

In Defense of Sales to Defective Grantor Trusts

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In what has become a near-landmark publication, Juile K. Kwon and Daniel J. Loewy, two senior analysts from Bernstein Global Wealth Management, published their article *GRATs: On a Roll*¹ in the June 2005 Edition of *Trust & Estates Magazine*. In their article, Kwon and Loewy analyze the “probabilities of success” when comparing a rolling grantor-retained annuity trust (a rolling “GRAT”) to other investment-driven gifting strategies for large estates, including a sale to a defective grantor trust (a sale to a “DGT”). Using a highly advanced wealth forecasting analysis model, the same simulating over 10,000 capital market scenarios across a wide spectrum of asset classes, Kwon and Loewy determined that, in almost all cases, a rolling GRAT strategy statistically outperforms other popular strategies for increasing the likelihood of successful wealth transfer.² According to Kwon and Loewy, the success of rolling GRATs is largely due to the ability to significantly decrease the inherent market risk associated with investment-driven estate planning strategies while, at the same time, capturing the upside of market volatility.³ In other words, the ability to lock-in wealth transfer gains from previous years in a rolling GRAT strategy has a greater probability to outweigh any advantage from lower interest-rate benefits and the avoidance of all mortality risk generally provided by a sale to a DGT.⁴

However, in recent years, Kwon and Loewy’s incredible analysis has seemingly been misinterpreted by many in the estate planning world. This misinterpretation has created somewhat of a trend in the estate planning and wealth management community to promote the superiority of GRAT strategies over sales to DGTs and other investment-driven estate planning tools. Notwithstanding the amazing benefits rolling GRATs afford clients to effectively minimize potential estate tax liability and “locking-in” the upside of market volatility, the advantages of a rolling GRAT over a sale to a DGT should not be overemphasized. It is important for practitioners to recognize various, often overlooked advantages involving sales to DGTs which, when taken as a whole, may favor using a sale to a DGT over a rolling GRAT depending on a client’s unique estate planning objectives.

There is no dispute that rolling GRATs are able to capture the upside of market volatility and have certain advantages over other investment-driven planning vehicles in their ability to consistently lock-in wealth transfer gains as the strategy progresses. Nonetheless, rolling GRATs also have an increased interest-risk because of (a) the higher section 7520 rate mandated for all GRAT strategies and (b) the decreased flexibility of GRATs to “lock-in” lower interest rates in the long-run during favorable rate markets. Present interest rates, including the AFR and the section 7520 rate, still remain at near historical lows. A client today could take advantage of this current market scenario by executing a sale to a DGT and effectively “lock-in” the lower rates of interest for the entire term of the DGT note. In contrast, a client utilizing a rolling GRAT strategy would only be able to “lock-in” present interest rates for the next two years (i.e., the term of the first GRAT in the series). If interest rates were to increase during the comprehensive term of a GRAT strategy, which they are bound to do moving forward, so would the overall hurdle rate for the technique. The point to be made is that, while Kwon and Loewy took this increased interest-rate risk into consideration in their financial modeling analysis, practitioners should understand that decreased investment risk does not necessarily negate increased interest-rate risk.

¹Kwon & Loewy, *GRATS: On a Roll*, 33, Vol. 144, No. 6 (Trusts & Estates, June 2005).

²*Id.*

³*Id.*, at 42-44.

⁴*Id.*

It should be noted that the two most important advantages of a DGT strategy are the two main disadvantages of a rolling GRAT: (1) the ability of the DGT strategy to provide for a more flexible repayment structure on its obligations back to the grantor; and (2) the ability of the DGT strategy to allow for long-term generation-skipping transfer tax planning. For example, a DGT note could be drafted to provide for either a short-term or a long-term payment period. The note could also require payments of either (1) both principal and interest or (2) interest only payments with a principal payment due at maturity. Additionally, the note could be structured to allow for no annual payments at all with one final balloon payment of principal and interest at the date of maturity. Most importantly, however, the terms of the DGT note could be renegotiated and revised depending on the changing circumstances of the rate markets – thus allowing the client to capture the upside of interest rate volatility to maximize wealth transfer gains or retain the actual, original assets transferred to the trust without liquidation. The DGT note could also be “self-cancelling” to further decrease the mortality risk, of course with a higher rate of interest (i.e., a higher hurdle rate).

In contrast, rolling GRAT strategies must calculate and pay annuity payments back to the grantor of the trust on at least an annual basis and at an inherently higher rate of interest. The flexibility in payment structure of the DGT note over the inflexibility of the payment structure of a GRAT strategy increases the probability of successful wealth transfer and maximizes the overall benefit to the client both by (1) effectively decreasing interest-rate risk and (2) capitalizing on lower interest rates in depreciating asset markets.

Furthermore, while GRATs have an advantage over other investment-driven techniques in capturing the upside of market volatility, this is largely due to the assumption that the original assets transferred to the trust can be kept in the trust without liquidation to pay the mandated annual annuity. Not to disparage the immense benefits afforded by GRATs, these same benefits provided by a rolling GRAT strategy could be replicated in a sale to a DGT where the all principal and interest under the DGT note were deferred until the maturity of the note – especially in cases where the note could be adjusted and modified during the repayment term. Due to a DGT’s inherently lower hurdle rate and by providing for a balloon payment of both principal and interest at the maturity date of the DGT note, a DGT is better situated than even a rolling GRAT to retain its originally contributed assets and to avoid potential liquidation of trust assets in unfavorable markets. This allows for the increased probability that, over the term of the DGT note, the assets sold to the DGT will realize a greater return than the hurdle rate. Moreover, a DGT’s ability to structure and revise its payment obligations can assist clients to transfer not only the value of their property, but also the property itself without forced liquidation.

For this reason, a sale to a DGT is not only an effective investment-driven wealth transfer mechanism, but also an important business or real property succession tool. It is one thing if the client is transferring a highly diversified portfolio of marketable securities; it is another thing entirely where the assets are closely-held business interests or real properties which have been in the family for multiple generations. By providing greater flexibility for payments on the DGT note to the grantor, a sale to a DGT strategy is better able to avoid situations where the trust would be forced to sell the interests in a family’s business or real property in a poor income producing year. The abilities of a DGT strategy to (1) transfer the assets to a newly formed LLC to obtain a lack of marketability discount and (2) qualify for the inherent lower AFR rate only amplify the benefit of potentially avoiding a forced liquidation of a family’s assets by making it easier for the trust to make payments to the grantor according to the terms of the DGT note.

However, the most important advantage a sale to a DGT has over a rolling GRAT is the ability to engage in multi-generational planning. Of critical importance is that a grantor of a GRAT cannot allocate his generation-skipping transfer tax exemption to “leverage” property contributed to a GRAT under the estate tax inclusionary period rules of the Internal Revenue Code. On the other hand, property sold to a DGT may be made exempt from generation-skipping transfer tax due to the grantor’s allocation of his or her generation-skipping transfer exemption at the inception of the DGT. Long-term, such a trust would be able to provide tax-free distributions to “skip” persons for multiple generations. Now that several states, including Alaska, have

wholly done away with their rules against perpetuity, a DGT with a trust situs of Alaska could create a vehicle exempt from generation-skipping transfer tax that lasts for centuries.

In summary, both GRATs and sales to DGTs are effective estate planning tools practitioners can use to help wealth transfer benefits to future generations. Notwithstanding advances in quantitative modeling and capital markets forecasting, the outperformance of rolling GRATs over sales to DGTs should not be overemphasized. The single-minded advocacy of one strategy over the other is generally neither advantageous nor effective in maximizing the overall benefit to a client's estate. Attorneys and wealth managers should remain objective in deciding which investment-driven techniques are best suited for their clients' goals based on a comprehensive and complete analysis of the circumstances. It should not be forgotten that a sale to a DGT can be powerful investment-driven strategy in its own right — especially in cases where the client desires for the beneficiaries to succeed to the control and avoid potential forced liquidation of generational assets. This is important where the assets being transferred are long-held family business interests or real properties (i.e., non-traditional assets) and where the client desires to maximize the benefits of multigenerational planning.

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