Section 848 changed how a life insurance company must compute its itemized deductions from gross income for federal income tax purposes. Section 848 requires an insurance company to capitalize and amortize over a period of ten years part of the company's general expenses for the current year. Under prior law, these general expenses were deductible in full from the current year's gross income.

5. The amount of expenses that must be capitalized and amortized over ten years rather than deducted in the year incurred is based solely upon ''net premiums'' received in connection with certain types of insurance contracts. Section 848 of the Code defines ''net premium'' for a type of contract as gross premiums received by the insurance company on the contracts minus return premiums and premiums paid by the insurance company for reinsurance of its obligations under such contracts. Applicants state that the effect of Section 848 is to accelerate the realization of income from insurance contracts covered by that Section, and, accordingly, the payment of taxes on the income generated by those contracts.

6. The amount of general expenses that must be capitalized depends upon the type of contract to which the premiums received relate and varies according to a schedule set forth in Section 848. Applicants state that the Contracts are ''specified insurance contracts'' that fall into the category of life insurance contracts, and under Section 848, 7.7% of the year's net premiums received must be capitalized and amortized.

7. Applicants state that CG Life's increased tax burden resulting from section 848 may be quantified as follows. For each $10,000 of net premiums received by CG Life under the Contracts in a given year, section 848 requires CG Life to capitalize $770 (7.7% of $10,000), and $38.50 (one-half year's portion of the ten year amortization) of this $770 may be deducted in the current year. This leaves $731.50 ($770 minus $38.50) subject to taxation at the corporate tax rate of 35%, and results in an increase in tax for the current year of $256.03 (.35×$731.50). This increase will be partially offset by 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).

8. In the business judgment of CG Life, a discount rate of 10% is appropriate for use in calculating the present value of CG Life's future tax deductions resulting from the amortization described above. Applicants state that CG Life seeks an after tax rate of return on the investment of its capital in excess of 10%. To the extent that capital must be used by CG Life to meet its increased federal tax burden under section 848 resulting from the receipt of premiums, such capital is not available to CG Life for investment. Thus, Applicants contend, the cost of capital used to satisfy CG Life's increased federal income tax burden under section 848 is, in essence, CG Life's after tax rate of return on capital; and, accordingly, the rate of return on capital is appropriate for use in this present value calculation.

9. Applicants submit that, to the extent that the 10% discount rate is lower than CG Life's actual targeted rate of return, a measure of comfort is provided that the calculation of CG Life's increased tax burden attributable to the receipt of premiums will continue to be reasonable over time, even if the corporate tax or the targeted after tax rate of return applicable to CG Life is reduced. CG Life undertakes to monitor the tax burden imposed on it and to reduce the charge to the extent of any significant decrease in the tax burden.

10. In determining the after tax rate of return used in arriving at the 10% discount rate, Applicants state that CG Life considered several factors, including: historical capital costs; market interest rates; CG Life's anticipated long term growth rate; the risk level for this type of business; and inflation. CG Life represents that such factors are appropriate factors to consider in determining CG Life's cost of capital. Applicants state that CG Life projects its future growth rate based on its sales projections, the current interest rates, the inflation rate, and the amount of capital that CG Life can provide to support such growth. CG Life then uses the anticipated growth rate and the other factors enumerated above to set a rate of return on capital that equals or exceeds this rate of growth. Applicants state the CG Life seeks to maintain a ratio of capital to assets that is established based on CG Life's judgment of the risk represented by various components of CG Life's assets and liabilities. Applicants state that maintaining the ratio of capital to assets is critical to offering competitively prices products and, as to CG Life, to maintaining a competitive rating from various rating agencies. Consequently, Applicants state that CG Life's capital should grow at least at the same rate as do CG Life's assets.

11. Applying the 10% discount rate, and assuming a 35% corporate income tax rate, the present value of the tax effect of the increased deductions allowable in the following ten years amounts to a federal income tax savings of $160.40. Thus, the present value of the increased tax burden resulting from the effect of section 848 on each $10,000 of net premiums received under the Contracts is $95.63, *i.e.*, $256.03 minus $160.40 or 1.47%.

12. State premium taxes are deductible in computing federal income taxes. Thus, CG Life does not incur incremental federal income tax when it passes on state premium taxes to owners of the Contracts. Conversely, federal income taxes are not deductible in computing CG Life's federal income taxes. To compensate CG Life fully for the impact of section 848, therefore, it would be necessary to allow CG Life to impose in additional charge that would make CG Life whole not only for the $95.63 additional federal income tax burden attributable to section 848 but also for the federal income tax on the additional $95.63 itself. This federal income tax can be determined by dividing $95.63 by the complement of the 35% federal corporate income tax rate, *i.e.*, 65%, resulting in an additional charge of $147.12 for each $10,000 of net premiums, or 1.46%.

13. Based on prior experience, CG Life expects that all of its current and future deductions will be fully taken. It is the judgment of CG Life that a charge of 1.15% would reimburse CG Life for the impact of section 848 on CG Life's federal income tax liabilities. Applicants represent that the charge to be deducted by CG Life pursuant to the relief requested is reasonably related to the increased federal income tax burden under section 848, taking into account that benefit to CG Life of the amortization permitted by section 848, and the use by CG Life of a discount rate of 10% in computing the future deductions resulting from such amortization, such rate being the equivalent of CG Life's cost of capital.

14. CG Life asserts that although a charge of 1.15% of premium payments would reimburse CG Life's for the impact of section 848 (as currently written) on CG Life's federal income tax liabilities, it will have to increase this charge if any future change in, or interpretation of section 848, or any successor provision, results in an increased federal income tax burden due to the receipt of premiums. Such an increase could result from a change in the corporate federal income tax rate, a change in the 7.7% figure, or a change in the amortization period.

Applicant's Legal Analysis

1. Applicants request an order of the Commission pursuant to Section 6(c)