Manulife

TAX TOPICS

The Exempt Test

Introduction

For income tax purposes, a life insurance policy will either be considered exempt or non-exempt. If the policy qualifies as an exempt policy, the investment earnings associated with the cash value accumulation in the policy are not subject to annual taxation. As well, the death benefit proceeds (including the cash value) are received tax-free upon the death of the life insured. On the other hand, non-exempt policies are subject to accrual taxation on the annual investment earnings. Virtually all life insurance contracts currently available in Canada are structured to be exempt life insurance policies.

The Income Tax Act (the "Act") contains rules for determining if a life insurance policy is an exempt policy. The rules exist to ensure that the tax advantages associated with exempt life insurance policies are not available to policies that are mainly investment vehicles with only ancillary insurance protection. This Tax Topic will review the tests used to determine if a life insurance policy qualifies as an exempt policy and the respective maximum deposit amounts for a policy. It will also review the impact on the tests resulting from term conversions and other policy changes.

Future Modifications to the Exempt Test

In June 1994 the Department of Finance invited the Canadian Life and Health Insurance Association (CLHIA) to recommend changes to the exempt tests contained in the Act. They were interested in changes that would modernize the rules and address specific concerns regarding the tax shelter capacity of universal life insurance products. In a consultation paper submitted to the Department of Finance in 1998, the CLHIA recommended that the exempt test be redesigned, alternatives to the 250% test be introduced and interpretation of the tests be standardized for all insurance products and insurance carriers. They recommended that existing policies be grandfathered. Over the course of the ensuing years, Finance and the CLHIA have continued to discuss potential changes.

The 2012 Federal Budget announced an outline of proposed changes to the exempt test and on August 23, 2013 draft legislation was released. Further draft legislation was released on August 29, 2014, and with some minor modification, included in Bill C-43 which received Royal Assent on December 16, 2014. In general, the changes were within the range of what the insurance industry expected.

In general, the proposed changes will not bring about a wholesale, fundamental reform of the exempt test rules and appear to maintain the basic framework of the exempt test with updates to underlying assumptions and methods within it. However, the updates are significant and will generally negatively impact the level of tax-deferred growth permitted within exempt life insurance policies, both participating and non-participating alike.

The general conclusions regarding the impact of the changes may be summarized as follows:

- A reduction in the maximum premiums and/or deposits permitted in an exempt policy,
- A lengthening of the "quick-pay" period possible under any given set of assumptions in a life insurance policy illustration, and
- Lower permissible maximum cash value accumulations inside exempt insurance policies.

For further discussion of the main highlights of the future changes to the exempt test see the Appendix.

The new measures will not take effect until January 1, 2017 and will not apply to policies issued before 2017 where certain conditions are met. For a more detailed discussion of the conditions for grandfathering policies issued prior to 2017, see the November 2014 As a Matter of Tax "Draft Exempt Test Rules – Grandfathering of existing policies." .

The following article (with the exception of the Appendix) summarizes the current exempt test rules.

The Accumulating Funds

A life insurance policy is considered an exempt policy if it meets the exemption test contained in Regulation 306 of the Act. This test compares the accumulating fund of the actual policy to the accumulating fund in a theoretical policy known as the exemption test policy ("ETP"). Essentially, the ETP establishes the upper limit of the accumulating fund (which in many policies is determined to be the cash value accumulation within a policy) a policy can have and still be considered primarily a life insurance policy rather than primarily an investment vehicle. When performing the test there are two values to be concerned with: the accumulating fund of the actual policy and the accumulating fund of the ETP.

Canada Revenue Agency (CRA) commentary at the 2004 Conference for Advanced Life Underwriting annual meeting indicated that where a policy is issued in a currency other than the Canadian dollar, the exempt test rules are to be applied by converting the amounts in the computations to Canadian dollars using the currency exchange rate at the relevant time (i.e. at each policy anniversary). This would factor in foreign currency fluctuations when determining whether a policy is an exempt policy at any particular time. (Technical Interpretation #2004-0065391C6)

The Accumulating Fund of the Actual Policy

The accumulating fund of the actual policy is defined in Regulation 307 and Regulation 1401 of the Act. Not only is the accumulating fund used to determine whether a policy remains exempt, it is also used in determining the taxable policy gain, if any, when there is a partial surrender, and in determining the insurers liability for investment income tax. It is generally equal to the prescribed tax actuarial reserve of the policy. This reserve is the greater of the cash surrender value, and the one and one-half year preliminary term reserve. It is calculated without regard to any policy loan. In more technical terms, the preliminary reserve represents the excess of the present value of future benefits over the present value of future modified net premiums. The assumptions used to calculate the present value, the benefits, and premiums for purposes of calculating the preliminary reserve will differ with each product. For many products and in particular UL type policies as discussed below the accumulating fund equals the cash surrender value of the policy. The value of the accumulating fund changes with every premium and benefit payment.

In technical interpretation #2005-0145821E5 CRA was asked to consider whether a "modified net premium" could be determined when calculating the accumulating fund for a universal life policy. Universal life policies generally do not require an insurer-determined premium to be paid and, while deposits to the policy are actually premiums paid, they are not determined by the insurer and are not fixed in advance. The CRA confirmed, in the context of determining an insurer's investment income tax liability, that "in the event that the insurer can support its position that no reasonable amount in respect of its universal life insurance policies can be computed…it is our view that it would be acceptable to consider the amount determined …based on the CSV of the universal life insurance policies." As a result, many insurers assume the accumulating fund for their universal life insurance policies is equal to the cash surrender value.

The Accumulating Fund of the Exempt Test Policy (ETP)

The accumulating fund of the ETP is based on a hypothetical policy with the same life insured and the same death benefit as the actual policy. The accumulating fund of an ETP at the time it has been in force for at least 20 years is equal to the accumulating fund of a paid-up endowment at age 85 policy. (A policy endows when the accumulating fund equals the total death benefit payable.) In other words, the accumulating fund of the exempt test policy is essentially the size of a fund that would grow to an amount equal to the face amount of the policy by age 85 (growing at an assumed interest rate minus the cost of insurance). For the first 19 years, the accumulating fund is based on a fraction of the fund value for the 20^{th} year. Thus, in the first year, it is one-twentieth of the 20^{th} year fund value, two-twentieths in the second year, etc. As a result, the accumulating fund of an ETP deemed to have been issued before age 65 is approximately the same as that of a 20-pay endowment at age 85 policy. Policy loans are not deducted in this calculation. If the issue age is greater than 65 but less than 75, the accumulating fund of the ETP is based on a premium payment period of the difference between age 85 and the age at issue. If the issue age is greater than or equal to 75, the accumulating fund of the ETP is based on a 10 year endowment policy. The accumulating fund of an ETP is defined in Regulation 307 of the Act. The value of the accumulating fund of the ETP is based on the interest rates and insurance charges used by the insurance carrier when designing the actual policy.

The actual policy may have a number of ETPs associated with it. An ETP represents the death benefit of each coverage on the policy and each coverage may have a family of ETPs. The first ETP is created on the day the real policy is issued. On a single coverage policy there would only be one ETP at policy issue whereas for multiple coverages there will be several ETPs with a policy issue date, one for each coverage. Additional ETPs are created on every policy anniversary that the death benefit of the actual policy has increased by more than 8% over the previous year. This is a two step process. Step one is that the death benefit on the first ETP is increased up to 8%. Step two results in a new ETP created for insurance coverage in excess of the 8%. The issue date of the new ETP is the policy anniversary it was created on. This means that the accumulating fund of the new ETP begins on that date and grows gradually in respect of that coverage. Each ETP has its own accumulating fund calculated in the same manner as the first ETP. The sum of the accumulating funds of all the ETPs is the benchmark used in the exempt test.

The Exempt Tests

The test in its entirety is comprised of three different components; the pre-test, the annual test and the 250% test. The Act states that the actual policy must be tested by the life insurance carrier on every policy anniversary. The policy is exempt as long as the accumulating fund of the policy does not exceed, at any duration, the accumulating fund of the ETP, or the sum of the accumulating funds of all ETPs.

The pre-test

To be considered exempt, the accumulating fund must not only meet the test at that time (current test) but must also be expected to continue to meet the test on a prospective basis at each anniversary until the life insured attains age 85 (future test).

In the pre-test, the insurer is to assume that the terms and conditions of the policy do not change from those in effect on the last policy anniversary. For example, this includes assumptions that the dividend option elected will not change and that future premiums will be paid. The insurer must also make reasonable assumptions about all other factors, including the assumption that the amount of dividends paid will follow the current dividend assumptions. In order to negate the need for pre-testing and in recognition of the fact that it is not possible to definitively determine the amount which may be deposited and pass the exempt test on the next anniversary, many companies include contract wording committing to take steps to attempt to preserve a policy as an exempt policy. Where there is no contractual wording this pre-test must be performed at each anniversary along with the annual test.

The Annual Test

First, the policy's death benefit is compared to the policy's death benefit at the previous anniversary. If the comparison indicates that the death benefit of the policy has grown by more than 8%, the excess must be essentially treated like a brand new policy with a new ETP. A new and separate ETP is created for the excess with an issue date of that policy anniversary. This means that there is no room for additional deposits for the new ETP until after the policy anniversary. If the death benefit increase is less than 8% the increase is treated as if it occurred at the tax effective date of the policy. The tax effective date of the policy is generally the policy issue date.

A Canada Revenue Agency (CRA) interpretation letter dated November 2, 2001 (#2001-007922) indicates that all elements of the policy that can be paid out as a death benefit should be included in the calculation of the 8% test. This includes pure death benefit amounts (face amount and any death benefit riders) and any account value.

Many universal life products have riders that are specifically designed to take advantage of this 8% test. For example, Manulife's Wealth Enhancer rider available on InnoVision (one of our universal life products) automatically increases death benefit coverage by up to 8% when required in order to maximize the amount that can grow tax-deferred under the policy and still keep the policy exempt.

Secondly, the accumulating fund is compared to the sum of all the accumulating funds of the ETPs associated with the policy. Again, if the accumulating fund of the real policy is in excess of the sum of all the accumulating funds of the ETPs, the policy fails the exempt test.

The 250% test
In addition to the standard anniversary exempt test, another test is performed on the tenth and subsequent anniversaries of the policy. This test, commonly referred to as the "anti- dump-in rule" or "250% test" is intended to prevent large lump-sum deposits to a policy after the seventh anniversary date. This test examines the accumulating fund from the last three years. Under this test, if the accumulating fund exceeds 250% of the accumulating fund on the third preceding anniversary, then the ETPs associated with the policy are redated. That may or may not be to the advantage of the policy owner depending on the level of funding. Generally, the issue dates of all the ETPs associated with the policy are changed to that third preceding anniversary which limits the growth in the policy so that it would be similar to a policy issued three years prior. The annual test is then performed using the redated ETPs.

Failing the 250% test changes the structure of the ETP by redating. To be proactive, Manulife chooses to invoke the 250% test when calculating the maximum deposit amount for most universal life policies immediately after the seventh policy anniversary to prevent large withdrawals or refunds at the 10^{th} and subsequent anniversaries.

In practice, the ETPs do not have to be redated if sufficient funds are removed from the policy to reduce the accumulating fund to be 250% of the accumulating fund at the third preceding anniversary. At Manulife, the general administrative practice is to take the course of action that results in the greatest potential for future accumulation within the policy.

To minimize the effect of the 250% test, one should avoid having a low accumulating fund (i.e. cash value in the case of UL policies) on any policy anniversary after the sixth policy anniversary. For the initial 250% test, the maximum accumulating fund value allowed should be accumulated under the policy prior to the seventh anniversary. For example, any additional planned deposits should be made prior to the seventh anniversary.

Keeping the Policy Exempt
Generally, under the terms of the insurance contract, the life insurance carrier takes responsibility to take steps to attempt to preserve a policy as an exempt policy. The life insurance carrier can take actions on the anniversary date to ensure that exempt status is retained. Most Manulife contracts specify that the following actions (or a combination) will be taken, in the stated order, when a policy fails the exempt test on any anniversary date:

1. The death benefit is increased, within the limits prescribed by the regulations in the Act (i.e. the 8% increase described above), if this is a feature of the policy as defined in the contract.
2. A policy loan repayment is made by withdrawing from the cash value of the policy, if policy loans are a feature of the policy as defined in the contract. This would lower the accumulating fund.
3. Funds are withdrawn from the cash value of the policy. This may result in a taxable policy gain that must be included in the income of the policy owner

Another course of action which some insurers may take is to reverse any excess premiums deposited to the policy by the current owner in the policy year. In other words, the excess premium is treated as if it was never deposited to the policy in the first place. In 2006 CRA was asked whether the reversal of premiums in a universal life insurance policy constitutes a disposition under Section 148 of the Income Tax Act (see technical interpretation #2006-0181641E5). CRA indicated that a "premium reversal" appears to result in a partial disposition of the policy under section 148 of the Act and that there is no legal basis to reverse transactions that have previously occurred. In the past, Manulife used premium reversals to keep policies exempt. This is no longer part of Manulife's process for maintaining exempt status.

Older inforce policies may not contain exempt test wording in their contracts. In these cases the policy owner has 60 days grace to restore the policy's exempt status. The insurer cannot take corrective action until the policyholder provides direction to do so. If there is no corrective action and 60 days from the date of failure has passed, the policies will become non-exempt and subject to accrual taxation.

The Maximum Deposit Amount

Keeping the policy exempt may also be done during the policy year by not allowing deposits into the policy that exceed maximum amounts expected to be permitted as of the subsequent policy anniversary. At Manulife, a maximum deposit evaluation is performed on most universal life policies whenever a deposit is received. The evaluation estimates the greatest deposit that can be applied to the policy, on that date, without causing the policy to fail the exempt test at the next policy anniversary. The estimate is based on a projection of the values, dividends, investment growth and insurance coverages and costs of the actual policy on the date the estimate is prepared compared to a projection of the accumulating fund of the ETPs for the policy. The projection of the ETPs is based on the death benefit at the last anniversary plus 8% or the projected growth in the accumulating fund. It assumes that there will not be any changes to the policy over the next policy year. For example, additional deposits, changes to the investment mix, market fluctuations that impact rates of return on the investments and changes in insurance coverage are not considered.

The 8% test allows the death benefit of the exempt test policy to grow by 8% each year. This not only has an impact on the actual policy's death benefit growth, but also its deposit room. In essence, the amount you are permitted to put into a policy is a function of the growth allowed within the policy under the exempt test rules. The growth is based on a linear scale and provides for better funding in the early years. However, since the ETPs are set annually and the test is based on the prior year's death benefit the 8% opportunity is not cumulative. In years that it is not fully utilized, the excess room cannot be carried forward into the next policy year. For maximum deposit room and death benefit growth the full 8% increase in death benefit should be utilized each year.

Term Conversions

Term life insurance is pure protection insurance that provides a death benefit if the life insured dies within the specified period of the policy. Term insurance policies typically do not have an investment component or the ability to accumulate cash value within the policy. However, term insurance contracts often contain an option to have the policy converted to a permanent insurance contract. It has been generally held in the industry that a new permanent life insurance policy that is issued as a conversion under a contractual right of a term policy is considered a continuation of the original policy provided certain criteria apply (such as the owner and life insured of the new permanent policy are the same as the term policy), and provided it is administratively possible. In these circumstances the industry view has generally been that there is no disposition for income tax purposes due to the exception in paragraph 148(10)(d) of the Act and the tax attributes of the original term policy, such as the adjusted cost basis and ETP, are carried forward to the new insurance policy. (See further discussion on this viewpoint below.)

Continuation means that the ETP associated with the new permanent policy is the same ETP that was associated with the term policy. Therefore the issue date of the ETP is the date that the term policy was issued. For term policies that are converted prior to the seventh anniversary there will be room to deposit funds into the permanent policy because of the growth of the accumulating fund of the ETP. It is important to deposit the maximum allowed immediately after the conversion to minimize the effect of the 250% test in future years.

Where a term policy is converted after its seventh policy anniversary, the 250% test may significantly restrict the amount of deposits that can be made to the permanent policy. This is because the 250% test will be applied on the tenth and subsequent anniversaries. The test will compare the accumulating fund on that anniversary to the accumulating fund on the third preceding anniversary. At the third preceding anniversary the policy was term life insurance and the accumulating fund may be essentially nil. This means that the policy will fail the 250% test (250% of nil = nil) and the ETP will be redated to the third preceding anniversary. The policy will fail the 250% test for the two years following and the ETP will be redated to the third preceding anniversary each time. As a result, the policy will have roughly the same deposit room that it would have had if the policy had been issued three years ago. In essence, the rate of growth of the accumulating fund is limited.

Accordingly, it makes sense to convert term policies prior to the seventh anniversary so that larger deposits can be made to the new permanent policy to take advantage of the room available from the carried forward ETP. This deposit room is limited by the 250% test if the conversion takes place after the seventh anniversary.

Note, however, that the industry position that 148(10)(d) applies to deem term conversions not to be a disposition has been brought into question by some CRA commentary (technical interpretation #2007-0229771C6). In this commentary CRA stated that

> …Paragraph 148(10)(d) provides that a policyholder will not be deemed to have disposed of or acquired an interest in a life insurance policy (other than an annuity contract) as a result **only** of the exercise of any provision (other than a conversion into an annuity contract) of the policy. In order to give meaning to the word "only", it is our view that it is necessary to determine whether the changes that are made to the terms of the policy, including but not limited to the premium structure, are so fundamental as to go to the root of the policy. If this were the result, there would be a disposition of the policy and the acquisition of a new policy. Such a determination can only be made on a case by case basis.

At the 2005 CLHIA Conference CRA confirmed there is no disposition of the policy where the conversion of a life insurance policy issued by one company into a policy issued by another company where there has been a consolidation of the two companies (2005-0164711C6). However the interpretation laid out the facts in a way that assumed there would not have been a disposition if the converted policy were issued by the original company. The 2007 interpretation noted above commented on the 2005 interpretation as follows:

> To clarify [we] were not asked to nor did we provide any comment on whether a disposition results on the conversion of a policy into another life insurance policy issued by the same insurer in accordance with the terms of the policy. In that particular situation, if the exercise of the conversion right would not, by virtue of paragraph 148(10)(d), result in a disposition of the term policy if the whole life policy had been issued by Company A, it would not result in a disposition where Company B issues the whole life policy.

As a result of these comments, the commonly held industry position may not be as clear cut as was previously thought.

Policy Changes

When contemplating policy changes, consideration should be given to the impact on the exempt test and maximum deposit room. Policy changes such as coverage increases and decreases or coverage additions and deletions affect the death benefit and therefore will affect the deposit room and the exempt test at the next anniversary. The test compares the policy's death benefit at the end of the year to the policy's death benefit at the previous anniversary. The net change in the death benefit is measured. Care must be taken where there is a significant decrease in death benefit that the policy will not be off side when exempt tested at the next anniversary. Where the death benefit has decreased, the ETPs are adjusted on a LIFO (last in, first out) basis. That is, ETPs will be reduced in the reverse order to which they were created. Since ETPs are only set up at policy anniversary dates, additional insurance coverage added during the policy year does not create additional deposit room until the next policy anniversary date.

For policies which define the accumulating fund as the cash surrender value, where the account value is paid out on first death, the accumulating fund and cash surrender value of the policy is depleted. The policy values must be brought up to pre-death levels before the next policy anniversary to prevent any impact on exempt testing.

Substituting lives is another policy change that affects the age and duration that the exempt test is based on. Neither the Act nor the Regulations address the issue of substituting one life insured for another life. This issue was studied at length by the Exempt Test Sub-Committee of the Committee on Policyholder Taxation during 1991. In its subsequent report in 1997 the committee did not recommend changes to the Act or Regulations, rather it recommended that some industry guidelines be provided. The guidelines set forth in the CLHIA Policyholder Tax Manual are as follows. Where a life insurance policy provides a contractual right to allow one life insured to be substituted for another life insured a disposition should not result since there has been no change in ownership of the policy. The exempt test should then be based on the lesser of the age of the new life at the real duration of the policy at the time of the substitution of life and the exempt test for the policy, based on the real duration of the policy before the substitution of the life insured. Where the result is a reduction in the accumulating fund, because of a change in the exempt line, the excess above the amount to maintain the policy should be paid out of the policy to the policyholder and treated as a partial disposition. Note that CRA commentary on the issue of whether substituting lives results in a disposition, is unclear. In technical interpretation 2002-0127505 from the 2002 CALU roundtable the CRA indicated that in the context of substituting lives "..It would be necessary to determine whether the alteration of the agreement constitutes a variation of the existing agreement such that the original agreement survives, or whether the alteration is so fundamental that it results in the creation of a new contract between the parties and the extinguishment of the original agreement." The 2007 commentary mentioned earlier (technical interpretation #2007-0229771C6) with regard to paragraph 148(10)(d) again raises uncertainty as to whether policy changes (including a substitution of lives) would be considered a disposition.

Note that other policy changes may also affect the deposit room and the exempt test with varying results such as a switch to level cost of insurance, fund switches, and smoker status changes.

Conclusion

In summary, a life insurance policy will qualify as an exempt policy if the accumulating fund of the actual policy does not exceed and is not expected to exceed the sum of the accumulating funds of the associated ETPs. The annual 8% increase in death benefit provides for substantial tax deferred savings when fully utilized. The 250% test will prevent large lump-sum deposits to a policy after the seventh anniversary.

The tax advantages associated with exempt life insurance policies are significant and therefore it is important to maintain exempt status.

Last updated: February 2015

Appendix

Changes to Life Insurance Policy Exempt Test Effective January 1, 2017 - Highlights

The general impact of the new rules will be as follows:

- A reduction in the maximum premiums and/or deposits permitted in an exempt policy;
- A lengthening of the "quick-pay" period possible under any given set of assumptions in an illustration;
- Lower permissible maximum cash value accumulations inside exempt insurance policies.

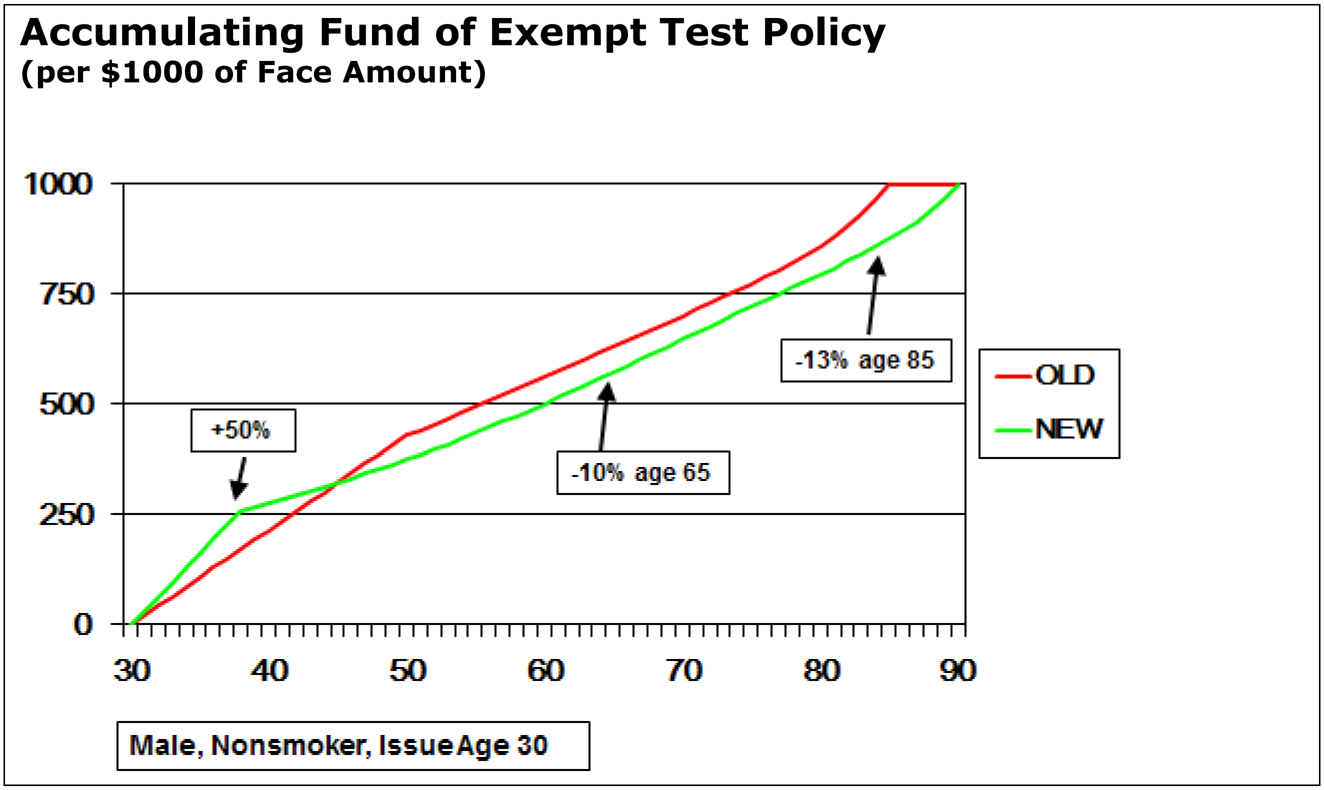
The new rules make changes to the hypothetical benchmark policy and to the calculation of the savings component of both the benchmark policy and the actual policy.

The current benchmark policy is generally described as a 20-pay endowment at age 85 policy. The savings component is determined using interest, mortality and lapse assumptions that are selected by insurance companies. The new rules change the benchmark policy to an 8-pay endowment at age 90 policy and mandates the interest and mortality assumptions that are to be used to determine the savings component of this benchmark policy. A 3.5% interest rate and the Canadian Institute of Actuaries ("CIA") 86-92 mortality table must be used.

The savings component of a policy is currently the greater of the cash surrender value of the policy (i.e. after deducting surrender charges) and a reserve calculation using the same insurer-selected assumptions as used to determine the savings component of the benchmark policy. The new rules change this to the greater of the fund value of the policy (i.e. cash values prior to the deduction of surrender charges) and a new reserve calculation using the same mandated interest and mortality assumptions that are used to determine the savings component of the benchmark policy.

The changes in the benchmark policy generally increase the permitted level of savings in the first 8-12 years of a policy but reduce the permitted savings thereafter. The changes in the measurement of the savings component of the policy generally decrease the permitted savings in all policy years. The net result of these two changes for most insurance policies is generally neutral in the first 8-12 policy years (i.e. no material increase or decrease in maximum premiums/deposits) and lower permitted savings thereafter. Universal life policies that apply relatively large surrender charges will see material reductions in maximum premiums/deposits in all policy years. Although participating whole life policies do not generally carry surrender charges and will therefore not be affected by the provisions that specifically address surrender charges, participating policies will be subject to the changes in the benchmark policy and the changes in the reserve calculation for the savings component of the policy and can be expected to experience lower permitted savings as a result of these changes.

The following chart graphs the impact of the changes to the underlying assumptions by comparing the Accumulating Fund of the Exempt test policy as currently calculated to the Accumulating Fund of the Exempt test policy as calculated using the proposed assumptions:



While the change to shorten the assumed payment period in the Accumulating Fund of exempt test policies appears to increase the available funding room in the early years of a policy, this graph does not reflect the changes regarding surrender charges and the reserve calculation for the Accumulating Fund of the policy discussed above. These additional changes are expected to partially or perhaps totally eliminate this effect.

In addition, the new rules will change the 8% test, the 250% test and several policyholder tax rules relating to exempt policies.

Under the current legislation the 8% test applies to the total death benefit of a life insurance policy. Under the new rules post-2016 policies are to apply this rule separately to each insurance coverage under the policy.

This change is primarily intended to ensure that the legislation appropriately addresses the modularity and flexibility of Universal Life policies. For example, it will lessen the increase in the maximum premiums and/or deposits that occurs when a new insurance coverage is added to an existing life insurance policy but will not otherwise have a significant effect on the results of the exempt test.

Under the new rules, the general structure of the 250% test is preserved. For all policies (whether pre-2017 or post-2016), starting on the tenth anniversary, the test compares the current accumulating fund of the policy to 250% of the accumulating fund of the policy three years previous.

The new rules expand relief provisions in the event that the accumulating fund of the policy grows to more than 250% of its value from three years prior. These expanded relief provisions will apply retroactively to all policies that are subject to the exempt test.

The first relief provision allows the accumulating fund of the policy to grow by more than this 250% limit over the three-year period of the test provided the growth in the accumulating fund of the policy is less than the growth in the accumulating fund of the exempt test policy(s) over the three-year period. This relief provision addresses situations where the accumulating fund of a policy was very low. For example, a policy that had an accumulating fund of $0 three years prior to the test is not allowed any growth in the absence of this relief provision as 250% of $0 is still $0.

The second relief provision applies when the 250% test is failed and as a consequence of this failure the exempt test policies of a policy are re-dated to be no more than 3 year old. The new rules specify that when such re-dating of the exempt test policies occurs, the 250% test is not to be applied again until seven years have elapsed. Essentially, the 250% test is only to be applied on or after the policy anniversary at which the duration of the oldest exempt test policy associated with a policy is ten years. In the absence of this relief provision the re-dating of exempt test policies in response to a failure of the 250% test was often required to take place in consecutive policy years.

Related policyholder tax rules will also change. These are discussed in the September 2013 As a matter of tax article entitled "Exempt test draft legislation – Highlights" and the September 2014 As a matter of Tax article entitled "August 2014 Exempt Test Draft legislation – Highlights".