Clash of The Titans: GRATs vs. DGTs

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I. Introduction: The Controversy

Maximizing tax efficiencies is a key goal to any comprehensive estate planning model. This is especially true in planning for high-wealth estates and the potential imposition of the Federal wealth transfer tax regime.[1]

Federal wealth transfer taxes represent some of the most burdensome taxes and levies by the U.S. government. Under the present regime, property owned at one's death may be subject to a whopping forty-five percent (45%) highest marginal rate of tax. Property given away during life may not only be subject to the same oppressive tax rate structure, but also may be taken into account in computing taxes on one's estate at death.[2] Additionally, taxes may be imposed as expectancies and beneficial interests to one's property accede to the enjoyment of future generations pursuant to the generation-skipping transfer tax.[3] Even though rates for the Federal wealth transfer taxes are currently set at an all time low, they remain a full ten percent (10%) above the current highest marginal income tax rate for corporations and individuals.[4]

Because of the highly oppressive structure of the wealth transfer tax regime, clients' assets are easily exposed and can easily fall prey to the government without proper planning. These problems are further exacerbated by the finite amount of the gift tax annual exclusion and applicable credit amount for large estates.[5] It is no wonder that practitioners and scholars alike have devoted substantial time and resources to developing strategies to maximize their clients' transfer of wealth to successive generations.[6]

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[1] Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, Tax Management Memorandum, Vol. 47, No. 2 (January 23, 2006).
[2] Stephens et al., Federal Estate and Gift Taxation, 1-3 (8th ed. 2002).
[3] *Id*.
[4] *Id*.
[5] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-7, Vol. 1 (2007).
[6] Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, Tax Management Memorandum, Vol. 47, No. 2 (January 23, 2006).

Presently, two (2) competing strategies at the forefront of this battle against the Service are: (1) the "grantor-retained annuity trust" ("GRAT") and (2) the sale to the "defective grantor trust" ("DGT"). These vehicles are often used by practitioners to: (a) freeze the value assets so the appreciation is outside the grantor's gross estate for Federal estate tax purposes and (b) maximize the transfer of wealth through "tax-free gifting." Both of these "investment-driven" strategies represent the best the estate planning world has to offer in answer to the wealth transfer tax dilemma and to protect clients' hard-earned fortunes from the Federal fisc.[7]

Despite the effectiveness of these two strategies in maximizing wealth transfer, wealth management and estate planning practitioners are often divided in championing one technique or the other.[8] Generally, a practitioner's choice of strategy is largely dependant upon which method he or she is most familiar with and regularly uses in his or her own practice. [9] Of course, many of these money-managers and attorneys often fail to recognize when it is most advantageous to establish a GRAT strategy over a sale to a DGT and vice versa.[10]

Rather than championing a single strategy in particular, this Article seeks to objectively analyze the unique benefits of both GRATs and sales to DGTs while highlighting their separate and distinct tax, financial, administrative, and regulatory shortcomings and pitfalls. The Article first introduces and analyzes these vehicles when involving particular client situations – finding that some situations would most likely be better served by establishing a GRAT, while other situations should mandate the use of a sale to a DGT. The Article ultimately concludes in finding that both GRATs and sales to DGTs are effective estate planning techniques to help clients avoid the oppressive Federal wealth transfer tax regime and that, through understanding

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[7] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-7 (Vol. 1 2007).
[8] *Id*.; Kwon & Loewy, *GRATS: On a Roll*, Trusts & Estates, 33, Vol. 144, No. 6(June 2005).
[9] Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, Tax Management Memorandum, Vol. 47, No. 2 (January 23, 2006).
[10] *Id*.

these strategies and their distinct risks and benefits, practitioners can better serve their clients' in helping them realize their wealth transfer goals.

II. Investment-Driven Estate Planning Mechanisms (Generally).

Both GRATs and sales to DGTs are considered "investment-driven" strategies.[11] This means that these strategies attempt to arbitrage the difference between the rate of return the IRS assumes taxpayers will realize and the rate of return actually realized on the property transferred.[12] Investment-driven strategies attempt to transfer the value of any future appreciation with respect to the transferred property out of the gross estate of the individual and, thereby, convey potentially unlimited amounts of wealth to the clients' heirs free of wealth transfer taxes.[13]

For example, the investment-driven strategy generally begins with attempting to determine the current, present value of the assets to be transferred for gift and estate tax purposes. The present value of the property to be transferred is calculated based on what the Service deems a person should pay for that property in order to achieve the rate of return he or she requires to assume the risk associated with the asset.[14] To do this, the IRS most often employs one of two rates: the Applicable Federal Rate ("AFR") or the Section 7520 Rate (the "7520 Rate").

The AFR is the rate of interest rate published by the U.S. Treasury to calculate imputed interest charges.[15] Pursuant to Section 7872 of the Code, the AFR is the absolute minimum rate of interest that must be applied to outstanding debt obligations in order to avoid imputed interest

[11] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-7 (Vol. 1 2007).
[12] *Id*.
[13] *Id*.
[14] *Id*., at 11-8.
[15] http://www.investopedia.com/terms/a/applicablefederalrate.asp.

income and/or to avoid the classification of the property transferred by use of the investment-driven vehicle as a "taxable gift" for gift tax purposes.[16]

While the AFR is generally used by the Service as the discount rate to determine the minimum present value for all notes, loans, and debt obligations,[17] certain publications mandate that the 7520 Rate be used as the discount rate to determine the minimum present value for all income, remainder, annuity, and unitrust remainder factors.[18] The 7520 Rate is basically equal to one hundred twenty percent (120%) of the annual, mid-term AFR.[19] As discussed below, this distinction is of key importance when comparing the use of a GRAT to a sale of property to a DGT since the present value for property transferred to a GRAT is determined based under annuity principals and, therefore, must satisfy a higher hurdle rate — i.e., the 7520 Rate.[20] With the sale to a DGT strategy, the client can use the lower mid-term AFR and even potentially the lowest short-term AFR depending on the terms of the note.

Once the appropriate discount rate and present value of the property to be transferred has been determined, the client can either, transfer, sell, or exchange these assets for: (a) an annuity under the GRAT model or (b) a promissory note under a sale to a DGT strategy.[21] The important point that needs to be made here is that either strategy, a GRAT or a sale to a DGT, only works if the assets transferred appreciate in value faster than the prescribed "hurdle rate" for the transaction.[22]

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[16] IRC § 7872.
[17] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-9 (Vol. 1 2007); Pratt et al., *Estate Planning During Turbulent Times*, Florida Bar Journal, 37 (December 2008).
[18] IRS Publication 1457, *Actuarial Tables*, *Book Aleph*; IRS Publication 1458, *Actuarial Tables*, *Book Beth*.
[19] Pratt et al., *Estate Planning During Turbulent Times*, Florida Bar Journal, 37 (December 2008).
[20] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996); Shore & Craig, *Beyond the Basis Superfreeze – an Update and Additional Planning Opportunities*, 75 Taxes 41 (Jan. 1997).
[21] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996).
[22] Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, Tax Management Memorandum, Vol. 47, No. 2 (January 23, 2006).

The whole point of the investment-driven strategy is to arbitrage the difference between the hurdle rate and the actual rate of return on the assets transferred.[23] Clients, therefore, generally only transfer those assets with high expected rates of return – often business interests and certain real estate – to help ensure the success of the arbitrage.[24] Moreover, the axiom principal of finance is that risk is equal to the expected rate of return of an investment.[25] By transferring an asset with a high-risk and a high-expected rate of return, the arbitrage is further enabled since the artificially low hurdle rate may not sufficiently compensate the transferor client causing the overall value of the transfer of the property to accrue to the benefit of the transferee beneficiary or heir.[26]

For example, if the transferred property generates a greater rate of return than the artificially low rate of interest prescribed by the Service, then the client will not only have successfully moved the excess value of the property out of his or her estate free of wealth transfer taxes, but will also have transferred any income or appreciation derived from that property.[27] In summary, the investment-driven strategy often successfully transfers a client's wealth with no or minimal estate, gift, or generation-skipping transfer tax consequences.[28] Ultimately, the client only retains the annuity or payments pursuant to the artificially low hurdle rate.[29]

Because investment-driven strategies are based upon the arbitrage between the difference in the rate the IRS prescribes to avoid gift taxation and imputed interest and the actual rate of return the client realizes with respect to the transferred properties, these strategies often work

[23] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-9-11-10 (Vol. 1 2007).
[24] *See generally*, Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996).
[25] Handler & Dunn, Drafting the Estate Plan: Law and Forms, 11-9 & 11-10 (Vol. 1 2007).
[26] *Id*.
[27] *Id*.
[28] Blattmachr, *Evaluating the Potential Success of a GRAT Against Competing Strategies to Transfer Wealth*, Tax Management Memorandum, Vol. 47, No. 2 (January 23, 2006).
[29] Handler & Dunn, at 11-10.

best if the client incorporates an appropriate investment strategy with an eye towards asset diversification.[30] Since the high-return assets transferred also carry high risk, market volatility can destroy the investment-driven planning efforts. Even so, it should be noted that the assets transferred need only outperform the artificially low hurdle rate. Therefore, when using GRATs or sales to DGTs, it is highly beneficial for the estate planner to recognize the value of a well-qualified and conservative money-manager in creating a coordinated effort to ensure the success of the arrangement.[31]

III. An Overview of Grantor-Retained Annuity Trusts.[32]

There are many different types of GRATs and GRAT variations, some of which are discussed in detail below. However, a basic, straight-forward GRAT is an investment-driven vehicle where the grantor client transfers property to the trust and, in return, receives a fixed annuity interest for a term of years.[33] The trust must make payments pursuant to this annuity interest on at least an annual basis.[34]

Both GRATs and DGTs are originally established as "grantor trusts" according to Section 671-679 of the Internal Revenue Code (the "Grantor Trust Rules").[35] All trusts are mere fiduciary arrangements where the trustees hold legal title to the assets with the beneficiaries holding equitable title.[36] Technically, trusts do not have "owners."[37] However, under the Grantor Trust Rules a grantor of a "grantor trust" is considered to be the "owner" of the trust for

[30] *Id*.
[31] *Id*.
[32] Diagram 1 attached to this Article illustrates how an effective GRAT strategy functions to avoid the Federal wealth transfer tax regime.
[33] Pratt et al., *Estate Planning During Turbulent Times*, Florida Bar Journal, 37, 40-41 (December 2008).
[34] *Id*.
[35] Handler & Dunn, at 11-10; IRC §§ 671-679.
[36] Dukminier & Johanson, Wills, Trusts, and Estates, 553-554 (6th ed. Aspen 2000).
[37] *Id*., at 561-562.

income tax purposes – i.e., there is no independent existence between the trust and the grantor under the Grantor Trust Rules.[38] As a result, all income from the trust is taxable to the grantor of the trust, regardless of whether income is distributed to the grantor for his or her benefit.[39]

Establishing investment-driven vehicles as grantor trusts under the Grantor Trust Rules provides additional estate planning benefits;[40] the payment of the trust's income taxes provides an additional tax-free gift from the grantor to the beneficiary-heirs of the trust under both a GRAT and DGT strategy.[41] This reduces the value of the grantor's gross estate for estate tax purposes while, at the same time, increasing the value of the assets of the trust held for the benefit of the beneficiaries.[42]

When a establishing a GRAT, the grantor contributes the property to be transferred to the trust.[43] At this same time, an appropriate "gift value" for the property transferred is calculated.[44] To find this gift value, the IRS determines the present interest value of the property using the appropriate discount rate for the annuity (i.e., the 7520 Rate), less the value of the annuity payments through the end of the term of years.[45] At the time of formation of the GRAT, this gift value is considered a gift to the beneficiaries for gift tax purposes, but may be "zeroed-out" through the use of a zeroed-out GRAT strategy discussed below.[46] The beneficiaries of the GRAT are often the descendants and family members of the grantor or the heirs of his or her estate.[47] At the conclusion of the term of years, the GRAT terminates and the trustee of the

[38] IRC §§ 671-679.
[39] *Id*.
[40] Handler & Dunn, at 11-10 & 11-11.
[41] *Id*.
[42] *Id*.
[43] Pratt et al., at 40-41.
[44] *Id*.
[45] IRC §1274(d)(1); 34 Am. Jur. 2d ¶ 40204: *Grantor Retained Annuity Trusts (GRATs) and Grantor Retained Unitrusts* (GRUTs).
[46] Handler & Dunn, at 11-23.
[47] Blattmachr, at 1& 2.

GRAT distributes the remaining corpus to the beneficiaries. With the exception of potential generation-skipping transfer taxes, the transfer is free of any additional wealth transfer tax obligations.[48]

For the GRAT to realize an actual tax benefit as an investment-driven strategy, the present value of the scheduled, fixed-term annuity payments needs to be calculated.[49] This calculated value is often made equal to the value of the property transferred. As a result, the gift value of the remaining corpus is effectively zero (or approximately zero), thus avoiding any gift tax consequences at the formation of the GRAT. This is known as a "zeroed-out" GRAT strategy or a "Walton GRAT."[50]

However, a GRAT can be an all or nothing gamble with the IRS – a deal with the devil so to speak.[51] In the event the grantor fails to survive the term of years, the assets are included in his or her gross estate under IRC Section 2036 (for the retained life estate) and IRC Section 2033 (for the retention of the reversionary interest).[52] Effectively, therefore, there is no benefit to establishing the GRAT in the event the grantor dies before the specified date of termination.[53]

However, if the grantor lives to the expiration of the term of years and the gift value was effectively zeroed-out at the time of the formation of the GRAT, then the appreciation on the assets in excess of the annuity payments transfers free of estate tax to the beneficiaries of the GRAT.[54]

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48 Blattmachr, at 1& 2.
49 Handler & Dunn, at 11-23.
50 *Id*.
51 Handler & Dunn, at 11-36 & 11-37.
52 *See Generally*, IRC §2036; IRC §2033; Handler & Dunn, at 11-36 & 11-37.
53 Handler & Dunn, at 11-36 & 11-37.
54 *Id*., at 11-12 & 11-13.

IV. An Overview of Sales to Defective Grantor Trusts.[55]

Like a GRAT, a sale to a DGT is an investment-driven strategy executed through establishing a grantor trust under the Grantor Trust Rules.[56] Similar to the GRAT strategy, an additional estate planning benefit is derived from the use of a DGT since the trust's income passes through to the grantor, constituting an additional tax-free gift from the grantor to the beneficiaries of the trust on an annual basis.[57]

However, unlike a GRAT strategy, the grantor of the DGT does not contribute the property to the trust in exchange for an annuity interest. Rather, the client first makes a seed contribution to establish the trust -- generally ten percent (10%) of the value of the property to be transferred.[58] The reason for this seed amount is to give economic substance to the transaction and to solidify the grantor's status as the grantor of the DGT pursuant to the Grantor Trust Rules.[59]

After seeding the trust, the client essentially enters into a seller-financed transaction with the trust.[60] In other words, the grantor sells the property to the trust and, in exchange, takes back a promissory note. This is an important difference between a GRAT and a sale to a DGT because the payments being made back to the grantor under a DGT strategy are considered a "debt obligation" and not an "annuity interest."[61] As a result, interest on the note does not accrue at the higher 7520 Rate.[62] Rather, interest accrues at the AFR existing at the time the property is sold to the trust. Since the AFR represents the absolute minimum rate prescribed by the Service

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[55] Diagram 2 attached to this Article illustrates how a sale to a DGT helps avoid the Federal wealth transfer tax regime.
[56] *Id*., at 11-52.
[57] *Id*., at 11-10 & 11-11.
[58] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996).
[59] IRC §§ 671-679.
[60] Handler & Dunn, at 11-53 & 11-54.
[61] IRS Publication 1457, *Actuarial Tables, Book Aleph*; IRS Publication 1458, *Actuarial Tables, Book Beth*.
[62] *Id*.

to avoid imputed interest and a taxable gift to the trust's beneficiaries, DGT strategies are generally said to have a lower "hurdle rate" than GRAT strategies.[63] The trustee of the DGT then uses the income generated by the property to pay off the debt obligation under the note.[64] Principal may also be used to pay the obligation.

In Revenue Ruling 85-13[65] and several private letter rulings,[66] the Service held that because the grantor of a grantor trust is treated as the "owner" of the trust's assets for income tax purposes, there is no taxable event recognized (no sale or disposition) on the sale of the client's assets to the trust. Therefore, there are no capital gains or income tax liabilities that result from the transaction. In essence, since the grantor is deemed to be the "owner" of the trust property under the Grantor Trust Rules, the grantor is treated as selling the property to himself for income tax purposes.[67]

Under a DGT strategy, the grantor sells the property to the trust in exchange for a valid, interest-bearing note. [68] As a result, the grantor is treated, for all but income tax purposes, as having effectively sold his or her assets to the trust for an amount equal to the full and fair consideration for that property. Excepting the initial seed contribution to establish the DGT, there are no gift tax consequences from the client transferring the property to the trust.[69] Additionally, the DGT is established so that the grantor has no "retained rights" for estate tax purposes.[70] In the event of the grantor's death, the property is considered to be outside his or her

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[63] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996).
[64] See Supra n. 55.
[65] 1985-1 C.B. 184.
[66] **Error! Main Document Only.***PLR 9837007; Rev. Rul. 76-103, 1976 CB 293; Ltr. Rul. 9332006*.; *See*, Handler & Dunn, at 11-53.
[67] Pratt et al., at 40-41.
[68] Blattmachr, at 5 - 8.
[69] *Id*.
[70] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996); Shore & Craig, *Beyond the Basis Superfreeze – an Update and Additional Planning Opportunities*, 75 Taxes 41 (Jan. 1997).

gross estate for estate tax purposes.[71] Furthermore, any appreciation that occurs between the time of the sale and the time of the grantor's death with respect to the property will also be outside of the grantor's estate.[72]

Other than the initial seed contribution, the client has transferred his or her assets to the beneficiaries of the DGT free of estate tax, income tax, and gift tax.[73] Though the note the grantor receives in exchange for the sale of the property is includible in his estate, the value of this note can be reduced (or entirely eliminated) using certain advanced strategies mentioned in the analysis below.

V. Putting it All Together: The Clash.

Now that introductions have been made to GRATs, DGTs, and investment-driven planning strategies in general, the question remains, "Which strategy is best?" Like all great legal questions, the answer is, "It depends." This Section discusses and analyzes the various comparative benefits and short-comings of the both GRAT and DGT strategies and offers insight as to when practitioners should employ one strategy over the other based the uniquely defined estate planning goals of their clients.

a. An Analysis of GRATs and the Benefits of Rolling GRATs.

One of the key benefits to using a GRAT strategy over a sale to a DGT is that, when establishing a GRAT, the grantor does not have to make an initial seed contribution to the trust to establish his status as its grantor under the Grantor Trust Rules. Provided that the present value of the scheduled annuity payments is made equal to the value of the property transferred at the

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[71] *Id*.
[72] *Id*.
[73] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996).

trust's formation (i.e., so that the GRAT is effectively "zeroed-out"), there are generally no gift tax consequences to the grantor. For this reason, GRAT strategies are often said to have less overall "gift tax risk" than sales to DGTs.[74]

Another benefit that a GRAT strategy can provide to clients is that GRATs are often considered to be more "statutory" than sales to DGTs.[75] The grantor's retained annuity interest in a GRAT is specifically referred to in Section 2702(b) as a type of "qualified interest" and is "authorized" in the Code and regulations.[76] In contrast, an installment sale to a DGT strategy is based solely on a hodgepodge of multiple, complex Code provisions.[77] The "statutory" nature of a GRAT strategy offers clients additional certainty that the investment-driven strategy will not be contested by the IRS; if the client follows the statutory rules, there can be little room to dispute the benefits provided by the GRAT.[78]

One of the key pitfalls with a GRAT strategy, however, is the risk of the grantor's mortality.[79] Due to the nature of the annuity interest and the client's retained reversionary interest, the property contributed to a GRAT is fully included in the grantor-client's gross estate in the event the client fails to survive the GRAT's term of years.[80] Moreover, a straight GRAT strategy is often seen as have more "interest-rate risk" than a sale to a DGT because of the mandated use of the 7520 Rate, a higher rate of interest (i.e., hurdle rate) than the AFR.[81] Because of the higher hurdle rate, even a single year of poor investment returns can greatly

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[74] However, practitioners should be careful to avoid equating "less gift tax risk" with "no gift tax risk." In the event a GRAT is zeroed-out to avoid gift taxation on the contribution of the assets to be transferred, there is still a risk the IRS may set the transfer aside on public policy grounds. The regulations appear to allow zeroed-out GRATs and the risk appears to be minimal at present, but it does exist.

[75] Blattmachr, at 8.

[76] *See*, IRC § 2702(b).

[77] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996); Shore & Craig, *Beyond the Basis Superfreeze – an Update and Additional Planning Opportunities*, 75 Taxes 41 (Jan. 1997).

[78] Blattmachr, at 8.

[79] Weinreb & Singer, *An Analysis of GRAT Immunization*, 34 (ACTEC Journal, Winter 2008).

[80] *Id*.

[81] Handler & Dunn, at 11-38.

decrease the probability that the GRAT will be successful and provide any benefit to the remaindermen of the trust.[82]

These inherent problems in basic GRAT strategies have led practitioners to seek and develop new ways to reduce risk while maximizing the overall wealth transfer to the client. Many of the aforementioned problems associated with GRAT strategies can be overcome by using a “rolling GRAT” strategy.[83] In fact, some practitioners claim that, a short-term rolling GRAT strategy can meet wealth transfer objectives better than a single long-term GRAT and even outperform a long-term installment sale to a DGT.[84] It is important to note that these claims are not just mere puffery, but are based on advances in quantitative modeling and capital-markets forecasting procedures.[85]

A rolling GRAT involves a series of short-term (two-year) GRATs.[86] Each new GRAT is funded by the existing annuity payments from the GRATs already in effect. This way, the annuity payments are continuously redirected to newly formed GRATs, locking-in wealth transfer gains from previous GRATs in the series.[87]

The first and most obvious benefit to a rolling GRAT strategy is that the mortality risk generally associated with GRAT is greatly reduced.[88] Each successive two-year GRAT essentially “locks-in” the wealth transfer gains from the prior GRATs in the series. Moreover, each GRAT in the series exists for only a short-term (two years). In the event the grantor dies, the final trust terminates, but only the assets held in the final GRATs in the series revert back into the original grantor’s gross estate. Assets and any appreciation gains that have transferred to

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[82] *Id*.
[83] *Id*.
[84] Kwon & Loewy, *GRATS: On a Roll*, 33, Vol. 144, No. 6 (Trusts & Estates, June 2005).
[85] *Id*.
[86] Handler & Dunn, at 11-38.
[87] *Id*.
[88] *Id*.

the beneficiaries through the use of prior GRATs in the series remain outside the grantor's taxable estate, significantly increasing the overall benefit of the GRAT technique.[89] Since the probability of the grantor dying during a particular GRAT term (i.e., the mortality risk of the GRAT) is greatly reduced, so is the overall mortality risk associated with the transfer of the property pursuant to the GRAT.[90]

For example, a client and his attorney are evaluating their options to either establish a ten-year term GRAT or a series of eight two-year rolling GRATs.[91] One of the clear benefits to the rolling GRAT strategy is the reduced mortality risk. If the grantor-client chooses the ten-year term GRAT and dies in year eight, the full value of the transferred assets are included in the grantor's gross estate and, ultimately, there is no benefit to the trust. In contrast, under the rolling GRAT strategy, the grantor who passed away in year 8 would not lose any of the benefits from the initial six GRATs in the rolling series – these benefits have been "locked-in." Based on this analysis and in most cases, the practitioner should advise his client to execute a rolling GRAT strategy over the ten-year term strategy because of the decreased mortality risk associated with the rolling GRAT.[92]

More importantly, however, a rolling GRAT strategy is said to have significantly lower investment risk than long-term GRATs and even sales to DGTs.[93] As mentioned, once GRAT returns are "in the hole," it becomes extremely difficult for the trust's investments to "catch up" and ultimately beat the 7520 Rate. This is especially true since capital markets and investment returns can fluctuate drastically and GRATs, by their nature, already have an inherently higher

[89] *Id*.
[90] *Id*.
[91] *Id*.
[92] *Id*.
[93] *Id*., at 11-38 & 11-39; Kwon & Loewy, at 42-44.

hurdle rate than other investment-driven planning vehicles – like sales to DGTs.[94] However, in a rolling GRAT, a year of poor returns only affects the GRAT in effect during that same year. Consecutive GRATs in the series are unaffected and get a new beginning from an investment standpoint.[95]

This minimization of investment risk provided by a rolling GRAT strategy is perhaps the number one advantage GRAT strategies have over sales to DGTs.[96] In their article, *GRATs: On a Roll*,[97] Juile K. Kwon and Daniel J. Loewy compared the "probabilities of success" — defined as leaving at least some transferable remainder — for both term and rolling two-year GRAT strategies and sales to DGTs.[98] This comparison used a highly advanced wealth forecasting analysis model simulating 10,000 market scenarios across a wide spectrum of asset classes.[99] What they found was that, in almost all cases, the rolling GRAT strategy outperformed the likelihood of successful wealth transfer from both the long-term GRAT and the sale to the DGT because of the reduced market risk associated with the rolling GRAT.[100] In other words, the ability to lock-in wealth transfer gains from previous years has a greater probability to outweigh any interest-rate benefit and avoidance of mortality risk provided by a sale to a DGT.[101] As stated by Julie K. Kwon and Daniel J. Loewy "rolling GRATs are likely to succeed in nearly all capital market environments."[102] Because a rolling GRAT mitigates the overall investment and

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[94] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996); Shore & Craig, *Beyond the Basis Superfreeze – an Update and Additional Planning Opportunities*, 75 Taxes 41 (Jan. 1997).
[95] Handler & Dunn, at 11-39.
[96] *See generally*, Kwon & Loewy, at 42-44.
[97] Kwon & Loewy, at 34.
[98] *Id*.
[99] *Id*.
[100] *Id*., at 42-44.
[101] *Id*.
[102] *Id*., at 35.

mortality risks generally associated with GRAT strategies, they can provide a greater level of certainty to clients in recognizing a successful wealth transfer.[103]

Despite these amazing benefits, the advantages of a rolling GRAT over a sale to a DGT should not be overstated. A rolling GRAT strategy is far from perfect and in no way should be assumed to be the "end all" to investment-driven estate planning vehicles.[104] For example, while it is true that rolling GRATs are able to capture the upside of market volatility and have certain advantages over other investment-driven planning vehicles, rolling GRATs have an increased interest-risk because of (a) the higher hurdle rate mandated for all GRAT strategies and (b) the added interest-rate risk from the inability to "lock-in" a lower rates of interest during favorable interest rate markets.[105] As of the date of this Article, interest rates, including the AFR and the 7520 Rate, are presently at near historical lows.[106] A client could take advantage of this current scenario by executing a term GRAT or sale to DGT strategy and effectively "lock-in" the low rate of interest. Under a rolling GRAT strategy, the client would only be able to "lock-in" present interest rates for the next two years (i.e., the term of the first GRAT in the series). If interest rates were to increase during the comprehensive term of the GRAT strategy, so would the overall hurdle rate for the technique. While Kwon and Loewy purportedly took this increased interest-rate risk into consideration, savvy practitioners should understand that decreased investment risk does not exactly negate increased interest-rate risk.[107]

[103] *Id*.
[104] Travagliato & Weickel, *Let's Not Overstate the Benefits of Short-Term Rolling GRATs*, 12, Vol. 144, No. 11, (Trusts & Estates, June 2005).
[105] *Id*.
[106] http://www.timevalue.com/afrindex.aspx.
[107] Travagliato & Weickel, *Let's Not Overstate the Benefits of Short-Term Rolling GRATs*, 12, Vol. 144, No. 11, (Trusts & Estates, June 2005).

Furthermore, Kwon and Loewy's analysis assumes that a GRAT can keep all of the original principal in the trust to work for the benefit of the remainder beneficiaries.[108] When assets transferred to a GRAT are readily marketable capital and debt securities with high income/dividend producing attributes or are easily liquidated and substituted for other assets, this assumption is often taken for granted.[109] For example, under any GRAT strategy, including a rolling GRAT strategy, annuity payments must be paid back to the grantor on at least an annual basis. What happens when the assets being transferred are interests in a closely-held family business and the client intends to have the beneficiaries of the trust ultimately succeed to the ownership of the business? What happens if, after the interests in the closely-held business are transferred to the rolling GRAT, the market declines and, in order to make the required annual annuity payments at the higher Section 7520 Rate, the trustee is forced to liquidate the interests?

The truth is that Kwon and Loewy's analysis does not take into consideration increased investment risk which is inherent in all GRATs from the lack of flexibility in the payment structure to meet the trust's obligation back to the grantor.[110] The GRAT mandates that at least annual payments must be made. If the income from the trust's assets for any given year is insufficient to pay the mandated annuity back to the grantor, then the assets must either be liquidated or distributed back to the grantor to pay the annuity and the client's intent and wealth succession goals may be thwarted.

Additional problems with rolling GRATs also involve additional administrative oversight and increased costs associated with monitoring the formation and termination of the various GRATs in the series as well as the titling of the assets transferred from GRAT to GRAT. As noted, a rolling GRAT essentially involves multiple "re-GRATs" with overlapping terms. It

[108] *Id.*
[109] *Id.*
[110] Kwon & Loewy, at 42-44.

is imperative to this model that: (1) subsequent "re-GRATs" are established; (2) the transfers and titling of the assets are closely monitored and (3) the annuity amounts are property calculated, re-calculated, and paid on at least an annual basis.[111] It is naïve to think that monitoring the compliance of a rolling GRAT strategy would not involve the work of a professional estate planning attorney, money-managers, and CPAs. Additional professional fees could be incurred using this type of investment-driven strategy.

The most important limitation associated with all GRAT techniques, however, is imposed by IRC Section 2642(f)(1) of the Code.[112] To understand this limitation, however, one must first understand that every individual is allowed an exemption for generation skipping transfers.[113] Furthermore, an individual may generally allocate this exemption to property transferred to a trust.[114] In the event the grantor allocates his or her exemption in an amount equal to the full value[115] of the property gifted to the trust, then the inclusion ratio for that trust is equal to zero – i.e., effectively negating the imposition of any generation-skipping transfer tax under Chapter 13 of the Code.[116] In other words, if a grantor of a trust is able to allocate his or her generation-skipping transfer exemption to gifted trust property, then all or part of the trust's principal and income will be exempt from the imposition of the generation-skipping transfer tax which would otherwise result from the trust's termination or distributions made from the trust to the benefit of "skip-persons" (i.e., grandchildren and heirs two or more generations removed from the original grantor).[117]

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[111] Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 Est. Plan. 3 (Jan. 1996); Shore & Craig, *Beyond the Basis Superfreeze – an Update and Additional Planning Opportunities*, 75 Taxes 41 (Jan. 1997).
[112] IRC § 2642(f)(1).
[113] IRC § 2631(a).
[114] IRC §§ 2631(a), 2652(a).
[115] IRC §§ 2642(b), 2642(e), 2642(f).
[116] See IRC §§ 2641, 2642.
[117] *See generally*, IRC § 2613.

Section 2642(f)(1), however, limits a grantor's allocation of his or her generation-skipping transfer exemption. According to this Section of the Code, a grantor of a trust cannot allocate his or her lifetime generation-skipping transfer tax exemption if the assets are transferred during the estate tax inclusionary period ("ETIP").[118] Generally speaking, ETIP is the period of time during which the value of the assets transferred would be includible in the transferor's gross estate.[119] As mentioned, the full value of property transferred to a GRAT is includible in the grantor's estate in the event he or she dies prior to the end of the trust's term of years. The transfer of property to a GRAT is, therefore, subject to the ETIP rules and a grantor's GST exemption may not be allocated until the end of the term of years – i.e., when the trust property has already appreciated in value. The end result is that ETIP rule severely limits a GRAT's ability to leverage the client's generation-skipping transfer exemption and, thereby, "lock-in" wealth transfer gains for successive "skip" generations.[120]

In summary, GRATs can provide unique benefits to clients by minimizing the overall gift tax risk while, at the same time, maximizing the potential success of the wealth transfer – especially when using a rolling GRAT strategy. Advances in quantitative, capital markets forecasting techniques have determined that, by minimizing investment risk to the wealth transfer, a rolling GRAT most likely outperforms all other investment-driven techniques – including sales to DGTs.[121] Nonetheless, careful considerations should still be made by practitioners regarding the various planning limitations associated with all GRAT strategies – including (a) higher interest-rate risk, (b) less flexibility in making payment obligations, and (c)

[118] Handler & Dunn, at 11-42.
[119] *Id.*
[120] *Id.*
[121] *See generally*, Kwon & Loewy.

important limitations in long-term, multi-generational transfer planning and closely-held business succession.

b. *An Analysis of Sales to DGTs.*

Notwithstanding the numerous benefits to the rolling GRAT strategy, it is important to recognize various advantages involving sales to DGTs which, when taken as a whole, may be more beneficial for a client and his or her wealth transfer and estate planning objectives.[122]

Under a sale to a DGT strategy, an initial seed contribution is gifted to the DGT and additional assets are transferred to the trust pursuant to a sale of the property. The obligation of the trust to make payments back to the grantor-client is considered a "debt obligation," not the retention of an annuity interest. This allows DGT strategies to utilize the lower AFR rate as the applicable "hurdle rate" for the technique.[123]

Also in advanced DGT strategies, the grantor first contributes assets to a newly formed limited liability company ("LLC") and is able to take advantage of the lack of marketability discount and, possibly, the lack of control discount for the resulting membership interests.[124] This technique allows for immediate wealth transfer benefits due to the discounts.

For example, the courts have long recognized that membership interests in closely-held businesses, like an LLC, cannot be readily sold and, therefore, are entitled to substantial valuation discounts for estate, gift, and generation-skipping transfer tax purposes.[125] This is true even in cases where the member owns a controlling interest or where the member is the only

[122] *See generally*, Mulligan.
[123] Pratt et al., *Estate Planning During Turbulent Times*, Florida Bar Journal, 37, 40-41 (December 2008).
[124] Lavner, *Tax-Free Giting: Comparing GRATs and Sales to Grantor Trusts*, 804-809, Practising Law Institute: Tax Law and Estate Planning Course Handbook Series, PLI Order No. 13928 (September 8-9, 2008).
[125] *Estate of Andrews v. Comm'r*, 79 TC 938, 953 (1982).

member of the LLC.[126] Moreover, if minority interests in LLCs are transferred, additional discounts may be taken.

For example, in *Estate of Bennett v. Comm'r*,[127] the Tax Court approved a fifteen percent (15%) marketability discount even though the decedent owned all of the interests in the business entity. Like discounts available for minority interests, there is no fixed amount for the lack of marketability discount prescribed by the Service. Rather, the courts have determined that this is a fact-based inquiry.[128] Based on the court's finding in *Bennett,*[129] a fifteen percent (15%) discount with respect to the value of the property to be transferred should be allowed.

Also important is that a sale to a DGT strategy does not contain the mortality risk inherent in basic term GRATs.[130] At the grantor's death, any outstanding principal obligations on the note will be included in the value of the grantor's gross estate for estate tax purposes but, due to the defective nature of the trust and the completed sale, the value of the trust property should be excluded.[131]

However, probably the two most important advantages of a DGT strategy happen to be the two main disadvantages of a GRAT: (1) the ability of the DGT to provide a flexible repayment structure to help ensure original asset retention and (2) the ability of the DGT to allow for long-term generation-skipping transfer tax planning.[132] For example, one of the main benefits to a DGT strategy is that the note can be drafted so as to provide maximum flexibility in

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[126] *Id.*; *Estate of Dougherty v. Comm'r*, 59 TCM (CCH) 772 (1990).
[127] 65 TCM (CCCH) 1816 (1993).
[128] *Mandelbaum v. Comm'r*, 91 F.3d 124 (3d Cir. 1996).
[129] *See* Supra n. 9.
[130] Lavner, at 808.
[131] However, if the trust has not been pre-funded with the appropriate seed contribution, the IRS may argue inclusion of the property in the grantor-client's gross estate under IRC Section 2036 for a retained life estate. Also, most practitioners provide that the note be repaid when the death of the grantor of the DGT becomes imminent. This repayment would cause the value of the remaining outstanding balance on the note to come back into the grantor's estate just prior to his or her death. This is to avoid potential gift tax arguments which could defeat the strategy.
[132] Lavner, at 808.

payment of the debt obligation.[133] Under a GRAT, for example, an annuity must be calculated at the formation of the trust and the trust must make at least annual payments back to the Grantor based on the terms of that annuity. In contrast, a DGT makes payment back to the grantor pursuant to a promissory note. Depending on the circumstances, this note can provide for a short-term or a long-term payment period and require payments of either both principal and interest or interest only payments.[134] The note could also allow for no annual payments with a balloon payment of principal and interest at the maturity date. More importantly, however, the terms of the note could be renegotiated and revised depending on the circumstances – allowing the client to capture the upside of constantly changing interest-rates to maximize his wealth transfer gains or to help the client keep the original assets transferred in the trust without liquidation. The note could also be "self-cancelling."[135]

This flexibility in payment structure increases the probability of successful wealth transfer and maximizes the overall benefit to the client through effectively decreasing interest-rate risk and investment risk.[136] Vincent Travagliato and Marcus Weickel in their article, *Let's Not Overstate the Benefits of Short-Term Rolling GRATs*,[137] pointed out that while rolling GRATs have an advantage over other investment-driven techniques in capturing the upside of market volatility, this is largely due to the assumption that the original assets can be kept in the trust to "work for the benefit of the remainder beneficiaries."[138] Travagliato and Weickel further concluded that the benefits provided by rolling a GRAT strategy could, therefore, be replicated

[133] *Id.*
[134] *Id.*
[135] A self-cancelling installment note ("SCIN") is a deal with the IRS where, based on the note-holder's age and potential mortality (i.e., life expectancy), the note bears a higher rate of interest, but at the death of note-holder, cancels so that the value of the note is not included in the gross estate of the note-holder. A SCIN requires computations based on life expectancy in order to avoid unanticipated gifts.
[136] Travagliato & Weickel, *Let's Not Overstate the Benefits of Short-Term Rolling GRATs*, 12, Vol. 144, No. 11, (Trusts & Estates, June 2005).
[137] *Id.*
[138] *Id.*

with "a sale to a grantor trust in exchange for a note with all the principal and interest deferred."[139] By providing for a balloon payment of both principal and interest at the maturity date of the note, a DGT is better situated than even a rolling GRAT to retain its originally contributed assets, avoid potential liquidation of trust assets in unfavorable markets, and capture the upside of interest rate volatility. This allows for increased probability that, over the term of the note, the assets sold to the DGT will realize a greater return than the hurdle rate.[140]

Moreover, a DGT's ability to structure and revise its payment obligations can help clients transfer not only the value of their property, but also the property itself without forced liquidation. For this reason, a sale to a DGT is not only an effective investment-driven wealth transfer mechanism, but also an important business or real property succession tool.[141]

But most important is the advantage that DGT techniques have over GRATs with respect to multi-generational planning.[142] As mentioned, a grantor of a GRAT cannot allocate his generation-skipping transfer exemption to "leverage" property contributed to a GRAT under the ETIP rules.[143] On the other hand, a DGT, may be made exempt from generation-skipping transfer tax due to the grantor's allocation of his or her generation-skipping transfer exemption at the inception of the DGT.[144] Long-term, such a trust would be able to provide tax-free distributions to "skip" persons for many generations. Now that several states, including Alaska and Nevada have done away with their rules against perpetuity,[145] a DGT with a trust situs of Nevada or Alaska could create a long-term vehicle exempt from generation-skipping transfer tax that lasts for centuries, or even into perpetuity.

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[139] See Regs. §26.2601-(b); IRC §2642(a).
[140] Lavner, at 808.
[141] *See generally*, Mulligan.
[142] Blattmachr, at 14.
[143] IRC §2642(f).
[144] Blattmachr, at 14.
[145] AK ST §34.27.100; AK ST §34.27.051; NRS §111.103.

Sales to DGTs, however, contain more inherent gift tax risk than a GRAT.[146] In the event the grantor fails to contribute an appropriate seed amount to the trust at its formation, then the Service may claim that the promissory note represents a "retained interest in the property sold."[147] According to Section 2702 of the Code,[148] the IRS could argue that the grantor has made a taxable gift of the entire property, destroying the overall investment-driven strategy. While this risk can be overcome through ensuring that a sufficient seed contribution is made prior to the sale of the assets to the DGT, this seed contribution — which is usually equal to at least ten percent (10%) of the value of the assets to be sold — is a taxable gift.

Moreover, it is difficult to overcome the staggering outperformance of rolling GRATs over sales to DGTs based on recent quantitative and capital-markets forecasting models.[149] Nevertheless, a DGT technique is a powerful investment-driven strategy in its own right – especially in cases where the client desires to transfer both the value of the assets and the assets themselves and avoid potential forced liquidation or provide for business succession.

VII. Conclusion.

Both GRATs and sales to DGTs are effective estate planning tools practitioners can use to help clients avoid taxation when transferring their property to future generations. As discussed in this Article, the single-minded advocacy of one strategy over the other is generally nether advantageous or effective in maximizing overall benefits to a client's estate.

Both strategies, including all of their multiple variations, contain distinct benefits and short-comings. For example, a GRAT often has less overall gift tax risk because, unlike a sale to

[146] Lavener, at 808.
[147] *Id*.
[148] See generally, IRC § 2702.
[149] *See generally*, Kwon & Loewy.

a DGT, there is no base seed amount required to fund the trust at its formation and a GRAT is often seen as being more "statutory." Through the use of a rolling strategy, a GRAT is also better suited to protect against: (1) mortality, (2) volatile markets and (3) unforeseen, drastic fluctuations in asset values. Advances in quantitative modeling show that this safeguard under a rolling GRAT strategy allows clients to overcome the higher hurdle rate and mortality risk generally associated with GRATs and, ultimately, allows clients a better opportunity to recognize a greater tax-free gift than sales to DGTs by locking-in wealth transfer gains from prior years.[150] Based on these findings, clients who desire to transfer the value of highly-liquid and marketable assets out of their gross estates will most likely find that a rolling GRAT strategy serves their needs and objectives better than a sale to a DGT.

Nevertheless, the sale to a DGT may replicate the lower investment risk of a rolling GRAT and provide for a greater tax-free gift through: (1) employing an inherently lower base hurdle rate, (2) leveraging the lack of marketability and lack of control discounts on contributed assets prior to the sale through the establishment of a separate limited liability company, and (3) allowing for more flexible payments to the grantor. Accordingly, the sale to a DGT strategy may have an overall greater risk in some cases; but also an overall greater reward than even a rolling GRAT strategy. A DGT may have less overall "asset-liquidation risk" due to more flexible payment structures under the terms of a note as opposed to a guaranteed annuity — thus allowing for a greater chance of actual asset succession to the beneficiaries.

Sales to DGTs also provide certain generation-skipping transfer tax benefits for long-term, multi-generational planning. When combined with recent changes in the trust laws of various states, DGTs can provide tax-free gifting to multiple generations and even into perpetuity. Furthermore, a DGT is often much simpler and more cost efficient to administer on

[150] *See generally*, Kwon & Loewy.

an ongoing basis than rolling GRATs. Practitioners should be aware of these benefits — especially in cases where the client desires his or her heirs to succeed to the ownership of a particular asset or closely-held business.

As a result, attorneys and wealth managers should remain objective in deciding which techniques are best suited for their clients' needs based on a comprehensive analysis of the particular circumstances involved. By understanding these strategies and the respective risks and benefits associated with them, practitioners can better meet and exceed their clients' wealth transfer goals.