TRANSFER TAXES IN FLUX: A COMPARISON OF ALTERNATIVE PLANS FOR GRAT REFORM

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ABSTRACT—Estate and gift taxes may be a topic of national discussion, but few Americans are familiar with the methods taxpayers utilize to minimize these taxes. For decades, the Internal Revenue Code (the Code) has rewarded taxpayers who employ complex transfer tax strategies that take advantage of “estate freeze” techniques, which can reduce or even eliminate the taxes imposed on large wealth transfers. One particularly popular technique, the grantor retained annuity trust (GRAT), facilitates tax savings for individuals who plan in advance of significant asset appreciation. Regrettably, such tax savings fail to conform to the widely held belief that taxpayers of comparable income or wealth should pay similar taxes. Aiming to tighten the rules on GRATs, President Obama has repeatedly introduced reform proposals, but each time, he has neglected to address the technique’s biggest vulnerability to abuse: that it allows ultra-wealthy individuals to shield unlimited amounts—potentially billions of dollars—from the transfer taxes that other Americans must pay. This susceptibility to aggressive planning undermines the spirit of the Code and deprives the government of much-needed tax revenue. Recognizing that GRATs fit snugly within a larger body of interrelated tax provisions, this Comment advocates for the imposition of a lifetime limit on tax-free GRAT transfers, a solution that hampers the technique’s more dubious uses while preserving, to the greatest extent possible, its creation of an incentive to invest in entrepreneurial activity.

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INTRODUCTION

Given only two guarantees in life—death and taxes—it seems puzzling that so many people fail to appreciate the one that keeps them breathing. Whether they appreciate it or not, the vast majority of Americans pay taxes, in one form or another, to the federal government each year.1 Most pay their share in the form of federal income, excise, and payroll taxes.2 The nation’s

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wealthiest must navigate an additional layer: gift\textsuperscript{3} and estate\textsuperscript{4} taxes, collectively known, along with the generation-skipping tax,\textsuperscript{5} as transfer taxes.

A grantor retained annuity trust (GRAT) takes advantage of special provisions in the Internal Revenue Code (the Code) to facilitate the transfer of assets essentially outside the gift and estate tax system.\textsuperscript{6} In a GRAT, an individual places assets into an irrevocable\textsuperscript{7} grantor trust\textsuperscript{8} that pays back an annuity,\textsuperscript{9} the total present value of which generally equals, or comes close to equaling, the fair market value of the initial trust assets.\textsuperscript{10} If the grantor creates the trust so that the present value of the annuity and the fair market value of the initial trust assets are perfectly equal, then the GRAT contains no taxable gift and acquires the moniker “zeroed out.”\textsuperscript{11} In such a case, beneficiaries receive—free of gift tax—whatever appreciation has accrued during the trust term above the fair market value of the initial trust assets, plus interest (at a rate dictated by § 7520 of the Code),\textsuperscript{12} upon the trust’s


\textsuperscript{3} I.R.C. § 2501 (2006).

\textsuperscript{4} Id. § 2001.

\textsuperscript{5} Id. § 2601.


\textsuperscript{7} An irrevocable trust is one in which the grantor disclaims the right to revoke or modify the trust. See RESTATEMENT (THIRD) OF TRUSTS § 63 & cmt. e (2003).

\textsuperscript{8} A grantor trust is one in which the grantor is personally responsible for paying the income taxes of the trust because he has retained a reversionary interest of more than 5% of the initial trust assets. See BORIS I. BITTKER & LAWRENCE LOKKEN, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 80.1.1, at 80-5 (3d ed. 2003).

\textsuperscript{9} This annuity can be expressed either as a fixed dollar amount or as a fraction of the initial fair market value of the trust assets, preventing any surprise gift tax consequences stemming from audit-related changes to the initial fair market value. See BELCHER, supra note 6, at 4.

\textsuperscript{10} See id. at 2–3.


\textsuperscript{12} See I.R.C. § 7520 (2006). The interest rate used in § 7520 is updated monthly and defined as “120% of the federal mid-term rate under §1274(d)(1), compounded annually, rounded to the nearest 2/10ths of 1%.” Alan S. Gassman & James F. Gulecas, Comparing the GRAT to the Installment Sale to a Defective Grantor Trust, and Who’s Afraid of the Exhaustion Test?, PRAC. TAX LAW., Fall 1999, at 43, 45. A grantor obtains the interest rate used to calculate a GRAT’s annuity payments on the date of a GRAT’s creation, and this rate is fixed for the entire trust term. See RONALD D. AUCUTT, MCGUIREWOODS LLP, GRANTOR RETAINED ANNUITY TRUSTS (GRATS) AND SALES TO GRANTOR TRUSTS 4 (2011), available at http://www.mcguirewoods.com/news-resources/publications/taxation/grats.pdf. Section 7520 establishes the baseline rate from which the benefits of GRATs arise, allowing GRATs to “capitalize on the mismatch between interest rates used to value transfers and the actual anticipated performance of the transferred asset.” See id. at 1.
expiration. If the two values are not equal, then the difference between the fair market value of the trust’s initial assets and the present value of the annuity constitutes what is known as the initial trust remainder, the GRAT’s optional taxable gift. Current regulations permit grantors broad powers to select the length, or term, of their GRATs and to structure the form and size of the annuity payments that they will receive.

Estate planners have held the GRAT in high esteem for over two decades because the technique delivers what amounts to upside-only potential. The GRAT’s basic structure provides this have-your-cake-and-eat-it-too feature. When a GRAT fails to perform as desired, meaning the trust assets fail to appreciate above the § 7520 rate, the trust can simply dissolve with no cost to the grantor—except, of course, the cost of legal services rendered. On the other hand, when trust assets outperform the § 7520 rate, grantors can transfer wealth not without being subject to the

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13 See Belcher, supra note 6, at 2–3.
14 See id.
15 A two-year GRAT term has emerged as the widely accepted minimum after Walton, 115 T.C. at 604. Prior to Walton, the Service took the stance that a GRAT’s term needed to exceed two years, but in more recent cases, it has indicated that a GRAT of even one year may be acceptable. See Aucutt, supra note 12, at 12; see also Kerr v. Comm’r, 292 F.3d 490 (5th Cir. 2002) (upholding, in passing, a GRAT with a term of 366 days). In any event, the Code contains no provisions on this point, and Walton is a rare case in its delineation of the boundaries of GRAT rules. Indeed, the fog of uncertainty shrouding complex transfer tax planning is thick, owing to a combination of factors including the Service’s devotion of fewer resources to enforcing the gift tax than the income tax, see U.S. DEP’T OF THE TREASURY, INTERNAL REVENUE SERVICE DATA BOOK 22 (2011) (stating that the Service audits 12.5% of individual income tax returns with total positive incomes of $1 million or more but only 1.2% of gift tax returns and 0.1% of estate and trust income tax returns), and its settlement of many cases before precedent is created, see Leandra Lederman, Which Cases Go to Trial?: An Empirical Study of Predictors of Failure to Settle, 49 CASE W. RES. L. REV. 315, 329 (1999) (noting that the IRS Appeals Office settles approximately 90% of the cases that it handles).
18 See Ashlea Ebeling, Goodbye GRATs?, FORBES.COM (Mar. 24, 2010, 11:17 AM), http://www.forbes.com/2010/03/24/estate-gift-tax-house-jobs-bill-personal-finance-obama-grat-crackdown.html (noting that the set-up fees for a GRAT typically start at $2500). It could be argued that the grantor of a failed GRAT also incurs opportunity costs, considering the wide range of alternative estate planning techniques available during a GRAT term. See Ronald D. Aucutt, Capital Letter No. 24: The House of Representatives Votes to Restrict GRATs, ACTEC (Mar. 29, 2010), http://www.actec.org/public/CapitalLetter24.asp. Finally, to the extent that a GRAT is not zeroed out, a grantor risks sacrificing some applicable exclusion amount or unnecessarily paying some gift tax on an amount equal to the difference between the taxable initial remainder value and the remainder actually transferred. See id.
gift or estate tax\textsuperscript{19} in quantities limited only by the amount of a GRAT’s underlying asset appreciation.

As part of a broad effort to reform the Code and increase tax revenue, President Obama has repeatedly introduced proposals to restrict the use of GRATs.\textsuperscript{20} The President’s most recent reform proposals would require GRATs to have (1) a minimum term of ten years, (2) an initial remainder interest value greater than zero, and (3) annuity payments that do not decrease during the term of the trust.\textsuperscript{21} Although these proposals have gained little traction in Congress,\textsuperscript{22} they highlight the need to strengthen GRAT rules in order to prevent abuses by the most aggressive grantors and estate planners.

To appreciate the logic underlying the President’s proposals, the mechanics of another Code provision, § 2036,\textsuperscript{23} must be examined. Under § 2036, which concerns transfers made with retained life estates, if a grantor dies during the term of a GRAT, the GRAT’s tax benefit—the gift-tax-free transfer of appreciation above the § 7520 rate\textsuperscript{24}—disappears, and the trust assets fall into the grantor’s estate.\textsuperscript{25} Thus, the President’s most significant reform proposal, requiring a minimum trust term of ten years, aims to increase the probability that GRATs will become worthless by mandating that they bear significant mortality risk.\textsuperscript{26} Agreeing that reform is overdue, this Comment compares the President’s plan with other potential proposals and offers an alternative solution: apply the gift tax at a one-half rate to GRAT transfers that currently enjoy tax-free status above a lifetime

\textsuperscript{19} This transfer occurs completely untaxed, excepting any implications for possible future capital gains, since donees generally pay no income tax on amounts received by gift. See I.R.C. § 102 (2006).

\textsuperscript{20} See U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS 80 (2012) [hereinafter 2013 REVENUE PROPOSALS]; U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2012 REVENUE PROPOSALS 128 (2011) [hereinafter 2012 REVENUE PROPOSALS]; see also AUCUTT, supra note 12, at 23–26 (explaining that President Obama proposed similar rule changes in 2009 and 2010 and that several bills containing GRAT-limiting provisions have been introduced in Congress since that time).

\textsuperscript{21} See 2013 REVENUE PROPOSALS, supra note 20, at 80.

\textsuperscript{22} The first of these bills passed in the House but failed in the Senate, while the later bills failed to advance in either chamber. See Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849, 111th Cong. § 307; AUCUTT, supra note 12, at 25–26.

\textsuperscript{23} I.R.C. § 2036.

\textsuperscript{24} For simplicity of exposition, this Comment generally assumes a zeroed-out GRAT.

\textsuperscript{25} See Craig L. Janes, Grantor Retained Annuity Trusts: Avoiding the Petards in an Otherwise Safe Harbor, EST. PLAN., May 2006, at 10, 10.

\textsuperscript{26} Assuming zeroed-out status, GRAT worthlessness creates no risk of loss to the grantor beyond being taxed as if no GRAT had ever been formed. Still, this change in tax treatment would cause real financial loss to beneficiaries of GRATs that would have contained above-§ 7520 appreciation had a grantor survived the trust term. Assuming the beneficiary takes those same assets via the estate, the beneficiary’s loss would equal the portion of the estate tax levied on that appreciation minus any value received from obtaining stepped-up basis on capital assets. See AUCUTT, supra note 12, at 18–19, 25–26.
cumulative of $5 million and apply the tax in full once such transfers exceed a lifetime cumulative of $10 million.

Part I of this Comment describes the history and mechanics of GRATs in the transfer tax system. Part II examines the benefits that GRATs provide to the economy, our society, and the coherence of the Code. Part III advances a framework for reform and uses it to critique President Obama’s proposals. Finally, Part IV presents four alternative proposals and applies the framework developed in Parts II and III to recommend a progressive reform that combines one of President Obama’s proposals with two alternatives.

I. THE HISTORY AND MECHANICS OF GRATS IN THE LARGER TAX CODE

Over its more than seventy-year existence, the Code has swelled into a complex jumble of rules. Transfer tax policy is no exception; it has been complicated by various legislative reformations, which inevitably attract attention from special interest lobbyists. In an effort to untangle this mess for the nontechnical reader, Part I examines the history of the transfer tax and explains how the GRAT gained popularity as an estate planning tool. It also sheds light on how GRAT rules interact with other Code provisions that concern estate planning, providing context for a later discussion about whether and how GRAT policy should be altered.

A. The Transfer Tax: Background and Debate

The roots of transfer taxes in the United States can be traced back to 1797, but, until the twentieth century, the tax was only implemented intermittently, typically to fund war-related activities. Congress passed the

27 See 1 BITTKER & LOKKEN, supra note 8, ¶ 1.1.5, at 1-10.
28 See 1 NAT’L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS 4 (2008) (“The Code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted in the course of preparing this report turned up 3.7 million words.”).
30 See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 4–7 (Comm. Print 2007) (detailing the American military efforts that transfer taxes have funded, including a post-Revolutionary War naval force, Union armies during the Civil War, federal forces that fought in the Spanish-American War, and national spending related to both World Wars).
precursor to the modern transfer tax system in 1916, three years after the Sixteenth Amendment vested Congress with the authority to levy income taxes. Gift and estate taxes operated separately until 1976, when Congress unified the systems by mirroring their tax rates and introducing the unified credit, which provides for an applicable exclusion amount—a joint limit on tax-free lifetime gift and estate transfers. Under this system, which still operates today, the Internal Revenue Service (the Service) basically subtracts each dollar of the applicable exclusion amount an individual uses while still alive from the exclusion available to his estate.

A bit of background on the interplay between the income tax, the gift tax, and the estate tax is required before our discussion can proceed. Due to income tax provisions that permit a step-up in basis for capital assets at death, many heirs escape significant capital gains taxes when they take through an estate. On the other hand, inter vivos gifts, or those made during life, provide two major advantages that counterbalance this favorable treatment of capital assets at death and make them an attractive option. The first is the annual gift exclusion, which permits yearly transfers that are separately capped for each individual recipient and do not count against a donor’s applicable exclusion amount. In 2012, the annual exclusion amount was $13,000; so, for example, a husband and wife could give each of their children, children’s spouses, grandchildren, and whomever else they desired up to a combined $26,000 without using up any of their applicable exclusion amounts.
Lifetime gifts have a second, structural advantage: the gift tax is computed using a smaller basis than the estate tax. A simple comparison illustrates the point. To calculate the gift tax, the Code mandates the use of an exclusionary method that taxes only the amount of wealth transferred.\footnote{See Kerry A. Ryan, Human Capital and Transfer Taxation, 62 Okla. L. Rev. 223, 227 (2010).} In contrast, the Service computes the estate tax using an inclusionary method that taxes the value of an entire estate, including the amount that will be paid toward the estate tax.\footnote{Id.} Given identical pretax amounts, this discrepancy allows for more post-tax wealth to be transferred via gift than estate.\footnote{See \textit{Ryan}, supra note 39, at 227.}

Returning to the history of transfer taxes, from 1984 to 2001, the gift and estate tax system was relatively consistent, with a top rate of 55% and an applicable exclusion amount that roughly tracked inflation, rising from $325,000 to $675,000.\footnote{See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 11 (Comm. Print 2007).} With the passage of President George W. Bush’s Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the burden of transfer taxes was lessened through a combination of gradual increases to the applicable exclusion amount and decreases to the top tax rate.\footnote{See id. at 10–11.} By 2009, the applicable exclusion amount had risen to $3.5 million and the tax rate on transfers had fallen to a flat rate of 45%.\footnote{See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 13–14. The morbid incentives created by drastic changes to the estate tax rate were explored by Wojciech Kopczuk and Joel Slemrod, who found that individuals who know such tax rates in advance will time their deaths accordingly. See Wojciech} EGTRRA culminated in 2010, its last year of effect, by repealing the estate tax and setting the gift tax rate at 35%.

nine grandchildren could transfer $390,000 each year without incurring transfer taxes or using up any of their applicable exclusion amount. Over twenty years, they could transfer $7.8 million this way. Taxpayers have found ways to maximize this opportunity, including the use of Crummey trusts. Crummey trusts are cleverly designed to allow the transfer of wealth to minors by utilizing a donor’s annual exclusion without actually giving the minor any control of the funds until they are older, often past the age of majority. For a more thorough discussion of Crummey trusts, see Bradley E.S. Fogel, \textit{Back to the Future Interest: The Origin and Questionable Legal Basis of the Use of Crummey Withdrawal Powers to Obtain the Federal Gift Tax Annual Exclusion}, 6 Fla. Tax Rev. 189 (2003).
With EGTRRA’s sunset, 2011 would have brought a return to a $1 million applicable exclusion amount and a 55% tax rate.\textsuperscript{46} Instead, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which reinstated the estate tax, increased the applicable exclusion amount to $5 million and $5.12 million for 2011 and 2012, respectively,\textsuperscript{47} and lowered the transfer tax rate to a nonmarginal 35%.\textsuperscript{48} Given all of this tumult, politicians on both sides of the aisle have come to view transfer taxes as, yet again, ripe for reform.\textsuperscript{49}

The chances of policymakers reaching a broad consensus are slim. With hot-button issues such as progressivity,\textsuperscript{50} wealth concentration, and meritocracy involved, transfer taxes breed contentious debate. Indeed,
progressivity practically defines transfer taxes.\textsuperscript{51} Even with an applicable exclusion amount more in line with recent history than the current $5.12 million,\textsuperscript{52} gift and estate taxes affect only the wealthiest American families.\textsuperscript{53} Progressivity is rooted both in the notion that wealth has a declining marginal utility\textsuperscript{54} and in the desire to reduce the rate of rising wealth inequality,\textsuperscript{55} but it attracts ardent critics who argue that it violates principles of equality,\textsuperscript{56} applies arbitrarily,\textsuperscript{57} and disincentivizes the wealthy from engaging in socially beneficial activity.\textsuperscript{58} Some of these critics point


\textsuperscript{52} Rev. Proc. 2011-52, 2011-45 I.R.B. 701, 707. For example, in 2001, before EGTRRA took effect, the applicable exclusion amount was $675,000. See STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 11 (Comm. Print 2007).

\textsuperscript{53} The average individual net worth of the wealthiest 2,728,000 Americans in 2004 was approximately $3,739,000. See U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2012, at 467 tbl.717 (2012). This fortunate group constituted an even more exclusive cutoff than the top 1% of Americans, given a 2004 census population of 293,655,404. U.S. CENSUS BUREAU, ANNUAL ESTIMATES OF THE POPULATION FOR THE UNITED STATES AND STATES, AND FOR PUERTO RICO: APRIL 1, 2000 TO JULY 1, 2004, at 1 tbl.1 (2004), available at http://www.census.gov/popest/data/state/totals/2004/tables/NST-EST2004-01.pdf.


\textsuperscript{55} See JASON FURMAN ET AL., BROOKINGS INST., ACHIEVING PROGRESSIVE TAX REFORM IN AN INCREASINGLY GLOBAL ECONOMY 7–13 (2007) (“All told, the distribution of before-tax income between the top 1 percent and the bottom 80 percent has shifted by $664 billion since 1979 . . . .”). This effect can be at least partially traced to the higher rates of return that larger investments tend to earn in market economies due to economies of scale, leading some to believe that the concentration of wealth naturally accelerates, thus requiring a counterbalance. See Edward S. Adams & Richard A. Saliterman, The Trusteeship of Legal Rulemaking, 30 HOFSTRA L. REV. 483, 487–88 (2001) (reviewing ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2000)). But see DAVID A. HARTMAN, INST. FOR POLICY INNOVATION, DOES PROGRESSIVE TAXATION REDISTRIBUTE INCOME? 8 (2002) (“[W]ithout progressive taxation, Americans would find once again that poverty is best dispelled by growth-oriented public policies promoting a growing economic tide that raises all boats, not the . . . confiscation of the efforts of our most productive citizens and productive capital.”).

\textsuperscript{56} See, e.g., Kip Hagopian, The Inequity of the Progressive Income Tax, POL’Y REV., Apr. & May 2011, at 3, 22 (“[I]ncome redistribution is simply a coercive transfer of wealth from one group to another without an equity principle to support it.”).

\textsuperscript{57} See, e.g., id. at 24 (“The progressive tax system rests on a very slippery slope, making the term ‘fair share’ so subjective as to be an invitation to abuse.”).

\textsuperscript{58} One frequently mentioned distortion concerns tax avoidance, which the wealthy are more prone to engage in under systems with higher marginal rates. See, e.g., Joseph Bankman & Thomas Griffith, Social Welfare and the Rate Structure: A New Look at Progressive Taxation, 75 CALIF. L. REV. 1905, 1941–44 (1987); see also Clive Crook, Look Past Taxes to Fix Global Puzzle of Inequality, BLOOMBERG (Dec. 27, 2011, 6:00 PM), http://www.bloomberg.com/news/2011-12-28/look-past-taxes-to-fix-global-inequality-puzzle-commentary-by-clive-crook.html (“The rich can afford to be clever about tax shelters,
out that the mounting federal deficit could not be fully contained even if the wealthy had their incomes taxed to the hilt. \(^{59}\) Transfer taxes, especially if targeted at the middle class, could help close the gap. Any path to such a change would face serious hurdles, however, because regardless of whether one believes that an acceleration of income inequality endangers the nation’s meritocratic heritage, \(^{60}\) inheritance plays a significant cultural role in American society. \(^{61}\) Indeed, the custom is so inherent to human nature that it extends even to preliterate societies. \(^{62}\)

On balance, it may be the case that transfer taxes attract disproportionate hype given that they brought in relatively little revenue even before Congress passed EGTRRA’s cuts. \(^{63}\) Out of $2.1 trillion in gross federal tax collections in 2001, estate and gift taxes generated only

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\(^{59}\) See, e.g., Editorial, The 2% Illusion, WALL ST. J., Feb. 26, 2009, at A12 (“A tax policy that confiscated 100% of taxable income of everyone in America earning over $500,000 in 2006 would only have given Congress an extra $1.3 trillion in revenue. That’s less than half the 2006 federal budget of $2.7 trillion and looks tiny compared to the more than $4 trillion Congress will spend in fiscal 2010.”).

\(^{60}\) See Ever Higher Society, Ever Harder to Ascend, ECONOMIST, Jan. 1, 2005, at 34, 34–35 (noting that “[t]he United States likes to think of itself as the very embodiment of meritocracy,” in which wealth is distributed in accordance with ability and performance but questioning whether that belief is becoming an illusion). But see Erik Hayden, The Wealthy Elite Added More Self-Made Types This Year, ATLANTIC WIRE (Sept. 22, 2011), http://www.theatlanticwire.com/business/2011/09/wealthy-elite-added-more-self-made-types-year/42798/ (highlighting that recent American history is replete with stories of self-made wealth).


\(^{62}\) See Judith N. Cates & Marvin B. Sussman, Family Systems and Inheritance, MARRIAGE & FAM. REV., Fall 1982, at 1, 1 (describing some representative rules of descent that govern the passage of life-sustaining property in preliterate societies). One interesting anecdote about the cultural persistence of inheritance arises from the period shortly after the Russian Revolution when the Bolsheviks attempted to eliminate inheritance, consistent with Marxist theory, but quickly reversed course in the face of popular discontent, ignoring their own written law. See Frances Foster-Simons, The Development of Inheritance Law in the Soviet Union and the People’s Republic of China, 32 AM. J. COMP. L. 33, 33–37 (1985).

$29.2 billion, accounting for 1.4% of the total. Nonetheless, though they are only a minor revenue driver, transfer taxes act as a compromise between powerful competing interests, diminishing the ability of intergenerational transfers to concentrate wealth while still fulfilling society’s desire for inheritance. In effect, GRATs dull the impact of transfer taxes for highly appreciative assets, creating a gift and estate tax escape hatch that holds the capacity to facilitate intriguing social benefits.

B. The Rise of the GRAT

Common sense suggests that rational taxpayers facing transfer taxes will seek means to pass money to loved ones by avenues that minimize or eliminate their tax burdens. To accomplish this goal, well-advised taxpayers frequently employ “estate freeze” techniques, some of which are expressly blessed by both the Code and the Service. Although these techniques vary in form, most operate by the same basic process: a taxpayer transfers assets directly to a beneficiary (or temporarily to a third-party entity) to remove any future appreciation from the value of his estate, freezing the taxable value of the assets at their fair market value on the transfer date. Under this construct, one could even consider an outright, taxable gift to be an estate freeze. Naturally, because they exist solely to reduce transfer taxes, only taxpayers who expect to fully utilize their applicable exclusion amount find estate freezes to be useful.

Numerous freeze techniques have been developed over the years, ranging in complexity from simple installment sales to complex arrangements involving combinations of annuities and trusts like the GRAT. Unique situational factors define the best freeze technique to use for a given taxpayer, and GRATs are not always an ideal choice. For

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64  INTERNAL REVENUE SERV., DATA BOOK 2001, at 6 tbl.1 (2002). In 2009, this number decreased to 1.1%, as the Service brought in $24.7 billion via estate and gift taxes out of $2.3 trillion in total collections. INTERNAL REVENUE SERV., DATA BOOK 2009, at 3 tbl.1 (2010).
65  See 5 BITTKER & LOKKEN, supra note 8, ¶ 136.1, at 136-3 to -4.
67  See id. at 6.
68  Aside from GRATs, trust and estate experts have a wide range of estate freeze techniques to choose from when building an estate plan. Common techniques include intentionally defective grantor trusts, grantor retained income trusts, low-interest loans to grantor trusts, private annuities, self-cancelling installment notes, personal residence trusts, and sales of remainder interests in marital or charitable trusts. See ROY M. ADAMS, CRITICAL CONCERNS OF ESTATE PLANNERS: PRACTICAL APPLICATIONS FOR ADVISORS 503–68 (11th ed. 2010) (providing a concise summary of each technique); Estate Freeze Techniques, WIGGIN & DANA (Jan. 1, 2000), http://www.wiggin.com/3570; see also Lawrence P. Katzenstein, Some Interest-Sensitive Estate Planning Techniques (with an Emphasis on GRATs and QPRTs) and a Look at the Proposed Legislation, in 1 PLANNING TECHNIQUES FOR LARGE ESTATES 313 (ALI-ABA Course of Study, Apr. 23–27, 2012), available at Westlaw, ST04 ALI-ABA 313 (comparing the advantages and disadvantages of many of these estate freeze techniques).
example, a cousin of the GRAT, a sale to an intentionally defective grantor trust (IDGT), often proves more advantageous than a GRAT, but it is also considered a more aggressive strategy without statutory support in the Code or direct approval from the Service. GRATs are among the most popular and Code-favored estate freeze techniques for transferring wealth, and for that reason, they are the focus of this Comment, although much of the analysis contained herein applies to grantor retained unitrusts (GRUTs) as well.

To form a GRAT, an individual must create an irrevocable grantor trust for a fixed term of years, designate one or more trustees, name one or more beneficiaries (typically family members), and transfer assets into the trust. The grantor retains an interest in the GRAT consisting of an entitlement to receive annuity payments from the trust, which can be paid in the form of cash or in-kind assets. At the conclusion of the trust term, the beneficiaries receive the assets remaining in the trust. The Service, for its part, presumes that GRAT assets will produce a rate of return equal to the § 7520 rate. Thus, the tax-free gift, if there is one, equals the amount

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69 See ADAMS, supra note 68, at 535 (“In contrast [to the GRAT], no such certainty exists with respect to the sale to an intentionally defective grantor trust. The sale technique has been created based on a number of previously unconnected legal principles . . . .”); BLANK ROME LLP, INSTALLMENT SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS (2007), available at http://www.blankrome.com/siteFiles/PrivateClient-IDGTs.pdf. Interestingly, President Obama’s revenue proposals for fiscal year 2013 include, for the first time, a plan to eliminate the transfer tax benefits of sales to intentionally defective grantor trusts. See 2013 REVENUE PROPOSALS, supra note 20, at 83.


71 Cf. Martin D. Begleiter, Estate Planning in the Nineties: Friday the Thirteenth, Chapter 14: Jason Goes to Washington—Part II, 47 DEPAUL L. REV. 1, 35 (1997) (“The result of . . . section 2702 is that certain techniques, such as GRATs, GRUTs, and QPRTs and indeed outright gifts are favored, whereas GRITs, joint purchases and retained life estates are disfavored.” (footnote omitted)).

72 See Michael M. Mariani, Trusts Provide Variety of Options to Manage and Preserve Assets, N.Y. ST. B. ASS’N J., Jan. 2003, at 38, 38–39. Although any entity may be designated as a beneficiary, those other than “members of the family” as defined by § 2702 may be better served with a grantor retained income trust, which often provides some key economic advantages over a GRAT. See discussion infra Part II.B.

73 See BELCHER, supra note 6, at 2.

74 See John B. Atkins, Grantor Retained Annuity Trusts (GRATs), NEB. LAW., Oct. 2003, at 7, 8.

75 See AUCUTT, supra note 12, at 9 (noting that although the Service has not officially recognized that in-kind transactions satisfy the requirements of annuity payments, estate planners have long operated under the assumption that they do). In-kind payments do have some drawbacks: whatever method of valuation applied to the assets when they were initially placed into the GRAT must also be applied to in-kind payments, and new appraisals may be needed. See Robert G. Alexander, Enhancing the Planning Value of GRATs, Part 2, 2 J. PRAC. EST. PLAN., Feb.–Mar. 2009, at 45, 48; Alexander & Klemmer, supra note 70, at 361.

76 See Atkins, supra note 74, at 7.

77 See I.R.C. §§ 2702(a)(2)(B), 7520 (2006); Atkins, supra note 74, at 7. The § 7520 rate has historically exceeded the rate of U.S. government bonds. From 1990 to 2009, the average § 7520 rate
of asset appreciation that exceeds the § 7520 rate at the expiration of the trust term. 78 Any taxable gift—the inclusion of which is optional79 and can be calculated at trust formation—equals the initial fair market value of the assets less the present value of the annuity payments.80 Any gift tax must be paid by the grantor, as is generally the case with the gift tax,81 and the grantor also pays any income gains taxes that accrue from the trust assets during the trust term.82

A simple illustration explaining the basic functionality of a GRAT should be instructive. Table 1 depicts a zeroed-out GRAT with $10,000,000 in initial trust assets, a five-year term, June 2012’s 1.2% § 7520 rate,83 10% annual asset appreciation, and level annuity payments. The annual annuity payment is calculated by finding the future value of $10,000,000 in five years at 1.2% interest—$10,614,574—and dividing this by the number of annuity payments—five. The remainder of $3,144,493 represents the amount of above-$§ 7520 appreciation that beneficiaries receive free of gift tax.84

topped the average two-year U.S. note rate by 1.89%, the average ten-year U.S. bond rate by 0.86%, and the average thirty-year U.S. bond rate (excluding unavailable data for 2003–2005) by 0.61%. This analysis was compiled using data available in Katzenstein, supra note 68, at 315–16, and historical U.S. bond rates available online at Selected Interest Rates—Historical Data, FED. RESERVE, http://www.federalreserve.gov/releases/h15/data.htm (last updated Apr. 13, 2011).

78 See BELCHER, supra note 6, at 2.

79 Recall that estate planners often recommend zeroed-out GRATs, or those in which the contemplated taxable gift to the beneficiaries is zero. See AUCUTT, supra note 12, at 14. Although the Service has not formally acquiesced to the use of zeroed-out GRATs, President Obama’s proposal for GRAT reform appears to tacitly acknowledge their current validity by seeking to restrict their use. See 2013 REVENUE PROPOSALS, supra note 20, at 80 (“The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created . . . .”).

80 See Atkins, supra note 74, at 7. Present value, as used in this calculation, utilizes the interest rate dictated in § 7520. See Anthony M. Brown, Estate Planning for Same-Sex Couples: Practicalities, Precautions, Perils, and Proposals, 12 FLA. COASTAL L. REV. 217, 231 (2010). The Service imposes the gift tax on the planned initial remainder regardless of whether this transfer actually takes place. See Aucutt, supra note 18, at 2.

81 See KATHRYN G. HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶ 1.02[2], at 1-3 (abr. ed. 2003).

82 See Ronald D. Aucutt, Installment Sales to Grantor Trusts, in 2 PLANNING TECHNIQUES FOR LARGE ESTATES 1793, 1841 (ALI-ABA Course of Study, Apr. 20­–24, 2009).


84 Running this same calculation with an appreciation level of just 5% yields a tax-free transfer of $1,032,371, indicative of 2012’s low interest rate environment. An appreciation level of 20%, an unusually high return, yields a tax-free transfer of $9,085,317.
### Table 1: Five-Year Zeroed-Out GRAT

<table>
<thead>
<tr>
<th>Year</th>
<th>Trust Assets Before Annuity Payment</th>
<th>Annuity Payment</th>
<th>Trust Assets After Annuity Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$10,000,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>$11,000,000</td>
<td>($2,122,915)</td>
<td>$8,877,085</td>
</tr>
<tr>
<td>2</td>
<td>$9,764,794</td>
<td>($2,122,915)</td>
<td>$7,641,879</td>
</tr>
<tr>
<td>3</td>
<td>$8,406,067</td>
<td>($2,122,915)</td>
<td>$6,283,152</td>
</tr>
<tr>
<td>4</td>
<td>$6,911,467</td>
<td>($2,122,915)</td>
<td>$4,788,553</td>
</tr>
<tr>
<td>5</td>
<td>$5,267,408</td>
<td>($2,122,915)</td>
<td>$3,144,493</td>
</tr>
</tbody>
</table>

Even with such impressive potential, GRATs are far from a perfect solution for minimizing transfer taxes. As mentioned above, a grantor could die during the term of a GRAT, in which case the tax benefits of the technique would be lost because the value of the remainder interest in the trust would fall into the grantor’s taxable estate. 85 Or the trust assets could fail to appreciate above the § 7520 rate, causing the grantor’s scheduled annuity payments to exhaust the trust assets. 86 In either scenario, the grantor fails to achieve the sought-after tax benefits but suffers no other negative tax consequences. 87 Thus, while GRATs offer taxpayers a great deal of upside benefit, they pose no significant downside risk. 88

Playing by these rules, estate planners have identified three guiding principles to maximize GRAT performance. First, short-term rolling

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86 See Katzenstein & Zaffos, supra note 17, at 2–3; see also AUCUTT, supra note 12, at 11 (discussing options for collapsing an underperforming GRAT). In fact, given enough notice of impending death, grantors and trustees may be able to eliminate § 2036 inclusion of the GRAT assets in the grantor’s estate. Although GRATs are irrevocable, meaning the grantor no longer controls the trust property, cf. Erica Bell, Estate Planning for Domestic Partners and Non-Traditional Families, in 40TH ANNUAL ESTATE PLANNING INSTITUTE 273 § IV(C) (PLI Course Handbook Series No. 18923, 2009), agreeable trustees can generally collapse the trusts through one of two ways: either through the sale of an annuity interest to a third party or through the purchase of a GRAT remainder by a grantor for its “actuarial fair market value,” a statistical estimation of the remainder’s value, see Michael D. Whitty, GRAT Expectations: Questioning, Challenging, and Litigating the Service Position on Estate Tax Inclusion of Grantor Retained Annuity Trusts, 36 ACTEC L.J. 87, 135–36 (2010); see also AUCUTT, supra note 12, at 11. Sales made using the latter method are “presumably [made] at a depressed sale price” and have “no income tax consequences if the GRAT is a wholly-owned grantor trust.” AUCUTT, supra note 12, at 11.

87 See Katzenstein & Zaffos, supra note 17, at 3–4.

GRATs typically outperform long-term GRATs. To illustrate this point, imagine consecutive two-year GRATs in which “up” trusts can be booked for a tax-free transfer while “down” trusts count for no negative tax consequence, and compare this situation to a ten-year GRAT in which losses offset gains over the term. Second, grantors should usually fund GRATs with a single type of asset rather than two or more different assets. This is because if two or more assets are placed in a GRAT, the losses from one asset that fails to exceed the § 7520 rate could offset the gains made by another asset that appreciates above the rate. Third, GRATs tend to be most successful when funded with high-volatility assets because tax-free transfers are maximized by reaping as many of the highest “up” GRATs as possible, and any correspondingly low “down” GRATs have no tax consequences.

II. THE BENEFITS OF GRATs

At first blush, GRATs seem little more than another tax break for the rich. But dig a little deeper and a more intricate web of economic incentives, social policy, and Code balancing comes to light. In this spirit, Part II explores some of the GRAT’s benefits, which include encouraging investment in volatile assets, preserving family businesses, supporting popular opinion, and increasing Code consistency. The observations made here build the foundation for Parts III and IV, which analyze how various GRAT-reform proposals would maintain or diminish these benefits.

A. GRATs Minimize Inexplicable Differences in Tax Treatment

Looking back over the past few decades of estate planning, it is apparent that GRATs were not always in vogue. Indeed, before 1990, the grantor retained income trust (GRIT), a close cousin of the GRAT,
dominated the field. GRITs resemble GRATs in some respects but have significant advantages in times of high interest rates. While both techniques contain a reversionary interest if the grantor dies during the term, they differ in that whereas a GRAT grantor retains an interest in fixed annuity payments typically equal to the fair market value of the trust assets, a GRIT grantor retains an income interest in the trust assets, crudely calculated using the § 7520 rate. Unlike a GRAT, a taxable gift always takes place in a GRIT, which the Service calculates by subtracting the present value of the grantor’s retained income and reversionary interests from the fair market value of the initial trust assets.

GRITs have a major perk: so long as the grantor survives the trust term and the combined calculated present value of the grantor’s retained income and reversionary interests exceeds the actual income from the trust, then regardless of whether the assets outperform the § 7520 rate, the GRIT can still generate gift tax savings through its valuation discount on the transferred principal. Essentially, even with zero appreciation, beneficiaries would receive the entire trust principal but only owe gift tax

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94 See id. at 762–63.  
96 See HENKEL, supra note 81, ¶ 24.03[1], at 24-11 (“A GRIT will generally be better from a transfer tax perspective than a GRAT. With a GRIT, the initial gift will be computed on the assumption that the property earns (and thus returns to the grantor) the 7520 rate; however, the property can be invested in growth assets, so that the grantor does not actually receive as much income as the gift computation assumes he will.” (footnote omitted)).  
97 See McKay, supra note 95; see also NOEL C. ICE, WHAT YOU SHOULD KNOW ABOUT YOUR GRAT 1 (2005), available at http://www.trustsandestates.net/A rticles/2005_Nutshell_GRAT_Memo_to_Client.pdf. Like a GRAT, if a grantor dies during the retained interest period, the assets in the GRIT are included in the grantor’s estate by operation of § 2036. See Michael D. Whitty, Repercussions of Walton: Estate Tax Inclusion of GRAT Remainders, PROB. & PROP., May/June 2005, at 13, 14.  
98 See HENKEL, supra note 81 ¶ 24.03[1], at 24-10 to -11.  
99 See WENDY S. GOFFE, PLANNING FOR NONTRADITIONAL FAMILIES 80–81 (2011), available at http://www.americanbar.org/content/dam/aba/events/taxation/taxiq-fall11-goffe-nontraditional-families -paper.authcheckdam.pdf. The Service calculates the value of the taxable gift by multiplying the present value of the beneficiary’s income interest with the probability that the grantor will survive the trust term and subtracting this amount from the fair market value of the assets at the trust creation. See Lawrence P. Katzenstein, Running the Numbers: An Economic Analysis of GRATs and QPRTs, ALI-ABA EST. PLAN. COURSE MATERIALS J., Aug. 2000, at 5, 7–8.  
100 See GOFFE, supra note 99, at 80–81. Other types of valuation discounts play a large role in the estate planning world, including for GRATs. These techniques use “fractional interest discounts, minority interest discounts, lack of marketability discounts and discounts on capital gains” to reduce the recorded value of certain trust assets. ADAMS, supra note 68, at 79. Placing a combination of discounted and nondiscounted assets into a GRAT, using the nondiscounted assets to pay the grantor’s annuity, and leaving discounted assets to beneficiaries leverages the GRAT’s potential transfer tax benefits enormously. See Peter Melcher et al., Creating the Optimal Structure for Discounted Zeroed-Out GRATs, PRAC. TAX LAW., Spring 2003, at 25, 27–29. In response, President Obama has proposed curtailing the use of valuation discounts in estate freeze techniques that involve the transfer of interests in family-controlled entities to other family members. See 2013 REVENUE PROPOSALS, supra note 20, at 79.
on the principal minus the amount of income that the Service calculates the
grantor should receive. Of course, the grantor can invest in anything he
likes, and if the assets in a GRIT produce only a small amount of income—
or no income at all101—then the trust pays the grantor little or nothing
during the term. In times of high interest rates, a correspondingly high
§ 7520 rate will maximize the grantor’s supposed retained income interest,
increasing the value of investing in assets that actually pay no income
because the valuation discount for this supposed income goes up—a truly
odd creation of the Code.102

In response to criticism that estate freeze rules were too generous to
wealthy taxpayers, Congress added Chapter 14 to the Code in 1990,
limiting the possible beneficiaries of GRITs.103 Since then, the Code has
precluded beneficiaries considered “a member of the transferor’s family”
from enjoying the transfer tax benefits of GRITs.104 This class includes an
“individual’s spouse, any ancestor or lineal descendent of the individual or
the individual’s spouse, any brother or sister of the individual, and any
spouse of the foregoing.”105 Nephews and nieces, nonmarital partners, and
individuals to whom the grantor is engaged to do not fall within this group,
and grantors who choose to give to these beneficiaries can still reap the tax
benefits of GRITs.106

101 One example of such an asset is a growth stock that pays no dividends. See HENKEL, supra note
81 ¶ 24.03[1], at 24-11.
102 See DAVID K. JOHNS ET AL., 1 COLORADO ESTATE PLANNING HANDBOOK § 45.5.2 (6th ed.
2011). Conversely, in times of low interest rates, GRATs tend to outperform GRITs because grantors
more easily exceed a low, locked-in § 7520 rate. See John P. Donchees, Using GRATs in Tax Planning
Code maintained the viability of most estate freeze techniques but generally made “the hurdles . . .
higher and the rewards . . . not as great.” CHERYL E. HADER, ESTATE PLANNING & CHAPTER 14:
UNDERSTANDING THE SPECIAL VALUATION RULES, at ix (2001). In a larger sense, Chapter 14 shifted the
Service away from the assumption that a transferor with retained discretionary rights would exercise
them in his own favor against a junior family member. See id. at x.
104 See I.R.C. § 2702(a) (2006); John Jastremski, Grantor Retained Income Trust (GRIT),
grantor-retained-income-trust-grit/. Congress included an important exception to the “members of a
grantor’s family” rule by allowing otherwise ineligible individuals to qualify as GRIT beneficiaries
when the sole trust asset is a personal residence. See § 2702(a)(3)(A)(ii); Natalie B. Choate, The QPRT
Manual, 19 ACTEC NOTES 26, 28 (1993). This type of transfer, known as a qualified personal residence
trust (QPRT), remains popular today. See id. It should be noted that QPRTs can have a serious
drawback: the prospect that a grantor successfully outlasts the QPRT term and finds “that he no longer
owns his home and must either move out or begin paying rent to the new homeowners—who are often
his children.” Sarah Shirley MacLeod, Grantor’s Remorse: Reverse QPRTs and Other Creative Options
for Dealing With the Termination of a Qualified Personal Residence Trust, REAL PROP. PROP. & TR.,
Summer 2010, at 1, 1.
106 See ADAMS, supra note 68, at 546; see also Bell, supra note 86 (discussing relevant
considerations in naming GRIT beneficiaries); Brown, supra note 80, at 229 (discussing GRIT
In some situations, such as gifts between domestic partners, this treatment makes sense, but in other instances, the rule applies quite arbitrarily. Congress and, indeed, President Obama, may justify reforming GRAT rules while leaving GRIT rules static on the theory that large lineal gifts undermine meritocratic social goals, but it is not difficult to imagine examples illustrating the absurdity of drawing lines between beneficiaries under today’s rules. It certainly boggles the mind to understand how the disposition of a billionaire’s estate to nieces or nephews provides more or less benefit to society than one made to his own children. Similarly, it is difficult to grasp why a sizeable gift made to a wealthy best friend should be taxed at a lower effective rate than one made to a penniless brother-in-law. Even more bizarrely, premarital GRITs can be structured to favor the unborn children of a future spouse—the grantor’s future children—who are not technically members of the grantor’s family at the outset of the trust.

Since 1990, GRATs have essentially served as a policy compromise on intergenerational wealth transfers. On the one hand, transfer taxes mitigate the negative effects of dynastic transfers, and Congress’s decision to disallow the use of GRITs in some situations furthers that end. On the other, GRIT rules create issues of unfairness, and over-regulation of GRATs would leave an arbitrarily harsh drop-off in tax treatment between otherwise similarly situated beneficiaries—those who qualify for both GRITs and GRATs, like a grantor’s nieces and nephews, and those who only qualify for GRATs, like a grantor’s children. Assuming that the rules for GRITs remain static, any changes to restrict GRAT use will necessarily serve to widen this tax treatment differential.
B. GRATs Help Preserve Family Businesses

In today’s era of corporate consolidation, GRATs have the potential to assist the moderately wealthy in ensuring that family businesses and farms stay in family hands.111 When a business owner passes away, the process of collecting cash to pay the resulting estate taxes may require the monetization of capital stock, which can result in the loss of family control over longstanding ventures.112 To be fair, politicians likely overstate this consequence, and data shows that the estate tax causes breakups of control less often than the public imagines.113 Moreover, the Code allows some heirs of family businesses to pay the estate tax over time—up to as long as ten years—significantly easing their burden.114 Nevertheless, prominent examples of estate tax hardship arise in the media from time to time, and logical inference suggests that the problem is real for many families.115

Family businesses can be ideal GRAT assets as interests in family businesses are typically constituted of large, single equity positions. By allowing for a reduction in the transfer taxes that implicated families face, GRATs help to preserve family businesses and maintain their social benefits. These benefits are varied and cultural. For instance, family business owners are more likely to consider the long-term continuity of their businesses than nonfamily owners.116 Indeed, the lack of a lasting ownership dynamic in modern corporate management can incentivize the inflation of short-term profits and salaries at the expense of long-term

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111 See Dwight Drake, Transitioning the Family Business, 83 WASH. L. REV. 123, 166 (2008). But see id. at 163, 169 (discussing how GRATs are, for this purpose, an imperfect solution at best).


116 See Charles D. Fox, Keeping It in the Family: Business Succession Planning, in 1 PLANNING TECHNIQUES FOR LARGE ESTATES, supra note 68, at 969, 975.
strategy. This is less of an issue for family business owners who may naturally consider the health of the business they often plan to pass on to their heirs. Family-owned businesses may also be less prone to take actions that endanger the good standing of their owners, who frequently associate themselves with the long-term reputation of their companies. While a GRAT may seem a circuitous means to minimize the likelihood that the estate tax threatens a family business, it stands as one of only a handful of tools to mitigate this harsh outcome.

C. GRATs Limit the Unpopular Estate Tax

One might think that GRATs inherently defy the public interest as intuition would suggest wide support for transfer taxes. After all, the perception that the rich are undertaxed seems to be prevalent, and the transfer tax system squarely targets the nation’s wealthiest citizens. Nevertheless, years of poll data show that estate taxes are overwhelmingly

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118 See Fox, supra note 116, at 875–77. The characteristic independence of family businesses can also benefit society. Today’s large corporations control whole empires of companies with potentially conflicting interests. A dramatic finding by three Swiss researchers indicates that just 147 companies control 40% of the world’s wealth in a network of 43,060 transnational corporations. Stefania Vitali et al., The Network of Global Corporate Control, PLOS ONE, Oct. 2011, at 1, 4; see Bruce Upbin, The 147 Companies that Control Everything, FORBES (Oct. 22, 2011, 9:37 AM) http://www.forbes.com/sites/bruceupbin/2011/10/22/the-147-companies-that-control-everything/. These conglomerates are typically public and, as such, are beholden to increasing shareholder value as a top priority. One example concerns the Bancroft family’s famous sale of the Wall Street Journal to Rupert Murdoch’s NewsCorp in 2007, which inspired intense concern over the continued impartiality of the prestigious newspaper. See Steve Stecklow et al., Calling the Shots: In Murdoch’s Career, a Hand on the News, WALL ST. J., June 5, 2007, at A1. As part of the purchase negotiations, the two sides agreed to special rules protecting the editorial independence of the newspaper’s staff. See L. Gordon Crovitz, A Report to Our Readers, WALL ST. J., Aug. 1, 2007, at A14.

119 For a discussion of freeze techniques, see supra Part I.B.

120 Warren Buffett has emerged as a spokesman for higher taxes on the rich, claiming that overly generous deductions have tilted the system in favor of the wealthy. See In Response to Lawmaker, Buffett Claims 17.4% Tax Rate, N.Y. TIMES, Oct. 13, 2011, at B10. Recall, also, the Occupy Wall Street rallying cry that the rich are undertaxed. See Laura D’Andrea Tyson, Tackling Income Inequality, N.Y. TIMES ECONOMIX (Nov. 18, 2011, 6:00 AM), http://economixblogs.nytimes.com/2011/11/18/tackling-income-inequality/.

unpopular with the public. For example, in a 2009 survey commissioned by the nonpartisan Tax Foundation, 67% of respondents from a nationwide cross section of adults supported the complete elimination of the estate tax.

This finding may be at least partially explained if one considers that the estate tax is triggered by a morbid event—death—that does not share many of the hallmarks of other taxable events like the receipt of wages or the sale of stock. Certainly, the perception of a “death tax” existed long before the gurus of Republican political semantics adopted the phrase. Another theory traces back to taxpayers’ uncertainty (and, conceivably, unrealistic optimism) about whether they might someday face the estate tax, which causes them to oppose it. Others may skeptically attribute the phenomena to a public ignorant of the fact that only the wealthy pay estate taxes. Then again, perhaps Americans are simply expressing disdain for the notion of double taxation since much of the wealth captured by the transfer tax system has already been taxed as ordinary income or capital gains. One could even argue that the public intuitively understands that estate taxes incentivize consumption. Nevertheless, regardless of why

122 See Bartels, supra note 46, at 197–222 (providing extensive analysis on this counterintuitive observation); Fennell, supra note 113, at 595 (“[T]he estate tax appears to be a unique example of a tax that is widely opposed even by people who have had no direct experience with it and no objective reason to believe that such direct experience will be forthcoming.”); see also Edward J. McCaffery, The Uneasy Case for Wealth Transfer Taxation, 104 YALE L.J. 283, 364–65 (1994) (“[T]he people’s opposition and seventy-five years of increasingly settled practices have shown that democratic society does not want any meaningful wealth transfer tax.”).

123 Harris Interactive, 2009 Tax Attitudes Study 5 (2009), available at http://taxfoundation.org/sites/taxfoundation.org/files/docs/2009%2520survey%2520of%2520adults%2520towards%2520taxes%25202009%2520survey%2520of%2520us%2520attitudes%2520of%2520adults%2520towards%2520taxes%25202009%2520online.swf. The percentage quoted is based on online surveys conducted by Harris Interactive among 2002 adults in February 2009, with an error rate, at 95% confidence, of plus or minus 2.2%. Id. at 1. This result echoes those of similar Tax Foundation polls conducted in 2005, 2006, and 2007, id. at 5, as well as one conducted by American National Election Studies in 2002, see Bartels, supra note 46, at 198–99.


125 See, e.g., Joel Slemrod & Jon Bakija, Taxing Ourselves 73 (4th ed. 2008) (“Misperceptions about who bears the burden of the current tax system may help explain the apparent contradiction of significant levels of support for . . . taxes that would lower the tax rates on high-income people . . . .”). Slemrod and Bakija base their argument on data similar to that of a more recent survey, which finds that 55% of Americans believe “upper income people pay . . . less than their fair share [of income taxes].” Press Release, CBS News, CBS News/New York Times Poll: Americans’ Views on Taxes (Jan. 24, 2012), available at www.cbsnews.com/htdocs/pdf/Jan12c_taxes.pdf.

126 See McCaffery, supra note 122, at 365 (“[W]e ought to begin by presuming that the people are at least sensible, and entitled to respect, and it indeed turns out that there are good liberal reasons to oppose wealth transfer taxes. As mentioned above, such taxes hit at work and savings and induce consumption, especially the large-scale, distortionary consumption of the very wealthy.”).
sentiment against the estate tax arises, GRATs appear to align with popular opinion to the extent that the technique minimizes the impact of transfer taxes.

D. GRATs Encourage the Holding of High-Volatility Assets

Perhaps the most interesting role that GRATs play is as a tax incentive for innovation. While the late-2000s financial crisis tarnished the notion of risk subsidies, a successful capitalist economy depends on risk takers to innovate ways to better accomplish tasks with fewer resources, increasing the national gross domestic product. In the world of finance, volatility is often used as a metric for risk, and portfolio theory assumes that all investors want to maximize expected returns while minimizing risk. Taking this idea a step further, the efficient frontier model allows investors to measure the tradeoff between risk and return in portfolios containing multiple assets against that of portfolios allocated to produce the minimum level of risk for a given expected return, and investors utilize this tool to avoid leaving risk-free returns on the table. For better or worse, the Code alters the equation, creating a separate, after-tax efficient frontier. In short, GRATs make riskier investments—which capitalize on appreciation above the § 7520 rate—more attractive by increasing their after-tax expected returns without increasing their risk.

Since GRATs generally function best when they contain volatile assets, individuals who create GRATs may increase the volatility of their

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127 For instance, Fannie Mae and Freddie Mac, the government-sponsored enterprises charged with supporting the housing market, have been pilloried for subsidizing the subprime mortgage loans that supported a financial industry largely blind to the systemic risk it was creating in the months leading up to the late-2000s financial crisis. See Peter J. Wallison & Charles W. Calomiris, The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac, J. STRUCTURED FIN., Spring 2009, at 71, 71, 78.


130 Risk and volatility are discussed here as being largely synonymous, but they have somewhat different meanings in practice. ERIC FALKENSTEIN, FINDING ALPHA 5 (2009) (noting that risk was originally measured by “volatility, then covariance with the market, then covariance with several macroeconomic variables, and now it’s a covariance against something called a stochastic discount factor”).


132 See FALKENSTEIN, supra note 130, at 22. For a more thorough discussion of modern portfolio theory, see generally Harry Markowitz, Portfolio Selection, 7 J. FIN. 77 (1952).


134 On the whole, bonds have historically displayed little volatility, U.S. stocks have tended to have moderate volatility, and foreign emerging market stocks have exhibited high volatility. See Richard Shaw, The Importance of Major Asset Class Volatility Ranges, SEEKING ALPHA (May 6, 2008), http://seekingalpha.com/article/75823-the-importance-of-major-asset-class-volatility-ranges. GRATs are
investment portfolios to take full advantage of the technique. Unfortunately, the degree to which taxpayers reduce volatility in the rest of their portfolios in proportion to the volatility they add when creating GRATs—if they add any volatility—is unknown. To be sure, investors tend to react more strongly to the pain of loss than to the pleasure of gain, and one could argue that a sharp financial planner would rebalance the risk of a client’s portfolio accordingly. On the other hand, the addition of volatile assets does not necessarily increase portfolio volatility given that negatively correlated assets can offset some of one another’s risk. Companies with inherently volatile valuations often exhibit a dichotomous prospect of near-term success or failure and, thus, require high-risk financing. In addition to the research and development efforts constantly underway in major industries and academia, smaller companies willing to “bet the farm” also develop critical technological advances. Investments in risky companies, however, typically decline frequently funded with individual assets, including private company stock, which can differ greatly in volatility depending on a multitude of internal and external factors. See S. STACY EASTLAND, SOME OF THE BEST FAMILY LIMITED PARTNERSHIP PLANNING IDEAS WE SEE OUT THERE (THAT ALSO HAVE THE MERIT OF PLAYING HAVOC WITH CERTAIN “CONVENTIONAL WISDOM”) 88 (2010), http://www.sanantonioepc.org/SanAntonio-TX/Library/FLP%20Paper.Schedules.pdf.


See Fabio Bertoni et al., Venture Capital Financing and the Growth of High-Tech Start-Ups: Disentangling Treatment from Selection Effects, 40 RES. POL’Y 1028, 1028–29 (2011); Magnus Klofsten et al., Supporting the Pre-Commercialization Stages of Technology-Based Firms: The Effects of Small-Scale Venture Capital, 1 VENTURE CAP. 83, 84 (1999) (noting that for many emerging companies, initial financing is difficult to obtain because “it is a large financial risk for an investor to go in early in a firm when it is difficult or almost impossible to predict whether an enterprise will yield any return at all”). Although the majority of venture capital investment “is supplied by pension funds, college endowments, foundations, and insurance companies,” THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., R40411, THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION 11 (2010), wealthy individuals and families account for over 12% of such funding in a multi-billion dollar industry, see KEENAN SKELLY, DOW JONES PRIVATE EQUITY ANALYST: SOURCES OF CAPITAL 4 (2010) (reproducing chart showing that 5.7% and 6.6% of venture capital investment comes from “wealthy investors” and “family offices,” respectively).

The pharmaceutical industry provides a prime example of a research and development (R&D)-intensive industry—one that is so lucrative that major players are now spinning out their R&D activities into separate businesses. See Gunter Festel et al., Optimizing the R&D Process Using Spin-Outs: Case Studies from the Pharmaceutical Industry, RES. TECH. MGMT., Jan.–Feb. 2011, at 32, 33.

See Jean-Paul Chavas et al., Analysis and Decomposition of Scope Economies: R&D at U.S. Research Universities, 44 APPLIED ECON. 1387, 1401 (2012).

In a well-known example, high-tech startups that innovate important technologies and create valuable jobs have become a famous hallmark of Northern California’s booming entrepreneurial
during recessions and depressions. Risk tolerance generally declines in recessionary environments. See Roszkowski & Davey, supra note 136, at 42.

Recent history informs the discussion, as the sharp downturn in 2008 and signs of continued economic malaise have had a lasting impact on investors.

The wealthy, who reap low marginal gains in quality of life for each additional dollar earned, should be encouraged to put their money to work during recessions, and GRATs provide one method to incentivize such behavior. Our society has a history of successfully leveraging government subsidies to foster inventors who churn out cutting-edge technology. Indeed, one area of risky investments, those relating to the environment, has gained particular prominence as the world faces the prospect of providing food and energy for an unprecedented ten billion people. Tax incentives


Risk tolerance generally declines in recessionary environments. See Roszkowski & Davey, supra note 136, at 42.


See E.S. Browning, Volatile Market Sends a Warning, WALL ST. J., Oct. 10, 2011, at A1; see also Roszkowski & Davey, supra note 136, at 50 (“Our data suggest that risk tolerance appears relatively stable and was not drastically affected by the economic circumstances of 2008. However, there was clearly a change in people’s risk perception . . . .”).

See Lawsky, supra note 54, at 916–17.

To be fair, common sense dictates that many grantors structure GRATs around their already-held volatile assets as opposed to purchasing new ones. Still, the lure of the GRAT’s potential for tax-free transfers creates a powerful incentive for existing wealthy investors to funnel money into areas such as venture capital and growth equity, and many estate planners regularly explain the value of GRATs to wealthy clients as part of a typical investment pitch. See Ryland F. Mahathey, GRATs and Other Trust Strategies for Business Owners in the Succession Planning Process, in FAMILY AND BUSINESS SUCCESSION PLANNING 57 (2011).


See Steve Connor, Overpopulation ‘Is Main Threat to Planet,’ INDEP. (London), Jan. 7, 2006, at 18. If dire predictions on global warming prove correct, our current energy system almost certainly fails at environmental sustainability. Cf. Douglas J. Arent et al., The Status and Prospects of Renewable Energy for Combating Global Warming, 33 ENERGY ECON. 584, 592 (2011). To combat these possible negative outcomes and mitigate climate change, innovators are seeking funding for the development of new technologies to produce efficient, environmentally friendly energy. See, e.g., Justin Hall-Tipping, Address at TEDGlobal 2011: Freeing Energy from the Grid (July 12, 2011), available at http://www.ted.com/talks/justin_hall_tipping_freeing_energy_from_the_grid.html; see also About Us, NANOHOLDINGS, http://nanoholdings.com/about-us/ (last visited Nov. 23, 2012) (describing the mission statement of Nanoholdings, the company Hall-Tipping chairs, which includes development of cutting-edge energy products). The market, however, is pushing back on the companies that develop such technology, perceiving them as risky, untried, and unable to produce significant returns. See Ucilia Wang, Green Tech IPOs Get No Love, FORBES (Apr. 27, 2012, 5:20 PM), http://www.forbes.com/sites/uciliawang/2012/04/27/green-tech-ipo-get-no-love/. Because of this perception—or, others would argue, because of the projects’ economic nonviability—environmental innovators have found it difficult to secure
may seem counterintuitive to those versed in free market principles who might argue that the Code should not be used to stimulate certain economic behavior, \(^\text{149}\) but with government-sponsored innovation initiatives springing up abroad, \(^\text{150}\) policymakers should broadly seek to maintain U.S. competitiveness and global leadership—without picking individual recipients or industries deserving of capital—by ensuring that the Code fully supports innovation.

### III. GRADING THE PRESIDENT’S PROPOSED REFORMS

Looming large in the GRAT-reform discussion are the national budget deficit—which experts estimate will continue well into the next decade \(^\text{152}\)—and a polarization of wealth in favor of the richest Americans. \(^\text{153}\) What role should GRATs play in this larger picture? Keeping Part II’s discussion of GRAT benefits in mind, Part III develops a framework to answer that question. Using this framework, President Obama’s proposals for reform are then separately evaluated on their merits.

financing, and the federal government has controversially stepped in to directly fund some environment-conscious firms. See Matthew L. Wald, Panel Hears Defense of Loan to Solyndra, N.Y. TIMES, Nov. 18, 2011, at B10.

\(^\text{149}\) See Press Release, United Nations, Dep’t of Econ. & Soc. Affairs, World Population to Reach 10 Billion by 2100 if Fertility in All Countries Converges to Replacement Level (May 3, 2011).

\(^\text{150}\) See Scott A. Hodge, Cash for Washers and Dryers Undermines Corporate Tax Reform, TAX POL’Y BLOG (Feb. 24, 2011), http://taxfoundation.org/blog/cash-washers-and-dryers-undermines-corporate-tax-reform (“[W]e should not use the tax code to incentivize economic behavior—no matter how noble the cause.”). But see Julie Berry Cullen & Roger Gordon, Tax Reform and Entrepreneurial Activity, in 20 TAX POLICY AND THE ECONOMY 41, 42 (James M. Poterba ed., 2006) (“To the extent entrepreneurial activity generates [positive externalities], there are economic grounds to try to intervene to encourage more such activity.”).

\(^\text{151}\) See, e.g., INT’L TRADE ADMIN., U.S. DEP’T OF COMMERCE, COMMERCE PRELIMINARILY FINDS COUNTERVAILABLE SUBSIDIZATION OF CRYSTALLINE SILICON PHOTOVOLTAIC CELLS, WHETHER OR NOT ASSEMBLED INTO MODULES FROM THE PEOPLE’S REPUBLIC OF CHINA (2012), http://ia.ita.doc.gov/download/factsheets/factsheet-prc-solar-cells-adcvg-prelim-20120320.pdf; see also Transcript: George Stephanopoulos’ ABC News / Yahoo! News Exclusive Interview with President Obama, ABCNEWS (Oct. 3, 2011), http://abcnews.go.com/Politics/transcript-george-stephanopoulos-abc-news-yahoo-news-exclusive/story?id=14659193&page=5 (quoting President Obama, “[I]f we want to compete with China, which is pouring hundreds of billions of dollars into this space. If we want to compete with other countries that are heavily subsidizing the industries of the future, we’ve got to make sure that our guys here in the United States of America at least have a shot.”). But see HENRY HAZLITT, ECONOMICS IN ONE LESSON 44 (1979) (“[T]he recipients of government credit will get their farms and tractors at the expense of those who otherwise would have been the recipients of private credit.”).

\(^\text{152}\) See CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2012 TO 2022, at xii & tbl.1 (2012) (predicting that the U.S. debt held by the public will rise from $10.12 trillion in 2011 to $15.29 trillion in 2022 in an optimistic case).

\(^\text{153}\) Michael I. Norton & Dan Ariely, Building a Better America—One Wealth Quintile at a Time, 6 PERSP. ON PSYCHOL. SCI. 9, 10–11 & figs.2 & 3 (2011) (showing that the richest 20% of Americans possess over 80% of the nation’s wealth but also arguing that Americans in all wealth groups think greater equality would be preferable).
A. Considerations in GRAT Reform

Regrettably, GRATs achieve the social benefits described in Part II rather crudely. Because GRAT transfers are uncapped, the technique confers the capacity to shunt unlimited amounts of wealth out of the transfer tax system. Meanwhile, estate planners create GRATs for their clients by the dozen,154 delighted by the technique’s “heads you win, tails you break even” formula.155 Mindful of the nation’s increasingly dire need to balance the budget, I advance the following objectives as a sensible framework for GRAT reform: (1) increasing tax revenue and horizontal equity156 by (2) restricting the possibility of limitless tax-free transfers157 and (3) ensuring that a gift tax return is filed for all GRATs, while still (4) maximizing the benefits that GRATs confer.

Three of these goals—increasing tax revenue to counter record deficit spending,158 mandating that the Service have a mechanism to track GRATs, and maximizing the social benefits of the current GRAT regime—are self-explanatory. The goal of restricting limitless transfers demands a bit more explanation. The problem is real; in one recent instance, several Facebook insiders, including Mark Zuckerberg, made headlines for their eye-popping use of GRATs. Company co-founder Dustin Moskovitz even broke the nine-figure mark, using the technique to transfer an estimated $147 million free of gift and estate taxes.159

154  Similar problems were noted by President Reagan’s tax commission with regards to GRITs before they were restricted. See 2 U.S. DEP’T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 91–109 (1984). The commission chided not only “the creation of numerous trusts with essentially similar dispositive provisions” but also the “artificial and inefficient arrangements for the ownership and management of property.” Id. at 99.
155  See Proskauer Rose LLP, supra note 16.
156  Horizontal equity is the widely held belief that the Code should provide “equal treatment of people with equal ability to pay.” SLEMROD & BAKIJA, supra note 125, at 167. GRATs violate principles of horizontal equity, since wealthy donors who cannot effectively employ GRATs are subject to higher transfer taxes than those of similar wealth who benefit from the technique. This inequity is most acute when grantors transfer exceptionally large amounts, either in quantity or percentage, above the value of the initial trust assets.
158  See OFFICE OF MGMT. & BUDGET, supra note 59, at 146.
159  See Deborah L. Jacobs, Zuckerberg, Moskovitz Give Big Bucks to Unborn Kids, FORBES (Mar. 7, 2012, 11:28 AM), http://www.forbes.com/sites/deborahjacobs/2012/03/07/facebook-billionaires-shifted-more-than-200-million-gift-tax-free/. Interestingly, neither Zuckerberg nor Moskovitz had children when these trusts were created, illustrating the fact that GRATs can be created in the favor of even unborn beneficiaries. See id.
Of course, one could view the absence of a cap on tax-free transfers as part of the fundamental upside potential of a GRAT. While it is true that the potential for unlimited transfers would maximize the incentive to create a GRAT and, thus, increase the benefits described in Part II, it is also true that GRATs counter the inherent progressivity of gift and estate taxes. When considering reforms, policymakers should aim to balance the benefits conferred by GRATs against the benefits of transfer taxes, just as they do between transfer taxes and inheritance. The allowance of a means to transfer limitless, potentially nine- and ten-figure sums in fortuitous appreciation to one’s children without incurring taxes—taxes that Americans of similar wealth must pay—stretches this equilibrium beyond the breaking point.

Worst of all, grantors can easily manipulate GRATs, compounding the unlimited transfer problem. For example, the owner of a private business that knows that his company will soon undergo a major appreciative event can place his assets into a GRAT before they multiply in value. Though perfectly legal, this combination of lax regulation and asymmetric information fosters the potential for an unfair distribution of tax benefits. While the Service will occasionally audit a GRAT to revalue its initial trust assets, trust and estate attorneys customarily construct the trust to prevent any increase in gift tax if that occurs. If the IRS revalues the initial assets of a trust that contains such prophylactic terms, the grantor’s annuity payments increase correspondingly, disincentivizing the Service from performing such audits in the first place.

B. Applying the Framework to President Obama’s Proposals

President Obama’s larger plan to overhaul the Code includes significant changes to the rules governing GRATs, and legislators have repeatedly proposed bills that contain his GRAT-reform proposals. The President’s first proposal, the requirement of a ten-year minimum GRAT term, would be his most dramatic reform. This change would significantly

\[160\] See AUCUTT, supra note 12, at 4 (“[Treas.] Reg. § 25.2702-3(b)(1)(ii)(B) allows the annuity amount to be “[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes.”). Indeed, the process of retrospectively valuing a gift, performed using the willing buyer–willing seller test, requires exactly the type of factual inquiry that costs the Service time and money to perform. See Rev. Rul. 59-60, 1959-1 C.B. 237.

\[161\] See AUCUTT, supra note 12, at 4–5.

\[162\] See 2013 REVENUE PROPOSALS, supra note 20.


\[164\] See 2013 REVENUE PROPOSALS, supra note 20, at 80.
alter the calculus of creating GRATs, as today’s GRATs typically expire after two-year terms. Functionally, the proposal would increase the probability of a grantor’s death during the term of a GRAT, an event that would cause the trust remainder to fall back into the grantor’s taxable estate, depriving grantors of any potential transfer tax benefits.

Regrettably, a serious problem lurks in this proposal. The change would strongly favor younger grantors because a grantor’s ten-year mortality risk significantly increases with age. This difference can be surprisingly dramatic: an average sixty-five-year-old man has a life expectancy of 17.19 years, while an eighty-year-old man has a life expectancy of only 7.90 years. Furthermore, the generation-skipping transfer (GST) tax, which penalizes transfers made to heirs more than one generation removed from the grantor, generally applies to GRAT transfers, mooting arguments seeking to justify a baked-in age bias. In fact, this

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165 See AUCUTT, supra note 12, at 12–13. Extending the term of a GRAT can have positive consequences, especially during periods of historically low interest rates, when a grantor can lock in an advantageous § 7520 rate for the entire trust term. See STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL, PART ONE: INDIVIDUAL INCOME TAX AND ESTATE AND GIFT TAX PROVISIONS 149 (Comm. Print 2009); Katzenstein, supra note 68, at 373; discussion supra note 102.

166 See I.R.C. § 2036 (2006); Gans & Soled, supra note 88, at 772 n.58. In such a scenario, the GRAT’s beneficiaries would be no worse off than they would if the grantor had never created the GRAT, unless the grantor’s estate does not equally compensate the affected beneficiaries.


168 See Katzenstein, supra note 68, at 349. From an intergenerational perspective, the application of the estate tax is innately inconsistent, owing to the variance of individual life spans. Although Congress cannot remedy this flaw of horizontal equity so long as death remains the estate tax’s triggering event, the Code does strive to prevent its intentional manipulation. The GST tax, § 2601, prevents older individuals from reducing the number of times that transfer taxes are levied against intergenerational wealth by imposing an additional layer of tax on inter vivos gifts or estate transfers to much younger beneficiaries. See Kelly A. Moore, Proposal for Estate Tax Exclusion Provisions, 35 OHIO N.U. L. REV. 37, 41 n.31 (2009). The Service levies the GST tax at the highest applicable transfer tax rate whenever unrelated beneficiaries are more than 37.5 years younger than the donor or related beneficiaries are more than one generation younger. See Patricia A. Cain, Death Taxes: A Critique from the Margin, 48 CLEV. ST. L. REV. 677, 695 (2000). Like the applicable exclusion amount, the GST tax also provides a $5 million and $5.12 million exemption in 2011 and 2012, respectively. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 302(c), 124 Stat. 3296, 3301 (to be codified at 26 U.S.C. § 2641); Rev. Proc. 2011-52, 2011-45 I.R.B. 701. Many estate planning strategies maximize the GST tax exemption, see, e.g., Peter S. Gordon, Why Is Everyone Talking About Delaware Trusts?, in SOPHISTICATED ESTATE PLANNING TECHNIQUES (ALI-ABA Course of Study, Sept. 6–7, 2007), but the GRAT contains no viable mechanism to do so. See Katzenstein, supra note 68, at 349; see also AUCUTT, supra note 12, at 9 (“Making grandchildren the remainder beneficiaries of a GRAT . . . is generally not a good idea, unless the parents are deceased when the GRAT is created, because section 2642(f) (the ‘ETIP’ rule) prevents allocation of GST [tax] exemption to such a trust until the expiration of the GRAT term, when presumably the property will have increased greatly in value.” (emphasis omitted)).
proposal would enact a form of legislative discrimination against the elderly that the government itself has been lobbying to eliminate for decades.169

President Obama’s second proposal would require that all GRATs contain an initial remainder value, or planned taxable gift to the trust beneficiaries, greater than zero.170 Such a change would ban truly zeroed-out GRATs by mandating a greater than zero difference between the present value of the planned annuity payments and the fair market value of the assets placed into the trust at its formation.171 This proposal primarily serves to ensure that a beneficiary must file a gift tax return every time a grantor creates a GRAT, putting the Service on notice of the potential need for an audit.172 Some tax experts suggest that this proposal also aims to guarantee that the mortality risk contemplated in the President’s ten-year-minimum-term proposal could not be undercut by the regulatory grey area that currently surrounds zeroed-out GRATs.173 The debate on this grey area centers on whether, under § 2036, a zeroed-out GRAT’s trust remainder falls back into the estate of a grantor who predeceases the trust expiration.174


170 See 2013 REVENUE PROPOSALS, supra note 20, at 80.

171 See Katzenstein, supra note 68, at 373.

172 See id. at 374 (“Since this is a gift of a future interest, a gift tax return will always be required in this situation.”).

173 The mortality risk is predicated on an actual gift taking place and, therefore, bringing the GRAT assets into the grantor’s estate under § 2036. See Louis A. Mezzullo, Business Succession Planning, ALI-ABA EST. PLAN. COUR. MATER. J., Apr. 2011, at 17, 25.

174 While a full discussion of this point is beyond the scope of this Comment, the most interesting argument hinges on whether all GRAT assets should be returned to the estate upon a grantor’s death rather than simply the amount needed to support the remaining annuity payments. See Whitty, supra note 97, at 16–17. In a zeroed-out GRAT, the grantor seemingly avoids retaining a contingent reversionary interest in the trust corpus, allowing the grantor’s estate to stand in for the grantor as recipient of all remaining annuity payments. Janes, supra note 25, at 10; see also Whitty, supra note 86, at 99 (“[T]he author suspects that [the requirement of a minimum remainder] is at least partly aimed at eliminating the argument that the zeroed-out Walton GRAT escapes Section 2036 as a transfer for full and adequate consideration.”). Without § 2036 inclusion, even GRATs that contain an initial remainder would bear no mortality risk and would, thus, continue to operate until expiration with the grantor’s estate taking over as recipient of any annuity payments. For an insightful article arguing that § 2036 should be repealed, leaving the Code to treat gifts with retained interests as complete, see Richard L. Dees, Time Traveling to Strangle Strang+ (and Kill the Monster Again), Part 2, 116 TAX NOTES 657 (2007).
Technical justifications cutting against § 2036 inclusion disappear when a GRAT contains even a tiny initial remainder.  

The President’s third and final proposal would ban decreasing annuity payments to grantors. In recent years, estate planners have popularized a strategy in which GRATs make an oversized first-year annuity payment and a much smaller payment in the second and final year. Frontloading GRAT annuity payments provides the most benefit to grantors who have a strong hunch that an asset will substantially increase in value shortly after a trust is created—for example, when an initial public offering is announced. Such grantors could form a GRAT immediately before the appreciative event occurs, capture the appreciation during the trust term, and lock in much of that appreciation after only one year. Without a ban, this strategy would severely diminish the President’s minimum-term proposal, as grantors would be repaid most of their principal early into the term, avoiding exposure to long-term volatility. Notably, however, this ban provides no obstacle to a savvy trustee who simply replaces the original trust assets with ones from a more stable asset class, such as bonds.

Undoubtedly, these proposals would raise tax revenue by increasing the risk of GRAT worthlessness, guaranteeing the ability of the Service to audit GRATs, and eliminating the ability of grantors to frontload annuity payments. However, the proposals fail to limit the amount of money that can be transferred through a GRAT. And although a ten-year minimum would mandate a term in which losses are more likely to offset gains by severely limiting the practice of culling appreciation, it would diminish the volatility-holding incentives created by short-term GRATs in the process.

Without mincing words, President Obama’s primary GRAT-reform proposal—to increase the risk of grantor mortality—should be rejected as discriminatory against senior citizens and ineffective at solving some of the GRAT’s most egregious problems. And absent the minimum-term proposal, the proposal to ban decreasing annuity payments is largely unnecessary. Grantors who would have made outsized early payments to maximize first-year appreciation under the President’s proposed regime could instead

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175 See Whitty, supra note 86, at 99.
176 See 2013 REVENUE PROPOSALS, supra note 20, at 80.
179 See id.
180 See Blattmachr et al., supra note 92, at 18.
simply form shorter term GRATs. In fact, without a ten-year minimum term, a more logical proposal might ban gradually graduated GRATs, which allow GRAT grantors to maximize possible appreciation by increasing annuity payments in 20% annual increments, thus allowing for a larger pool of trust assets to accumulate gains earlier.\textsuperscript{182} On the other hand, the President’s proposal to require a greater-than-zero initial trust remainder neatly solves two glaring problems—decreased auditability and questionable § 2036 inclusion—and should be incorporated in any sensible package of GRAT reform.

IV. COMPARING ALTERNATIVE PROPOSALS FOR REFORM

No matter what the change, reforming the Code necessarily involves tradeoffs. Yet, in this case, alternatives to the President’s proposals that have fewer negative consequences are not difficult to imagine. Applying the framework developed in Part III, Part IV explores the relative value of various alternative GRAT-reform proposals and concludes by recommending a straightforward solution that seeks to maintain the benefits of GRATs while reining in aggressive—some would say abusive—uses of the technique.

A. Treat GRATs like Options

Tweaking the existing rules on GRATs, as President Obama suggests, is one method of reform, but Congress could consider more radical change as well. Arguably the most accurate way to tax a GRAT would be to treat it as the gift of a call option—which it arguably is—and then apply the existing rules accordingly. A bit of background might be helpful for some readers. Call options are financial instruments that grant their holders the right to buy an asset at a specific price on or before a specific date.\textsuperscript{183} To be “in-the-money” on a call requires that the price of the underlying asset during the exercise period be greater than the option’s strike price, the price the seller of the call contracted to accept for the asset.\textsuperscript{184}

Similarly, in a zeroed-out GRAT, a grantor gives a beneficiary the right to receive whatever appreciation above the § 7520 rate has accumulated on the date the trust term ends. Like a call option, there is no guarantee that a GRAT will be in-the-money, and yet, also like a call, becoming the beneficiary of a GRAT has a monetary value from the

\textsuperscript{182} See AUCUTT, supra note 12, at 5 (“[Treas.] Reg. § 25.2702-3(b)(1)(ii) allows the annuity amount (whether expressed as a fixed dollar amount or a fraction of the initial fair market value of the trust property) to be increased by up to 20% each year. . . . [which] will generally outperform any other GRAT.”). Short-term GRATs that contain quickly-appreciating assets provide a notable exception to this rule of thumb. See \textit{id.}

\textsuperscript{183} See MICHAEL DURBIN, ALL ABOUT DERIVATIVES 2, 37 (2d ed. 2011).

\textsuperscript{184} See \textit{id.} at 37–39.
moment the trust is created. 185 If GRATs were to be taxed like options, the taxable gift would be calculated prospectively, most likely using the Black–Scholes model, which was developed to determine the monetary value of an option based on several relevant inputs. 186 This method would account for factors such as the value and volatility of the initial GRAT assets, the mortality risk of the grantor, the risk-free rate of return, the § 7520 rate, any prior dividends paid on the assets, and the duration of the trust. 187 Assuming that grantors had no insider knowledge indicating that an asset’s historical volatility would be unrepresentative of future risk and return, this method would tax, ex ante, the true value of the gift.

Comparing this proposal with the zeroed-out GRAT depicted in Figure 1, which transferred $3,144,493 free of transfer taxes, provides some context. Assuming that the calculated option value of being named the beneficiary of that GRAT equals $2,500,000—an arbitrary number for this example—then the gift tax would be applied to that amount, reducing the GRAT’s tax-free transfer to $644,493. Ignoring any annual and lifetime exclusion amounts, the grantor would owe gift tax on 35% of $2,500,000, or $875,000, using the gift tax rate for 2012.

The implementation of an option-like tax system for GRATs would create serious problems in practice, though. One obstacle is that grantors with asymmetric information on impending asset appreciation could manipulate the process of estimating future performance, which relies on past volatilities. While this problem could be mitigated if the Service screened for unusual GRAT performance and reevaluated the validity of the original calculations in appropriate circumstances, such a system carries the risk of leading to unfair retrospective scrutiny of all GRATs that achieve positive returns. Punishing honest grantors who happen to form successful GRATs would diminish the key economic basis of owning an option: the possibility to earn the full upside potential.

Further complicating matters, the Black–Scholes model proves unsatisfactory when pricing hard-to-value assets in several-years-long options, given that the method was established to value public stock options

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185 This statement proves especially true given the irrevocable nature of GRATs, which prevents grantors from changing beneficiaries once they have been named in the trust documents. See S. Jeanne Hall, *Estate Planning for Domestic Partnerships*, in *Valuation, Taxation & Planning Techniques for Sophisticated Estates* 389, 404 (PLI Tax Law and Estate Planning, Course Handbook Series No. D-332, 2005) (noting that a grantor may, however, vest a “power to an unrelated third party to change the beneficiary”).


with short maturities. 188 This prior volatility issue could be avoided by using the “minimum value” method for valuing options, which removes the volatility input from the Black–Scholes method. 189 Unfortunately, this approach is inherently flawed, as the removal of volatility prevents fair comparisons from being made because risk is no longer accounted for. 190 On top of that, if taxpayers submit records to the Service to support their claim of asset volatility, they will be incentivized to manipulate these records to minimize any negative impact. 191 Given that hard-to-value assets are just that—hard to value—catching cheaters would be incredibly challenging. Applying the Black–Scholes methodology would require time and energy on the part of the Service, and policing such a system would necessitate a significant increase in audits. 192

In evaluating this proposal, it is clear that an option-like tax system would increase revenue because all GRAT grantors would be forced to pay some gift tax, unlike today’s system, in which many pay little or nothing. This system also introduces a risk of loss because grantors will be unconditionally taxed on the option value received by beneficiaries. If properly applied, this proposal would control the darker side of the limitless transfer issue, but the assumption of proper application is exactly where this proposal falls apart. Unlike most options, which typically contain publicly traded securities as underliers, GRATs can be funded with many types of assets. Without the ability to efficiently and accurately calculate the option value given to beneficiaries, this proposal fails because of overwhelming administrative difficulty.

188 See id. at 263.

189 See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123, at 169 (2004); see also Markstein, supra note 186, at 264 (“The fair market value at the date of the grant of the option is measured as the current market price of the underlying stock, less the present value (using the risk-free rate) of (a) the striking price discounted from the expected exercise date, and (b) the amount of expected dividends on the underlying stock during the period in which the options are expected to be outstanding.”).

190 David Harper, ESOs: Using the Black–Scholes Model, INVESTOPEDIA, http://www.investopedia.com/features/eso/eso2.asp#axzz11O68Q (last visited Nov. 18, 2012) (noting that under the minimum value method, an option on one share of Wal-Mart stock would have the same value as an option on an emerging tech stock despite the differences in risk between the two); see FIN. ACCOUNTING STANDARDS BD., supra note 189.

191 See Joel Slemrod, Cheating Ourselves: The Economics of Tax Evasion, 21 J. ECON. PERSP. 25, 25 (2007) (discussing tax evasion in the United States and other high-income countries). Taxpayers might also encounter situations in which the records providing the past values necessary to calculate price volatility may be nonexistent or prediction based. Cf. STANLEY J. FELDMAN, PRINCIPLES OF PRIVATE FIRM VALUATION 7 (2005) (“Unlike public firms, whose prices are established in organized markets, the value of a private firm’s equity must be estimated under the assumption of a hypothetical transaction.”).

192 See Slemrod, supra note 191, at 43–44 (explaining that an efficient balance between the Service’s enforcement costs and revenue captured amongst taxpayers exists but remains elusive because of its extremely difficult calculation).
B. Require a 10% Minimum Initial Remainder Value

Another approach would supercharge President Obama’s proposal requiring GRATs to contain a nonzero initial remainder value by raising this minimum value to a hard floor: at least 10% of the initial trust assets. In addition to achieving the twin aims of the President’s nonzero initial remainder proposal—ensuring that GRATs require the filing of gift tax returns and dispelling any legal grey area regarding § 2036 estate inclusion—193—a 10% initial remainder proposal would generate revenue up to the amount of gift tax levied on the 10% (or greater) initial remainder.194

An example drives home an important operational point regarding this proposal. For illustrative purposes, Table 2’s scenario is tweaked from that of Table 1 to depict a GRAT with a 10% initial remainder value (which reduces the annuity payment displayed in Table 1) and annual asset appreciation of just 1%. The § 7520 rate remains constant at 1.2% in both tables.

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</table>

193 See discussion supra Part III.B.

194 Widely discussed as a likely GRAT reform before President Obama made his first budget proposal in 2009, this approach shares some characteristics with the one used for junior interests in capital freezes under § 2701(a)(4). See Aucutt, supra note 18; see also STEPHENS ET AL., supra note 38, ¶ 19.02[4][f], at 19-50 to -51 (discussing valuation of junior interests generally). An even more widely known “10% minimum rule” can be found in the Code section on charitable remainder trusts (CRTs). See I.R.C. § 664 (2006); Katzenstein, supra note 68, at 4–5, 61. The policy behind a minimum requirement in the case of CRTs—guarding against grantors taking advantage of the trust form by ensuring that charitable beneficiaries receive a portion of the initial assets, see Alex Espenkotter & Mildred Gomez, Charitable Trusts, in THE FLA. BAR, ADMINISTRATION OF TRUSTS IN FLORIDA 16-1, 16-6 (6th ed. 2009)—differs considerably from that in the case of GRATs, but the basic mechanics would function similarly. The question of what percentage to use is an interesting one, and the justification behind using 10% in the case of CRTs—to ensure that Congress’s intent to further charitable giving is not undermined—provides little guidance. See Coleman L. Catoe Jr., Even if the Estate Tax is Repealed . . . “It Is More Blessed to Give,” S.C. LAW., May/June 2001, at 33, 33. Nevertheless, the rate could certainly be tweaked to make GRAT rules more or less generous to grantors by altering the proportion of potential transfer tax benefits to assets transferred subject to tax.
The grantor of the GRAT in Table 2 would owe gift tax on a $1,000,000 transfer, even though only $701,302 was actually transferred. Since the trust assets at expiration are less than the minimum initial remainder value, the GRAT not only fails to facilitate a tax-free transfer, it introduces a risk of economic loss.

On the other hand, this proposal does little to counter the unlimited transfer issue, particularly when one considers that the crux of the proposal centers on the initial value of GRAT assets, which may have multiplied in value over the term of the GRAT. More than anything, this proposal would cut into the effectiveness of GRATs that most maximize the benefits discussed in Part II, such as incentivizing economic risk taking. This follows because the proposal would make extracting tax benefits from GRATs formed on the basis of public information more difficult while barely denting the efficacy of GRATs that take advantage of the technique’s inherent asymmetric information problem. Thus, this proposal should be cast aside both for its inability to preserve the benefits of GRATs and its failure to address the GRAT’s most pernicious problem.

C. Tax a Portion of Above-§ 7520 Appreciation

Perhaps a better approach would apply the gift tax, ex post, to a percentage of the above-§ 7520 appreciation transferred to a beneficiary. Although the creation of some GRATs may be chilled, especially under a high tax rate, such a system should bring in new revenue at a rate roughly proportional to the percentage of appreciation taxed. For example, if 20% of above-§ 7520 appreciation were taxed, the effective gift tax rate on formerly tax-free transfers would equal 7% (35% divided by 5) in 2012. Although this proposal would not strictly end the opportunity for unlimited transfers, it would at least tax them according to their size.

One could argue that applying 20% of the gift tax rate would prove inadequate for dealing with large transfers of above-§ 7520 appreciation, but this percentage is merely illustrative. Returning to a prior point, the cost of any rate increases would be measured in the GRAT benefits lost by the discouragement of GRAT creation—but would such discouragement even occur? Although wealthy transferors may shift to other, more exotic techniques, like the IDGT, GRATs would still have a positive, after-tax net present value whenever their expected benefits exceeded the expenses to draw up the trust. Finally, though this proposal could raise some of the same liquidity issues for family businesses as the estate tax, this concern is relatively slight as the effective gift tax rate would only equal 7% under this example.

195 Remember that any nonzero remainder is considered a taxable gift. See Belcher, supra note 6, at 2, 10.
D. Cap Above-§ 7520 Appreciation

Yet another proposal would place some form of limit on total tax-free appreciation transferred by GRATs. Such a cap could come in two different flavors: a percentage limit on appreciation per GRAT or a fixed-dollar lifetime cap assigned to every individual. In either case, if such a limit were exceeded upon GRAT expiration, any excess above-§ 7520 appreciation over the limit would be a completely taxable gift. Thus, both caps would be examined from an ex post perspective and neither would place any onerous administrative strain on the Service.

Using a percentage cap, the unlimited transfer and grantor manipulation problems would be well controlled. Should this cap be set at 20% of initial asset value per year—again, an illustrative number—then astronomical tax-free transfers would be more difficult to effect, especially those that are the result of large one-time pops in asset value. If implemented, this proposal would directly increase revenue to the extent that any appreciation above the percentage cap would be newly taxable. Unfortunately, this proposal would punish grantors who fairly achieve above-average returns, without any progressive regard for their level of wealth, and may prove difficult for the Service to police, given difficulties in valuing some assets.

A lifetime cap would handle the unlimited transfer problem more directly. Like a percentage cap, once a grantor reached the limit—for example, $10 million—then, upon GRAT expiration, any transfer of above-§ 7520 appreciation in excess of the cap would represent a gift for which tax must be paid. In this case, however, the grantor would no longer have any incentive to create new GRATs as he would not be permitted to take advantage of the GRATs’ benefits past this objective lifetime limit. Like the applicable exclusion amount, a spouse would be allowed a separate cap, doubling the GRAT benefit enjoyed by a couple given that inter-spousal wealth transfers are untaxed.

E. A Hybrid Proposal: The Best Way Forward for GRAT Reform

Revisiting the analysis of President Obama’s plan, the diamond in the rough is his proposal to require a greater than nonzero initial remainder value. This proposal, which ensures that the Service can keep track of GRATs for audit purposes and eliminates any § 2036 gross estate inclusion confusion pertaining to zeroed-out GRATs, represents a change that is both logical and overdue. The central recommendation of this Comment,

196 I refer to a failure to utilize progressivity, in this sense, to differentiate between a grantor with, for example, a net worth of $50 million and one with a net worth of $500 million.


198 See 5 BITTKER & LOKKEN, supra note 8, ¶ 123.1, at 123-2.
however, is to combine two reform alternatives—taxing a portion of above-
§ 7520 appreciation and implementing a lifetime grantor cap—into one
hybrid proposal.199 Consistent with the progressive justifications for the
estate tax, this proposal is implemented under a marginal system wherein
the gift tax is applied at a one-half rate to GRAT transfers that currently
enjoy tax-free status above a lifetime cumulative of $5 million, and applied
in full once such transfers exceed a lifetime cumulative of $10 million. Of
course, policymakers could debate the exact figures and rates presented
here, as the goal of this Comment is to focus on building an appropriate
reform structure, which should remain consistent even if the amounts are
scaled. In any case, inflation indexing should be included once the amounts
are chosen.

At a 35% gift tax rate, the first bracket would save grantors up to $1.75
million in out-of-pocket gift tax liability, and the second bracket would save
them up to $875,000, for a total of $2.63 million. Since the current $5.12
million applicable exclusion amount provides tax savings of $1.79 million,
postreform GRATs would still allow an additional tax savings worth greater
than 146% of 2012’s applicable exclusion amount, holding the tax rate
constant. Consistent with larger tax policy, all of these figures would be
essentially doubled in the case of married couples, and this proposal would
not prevent taxpayers from continuing to make annually excluded gifts.

The primary achievement of this proposal stems from its capacity to
increase tax revenue by ending the opportunity for limitless GRAT
transfers. Indeed, horizontal equity would rise to the extent that the transfer
tax burdens of the wealthiest Americans would be more evenly distributed,
regardless of whether they arranged an enormously successful GRAT.
Moreover, in case a grantor’s good fortune derives from asymmetric
information, this proposal places an objective bound against ill-gotten
gains. Although a cap-and-tax plan does not introduce any additional risk of
loss to grantors, it remains unclear that such a risk is necessary, and the
alternative reforms that achieved this feature are impractical, ineffectual, or
unfair. Although this proposal would sacrifice GRAT benefits to the extent
that it would bar some would-be grantors, such a tradeoff is inevitable
whenever use of a technique is restricted. In this case, the utility of taxing

199 There are certainly coherent reasons to believe the best solution may be the total elimination of
social engineering from the Code. See William McBride, How to Judge a Tax Plan, TAX FOUND. (Dec.
15, 2011), http://taxfoundation.org/article/how-judge-tax-plan (“[T]axes should play as small a role in
decision-making as possible.”). Even if one does not agree with that position, it must be admitted that
whenever policymakers seek to provide short-term benefits for a small group, we should ask about the
long-term effects on the larger community. See HAZLITT, supra note 151, at 17. In this case, a strong
argument can be made to retain Code provisions that incentivize entrepreneurship given that such
activity is commonly believed to incubate economic growth. See Julie Berry Cullen & Roger H. Gordon,
Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S., 91 J. PUB. ECON. 1479,
1479–81 (2007); see also Cullen & Gordon, supra note 150, at 41.
very large wealth transfers—those exceeding eight figures—overrides any forsaken benefits.

CONCLUSION

Altering tax policy is a deceptively difficult task. Policymakers must balance the costs and benefits of a proposed change against the current system and potential alternatives. Such balancing requires an understanding of how we arrived at the current policy, an appreciation of the integration of the Code, a thoughtful consideration of revenue needs, and a careful analysis of economic impact. GRAT reform is no exception.

This Comment examined the history of GRATs and the purposes they serve: minimizing the GRIT disparity, preserving family businesses, supporting public opinion against the estate tax, and inducing risk taking. Nonetheless, the free lunch that has characterized current GRAT policy must be restricted; it is simply too unfair, manipulable, and nonprogressive. With our national budget in disarray, policymakers should clearly focus on means to maximize revenue in addition to minimizing spending. Although GRAT reform may only make a minor contribution toward that effort, it would represent an important step in the right direction.

Regrettably, President Obama’s plan to reform GRATs is seriously flawed. Based on a biased method of increasing the risk of a GRAT’s worthlessness through § 2036 estate inclusion, it fails to limit some of the GRAT’s worst potentials for abuse. After examining reform alternatives, this Comment advanced a simple marginal system in which the gift tax is applied at a one-half rate upon GRAT transfers that currently enjoy tax-free status above a lifetime cumulative of $5 million, and applied in full once such transfers exceed a lifetime cumulative of $10 million. This approach attempts to balance the need to increase tax revenue with the risk of diminishing the benefits that GRATs confer to the Code, to the economy, and to our society. Taxpayers deserve policies that reflect more than mere legislative convenience, and GRAT rules should be fixed properly on their behalf.