Understanding the 8% and 250% tests

The cash value inside a tax-exempt life insurance policy accumulates on a tax-advantaged basis within certain limits set out in the *Income Tax Act* (Canada) ("ITA"). Two elements of these limits are the eight per cent and 250 per cent tests. This article takes a closer look at these two tests and highlights how they changed in 2017.

The exempt test and the eight per cent and 250 per cent tests

The ITA provides favourable tax treatment to life insurance policies that are protection oriented compared to policies that are investment oriented. The cash value inside protection oriented life insurance policies are allowed to accumulate on a tax-advantaged basis, while the cash value accumulating (annual growth) inside investment oriented policies are subject to annual accrual taxation. To differentiate a policy that is protection oriented from an investment oriented policy, the ITA and the *Income Tax Regulations* (ITR) include a measure called the "exempt test". If a policy passes the exempt test, it is considered an exempt policy – meaning the annual cash value growth inside the policy (generally referred to here as the accumulating fund) is not subject to annual accrual taxation.

The exempt test consists of testing the actual policy against a hypothetical policy called the "exemption test policy" (ETP)[i]. The ETP is a hypothetical policy with the same life insured and same death benefit as the actual policy. For a policy to remain tax-exempt, the accumulating fund inside it must not exceed the accumulating fund calculated for the ETP (or the associated ETPs, as discussed below).

Along with the ETP comparison, there are two other features of the exempt test that limit cash value growth:

1. The **8 per cent test**: An annual increase in the death benefit coverage over eight per cent cannot be used to create additional sheltering capacity in that year. Generally, the higher the death benefit, the more cash value that is permitted to accumulate within a policy on a tax-advantaged basis. The eight per cent test provides a limit on how much coverage a policyowner may add to a policy so that it remains tax-exempt.

2. The **250 per cent test**: It applies where the accumulating fund of the actual policy on its tenth or any subsequent anniversary exceeds 250 per cent of the accumulating fund on the third preceding anniversary date. This rule therefore becomes relevant to a policy's cash value on its seventh anniversary (e.g., since the 250 per cent test first applies on a policy's 10th anniversary, it looks back for applying the test, to the policy's cash value on its seventh anniversary).

Each of these two tests is described in more detail below.

The eight per cent test

As noted, the amount that is allowed to accumulate inside a policy on a tax-advantaged basis is dependent on the death benefit. The higher the death benefit, the greater the cash value that is permitted to accumulate within the policy on a tax-advantaged basis. In theory, if the actual policy's accumulating fund exceeds that of the ETP, the easiest solution to maintain its tax-exempt status is to add coverage to increase the death benefit. Indeed, typically a universal life policyholder can choose to have automatic adjustments made to their death benefit coverage levels to maintain the policy's tax-exempt status. However, the eight per cent test is designed to limit these coverage increases as a means of creating sheltering room. Any annual increase in death benefit coverage over eight per cent in a given year cannot be used to create additional sheltering capacity in that year.

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According to this rule, if the annual increase in death benefit of the policy is more than eight per cent higher than the policy's death benefit at its previous anniversary, a separate and new ETP is deemed to be issued at the anniversary for the excess amount. The excess amount of death benefit is treated as if it is a new policy issued for that amount. As a consequence of this rule, a single policy may have a family of ETPs associated with it over a period of time.

What's the impact of having a new ETP?

Similar to how a higher death benefit increases the amount of cash value that a policy may shelter from annual accrual taxation; the age of the ETP affects this amount as well. Older ETPs have more sheltering capacity, while the newer ETPs have less. This is because the cash value of the ETP will actually equal the death benefit by the time the life insured reaches age 85 (or 90 in case of policies issued after 2016). Thus, for death benefit increases in excess of eight per cent, the initial sheltering capacity will be less because the accumulating fund for that coverage will be measured against the separate ETP that is deemed to have been issued at that specific anniversary. As noted, there is no sheltering capacity available in the year that the new ETP is issued.

If a new ETP is issued to accommodate a coverage increase in excess of eight per cent, then going forward the accumulating fund of the actual policy is compared with the sum of accumulating funds of all ETPs associated with the actual policy.

The eight per cent test for policies issued after 2016

For policies issued before 2017, the test is applied at the *policy* level (e.g., total death benefit under the policy). Thus, in the case of (i) a multi-life policy, (ii) a policy with a term rider or (iii) a universal life policy designed to pay the face value plus fund value; the eight per cent increase can be applied to any coverage as necessary to avoid issuance of a new ETP.

For policies issued after 2016, the test is applied to the *coverage* level (e.g., separately to each insurance coverage under the policy). This takes away the flexibility at the policy level to apply the eight per cent increase to any coverage within the policy.

a) Example

Assume that two individuals are insured under one policy. Mr. A has coverage of $2,000,000, and Mr. B has coverage of $1,000,000.

Before 2017, the policy coverage can increase each year up to $240,000 ($3,000,000 X 8%) without requiring the deemed issuance of a new ETP. The increase of $240,000 can be allocated between the actual policy's two coverages in any ratio to maintain exempt status.

After 2016, up to $160,000 can be added to Mr. A's coverage and up to $80,000 can be added to Mr. B's coverage. Therefore it is no longer possible to use the potential death benefit increase available on one coverage to avoid the other coverage under the same policy failing the eight per cent test.

The 250 per cent test

The 250 per cent test is designed to limit the cash value growth within a policy in relation to its own deposit or premium history, rather than in relation to the ETP. This test is also known as the anti-dump-in rule.

In general terms, the 250 per cent test limits large deposits or premium increases into a policy after its seventh anniversary if there is not already a sizable accumulating fund built up within the policy. The test operates so that starting on the 10th policy anniversary, the accumulating fund of the actual policy is compared with its accumulating fund at the

third preceding anniversary (e.g., seventh policy anniversary). The test is failed if the accumulating fund increased by more than 250 per cent over this three year period.

If this test is failed, then in order to maintain the policy's tax-exempt status (i) the excess cash value must be withdrawn or (ii) the ETPs older than three years which are associated with the policy are re-dated to the third preceding anniversary. If a policyowner actively overfunds a policy then re-dating should be avoided as it may result in a considerable reduction of future sheltering capacity (as noted, older ETPs have more sheltering capacity). Generally speaking, insurance contracts typically allow a policyowner to withdraw the excess accumulating funds from the policy to preserve this (older ETPs) sheltering room. As discussed below, no action may be necessary after 2016 for policies that fail the test with relatively smaller accumulating funds.

The 250 per cent test after 2016

The 250 per cent test was seen as overly harsh in situations where the policyowner did little or no overfunding by the seventh policy anniversary. In these cases the 250 per cent test reduces any future overfunding opportunity due to re-dating of ETPs. To address this concern, the 250 per cent test is amended so that if the growth of the policy's accumulating fund is more than 250 per cent the policyowner no longer needs to either withdraw cash from the policy or have the ETP re-dated if:

- For policies issued **before 2017**, the accumulating fund of the actual policy does not exceed **15 per cent**[ii] of the accumulating fund(s) of the ETP(s) issued in respect of the policy.
- For policies issued **after 2016**, the accumulating fund of the actual policy does not exceed **37.5 per cent**[iii] of the accumulating fund(s) of the ETP(s) issued in respect of the policy.

Furthermore, if a policy fails these tests and its ETPs are re-dated, then unlike the current rule where the 250 per cent test is applied annually, the policy will not need to be retested again until the following seventh policy anniversary.[iv]

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[i] ITR 306(3)
[ii] ITR 306(6)
[iii] ITR 306(6)
[iv] ITR 306(7)

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