Life Insurance for Estate Tax Liquidity

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Life insurance serves as an essential tool in the estate planning process for high-net-worth clients. This article reviews the most frequent questions related to its use to transfer wealth more efficiently.

What is the Estate Tax?

The federal estate tax is a tax on the transfer of assets at death. For married couples, the tax is imposed on the transfer of assets at the second spouse's death. The fair market value of all assets at death is the "Gross Estate." After certain deductions are applied against the "Gross Estate", the remaining "net amount" is then added to the value of lifetime taxable gifts and the tax is computed. The tax is then reduced by the unified credit, frequently referred to as the estate and gift tax exemption.

What is the Unified Credit?

The unified credit unifies the gift and estate taxes into one tax system that decreases the tax bill of the individual or estate dollar for dollar. Until December 31, 2025, the Unified Credit is $10,000,000 (adjusted for inflation) per person, and sits at $12,060,000 for 2022 after inflation adjustments. For those who pass after January 1, 2026, the Unified Credit is scheduled to sunset back to $5,000,000 (adjusted for inflation) per person (or $10,000,000, adjusted for inflation, for a married couple).

What is the Problem?

Many high-net-worth estates are comprised of valuable, but rather illiquid assets. Being unable to predict the timing of one's death (and the associated market conditions) could force future generations to sell assets to create liquidity at an inconvenient and costly time. While costly extensions may exist for certain family-owned farms and businesses, the estate tax is generally due nine months after death.

How Does Life Insurance Help?

Life insurance provides liquidity (cash) for the estate exactly when it is needed. Gifts are made by the grantor each year into an Irrevocable Life Insurance Trust (ILIT). The trustee leverages the gifted sums into the much larger, liquid sum provided by the life insurance death benefit. For married couples, survivorship life insurance is frequently utilized as it (1) generally provides a lower premium than on an individual life policy and (2) funds the trust exactly when the liquidity is needed. Because the gifts are made irrevocably, the death benefit is kept outside of the taxable estate. The trustee is authorized to loan money to the estate or can purchase assets from the estate to ensure cash is available to pay any estate tax liability.

Example

John and Linda are in their mid-70s and have an estate currently valued at $30 million, largely comprised of commercial real estate and marketable securities. Their estate planning attorney has advised them to prepare for an estate tax of approximately $19.2 million to be levied upon the second death. Through gifting and other estate reduction strategies, she believes the amount of liquidity needed for the estate will be approximately $15 million and recommends they execute an irrevocable life insurance trust to purchase a survivorship life insurance policy in that amount.

An ILIT is created. Each year, gifts are made into the trust in the amount of $128,000, to cover the premium of the life insurance. At the time of the second spouse's death, the trust, as beneficiary of the life insurance policy, is funded with $15,000,000 of cash. Because the policy is owned by the ILIT, the death benefit proceeds are held outside of the taxable estate. Through loans to the estate or the purchase of assets from the estate, the estate will have the liquidity needed to shoulder the estate tax obligation without having to sell real estate and market-driven assets.