Life Insurance Planning Opportunities for 2026

Situation: As we enter 2026, life insurance planning stands at the intersection of evolving tax policies brought about by the One Big Beautiful Bill Act and the focus on our clients' long-term financial resilience. Life insurance is recognized not only as a tool for income protection but also as a component of broader wealth, estate, and legacy planning strategies. The recent tax law change is creating a timely environment to review existing coverage and explore planning opportunities. This Counselor's Corner will discuss three life insurance planning opportunities for 2026.

Life Insurance Planning Strategies for 2026: The following three life insurance planning opportunities highlight ways financial advisors can help clients achieve their long-term financial and legacy goals while avoiding tax land mines along the way.

Planning Opportunity #1

Reassess Estate Plans & ILITS

The continuation of a high federal estate and gift tax exemption has implications for estate planning, creating opportunities for individuals and families to plan proactively. By maintaining a high exemption individuals, will be able to implement estate planning strategies with reduced tax pressure. It also provides an opportunity to simplify estate plans and reassess the need for complex structures.

The reassessment should include a review of policies owned in an irrevocable life insurance trust (ILIT). The financial professional should determine if there are any available product solutions. One simple option is to stop paying premiums or take a reduced paid up on an existing policy, and establish a new ILIT that would purchase a new insurance policy. However, this may not be a feasible solution due to policy acquisition costs or in a situation where the insured's health has changed.

If the desire is to maintain the policy and repurpose its use, this begs the question, "Is it possible to get a policy out of an ILIT?" The answer is yes, but there are several legal and tax issues that must be avoided in the process. Irrevocable does not necessarily mean unchangeable or inflexible. So, what are the options for getting a policy out of, or to change the terms of, an irrevocable trust when the trust no longer meets the needs of the client?

The first place to start is to have the client's legal advisor review the existing trust document and the laws of the state to determine under what circumstances:

- The trust can be modified, or
- The trusts assets can be distributed to the beneficiaries, or
- The trust assets can be transferred to, to merged into, a newly created trust

It is possible to include language in an ILIT to deal with changes in the grantors' and beneficiaries' life circumstances. The trust document might contain trust language permitting modification or give a trustee the power to distribute to a beneficiary. A court may interpret this as giving the trustee the power to do something to a lesser extent, such as transfer to a further trust.

Furthermore, the laws of many states permit modification of trust provisions. For example, modifications are permitted in statutes that have adopted the Uniform Trust Code (UTC). In addition, several states have decanting statues that generally allow a trustee with discretionary distribution authority to pour over the assets of one trust to a new trust with modified terms and conditions.

Even where the trust provision or state law permits the distribution of the policy or modification of the trust, this capability may not meet the current needs of the client. In those situations, the trustee may be willing to sell the policy to an individual or a new trust that contains more appropriate provisions. However, before selling a policy to a new trust or individual, the trustee's fiduciary responsibilities must be considered and close attention must be taken to avoid obstacles presented by the following Internal Revenue Code sections:

- The **transfer-for-value rule** found in I.R.C. § 101(a)(2), is applicable to the **sale of a policy.** Unless an exception to this rule applies, the policy proceeds, less the total premiums paid by the transferee, will be included in the income of the beneficiary of the policy.
- The **three-year inclusion rule** found in I.R.C. § 2035, is applicable when a **policy is transferred by gift** (for less than full value). Code Section 2035 provides that the proceeds of a life insurance policy transferred by gift from the insured are includible in the insured's estate if he/she dies within 3 years of the date of transfer.

The following are two common ways to structure a sale to avoid the transfer-for-value tax consequences:

Sale to the insured
With this approach, the insured purchases the policy from the existing ILIT. While this transaction raises transfer-for-value concerns, a sale to the insured is an exception to the transfer-for-value rule. However, now that the insured owns his/her policy, the three-year inclusion rule will apply, causing the policy proceeds to be included in his/her estate and potentially subject to tax. If estate taxes are not a concern, this strategy may help the insured to achieve his goal. An important side consideration that is raised by the purchase of the policy is the income tax consequences within the trust. Unless the trust is structured as a grantor trust, the trust will be forced to recognize the gain amount and pay tax.

Sale to the insured, followed by gift or sale to a new ILIT
If the insured is concerned about having the proceeds included in his/her estate, the above sale to the insured can be followed by a second transfer structured as either a gift or sale to a new ILIT.

Where the subsequent transfer is structured as a gift, the policy proceeds will be included in the estate of the insured if the insured dies within three years of the transfer under the three-year estate inclusion rule. If the insured is healthy, this may not be a concern. However, if the existing policy has significant value, the transfer to the new trust may raise a gift tax concern unless the value of the policy transferred is less than the annual and/or lifetime exclusion amounts. One method of reducing the value of the policy is for the trustee or insured to borrow against the cash value of the policy prior to its transfer. In addition to the practical disadvantage of burdening the new ILIT by debt, the transfer of a policy subject to a loan may cause adverse income tax under the transfer-for-value rule.

If the insured wants to avoid the three-year estate inclusion rule, the second transfer can be structured as **a bona fide sale of a life insurance policy for full and adequate consideration.** While a sale for full consideration can avoid estate inclusion, it will result in disastrous income taxes if the new trust does not qualify as one of the exempt transferees under the transfer-for-value rule.

In this regard, most legal advisors believed that sales between a grantor and a grantor trust, or between two grantor trusts, do not have tax consequences. The theory is that the transaction is the same as a sale to the insured, which is an exception to the transfer-for-value rule. In 2007, the IRS confirmed this belief with the issuance of Revenue Ruling 2007-13.

While the ruling provides good news, there are additional hurdles. First, to avoid estate inclusion, the transfer must be for "full and adequate consideration." While the IRS has issued regulations and rulings on the valuation of life insurance, there remains a great deal of uncertainty as to what measure of value to use in many situations, including transfers subject to the three-year inclusion rule.[1] The variety of elements that make up an insurance product, the differences in the health of the insured, and other circumstances mean the same type of life insurance policy may have different values. Second, there are financial hurdles to selling the policy to the new ILIT. If the policy has significant cash value, funding the new ILIT may be a problem for the client. If cash gifts are made to the new ILIT gift tax could potentially result.

Planning Opportunity #2

Reassess Catch-Up Contributions to Qualified Plans

Beginning in 2026, a significant change to qualified retirement plan rules will affect how catch-up contributions to 401(k), 403(b), and governmental 457(b) must be made for highly compensated individuals over the age of 50. Under the SECURE 2.0 Act, individuals who earned more than $150,000 in FICA wages (2025 indexed for inflation) will be required to make any catch-up contribution as a Roth (on an after-tax) basis rather than as a traditional pre-tax deferral. If an employer plan does not offer a Roth catch-up option, highly compensated employees will not be able to make a catch-up contribution. Even if the retirement plan offers a Roth option, this change provides financial advisors an opportunity to help highly compensated individuals explore the feasibility of alternative retirement saving options. Two options worth exploring are nonqualified deferred compensation (NQDC) and life insurance retirement plan (LIRP). As explained below, the LIRP option will be more effective for a broader number of highly compensated employees.

With an NQDC plan an employer enters into an agreement where a select group of highly compensated employees can defer a portion of their income to a future date. From an employee's perspective, the income tax consequences of a NQDC plan are like a traditional qualified retirement plan in that contributions are pre-tax, accumulations are tax-deferred, and distributions are subject to income tax. However, unlike traditional qualified retirement plans contributions are not limited to $8,000 (2026 catch-up amount) and employers are not able to take a deduction at time of contribution. Consequently, since pass-through business owners are taxed on the underlying business income the year it's earned, even when the earnings receipt is delayed, owners do not achieve the benefit of tax deferral in a NQDC plan. Generally, this makes NQDC plans unattractive to owners of pass-through business entities.

Furthermore, for NQDC plans to be exempt from many of the ERISA requirements, the plan may only be maintained for a select group of so called "top hat" employees. While ERISA does not set a hard percentage cap on who is considered "top hat," courts have upheld plans covering up to 15% of an employer's workforce. As a result of this qualification, many individuals who are affected by the new Roth catch-up requirements will not be eligible.

Even those highly compensated individuals who qualify may want to avoid NQDC plans because they perceive the risks as outweighing the tax deferral benefit. Specifically, NQDC amounts remain company assets, making them vulnerable to employer bankruptcy or insolvency where participants rank as unsecured creditors and could lose all the plan benefits; "golden handcuff" provisions may cause benefits to be forfeited upon leaving the company early; and participants cannot take loans or make early withdrawals. As a result of these limitations and restrictions the LIRP alternative may be a more attractive option for many highly compensated individuals.

[1]See Revenue Procedure 2005-25 for safe harbor valuation guidance for IRC §§ 402,79,83.

A LIRP is a long-term financial strategy that uses the cash value of a permanent life insurance policy to supplement retirement income. One of the primary attractions of a LIRP is its tax treatment. Like a Roth, premiums paid on a life insurance policy are on an after-tax basis, cash value grows tax-deferred, and distributions can be accessed on a tax-free basis. In addition, LIRPs provide income tax-free death benefits to beneficiaries, providing an efficient wealth transfer tool. Because LIRPs are not subject to contribution limits, required minimum distributions, or early withdrawal penalties, they can be especially attractive to high-income individuals. However, when considering the use of life insurance as a retirement supplement, there are tax aspects that should be considered. Two of the most common ways to lose the favorable tax treatment of life insurance involves heavily funding a policy such that it is classified as a modified endowment contract or as a cash-rich policy.

The first way the tax-favored treatment of life insurance can be lost is by paying too much premium during the first seven years of the contract (or in the 7-pay period after a material change), causing the policy to be classified as a modified endowment contract (MEC). Death benefit from a MEC is still generally received income tax-free under IRC § 101(a). However, common policy distributions, including withdrawals, loans, and assignments from a MEC are taxed as income first and recovery of basis second. Furthermore, the portion of any distribution that is included in the policy owner's gross income and subject to a 10% tax penalty if the policy owner is under age 59 ½.

The second way the tax-favored treatment of life insurance can be lost is by violating what is sometimes referred to as the "cash-rich rules." In general, the rules affect policies with large premiums relative to the death benefits that are issued or exchanged after 1984. According to the cash-rich rules, anytime there is a cash withdrawal from a "cash-rich policy" that results in a reduction of the death benefit within the policy's first fifteen years there is the possibility that some portion of the distribution will be subject to income tax. The rule is most restrictive in the policies' first five years.

Fortunately, it's possible to avoid unfavorable tax treatment in both situations with a little advance planning. First, if the policy becomes a MEC because of excess payment, the insurance carrier is required to notify the policy owner and provide him/her an opportunity to request a refund to avoid MEC status. The best way for your clients to avoid problems created with distributions from a heavily funded "cash-rich policy" is to ask the carrier to perform a cash-rich test prior to taking a withdrawal to determine if any part of a proposed distribution will be subject to income tax. Alternatively, adverse tax treatment can be avoided by simply waiting until year sixteen, and if waiting to the sixteenth policy year is not an option, you can take a policy loan prior to year sixteen and, once beyond the fifteenth policy year, take distributions.

Planning Opportunity #3

Review Business Owned Life Insurance Funding Entity Purchase Buy-Sell Agreements

While it has been over a year since the *Connelly v. US*[2], decision, it continues to provide financial advisors with a reason to conduct reviews of business-owned life insurance policies. As a result of the review, financial advisors may find a need to purchase new or additional coverage to accomplish revised buy-sell objectives. In addition, the review may lay the groundwork for future conversations about planning to pay for estate taxes.

In Connelly, the Supreme Court held that life insurance proceeds received by a closely held business to fund an entity purchase buy-sell agreement must be included as part of the fair market value of the business for federal estate tax purposes, and that the entity's obligation to purchase a deceased owner's interest under the terms of the buy-sell agreement does not offset the proceeds. This decision overturned prior rulings and decades of common practice where advisors and business owners assumed that business owned life insurance would not inflate the value of a business.

Entity buy-sell arrangements funded with business owned life insurance have been popular because they are simple to execute, with one policy on each owner, and the funding is centralized with the business paying the premiums. However, the Connelly decision has undermined the entity purchase life insurance funding strategy. To mitigate its impact, many businesses are evaluating alternative forms of buy-sell agreements – driving interest in various cross-purchase strategies.

[2]*Connelly v. US, 602 U.S. 257 (2024).*

While recent tax and valuation concerns have caused many businesses to reconsider entity purchase buy-sell agreements, converting a business-owned life insurance policy to a cross-purchase structure is not easily accomplished. What may appear to be a simple change can involve significant tax and practical obstacles.

One of the most significant barriers to changing a business-owned policy to one supporting a cross-purchase structure is the transfer-for-value rule. If an existing business-owned policy is transferred to another business owner to support a cross-purchase arrangement, the death benefit will become partially taxable as a violation of the transfer-for-value rule, except where the new policy owner meets one of the qualifying exemptions. One exception is a transfer to a partner or partnership, but a transfer to a shareholder is not an exception. So, if the business is taxed as a partnership, it may be possible to use the existing policy to fund a cross-purchase arrangement. However, where the business is taxed as a corporation (either C or S) it may be easier to abandon the existing policy and purchase new policies.

In addition to the tax hurdles raised by the transfer-for-value rule, there are many practical obstacles in changing the form of the buy-sell structure. The cross-purchase structure becomes exponentially complex as the number of owners increases. Multiple policies must be monitored and maintained, increasing administrative burden and the likelihood of errors. Also, transitioning to a cross-purchase agreement shifts the premium burden to individual owners. This can create inequities among owners, especially if there is a big difference in premium as will be the case where you have health issues, significant age differences, or large differences in ownership percentage between owners. Although moving a business-owned policy to a cross-purchase arrangement may provide valuation advantages, businesses must carefully weigh whether restructuring is feasible. Where there is little risk of estate taxation, business owners may desire to maintain the simplicity of the entity purchase arrangement funded with business owned life insurance.

Even where the business owner does not have an estate tax valuation concern, or decides to maintain the entity purchase buy-sell structure because of the complexities of a cross-purchase arrangement, it's still important for an advisor to determine whether the business-owned policies have met the provisions of IRC 101(j) as part of the policy review. Failing to meet the requirements of IRC 101(j) will cause the death proceeds to be subject to income tax. To preserve the income-tax exclusion for death benefits, the Code imposes strict notice and consent requirements that must be satisfied before the policy is issued. While some insurance carriers provide so-called "Employer Notice and Consent" forms to help meet the notice requirements of IRC 101(j), several of the largest term carriers do not. For those policies that have not met this requirement, the only way to fix an IRC 101(j) error is to acquire a new policy that complies.

In Summary: The recent tax law change is creating a timely environment to review existing coverage and explore planning opportunities. Specifically, the continuation of a high federal estate and gift tax exemption provides financial advisors with a reason to reassess policies in life insurance trusts. Likewise, the change caused by the Connelly decision gives advisors a reason to review existing business-owned life insurance. Finally, the requirement that highly compensated employees must structure catch-up contributions as Roths starting in 2026 gives advisors an opportunity to discuss alternative retirement saving options.