

burden under Section 848 will be unavailable for investment. The cost of capital used to pay this increased tax burden essentially will be General American's after tax rate of return on surplus (i.e., return sought on invested capital), which is 10% to 12%. Accordingly, Applicants assert that the after tax rate of return on surplus is appropriate for use in this present value calculation.

11. In determining the after tax rate of return, General American considered a number of factors, including market interest rates, anticipated long-term growth rate, acceptable risk levels, inflation, and available information about the rates of return obtained by other mutual life insurance companies. General American represents these are appropriate factors to consider.

12. General American first projects its future growth rate based on sales projections, current interest rates, inflation rate, and the amount of surplus that it can provide to support such growth. General American then uses these factors, giving market interest rates, acceptable risk level, and inflation rate significantly more weight, to set a rate of return on surplus equal to or in excess of the anticipated rate of growth. General American seeks to maintain a ratio of surplus to assets that it establishes based on its judgment of the risks represented by various components of its assets and liabilities. Maintaining the ratio of surplus to assets is critical to General American maintaining a competitive rating from various rating agencies and to offering competitively priced products. Consequently, General American's surplus must grow at least at the same rate as its assets.

13. 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 and Other Contracts is therefore an increased tax burden with a present value of \$95.63 for each \$10,000 of net premiums received (i.e., \$256.03 minus \$160.40).

14. General 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 General American's federal income taxes. To compensate General American fully for the impact of Section 848, General American must impose an additional charge to make it

whole not only for the \$95.63 additional tax burden attributable to Section 848, but also for the tax on the additional \$95.63 itself. This federal tax 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%.

15. Based on its prior experience, General American reasonably expects to take almost all future deductions. It is General American's judgment that a 1.25% charge would reimburse it for its increased federal income tax liabilities under Section 848. Applicants represent that the 1.25 charge will be reasonably related to General American's increased federal income tax burden under Section 848. This representation takes into account the benefit to General American of the amortization permitted by Section 848 and the use of a 10% discount rate (which is equivalent to General American's cost of capital) in computing the future deductions resulting from such amortization. To the extent that General American's actual cost of capital exceeds an annual rate of 10%, the calculation of this increased tax burden will continue to be reasonable over time.

16. General American believes that the 1.25% charge would have to be increased if future changes in, or interpretations of, Section 848 or 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. Accordingly, the Contract, Future Contracts and endorsements to the Existing Contracts offered after issuance of an order in this matter will or may reserve the right to increase, or decrease, the 1.25% charge in response to such future changes or interpretations that increase or decrease its tax burden. Any increase of the charge above 1.25% would require additional exemptive relief from the Commission under the 1940 Act.

Applicants' Legal Analysis

1. Applicants request an order under Section 6(c) of the 1940 Act for exemptions from Section 27(c)(2) of the 1940 Act to the extent necessary to permit the deduction from premium payments of a DAC Tax Charge in an amount that is reasonable in relation to General American's increased federal tax burden based on receipt of premiums under the Contract. The DAC Tax Charge also may be included in Future Contracts and may be added to Existing Contracts issued after receipt of the order requested herein. Applicants

also request exemptions from Rule 6e-3(T)(c)(4)(v) under the 1940 Act to permit the proposed DAC Tax Charge 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 Rule 6e-3(T).

2. Applicants also request an order under Section 6(c) exempting them and any Future Accounts from Section 27(e) of the 1940 Act and Rules 27e-1 and 6e-3(T)(b)(13)(vii) thereunder to the extent necessary to eliminate the requirement of written notice to owners of the Contract or Future Contracts concerning certain withdrawal and refund rights.

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]."

A. DAC Tax Charge

1. *Section 27(c)(2)*. Section 27(c)(2) prohibits any deduction from premium payments made under periodic payment plan certificates other than a deduction for "sales load." "Sales load" is defined under Section 2(a)(35), in relevant part, as the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer (or in the case of a unit investment trust, by the depositor or trustee), less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities.

Sales loads on periodic payment plan certificates are limited by Sections 27(a)(1) and 27(h)(1) to 9% of total payments.

2. *Rule 6e-3(T)(b)*. Certain provisions of Rule 6e-3(T) provide exemptive relief from Section 27(c)(2) if the separate account issues flexible premium variable life insurance contracts, as defined in subparagraph (c)(1) of that Rule. Rule 6e-3(T)(b)(13)(iii) provides exemptive relief from Section 27(c)(2) to permit an insurer to make certain deductions, other than sales load, including "[t]he deduction of premium or other taxes imposed by any State or other governmental entity."