

LIVING TRUST  
&  
ESTATE PLANNING



# The ABA Practical Guide to Estate Planning

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# GRANTOR RETAINED ANNUITY TRUSTS

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### *Introduction*

Grantor retained annuity trusts (GRATs) can play an important tax-saving role in high-net worth estate plans. GRATs have one basic purpose: to save estate and gift taxes. Individuals with business interests or investment assets substantially in excess of the available exemption from the federal estate tax will have no choice but to consider the efficacy of GRAT planning. Simply put, GRATs are one of the most powerful estate planning tools available today; the technique has limited competition.

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### *History and Background*

The GRAT structure became effective as a planning technique in 1990. Prior to the enactment of GRATs as a statutorily authorized planning vehicle, estate planners utilized a tool called the grantor retained income trust (GRIT) for intrafamily gift tax planning. Many perceived the GRIT to be an “abusive” planning technique because it was too effective. In other words, in many circumstances, the GRIT technique was too good at tax-free transfer of wealth from one generation to the next.

In 1987, Congress enacted Internal Revenue Code (Code)<sup>1</sup> section 2036(c) to clamp down on the estate planning benefits of GRITs, but section 2036(c) was not ultimately seen as the appropriate answer to the perceived abuses of GRITs. Thus, in 1990, Congress repealed section 2036(c) and added a whole new set of provisions to the Internal Revenue Code (affectionately called “Chapter 14”). Among other provisions of Chapter 14, Congress included Code section 2702. Section 2702 specifically addresses transfers to trusts where the creator (or grantor) of a trust retains some form of periodic or annual payment from the trust.

The GRIT is still a viable estate planning tool for transfers to more distant family relations (e.g., nieces, nephews) or unrelated persons. In today's diverse community of wealth, such opportunities for wealth transfer are significant and should be examined in the appropriate circumstances. But for the traditional wealth-transfer targets (i.e., descendants), the GRAT must be considered as one of the main tools available for ultrahigh-net worth wealth transfer planning.

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### *What Is a GRAT?*

On its most basic level, a GRAT is a trust to which the grantor gifts property. The grantor of the GRAT (or a family member of the grantor) retains the right to a fixed annual payment from that GRAT for a certain specified period of time, determined at the time of the creation of the GRAT. The ultimate beneficiaries of the GRAT are members of the grantor's family (usually children or a trust for those children). Those beneficiaries receive whatever assets are left over in the GRAT after the term of the GRAT ends.

The basic concept of a GRAT is deceptive in its simplicity. The technical requirements that must be met in order to avoid potentially disastrous gift tax consequences are many. Section 2702 and related Internal Revenue Service (IRS) regulations set forth those requirements.

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### *The Application of Code Section 2702*

Section 2702 sets forth the requirements for establishing a GRAT. If followed, the grantor avoids otherwise harsh gift tax consequences for transfers in trust where the grantor retains an interest. But section 2702 does not apply in every situation where the grantor retains an interest. In order for section 2702 to apply, the trust must ultimately benefit a member of the transferor's family. Another section of Chapter 14 defines *family members*, a term that generally includes the grantor's spouse, lineal descendants, ascendants, and siblings of the grantor, as well as spouses of those individuals. If the trust does not benefit any one of the defined relationships, then section 2702 does not apply.<sup>2</sup>

Of course, in order for section 2702 to apply, the grantor (or a family member) must also retain an interest in the trust. If the grantor or family member does not retain an interest, the rules of section 2702 do not apply (and a GRAT has not been created).

The concept of "retaining an interest" is a little tricky. The person retaining the interest must have had an interest in the property both before and after the transfer. To illustrate, let's begin with an example that we will revisit throughout

the discussion. Assume Husband gifts a parcel of commercial rental real estate to a trust. Wife did not own any of the commercial real estate prior to Husband's transfer. The trust agreement requires that Wife receive an annuity payment for ten years from that trust, with the remainder passing to Child. In that example, section 2702 does not apply since Wife did not own the real estate prior to the transfer (she did not have any form of ownership interest in the real estate). Conversely, if Husband retained the right to the annuity payment after the transfer of the real estate to the trust, section 2702 would clearly apply because he had an interest in the commercial real estate both before and after the transfer. Husband's interest in the real estate after the transfer was his right to the annual payment after his gift to the trust.

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### *The Harsh Valuation Rule of Section 2702*

Assuming a particular factual pattern falls within section 2702's application, what is the effect of section 2702 on such a transfer? Let's go back to our example. Husband transfers a piece of commercial real estate (worth \$5 million on the date of transfer) to a trust in which he retains an interest. Assume that the retained interest is a payment of a set dollar amount every year for twelve years to Husband. In addition, if Husband dies during that twelve-year term, the trust document states that Husband's estate gets back the entire property transferred to the trust. At the end of the twelve years, assuming that Husband survived, whatever is left over in the trust passes to Child. In that case, unless an exception applies, section 2702 would dictate that the value of the gift by Husband on the date that he made the transfer would be \$5 million.

Because of section 2702, Husband would not be able to argue that his retention of the interest reduced the value of the transfer to the trust in any way. When a thoughtful economic analysis of the transaction is made, however, one must conclude that at least some value is retained by Husband in that transfer. In our example, (i) the annual payment to Husband and (ii) the possibility that the entire trust property would be returned to Husband's estate if Husband died prior to the end of the twelve years are the two "interests" retained by Husband. Those two interests can be actuarially valued. The logical result would be to subtract the value of those two interests from the value of the real estate transferred (i.e., \$5 million less (i) the present value of the annual payment to Husband and (ii) the actuarial value that Husband's estate will get back the entire property). In other words, the gift of the commercial real estate to the trust should, from a purely economic perspective, be something less than \$5 million. Unfortunately, that is not the case under section 2702. The gift is \$5 million unless another exception applies.

One may argue that such a result is not disastrous when exemptions from estate and gift tax are as high as \$5 million per person (and thus would not generate current gift tax if Husband has not previously used any of his current gifting exemption). However, the point is not to look at what exemption is available but to look at the true economic value of the transfer versus what section 2702 deems the value of the transfer to be. In our example, something significantly less than \$5 million in value is being transferred to the trust for the ultimate benefit of Child, yet section 2702 metes out a harsh result that ignores the economic reality of the transaction. One could structure the example so that the economics result in the transfer of little, if any, value to Child by making the annuity payment back to the grantor large enough. In other words, the fact pattern could be structured to result in an economic gift of almost zero because the value of what Husband retains approaches or equals \$5 million. Yet section 2702 would still value the gift at \$5 million. In sum, the club of section 2702 would kill the use of such structures for estate planning purposes.

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### *Circumventing the Harsh Results of Section 2702*

There are several exceptions to the application of the section 2702 valuation rule. One such exception is the personal residence trust (covered elsewhere in this book). Another “exception” to the section 2702 valuation rule is the part of section 2702 that effectively authorizes the use of GRATs.

Section 2702(a)(2)(B) provides that the harsh section 2702 valuation rule does not apply to a transfer of an asset to a trust where the grantor of the trust retains a “qualified interest.” One type of qualified interest is the grantor’s right to receive a fixed amount payable at least annually. Although there are other types of qualified interests, the right to receive a fixed amount payable at least annually, otherwise known as an annuity interest, is the statutory basis for the GRAT as a viable estate planning technique. The qualified interest in a GRAT is sometimes called a “qualified annuity interest.”

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### *Requirements of a Qualified Annuity Interest*

Anyone wanting to avoid the harsh valuation rule of section 2702 will structure the transfer so that the grantor retains a qualified interest. In the case of a GRAT, the interest that the grantor retains is a qualified annuity interest (thus the term *grantor retained annuity trust*). There are several requirements for an annuity interest to be “qualified.” Some of those requirements are basic to the conceptual understanding of a GRAT.

The first such requirement is that the length (or term) of the qualified annuity interest must be fixed and either last for the life of the interest holder, a specified

term of years selected at the creation of the trust (e.g., twelve years), or the shorter of the life of the term holder or a specified term of years.

The second such requirement is that the payment to the qualified annuity interest holder must be a fixed amount. One way to define a fixed amount is as a stated dollar amount payable annually or more frequently. This amount cannot increase more than 120 percent from the stated dollar amount payable in the immediately preceding year. In other words, the fixed dollar amount may increase 120 percent per year, at most. A fixed amount can also be defined as a fixed percentage of the initial fair market value of the property transferred. Again, the 120 percent per year increase is the maximum annual increase allowed in the annuity payment.

Even though the qualified annuity payment must be made at least annually, delaying the annual annuity payment past the annual annuity date is allowed. If the GRAT is structured so that the payments must be made based on a taxable year (i.e., December 31 year end), then the annuity may be paid after the close of the taxable year as long as the payment is made prior to the required filing date for the trust's tax return (extensions are not considered). If the annuity payment must be made based on the anniversary of the trust, then the annuity payment does not have to be made until 105 days after the anniversary date. These permissible delays in payment allow more time for the assets in the trust to grow and thus maximize the amount that can ultimately pass to heirs (since any extra growth that occurs should end up remaining in the GRAT for the benefit of the heirs).

Note that the qualified annuity interest payment does not have to be paid in cash. The payment can be made in kind with any asset owned by the GRAT (publicly traded securities, interests in real estate, stock, other interests in privately held entities, etc.). However, any payment that is not easily valued will require an appraisal to ensure that the payment is accurate. If the qualified annuity payment is made in any form other than easily valued assets (e.g., cash or publicly traded securities), annual appraisals will generally be needed. Obtaining those appraisals on an annual basis will substantially increase the administrative costs of the planning.

The trust instrument must provide for the redetermination of the annuity payment if the initial valuation of the assets transferred to the trust was incorrect. For example, if the IRS determines in a gift tax return audit<sup>3</sup> that the qualified annuity payment was incorrectly calculated because the initial fair market value of the property upon contribution was incorrectly determined, then the annuity payment must be corrected on a going-forward basis. Any incorrect amount paid in the past must also be corrected (by either the GRAT making additional payments to the annuity interest holder or by the annuity interest holder repaying the GRAT).

Finally, there can be only one contribution of assets to the GRAT. Any issues with that prohibition can easily be overcome by the creation of another virtually identical GRAT at a later date. Thus, the practical effect of the single-contribution rule is not very significant.

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### *Section 7520 Saves the Day (or, at Least, the Valuation Result)*

Assuming that the interest retained by the grantor is a qualified interest (and in the case of a GRAT, a qualified annuity interest), then the harsh valuation rule of section 2702 does not apply. Instead, the value of the interest gifted and the value of the interest retained by the grantor of the trust are determined under section 7520. The results under section 7520 for qualified annuity interests are wildly better than the results under section 2702 for nonqualified annuity interests. The section 7520 valuation method allows the retained interest to have economic substance. Thus, the gift of commercial real estate in our example will not be deemed to be a gift of the entire \$5 million. Instead, the gift can be something much less because value will be ascribed to the qualified annuity interest retained by the grantor. The value ascribed to the qualified annuity interest is subtracted from the value of the overall property to determine the value of the gift made to the GRAT by the grantor.

Section 7520 requires that certain specified actuarial tables published by the IRS be used in valuing a qualified annuity interest. In the valuation computation, section 7520 also requires the use of an interest rate that is equal to 120 percent of the “applicable federal midterm rate”<sup>4</sup> for the month in which the transfer to the GRAT takes place. This rate is often called the “7520 rate.”

The 7520 rate becomes fixed upon the transfer to the trust. Although the 7520 rate fluctuates on a monthly basis, once the GRAT is established, the rate applicable to that GRAT is fixed for the term of the GRAT (regardless of subsequent fluctuations in the 7520 rate after the GRAT is created). Thus, if the 7520 rate is 3 percent in the month that the GRAT is created, and the published 7520 rate swings wildly during the term of the GRAT, the variations in the published rate are irrelevant to the GRAT in question, which is bound to the 3 percent rate in effect in the month of its creation.

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### *Section 7520 Rate: The Hurdle for Measuring a GRAT’s Success*

Assuming that the qualified annuity interest is valued under the section 7520 regime, an important factor cannot be ignored: if the rate of return on the assets inside the GRAT does not exceed the 7520 rate applicable to the trust (i.e., the rate published for the month in which the transfer to the trust occurred), then the GRAT will fail as an estate planning technique. A GRAT fails when there is little, if any, value left over to pass to the beneficiaries at the end of the GRAT term. As a corollary, the greater the return on investments held by the GRAT (in excess of

the 7520 rate), the more value will be left over for the ultimate GRAT beneficiaries. Thus, the lower the initial 7520 rate at the creation of the GRAT, the better the likelihood of success.

The rate of return on investment for assets held in a GRAT has significant implications for the use of a GRAT as an estate planning technique. The first is that the GRAT is not foolproof. There is a real risk that the GRAT can fail if the return on the investments owned by the GRAT is weak. If the GRAT fails, nothing is ultimately transferred to the trust beneficiaries, but a gift has still been made upon creation of the GRAT. That may not be tragic if the GRAT was structured to result in a small gift, and only a tiny fraction of the grantor's lifetime gifting exemption was used in creating the GRAT. However, the GRAT was a big waste of time and effort, as well as legal and accounting fees.

The second implication is that when establishing a GRAT, the choice of assets must be carefully considered. There must either be real growth potential in the assets contributed to the GRAT or a very significant income stream produced by those assets over time. Without either one or both of these forms of investment returns, the GRAT will likely fail. Based on the need for investment return on GRAT assets, examples of assets appropriate for contribution to GRATs include interests in property generating significant annual cash flow (e.g., commercial rental real estate), closely held business interests, or equity in entities that may be candidates for an initial public offering in the next one to four years.

The third implication is that assets should be transferred to a GRAT in a format that will allow for discounting the value of the assets upon contribution to the GRAT. Planners often try to structure transfers to GRATs in ways such that the interests transferred qualify for discounts for lack of marketability and/or lack of control.<sup>5</sup> These discounts can reduce the value of the interest by 20 percent to 60 percent in some cases. By structuring the transfers to qualify for these types of discounts, a GRAT has a much greater chance of success.

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### *Putting the Pieces Together in Creating a GRAT*

In determining the value of a qualified annuity interest, certain variables must be determined and fixed. First, the value of the property transferred to the trust must be established. This is generally accomplished by obtaining a professional valuation of the property transferred to the GRAT. An appraisal can be a significant expense in itself. Second, the 7520 rate for the month of the transfer must be determined. Third, the term of the annuity period should be established. Fourth, the amount of the annuity must be decided upon. Finally, depending on the term of the qualified annuity interest, the grantor's age may be a required component of the computation (for example, where the annuity term is based on a period that is equal to the shorter of a fixed term of years or the grantor's death). Some of these variables

(e.g., the term and the annuity payout) can be manipulated so as to tailor the GRAT structure (and the value of the gift) to suit a client's particular planning needs and goals.

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### *Examples Bring the Benefits to Life*

To cut through this technical discussion, a comparative example can illustrate the effect of section 2702 and the benefits of structuring the transaction to fall within the valuation rule of section 7520. Assume in our example that the grantor of the trust is 60 years old and the commercial real estate contributed to the trust is valued at \$5 million. The trust is established to pay the grantor \$500,000 per year for a fixed twelve-year period. The commercial real estate's total return on investment is 6 percent per year (divided between income earned and growth of underlying capital). The 7520 rate at the time of the transfer to the trust is 3 percent. At the end of the twelve-year term, on these assumptions, approximately \$1,655,191 will be remaining in the GRAT, which by its terms, passes to the grantor's children. If, for some reason, the interest retained by the grantor is not a qualified interest (because, for example, the trustees are not required to timely pay the annual annuity to the grantor even though the trustees do so in practice), then the grantor will be deemed to have made a gift of \$5 million on day one but will only end up transferring the \$1,655,191 to his children at the end of the twelve-year term. If the annual payment is a qualified annuity interest, then the children will still receive the \$1,655,191 at the end of the twelve-year period, but the amount of the gift will be calculated to be only \$23,000 under section 7520. Depending on the gifting exemption in effect at the time, if the retained interest is not a qualified annuity interest, there will either be a massive waste of the available gifting exemption (because any gift would first utilize the grantor's remaining exemption from gift tax) or a potential generation of millions of dollars in immediate gift tax liability; in either case, only \$1,655,191 would pass to the children at the end of the twelve-year term. In contrast, if the annuity was a qualified interest, the gift would only be valued at \$23,000 upon creation, with the same \$1,655,191 passing to the children at the end of twelve years.

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### *The Death of the Grantor and Its Impact on Planning with GRATs*

A GRAT can be a very powerful planning tool. The better the ultimate return on the asset contributed to a GRAT relative to the 7520 rate, the more effective the GRAT can be. Unfortunately, the IRS takes the position that if the grantor of the GRAT dies during the term of the GRAT, all or a portion of the remaining GRAT property

will be included in the grantor's estate for estate tax purposes.<sup>6</sup> Estate tax inclusion at death may be considered the single most significant drawback of the GRAT as an estate planning tool because it means a complete failure of the technique (if the IRS's position is accepted, there is generally no middle ground or partial effectiveness). When comparing the GRAT as a planning option to its main competing planning tool (called a "sale to a defective grantor trust"), the sale technique has a major advantage in that certain benefits that it offers are not dependent on the grantor outliving the payment schedule applicable to that technique. Some benefits are locked in immediately upon consummating the sale technique.<sup>7</sup>

In recently released final regulations (2008), the IRS indicated that for a grantor who died during the term of the GRAT, the portion of a GRAT to be included in the decedent's estate is that portion of the trust corpus necessary to produce the qualified annuity interest for the rest of the term of the GRAT, applying the appropriate 7520 rate. In that computation, the value of the GRAT property as of the date of the grantor's death is used. Importantly, in reaching that result, the computation cannot take into account the exhaustion of principal to make that payment. Such a rule, in effect, makes virtually the entire corpus of the trust includable in the decedent's estate. It will take virtually all of the earnings generated in the trust, utilizing almost the entire trust corpus in generating those earnings, to satisfy the annuity payments, except to the extent that the GRAT experienced tremendous increases in value since inception (in which case, only a portion of the trust corpus may be included in the decedent's estate).

Given the IRS position, the conservative planner must weigh the potential benefits of creating a GRAT versus the risk of death during the term of the GRAT. The health of the client and the term of the GRAT are crucial considerations that require analysis and judgment.

For example, weighing whether a short-term GRAT (i.e., a GRAT with a relatively short duration, such as two to five years) is a better option than employing a long-term GRAT (such as a GRAT with a duration of nine years or more) depends on a number of considerations. If the assets contributed to the GRAT are of low value but may significantly appreciate after contribution to the GRAT, a shorter duration may be the most advantageous design. In that fact pattern, the goal may be to minimize the grantor's risk of death during the GRAT term or take advantage of short-term volatility in the marketplace for the asset (i.e., a dramatic short-term rise in value). Similarly, the use of a series of short-term GRATs can minimize the risk of estate tax inclusion, at least with respect to some of the assets in question. A series of GRATS (sometimes called "rolling GRATs") is often structured so as to contribute the annual annuity payment from earlier GRATs to new GRATs as the annuity payment is made. Some of the property will be successfully transferred out of the grantor's estate if the grantor survives at least a few years, whereas none of the property may be successfully transferred out of the grantor's estate if the

grantor dies during a long-term GRAT's duration. Thus, short-term GRATs have some advantages over longer-term GRATs.

Conversely, shorter-term GRATs also pose some significant disadvantages as compared to long-term GRATs. When using a series of short-term GRATs, the client's costs significantly increase. Extra legal fees, accounting fees, appraisal fees, and other administrative costs are inherent in rolling GRAT plans. In addition, with assets that have already achieved substantial value at the time of the creation of the GRAT, a long-term GRAT generally provides a better overall structure for minimizing the value of the gift upon contribution; this is especially true when combined with an appropriately large annuity interest and a method to hedge the risk of death for the duration of the GRAT term. In addition, with short-term rolling GRATs, the 7520 rate can increase (or decrease) from GRAT to GRAT because each GRAT would be created in a different year. In an environment where interest rates are predicted to trend (or spike) upward over several years, the loss of a lower hurdle rate could jeopardize the overall effectiveness of the GRAT planning.

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### *Are There Ways to Avoid the Risk of Inclusion Due to Death?*

Planners and clients with higher risk tolerances may choose methods of structuring GRAT transactions that challenge the IRS's view of full or substantial estate inclusion of GRAT corpus upon the grantor's death during the GRAT term. There have been theories and structures proposed that offer a competing view to the application of the law as interpreted by the IRS. Although a discussion of those techniques is beyond the scope of this chapter, a client willing to challenge the IRS's interpretation may well wish to explore the possibilities, risks, and ultimate benefits of taking such positions in designing a GRAT structure.

Of course, one of the easiest and safest ways to hedge the risk of death during the term of a GRAT is to purchase life insurance on the life of the grantor. Properly planned, such a technique can effectively hedge the risk of death. By utilizing a term life insurance policy to cover the mortality risk of the GRAT or a permanent policy to accommodate additional facets of the overall estate plan (or a combination of both types), the grantor can ensure tax-efficient wealth transfer. This is true regardless of whether the client dies prior to the end of the GRAT term (in which case the insurance death benefit makes up for the GRAT failure) or whether the client dies after the end of the retained term (in which case the GRAT was successful).

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### *Some Talk of Limiting GRATs*

In the past several years, there has been talk of limiting the use of GRATs as an estate planning technique because it, too, is being viewed as bestowing inordinate

wealth transfer benefits to those who utilize it effectively. Some proposals include requiring minimum terms for GRATs (e.g., ten years or more) so there is substantial risk of death (and thus GRAT failure) or increased likelihood that growth rates would average out over time (and thus diminish the wealth-transfer benefits).<sup>8</sup> Requiring a minimum gift (i.e., not being allowed to structure the gift at a value close to zero) is another method contemplated to limit the benefits of GRATs. In fact, none of the major limiting proposals have been passed to date. No one can say with any certainty if or when such limiting proposals will take effect. For now, GRATs can be used to leverage significant wealth from one generation to the next.

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### *Conclusion: You Have Survived the Term (and This Chapter)*

GRATs are one of the most important planning techniques available to minimize death taxes for the ultrahigh-net worth individual with significant investment or business interests. However, GRATs are complicated undertakings with numerous requirements and pitfalls. Substantial gift tax consequences ensue if a GRAT is not structured and maintained properly. Although a GRAT may have one real rival as an estate planning tool, it must be considered in any significant estate plan and will often be the structure of choice for the many benefits it brings to the table.

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### *Endnotes*

1. All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended or recodified.

2. If section 2702 does not apply, the grantor may choose to structure the trust as a GRIT without concern for the harsh valuation rules applicable under section 2702.

3. Any use of an individual's lifetime gifting exemption requires the filing of a gift tax return by that individual, reporting details of the gift. Even if no gifting exemption is used, transferors will often want to report the value of the gift so as to commence the three-year statute of limitations on revaluation of gifts by the IRS. Because of these two points, use of GRATs will invariably lead to reporting the transaction on a gift tax return.

4. The applicable federal rate is an interest rate system established by the Code. Rates are published monthly. The applicable federal rate has rates applicable to short-, mid-, and long-term periods. These rates are generally applied as minimum required interest rates in intrafamilial transactions (such as loans between parents and children).

5. A discount for lack of marketability is based on the theory that an interest in a nonpublicly traded entity has no liquid market for transferring interests such

as a stock exchange. Thus, it will take significant amounts of time and reductions in price to ultimately sell the interest. A lack of control discount is based on the theory that the interest being transferred does not carry with it a controlling voice in the entity's management (e.g., a minority interest or a nonvoting interest). An in-depth discussion of discounting is not possible in the content of this chapter.

6. The IRS takes the position that GRAT corpus would be included in the grantor's estate under a specific Code section dealing with estate tax inclusion (Code section 2036) if the grantor did not survive the GRAT term.

7. The sale technique is structured by the grantor of a trust selling an asset to that trust. In return, the grantor typically receives a down payment and a promissory note for the remaining balance to be paid over several years. The promissory note is frequently structured to be interest-only with a balloon principal payment at the end of the note term. The applicable federal rate, which is used as the interest rate for the note, is generally favorable compared to market rates of interest. Moreover, the transaction is structured so that significant discounts for lack of marketability and minority interest are obtained on the sale. Once the sale is consummated, the discounts are locked in, and all future appreciation from that moment on is removed from the grantor's estate. Note that the GRAT technique does have important advantages over the sale technique. For example, when the IRS does audit a gift tax return, the IRS invariably challenges the value of the assets transferred to the GRAT or the assets sold in the sale technique, as the case may be. There is a high probability that if the IRS is successful in adjusting the value of the assets transferred, a significant gift tax would be paid in an audit of the sale technique (and not in an audit of the GRAT because the unique design of the GRAT can avoid or substantially minimize such a result).

8. This proposal is actually contained in President Obama's current budget proposal as this chapter is going to press.