ESTATE PLANNING | WEALTH TRANSFER

Protecting What You've Built: Life Insurance as an Estate Planning Tool

For families with taxable estates, life insurance — structured and held correctly — is one of the most efficient tools available for preserving wealth and ensuring your legacy reaches the next generation intact.

Thoughtful estate planning involves more than deciding who receives your assets. For families with significant wealth, it requires anticipating the obligations that arise at death — and ensuring those obligations do not force difficult decisions at the worst possible time.

Federal estate taxes can consume a substantial portion of a taxable estate at a 40 percent rate, and they are due in cash within nine months of death. For families whose wealth is concentrated in real estate, a family business, or other assets that cannot easily be converted to cash, that deadline creates a liquidity challenge that no amount of careful investment planning can fully address on its own.

Life insurance, when properly structured within an estate plan, directly addresses that challenge. This article explains how it works, why it is particularly well-suited to the estate planning context, and what families should understand before deciding whether it belongs in their plan.

The Estate Tax: What Families With Significant Wealth Need to Know

The federal estate tax applies to the transfer of wealth at death above certain exemption thresholds. For 2025, the federal exemption is $13.99 million per individual, or approximately $27.98 million for a married couple.[1] Under the One Big Beautiful Bill Act, signed in July 2025, the exemption will rise to $15 million per person ($30 million per couple) beginning January 1, 2026, with annual inflation adjustments going forward.[2]

Estates exceeding those thresholds are subject to a federal estate tax of up to 40 percent on the taxable excess.[3] For a family with a $20 million estate, that could represent several million dollars owed to the federal government — in cash — within nine months of the second spouse's death. Some states impose their own estate or inheritance taxes at lower exemption levels, adding further exposure for residents of those states.

The challenge for most families is not the tax itself — it is the timing and the form. Estate taxes do not wait for a favorable real estate market or a good moment to sell a business interest. Without a specific plan to address liquidity at death, heirs may find themselves forced to sell valued assets quickly, often at a discount, simply to satisfy an obligation that could have been anticipated and funded in advance.

How Life Insurance Addresses the Liquidity Problem

Life insurance occupies a unique position among planning tools because it delivers a known, guaranteed benefit — in cash, free of income tax — at exactly the moment the estate needs it most.[4] Unlike other assets that require time, negotiation, or favorable market conditions to convert to liquidity, a life insurance death benefit arrives promptly, outside of probate, and without dependence on any external factor.

The planning logic is straightforward: rather than leaving heirs to fund a substantial, unpredictable estate tax bill from existing assets, a family uses a series of manageable premium payments over time to pre-fund that obligation. The death benefit — which in most cases significantly exceeds total premiums paid — is then available to cover estate taxes, settle debts, or provide heirs with liquidity while the estate's other assets are preserved intact.

For families with illiquid wealth — a family business, real estate portfolio, farmland, art, or private investments — this distinction is especially meaningful. Those assets represent a lifetime of work and, often, deep personal

significance. A well-designed life insurance strategy ensures that heirs are not put in the position of choosing between honoring the estate tax bill and preserving the assets that matter most.

A Question Worth Asking

If a significant portion of your estate were required to be converted to cash within nine months of your death, which assets would your heirs sell — and at what cost? Identifying the answer to that question is often the most clarifying step in an estate liquidity conversation.

The Irrevocable Life Insurance Trust: Keeping Proceeds Outside the Taxable Estate

There is an important structural consideration that families must understand: a life insurance policy owned by the insured will, in most circumstances, be included in the taxable estate.μ This means that without proper planning, a $10 million policy could itself generate estate tax rather than solve it — a result that defeats the strategy entirely.

The solution is an Irrevocable Life Insurance Trust, commonly referred to as an ILIT. When a life insurance policy is owned by an ILIT rather than by the insured, the death benefit falls outside the taxable estate. Proceeds flow directly to the trust, free of both income and estate tax, where the trustee can then distribute funds to heirs, cover estate taxes, or provide liquidity to the estate as specified in the trust document.

The ILIT structure also offers benefits beyond estate tax reduction. Because the trust owns the policy and controls the proceeds, families can specify precisely how and when distributions are made to beneficiaries. The trust's assets are generally protected from beneficiaries' creditors. And in situations where an estate includes a family business or real estate, the ILIT trustee can use proceeds to purchase those assets from the estate or lend funds to the estate — providing liquidity without a forced sale.

What families should understand about the ILIT structure

An ILIT is a powerful planning tool, and like most powerful tools, it comes with tradeoffs that should be understood clearly before proceeding:

- The trust is irrevocable. Once established, its terms generally cannot be changed, and the grantor cannot reclaim the policy. This permanence is the source of its tax benefits, but it requires confidence in the planning objectives before the trust is created.
- The insured should not serve as trustee. To preserve the estate tax exclusion, the insured cannot retain administrative control over the policy. An independent trustee — a trusted individual or a corporate trustee — is typically named.
- Best practice is to have the ILIT purchase the policy directly. Transferring an existing policy into an ILIT triggers a three-year rule under federal tax law: if the insured dies within three years of the transfer, the death benefit is pulled back into the taxable estate.[6] Having the trust own the policy from the outset avoids this entirely.
- Annual premium contributions require proper administration. Gifts to the trust to fund premiums can qualify for the annual gift tax exclusion ($19,000 per beneficiary in 2025[7]), but beneficiaries must receive timely written notice of a temporary right to withdraw each contribution — a process known as Crummey notices, established in Crummey v. Commissioner (9th Cir. 1968). Proper administration of this process is essential.

Choosing the Right Policy Structure

Not all estate planning situations are the same, and the type of life insurance policy that belongs inside an ILIT depends on the individual's circumstances — marital status, age, health, estate composition, and the timing of

when the tax obligation is most likely to arise. The most common structures are single-life policies and survivorship (second-to-die) policies, and each serves a distinct planning purpose.

Single-life policies

A single-life policy insures one individual and pays the death benefit upon that person's death. For individuals who are unmarried, divorced, or widowed, a single-life policy held in an ILIT is often the most direct and appropriate structure. The estate tax obligation arises at the individual's death, and the policy is designed to deliver liquidity at precisely that moment.

Single-life policies also make sense in situations where the estate tax exposure is concentrated in one person's estate regardless of marital status — for example, when assets are held separately, when the estate plan does not rely on the marital deduction, or when the planning objective is to address a known tax liability at first death rather than deferring it. Universal life (UL) policies, which offer premium flexibility and the potential for cash value accumulation, are commonly used in this context for large death benefit amounts.

Survivorship policies

For married couples, the federal estate tax is typically deferred until the death of the surviving spouse under the unlimited marital deduction. The estate tax obligation most often crystallizes at the second death — which is exactly when a survivorship, or second-to-die, policy pays its benefit. Because the policy insures two lives and pays only after both have passed, premiums are typically lower than equivalent single-life coverage for either spouse, making survivorship policies cost-efficient for large death benefits.

Regardless of which structure applies, the planning principle is the same: the policy is designed to deliver a known, income-tax-free benefit at the moment the estate needs liquidity most. When held in an ILIT, the death benefit stays outside the taxable estate and gives the trustee the flexibility to cover estate taxes, preserve illiquid assets, or provide for heirs according to the family's intentions.

Planning in the Current Environment

The One Big Beautiful Bill Act, signed into law on July 4, 2025, permanently raised the federal estate and gift tax exemption to $15 million per person beginning January 1, 2026, with annual inflation adjustments thereafter.[2] This represents meaningful stability for families who have been planning around the former TCJA sunset. The urgency of making large gifts before a legislative deadline has passed.

That stability does not diminish the planning opportunity — it clarifies it. Families with estates currently at or above $30 million face federal estate tax exposure now. Families with estates growing toward that threshold should plan accordingly. And because estate tax law has changed materially multiple times over the past two decades, the permanence of any legislative provision is never certain. A well-structured ILIT and life insurance strategy represents a durable hedge against a tax environment that remains subject to future change.

Families considering this approach should also be aware that medical underwriting for large life insurance policies — particularly for older insureds — takes time. The process of applying, underwriting, and placing coverage for a $10 million or larger policy can require several weeks to several months. Beginning that conversation early is not a matter of urgency; it is a matter of having options.

Questions Worth Discussing With Your Advisor

Whether life insurance belongs in your estate plan depends on your specific circumstances: the size and composition of your estate, your planning objectives, your family structure, and your intentions for the assets you've built. The following questions can help frame that conversation:

- What portion of my estate is illiquid, and what would it cost to convert those assets to cash on a compressed timeline?
- What is my projected estate tax exposure at current exemption levels, and how might that change if exemptions are reduced in the future?

- Are there assets in my estate that I would want my heirs to preserve — a business, a property, an investment — regardless of other estate obligations?
- What is the most cost-efficient way to pre-fund a known future obligation of this size?
- How does life insurance compare, in total cost, to the alternatives my estate would face without it?

These are not questions with universal answers. But they are questions that, when examined carefully alongside your advisor and estate planning attorney, tend to produce clarity about whether and how life insurance fits your plan.

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References

[1] Internal Revenue Service. “Tax Year 2025 Inflation Adjustments.” IRS Rev. Proc. 2024-40.

[2] Davis+Gilbert LLP. “After the One Big Beautiful Bill: Estate Tax Updates.” July 2025. https://www.dglaw.com/after-the-one-big-beautiful-bill-estate-tax-updates/

[3] Internal Revenue Service. “Estate and Gift Taxes.” https://www.irs.gov/businesses/small-businesses-self-employed/estate-and-gift-taxes

[4] Internal Revenue Code §101(a)(1). Life insurance proceeds generally excluded from gross income.

µ 26 CFR §20.2042-1. Proceeds of life insurance; inclusion in gross estate.

¶ 26 U.S.C. §2035. Three-year rule for transfers of life insurance within three years of death.

[7] IRS Revenue Procedure 2024-40. Annual gift tax exclusion for 2025: $19,000 per donee. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

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