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OBBBA Changes How High-Net-Worth Clients Use Life Insurance

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The [One Big, Beautiful Bill Act](#) permanently sets the federal estate tax exemption at \$15 million per individual and \$30 million for married couples as of January 1, 2026. High-net-worth individuals may no longer need to be concerned with liquidating as much as between 40% and 45% of their assets or buying life insurance to pay their share of federal estate taxes. This article provides an overview of the various options, strategies, and other information an advisor should be aware of to be able to respond to client questions and create a comprehensive plan for their clients' needs.

Before the Act, using a life insurance policy was often the most tax efficient and economical vehicle available to pay estate taxes. HNW individuals now have to make some important choices as to what to do with their previously accumulated life insurance policies that would have been used to pay their estate tax obligations. Keep in mind that depending on the state your client primarily resided in, there may still be a state inheritance tax the estate is responsible for.

The question for HNW clients is twofold. First, they must consider what to do with the millions of dollars of their current death benefit that is no longer needed as a result of the increased estate tax exemptions. Secondly, since more than 45% of policies, both large and small, sold over the last 20 to 30 years were non-guaranteed Universal policies, it's important to note that 30% to 35% of the coverage in those policies are prematurely expiring, and they must seek a remedy.

Advisors to these clients should give their advice as to how to best rearrange their client's current life insurance portfolio in the most beneficial manner. Great care needs to be taken in advising a client as to which coverage in which policy should be kept, rearranged with additional benefits, premiums reduced, or discontinued. Care also must be taken to not allow a policy to lapse prior to the insured's death as that would trigger a phantom tax on any gains and any outstanding loans would have to be repaid.

An understanding of all the available options and strategies for each client's individual needs, including those that simply can't afford to continue a policy that hasn't been managed properly and is now in the process of expiring prematurely, is important for the client and their advisor to get right. Several of the most popular options are listed below. It should be noted that the options listed below (are as effective or, work as well) for a \$250,000 policy as well as a \$2,500,000 policy or a \$25,000,000 policy. These same options are available for a trust owned life insurance policy as well as for an individually owned policy.

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Do Nothing

Simply maintain the client's existing coverage for the purpose of a charitable donation, either for tax purposes or for the benefit of endowing a chair, a building, or a wing at a university or hospital. Keep the death benefit as additional funds allocated to the next generation in a generation skipping trust for grandkids who may have significant estate tax problems of their own one day.

Increase Benefits in the Policy

As a result of the Pension Protection Act. PPA, an individual can now transfer the cash value of a life insurance policy on a tax-free basis to a Linked Benefit Policy that also offers tax-free long-term care benefits. This strategy provides maximum leveraged dollars (where \$1 becomes \$4 to \$5) that can be used to pay for qualified long-term care costs in any setting for any level of care in any state or many countries.

Upgrade the Policy

Since people are now living longer as a result of modern pharmacology and living healthier lifestyles, the majority of today's life insurance policies contain provisions or offer options that were not available 20 to 30 years ago, such as Private Placement Life Insurance (PPLI). PPLIs reward purchasers of such multimillion-dollar death benefit policies with institutional products that cost less, have additional tax benefits, and fewer restrictions on withdrawals. This combination often results in significantly better returns than traditional retail life insurance policies typically offered to the general public.

Repurpose the Policy

One can also decide to reduce the death benefit by 15% to 20% using any of the means described below. They can then increase the premiums they pay up to the Modified Endowment Contract (MEC) and use the policy for its ability to accumulate cash value on a tax deferred basis with the intent to later withdraw the cash value on a tax-free basis through a series of surrenders and loans against the death benefit that will never have to be paid back as long as the policy survives the insured.

These opportunities were made even more attractive as a result of the passage of the Consolidated Appropriations Act of 2021, which reduced the actuarial interest rate assumptions used by the life insurance companies to define a life insurance contract. Doing so made it possible for the owner of a life insurance policy to place an even larger premium into the policies' cash value without negatively affecting the policies' ability to continue to shelter the growth and distribution of the cash value on a tax preferred basis.

Surrender the Policy

Policies are often surrendered to the insurance company for two reasons: Either the client no longer needs or cannot afford the increased cost of the coverage, or they want to use the existing cash surrender value to supplement their own lifestyle (such as supplementing their retirement income or making a gift to their heirs while they are alive to enjoy it). The great majority of individuals that decide to cancel their policies in exchange for the remaining cash surrender value merely contact their broker or the company directly and request a form to surrender their policy. The process is convenient, but not the only (nor often the best) choice for the client.

Sell the Policy

Ever since the US Supreme Court in *Grigsby v. Russell* established that a life insurance policy is considered personal property that may be sold or assigned, the ownership rights in a life insurance policy have been placed on the same legal footing as a typical investment property, such as stocks and bonds, or a person's home or auto policy. As such, a life insurance policy could be transferred in whole or part to another person at the discretion of the policy owner.

Life Settlement Market. The "life settlement" market, primarily funded by hedge funds and often referred to as the institutional or secondary market, has greatly enhanced the consumer value of a life insurance policy. According to the London Business School [study](#), the life settlement market often offers two to three times the cash value offered by the

insurance company that issued the policy. The most important decision in considering a settlement is selecting an independent, experienced settlement broker who has access to and understands the marketplace and is adept with the negotiating process necessary to represent the client's best interests. A referral from a trusted adviser is always the best source.

The settlement market evolved in the late 1980s with the AIDS outbreak, when terminally ill individuals were liquidating assets to generate cash. Given the sellers' shortened life expectancy, investors were purchasing policies for an amount in excess of the policy cash value and expecting an attractive return from payment of the death benefit. Subsequently, the market expanded to include older and impaired risk-insured people. During the 2008–2009 financial markets crisis, settlement practices were questionable, and at times deceptive, causing a number of states to regulate this market for consumer protection purposes.

A life settlement can be entered into by anyone who owns a life insurance policy with a face value of at least \$100,000, and an insured who is at least age 65. Contrary to popular belief, even a healthy individual can receive an offer on a term policy if the policy is still within the convertible period. The more severe the health conditions, the more likely they are to receive a higher offer. In an attempt to prevent fraud and elder abuse, a life settlement broker is required to complete additional background checks by the FBI. The license process has defined the responsibility of the life settlement broker representing the seller and how this role should be overseen to safeguard the interests of all parties.

The majority of clients, and many of their advisers, are not familiar with the concept of a life settlement, nor do they feel this is a legitimate or legal solution. A recent study by the Life Insurance Studies Institute indicated that 90% of individuals older than age 65 that surrendered a life insurance policy for its cash value would have chosen a 'life settlement' had they been aware of that possibility. Of the approximate \$26 trillion of life insurance coverage in force, approximately \$125 billion is lapsed by seniors each year.

Many individuals, including their advisers, confuse a life settlement with Stranger Trust Owned Life Insurance (STOLI) which is where an individual agent or broker induces an insured to purchase a life insurance policy for the sole purpose of selling it for a profit within a few years of purchasing it. Such an arrangement is illegal, but a life settlement is not.

Partial Sale. It's also possible to settle part of the policy and maintain a partial/retained interest in a portion of the death benefit, in addition to a cash settlement. The value of a life insurance policy's worth is determined by obtaining at least two independent Life Expectancy Reports (LERs). Once the reviews of the insured's medical records and history are completed, an average of the two LERs is taken to determine the number of months the insured is likely to live. The fewer the months, the higher the offer.

Steven M. Schanker, Esq., partner in Schanker and Schanker P.C., a Long Island NY estate planning firm, said: "When I first entered this field of estate planning in 1979, almost every client had an estate tax problem. The client's choices were gifting and giving up control or life insurance. Now, with a vastly increased exemption, most clients have no estate tax due. The permanent insurance they purchased is no longer needed and they rush to surrender. I am contacted frequently by clients asking what happens if their policy is surrendered and the proceeds go into the ILIT. When I recommend, they explore a life settlement, the uniform response is they never heard of it, and they are surprised their life insurance agent never told them about it."

Taxation of Life Settlement

A life settlement on a Universal Life insurance policy is a taxable event, and the proceeds are taxed in three tiers.

- Tier 1: Tax-Free Return of Cost Basis: portion of sale proceeds up to the amount of the cost basis or amount paid in premiums are tax free.
- Tier 2: Ordinary Income: portion of sale proceeds above the cost basis and up to the policy's surrender value are taxed as ordinary income.
- Tier 3: Long-Term Capital Gain: any remaining sale proceeds above the surrender value are only taxed as long-term capital gains.

Life Settlement Case Example:

- Policy Type: \$1 million Universal Life
- Premiums: \$70,000 (cost basis)
- Cash Value: \$80,000 (surrender value)
- Policy Sale Price: \$300,000 (settlement amount paid to policy owner)
- Tax-Free Return of Cost Basis: \$70,000 (cost basis or amount paid in premiums)
- Ordinary Income: \$10,000 (portion of sale proceeds above cost basis (\$70,000) and up to surrender value (\$80,000))
- Long-Term Capital Gains: \$220,000 (remaining sale proceeds (\$300,000 less \$70,000 less \$10,000))
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Example of Recent Transactions:

- \$1.5 million convertible term insurance for healthy male, 74 years old
- Sold for \$310,000 just before expiration of the convertible period.

A recent case involved a male aged 74 with a \$750,000 policy with a loan against it for \$275,000 that he had accrued over the years as a result of the insured realizing that after the fifth year, he could maintain the policy without making a premium payment starting in the sixth year. He decided to forgo paying premiums while still maintaining the majority of the policy's death benefit for years six through 22.

In the 23rd year, he was referred to us to see if anything could be done to provide him with relief from the several hundred-thousand-dollar loan he had accumulated. Without the means to pay back the principal or the interest, or to pay the premium, he faced the possibility of having the policy lapse while he was still alive. He not only would have lost the death benefit but also would have been liable to pay the phantom tax on the gain over and above the premiums he paid.

Fortunately, a buyer was willing to take over the obligation to pay off the loan and continue to pay the premium, thereby absolving the seller from a significant tax bill that he would have been responsible for. While the seller received no cash in exchange for the policy, he was relieved of the potential tax liability and received a retained death benefit for \$100,000 for a number of years, which made him and his family happy.

Key Takeaways for Life Settlement Market

The secondary or life settlement market provides a better exit strategy for a client that finds their life insurance policy no longer needed for estate tax purposes or is no longer wanted or affordable. This process can turn a bill into an immediate liquid asset. Rather than having your client surrender their life insurance policy back to the insurance company because it's more convenient, or because they're not aware of any other alternative, consider educating your client about the benefits of retaining an independent experienced licensed life settlement broker—a professional who must contractually affirm their fiduciary duty to the seller and assist your client and their trustee in obtaining the best possible offer for the insured, or their trustee. In either case, they and their family will thank you.

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