amount of general deductions that must be capitalized and amortized is measured by the premiums received under the Contracts.

6. The amount of deductions subject to Section 848 equals a percentage of the current year's net premiums received (*i.e.*, gross premiums minus return premiums and reinsurance premiums) under life insurance or other contracts categorized under this Section. The Contracts will be categorized under Section 848 as life insurance contracts requiring 7.7% of the net premiums received to be capitalized and amortized under the schedule set forth in Section 848(c)(1).

7. The increased tax burden on every \$10,000 of net premiums received under the Contracts is quantified by Applicants as follows. For each \$10,000 of net premiums received in a given year, Golden American must capitalize \$770 (i.e., 7.7% of \$10,000), and \$38.50 of this amount may be deducted in the current year. The remaining \$731.50 (\$770 less \$38.50) is subject to taxation at the corporate tax rate of 35% and results in \$256.03 (.35%×\$731.50) more in taxes for the current year than Golden American otherwise would have owed prior to OBRA 1990. However, the current tax increase will be offset partially by deductions allowed during the next ten years, which result from amortizing the remainder of the \$770 (\$77 in each of the following nine years and \$38.50 in year ten).

8. It is Golden American's business judgment that it is appropriate to use a discount rate of at least 10% in evaluating the present value of its future tax deductions for the following reasons. Capital that Golden American must use to pay its increased federal tax burden under Section 848 will be unavailable for investment. The cost of capital used to satisfy this increased tax burden essentially will be Golden American's targeted rate of return (i.e., the return sought on invested capital), which is in excess of 10%. Accordingly, Applicants submit that the targeted rate of return is appropriate for use in this present value calculation. To the extent that the 10% discount rate is lower than Golden American's actual targeted rate of return, the calculation of this increased tax burden will continue to be reasonable over time, even if the corporate tax rate applicable to Golden American is reduced, or its targeted rate of return is lowered.

9. In determining the targeted rate of return used in arriving at the discount rate, Golden American considered a number of factors, which it represents are appropriate factors to consider. First, Golden American identified the level of

investment return that can be expected to be earned risk-free over the long term. This rate is based upon the expected yield on a 30-year U.S. Treasury Bond. Golden American then increased this rate by the market risk premium demanded by equity investors as compensation for the risks associated with equity investments. The market risk premium is based on the average excess return earned by investing in equities as compared to that earned by investing in risk-free instruments (i.e., long-term U.S. Treasury Bonds). Finally, the resulting rate was modified to reflect the relative volatility of an equity investments in Bankers, Golden American's indirect parent.

10. Using a federal corporate tax rate of 35% and assuming a discount rate of 10%, the present value of the tax effect of the increased deductions allowable in the following ten years, which partially offsets the increased tax burden, comes to \$160.40. The effect of Section 848 on the Contracts is therefore an increased tax burden with a present value of \$95.63 for each \$10,000 of net premiums (*i.e.*, \$256.03 less \$160.40).

11. Golden American does not incur incremental federal income tax when it passes on state premium taxes to Contract Owners because state premium taxes are deductible in computing federal income taxes. Conversely, federal income taxes are not deductible in computing Golden American's federal income taxes. To compensate Golden American fully for the impact of Section 848, Golden American must impose an additional charge to make it whole for the \$95.63 additional tax burden attributable to Section 848, as well as the tax on the additional \$95.63 itself, which can be determined by dividing \$95.63 by the complement of 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 1.47%.

12. Based on its prior experience, Golden American reasonably expects to fully take almost all future deductions. It is Golden American's judgment that a 1.38% charge would reimburse it for the increased federal income tax liabilities under Section 848. Applicants represent that the 1.38% charge will be reasonably related to Golden American's increased federal income tax burden under Section 848. This representation takes into account the benefit to Golden American of the amortization permitted by Section 848 and the use of a 10% discount rate (which is equivalent to Golden American's targeted rate of return) in computing the future deductions resulting from such amortization. Golden American believes

that the 1.38% charge would have to be increased if future changes in, or interpretations of, Section 848 of any successor provision result in a further increased tax burden due to receipt of premiums. The increase could be caused by a change in the corporate tax rate, or in the 7.7% figure, or in the amortization period.

## Applicants' Legal Analysis

1. Applicants request an order under Section 6(c) of the 1940 Act granting exemptions from Section 27(c)(2) of the 1940 Act to allow the deduction of a charge from premiums to compensate Golden American for its increased federal tax burden based on receipt of these premiums under the Contracts. The charge will be in an amount that is reasonably related to Golden American's increased federal tax burden. Applicants also request exemptions from subparagraph (c)(4)(v) of Rules 6e-2 and 6e–3(T) under the 1940 Act to permit the proposed deductions to be treated as other than "sales load," as defined under Section 2(a)(35) of the 1940 Act, for purposes of Section 27 and the exemptions from various provisions of that Section found in Rules 6e-2 and 6e-3(T), respectively. Applicants assert that it is appropriate to deduct a charge for an insurer's increased tax burden attributable to premiums received, and to exclude the deduction of this charge from sales load, because it is a legitimate expense of the company and not for sales and distribution expenses.

2. Applicants further request an order under Section 6(c) for exemptions from Sections 26(a)(2)(C), 27(c)(1) and 27(c)(2) of the 1940 Act, paragraphs (b)(1), (b)(12)(i), (b)(13)(iv) of Rules 6e-2 and 6e-3(T) and Rule 22c-1 thereunder, to permit the deduction of the charge from Contract cash value in deferred, equal periodic installments, as an alternative to a deduction of the charge from premium payments, to compensate Golden American for its increased tax burden under Section 848. Any unrecovered amount of the deferred charge will be deducted from such assets upon an early surrender of

3. Section 6(c) authorizes the Commission, by order and upon application, to exempt any person, security, or transaction, or class of persons, securities, or transactions, from any provisions of the 1940 Act. The Commission grants relief under Section 6(c) to the extent an 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]."