the tax burden charge are among the Specified Contracts. They fall into the category of life insurance contracts for which the percentage of net premium payments that determines the amount of otherwise currently deductible general expenses to be capitalized and amortized with respect to such contracts is 7.7%.

10. The increased tax burden resulting from the applicability of Section 848 to every \$10,000 of net premium payments received may be quantified as follows. In the year when the premium payments are received, the Company's general deductions are reduced by \$731.50*i.e.*, an amount equal to (a) 7.7% of \$10,000, or \$770, minus (b) one-half year's portion of the ten-year amortization, or \$38.50. Using a 35% corporate tax rate, this results in an increase in tax for the current year of \$256.03. This reduction will be partially offset by increased deductions that will be allowed during the next ten years as a result of amortizing the remainder of the \$770-\$77 in each of the following nine years and \$38.50 in the tenth year.

11. In the Company's business judgment, a discount rate of at least 8% is appropriate for use in calculating the present value of its future tax deductions resulting from the amortization described above. For business relating to participating insurance policies, the Company seeks an after tax rate of return on the investment of its surplus of at least 8%. To the extent that surplus must be used by the Company to satisfy its increased federal tax burden under Section 848 resulting from the receipt of premium payments, such surplus is not available to the Company for investment. Thus, the cost to the Company of "capital" used to satisfy its increased federal tax burden under Section 848 is, in essence, the Company's after tax rate of return on surplus, and accordingly, the rate of return on surplus is appropriate for use in this present value calculation.<sup>1</sup>

12. Again using a corporate tax rate of 35% and assuming a discount rate of 8%, the present value of the tax effect of the increased deductions allowable in the following ten years, which (as noted above) partially offsets the increased tax burden, comes to \$174.59. The effect of Section 848 on the Company in connection with the Existing Contracts is therefore an increased tax burden with a present value of \$81.44 for each \$10,000 of net premium payments received, (*i.e.*, \$256.03 minus \$174.59).

13. State premium taxes are deductible in computing federal income taxes. Thus, the Company does not incur incremental income tax when it passes on state premium taxes to contract owners. In contrast, federal income taxes are not tax-deductible in computing the Company's federal income taxes. Therefore, in order to compensate fully for the impact of Section 848, the Company must impose an additional charge that would make it whole not only for the \$81.44 additional tax burden attributable to Section 848, but for the tax on the additional \$81.44 itself. This additional charge can be determined by dividing \$81.44 by the complement of the 35% federal corporate income tax rate (*i.e.*, 65%), resulting in an additional charge of \$125.29 for each \$10,000 of net premium payments, or approximately 1.25% of net premium payments.

14. Tax deductions are of value to the Company only to the extent that it has sufficient gross income to fully use the deductions. However, based on its prior experience, the Company believes that it can reasonably expect to use virtually all future deductions available. That is, the Company believes that it can reasonably expect to have sufficient taxable income in future years to use all deferred acquisition cost deduction.

15. The Company also represents that the 1.25% charge is reasonably related to the Company's increased tax burden under Section 848 of the Code, taking into account the benefit to the Company of the amortization permitted by Section 848, and the use by the Company of a 8% discount rate in computing the future deductions resulting from such amortization, such rate being the equivalent of the Company's cost of capital.

16. The Company believes that a charge of 1.25% of premium payments would reimburse it for the impact of Section 848 (as currently written) on its federal tax liabilities. The Company believes, however, that it would have to increase this charge if future changes in, or interpretations of, Section 848 or any successor provision result in a further increased tax burden due to the receipt of premium payments. Such an increase could result from a change in the corporate tax rate, a change in the 7.7% figure, or a change in the amortization period. The Contracts will or may reserve the right to increase or decrease the 1.25% charge in response to future changes in, or interpretations of, Section 848 or any successor provision that increase or decrease the Company's tax burden. The Company understands, however, that it would need additional exemptions before increasing the charge above 1.25%.

## Applicants' Legal Analysis

1. Section 6(c) of the 1940 Act provides, in relevant part, that the Commission, by order upon application, may exempt any person, security or transaction (or any class or classes of persons, securities or transactions) from provisions of the 1940 Act or any rules thereunder, if and to the extent that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.

2. Applicants request an order of the Commission pursuant to Section 6(c) of the 1940 Act, exempting them from the provisions of Section 27(c)(2) of the 1940 Act and Rule 6e-3(T)(c)(4)(v)thereunder to the extent necessary to permit Applicants to deduct from premium payments received in connection with the Contracts an amount that is reasonable in relation to the Company's increased federal tax burden related to the receipt of such premium payments and that results from the application of Section 848 of

<sup>&</sup>lt;sup>1</sup> In determining the cost of capital, the Company considered a number of factors. First, the Company considered its anticipated long-term growth rate. The Company seeks an after-tax rate of return earned on investments that is at least equal to its long-term growth rate. The cost of capital should also represent a fair after-tax rate of return to the Company for investing surplus. This rate can be thought of as consisting of a "risk-free" rate of return plus a "risk premium" for engaging in this type of business. Other factors taken into consideration were market interest rates and information about the rates of return obtained by other insurance companies. The Company represents that these are appropriate factors to consider in determining its cost of capital.