

Proposed Retained Interest Regs: Much Left Unanswered

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Introduction

At the beginning of June, the Treasury Department issued proposed regulations providing guidance regarding the portion of a trust that is included in the grantor's gross estate for federal estate tax purposes when, among other circumstances, the grantor has retained the right to annuity or unitrust payments that last for the grantor's life, a period not ascertainable without reference to the grantor's death or a period that does not, in fact, end before the grantor's death.

Primarily, those trusts are charitable remainder annuity trusts (CRATs) or unitrusts (CRUTs), described in section 664(d) of the Internal Revenue Code of 1986 as amended, and grantor retained annuity trusts (GRATs) or unitrusts (GRUTs), described in reg. section 25.2702-3. The proposed regulations state that they also will apply to qualified personal residence trusts (QPRTs), described in reg. section 25.2702-5(c), and other forms of grantor retained income trusts (GRITs).

Background

Section 2036(a)(1) provides that property transferred during one's lifetime in trust or otherwise, other than in a bona fide sale for full and adequate consideration in money or money's worth, is included in the gross estate of the transferor for federal estate tax purposes if the transferor retained the right to the income from, or the possession and enjoyment of, the property for life, for a period not ascertainable without reference to the transferor's death, or for a period that does not, in fact, end before the transferor's death.

Section 2039 provides that a decedent's gross estate includes the value of an annuity or other payment under any form of contract or agreement (other than a policy

of insurance on the decedent's life) receivable by any beneficiary by reason of surviving the decedent if, under the contract or agreement, an annuity or other payment was payable to the decedent, or if the decedent (either alone or in conjunction with another) possessed the right to receive the annuity or other payment, for life, for a period not ascertainable without reference to the decedent's death or for a period that does not, in fact, end before the decedent's death.

In some cases in which an individual transfers property to another person and retains an interest in that property, the transferor will not retain the right to income from (or possession and enjoyment of) the property but will instead retain the right to a unitrust payment (a fixed percentage, such as 5 percent or 10 percent, of the annual value of the property) or an annuity (a fixed sum of money). For example, if a transferor creates a charitable remainder trust described in section 664, to qualify the trust for treatment under that section (which will allow the transferor an income tax deduction for the value of the remainder committed to charity and which will confer tax-exempt status on the trust), the transferor may retain only an annuity or unitrust interest (or the lesser of trust income or the unitrust amount) within the parameters described in that section. Similarly, under section 2702, an individual who wishes to transfer a remainder interest in property to a family member and be treated as making a gift only of the actuarial value of the remainder (and not the value of the entire underlying property) must either transfer a personal residence and meet some other requirements as described in reg. section 25.2702-5(b) or retain only the right to unitrust or annuity payments as described in reg. section 25.2702-3.

Prior Rules on Inclusion of CRAT or CRUT

In Rev. Rul. 76-273, 1976-2 C.B. 268, and Rev. Rul. 82-105, 1982-1 C.B. 133, the IRS set forth its views regarding the part of a CRUT or CRAT, respectively, that would be included under section 2036 in the gross estate of a decedent who created such a trust and retained the right to unitrust or annuity payments for life (or for a period not ascertainable without reference to the decedent's death or for a period that, in fact, did not end before the decedent's death). It is worth noting that Rev. Rul. 82-105 did not rule out the potential applicability of section 2039 to CRUTs or CRATs. Essentially, those two revenue rulings calculated the percentage interest in the trust that the unitrust or annuity represented based on the proportion of the trust necessary to produce an income interest of an equal amount at prevailing interest rates under the applicable tables. For example, if the annuity payable at the grantor's death is \$40,000 a year and the trust is then worth \$1 million, the \$40,000 annuity represents a 4 percent payout of the trust corpus. An income interest would produce a 6 percent annual payment at prevailing interest rates, and two-thirds (that is, 4 percent/6 percent) of the value of the trust at the grantor's death (that is, \$666,667) would be included in the grantor's gross estate. Those revenue rulings were issued before enactment of section 7520, which now provides for each month the percentage return that an income interest represents (for example, 5.6 percent for June 2007 and 6 percent for July 2007).

Prior Guidance on Inclusion of GRAT or GRUT

Although it is likely not advisable from an estate and gift tax planning perspective for a property owner to create a GRUT as opposed to a GRAT, it is possible a taxpayer

might do so.¹ The IRS, before the issuance of these proposed regulations, had expressed unofficial views about the inclusion of a retained annuity or unitrust interest in the grantor's estate with respect to GRATs and GRUTs. See, e.g., FSA 200036012, Doc 2000-23372, 2000 TNT 176-61; LTRs² 9451056, 94 TNT 252-86; 9345035, 93 TNT 233-65; and 9412036,³ 94 TNT 59-48, in which the IRS stated that a GRAT or GRUT is included in full in the gross estate of a grantor who dies during the annuity or unitrust term under both sections 2036(a)(1) and 2039.

What the Proposed Regs Provide

The proposed regulations set forth two general rules regarding the estate tax inclusion of retained interests. First, they amend reg. section 20.2036-1 essentially to apply the principles set forth in Rev. Rul. 76-273 and Rev. Rul. 82-105 to CRATs, CRUTs, GRATs, and GRUTs. In general, they adopt the same treatment for both charitable remainder trusts and grantor retained interest trusts. Second, the proposed regulations amend reg. section 20.2039-1 to provide that section 2039 will not apply to a CRAT, CRUT, GRAT, or GRUT. That is a welcome clarification of the scope of section 2039, which appears to eliminate the previously overlapping treatment of some grantor retained interests under both sections 2036 and 2039.

The scope and impact of the proposed regulations are described in several examples that, as described below, set forth general principles but do not provide sufficient detail to cover all types of retained interests commonly used in estate planning. The example in prop. reg. section 20.2036-1(c)(1)⁴ deals with a decedent who created an irrevocable trust during his lifetime to pay half of the income to the grantor and half to the grantor's spouse⁵ while they are both living, and all of the income to the survivor

¹ See Blattmachr, Slade, and Zeydel, *Partial Interests -- GRATs, GRUTs, QPRTs* (section 2702), BNA Tax Management Portfolio 836-2d at A-53 (hereinafter Portfolio 836-2d).

² Under section 6110(k)(3), neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent.

³ LTR 9412036 involved a joint purchase of interests in a GRUT.

⁴ The proposed regulations would "renumber" reg. section 20.2036-1 by, for example, designating the last paragraph of what is now reg. section 20.2036-1(a) as new reg. section 20.2036-1(c) and adding a heading to it.

⁵ The example recites that the grantor's spouse is a U.S. citizen. The citizenship of the grantor's spouse seems irrelevant to the conclusion reached or purpose of the example. Presumably, it is part of the example because a gift to a spouse cannot qualify for the gift tax marital deduction. See section 2523(i). The example should add words to the effect that: The estate tax result would be the same even if the grantor's spouse were not a U.S. citizen, but any gift made by the grantor upon creation of the trust would not qualify for the gift tax marital deduction under section 2523(a), on account of section 2523(i), and the portion of the trust included in the grantor's estate would not qualify for the estate tax marital deduction under section 2056(a), even if the spouse survives and the income interest continues for life of the grantor's spouse, unless the trust is in

of the spouses for the balance of his or her lifetime. The example concludes that the entire trust is included in the grantor's estate if the grantor is survived by his or her spouse. Presumably, it reaches that conclusion because, on the grantor's death, the grantor would be entitled to receive all the income, triggering full estate tax inclusion of the trust under section 2036(a)(1). The example concludes that only one-half of the trust would be included in the grantor's estate if the grantor were the first spouse to die. Presumably, that conclusion is based on the fact that at the grantor's death in that case, the grantor would be entitled to one-half of the income. Indeed, that conclusion seems to be supported by the second sentence in the last paragraph of reg. section 20.2036-1(a).⁶

But a more complete analysis suggests the second conclusion of this example may not be correct. The long-standing regulations under section 2036(a)(1) provide that even if the grantor is not entitled to income at the time of death but would succeed to the income if he had survived the current income beneficiary, the amount included in the grantor's gross estate is the value of the entire trust reduced by the actuarial value of the income interest held by the current income beneficiary. See reg. section 20.2036-1(a) (first sentence of last paragraph).⁷ Hence, even when the grantor is the first spouse to die, the value of the entire trust is included in the grantor's estate reduced only by the actuarial value of the income interest held by the grantor's spouse at the time the grantor dies.⁸ The value of the spouse's remaining income interest will be determined, presumably, under the principles of reg. section 20.2031-7. Unlike some lifetime transfers, the value of the spouse's income interest in this example will not be treated as having no value, as an income interest may be for gift tax purposes under section 2702. However, if the spouse's death is imminent, the actuarial value of the spouse's income interest may be very close to zero. See reg. section 25.7520-3(b)(3).

the form of a qualified domestic trust described in section 2056A. Perhaps, the statement that the spouse is a U.S. citizen is intended to suggest that the half interest devoted to the spouse constituted "qualified terminable interest property" under section 2523(f).

⁶ The sentence reads: "If the decedent retained or reserved an interest or right with respect to a part only of the property transferred by him, the amount to be included in his gross estate under section 2036 is only a corresponding proportion of the amount described in the preceding sentence."

⁷ The sentence reads: If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. As indicated above, the proposed regulations would make the paragraph in which the sentence is contained a new paragraph (c)(1).

⁸ An exception to the estate tax inclusion of the income interest of the spouse under section 2036 would arise if the portion of the trust in which the spouse had the income for life qualified as and was elected for qualified terminable interest property treatment under section 2523(f). See reg. section 25.2523(f)-1(f), examples 10 and 11.

For example, a decedent who created a trust of the type described in the example dies when her husband is 72 years old, the section 7520 rate is 6 percent, and the value of the trust is \$1 million (and alternate valuation is not elected under section 2032). The decedent's husband's death is not imminent. Half of the trust is included in the decedent's gross estate by reason of the decedent's unexpired income interest in half of the trust. But what about the other half of the trust for which the decedent has a succeeding income interest, following the husband's remaining income interest? The value of the husband's income interest in half of the trust is 47.971 percent x \$500,000, or \$239,855. Hence, \$760,145 (\$1,000,000 - \$239,855) of the trust should be included in the decedent's gross estate for federal estate tax purposes under section 2036(a)(1). Nonetheless, as suggested, the proposed regulations would require an inclusion of only \$500,000. That would be the case only if half the trust qualified for QTIP under section 2523(f).

New paragraph (c)(2) under reg. section 20.2036-1 is entitled "Retained Annuity and Unitrust Interests in Trusts," but its text applies not only to those retained interests but also to "other income interests in any trust (other than a trust constituting an employee benefit)." It provides the basic rule that "the portion of the trust's corpus includible in the decedent's gross estate . . . is the portion of the trust corpus necessary to yield the decedent's retained use [apparently referring to examples such as the right to use the personal residence in a qualified personal residence trust, which is mentioned in the paragraph] or retained annuity, unitrust, or other income payment." The paragraph contains several examples.

Example 1 deals with a taxpayer who creates a CRAT paying an annuity for life that is to continue for the taxpayer's child who survives the grantor. The example not only illustrates the portion of the trust included in the gross estate (which is two-thirds, or \$200,000, of the \$300,000 trust, in which the annuity of \$12,000 represents a 4 percent yield and the section 7520 rate then in effect as of the valuation date is 6 percent) but it also shows a calculation of the charitable estate tax deduction. The example, as indicated, assumes a 6 percent section 7520 rate in effect on the date of the decedent's death, but it does not mention what the 7520 rate was for either of the prior months, even though the rate for either prior month may be used under section 7520(a) (last sentence) in valuing a retained interest in a split-interest trust, such as a charitable remainder trust. It would be helpful if the example dealt with the ability to select the section 7520 rate for valuation of the retained interest and also dealt with a situation in which alternate valuation was elected under section 2032 (although Example 3, discussed below, dealing with a charitable remainder unitrust, mentions but does not describe the method of inclusion for the use of the alternate valuation date). As described above, Example 1 expressly states that the IRS will not seek to apply, and that the taxpayer cannot seek to apply, section 2039 to determine the portion of the trust included in the grantor's gross estate. That prohibition is presumably intended to prevent a taxpayer from seeking 100 percent inclusion under section 2039 to obtain a full step-up in basis of the entire trust estate under section 1014 when that would be tax advantageous (for example, if full estate tax inclusion of the trust were offset by increases in the applicable credit amount under section 2010).

Example 2 involves a GRAT in which the grantor retains the right to receive \$12,000 per year until the earlier of the expiration of 10 years or the grantor's death before the end of the 10-year term. The example calculates the amount of the trust (worth \$300,000 at the grantor's death) included in the grantor's gross estate, taking into account the adjustment necessary to account for the fact that the annuity is paid monthly.⁹ It expressly states that the grantor's executor did not elect alternate valuation, implying that the result could be different if alternate valuation were elected. Adding an illustration when the alternate valuation election is made would be helpful and would clarify not only whether just the alternate valuation value of the trust would be used to determine the portion included but also whether the section 7520 rate in effect on the alternate valuation date also should be used.¹⁰ Indeed, it would be helpful to illustrate the impact of a change in the section 7520 rate when the alternate valuation date used to value the underlying assets of the trust is different (for example, because one or more assets of the trust are sold within six months of the decedent's death). Also, if the section 7520 rate in effect on the alternate valuation date should be used, the regulations should clarify that use of the alternate valuation date is permitted as long as the gross estate and estate tax decrease, as required by section 2032(c), even if the value of the trust estate has increased. For example, if the trust is worth \$1 million on the date of the decedent's death, the annuity is \$40,000, and the section 7520 rate is 6 percent, two-thirds of the trust estate would be included (\$666,667). If, on the alternate valuation date, the trust has increased in value to \$1.2 million but the section 7520 rate has increased to 7 percent, less than half of the trust estate would be included. That would mean that the value of the gross estate and the estate tax due would decline, even though the value of the trust has increased, and the election to use the alternate valuation date should be available.

Although Example 2 is helpful in determining the portion of a GRAT included when the annuity is the same each year and when the grantor's entitlement to payments end on the grantor's death, it does not provide assistance in determining the portion included in the gross estate when the annuity varies from year to year or the annuity payments will continue to be paid, if the grantor dies during any fixed term, to the grantor's estate. As an actuarial matter, the grantor may retain an annuity stream for a fixed term (payable to the grantor or, if the grantor dies during that term, to the grantor's estate) and may even make the present value of the annuity stream equal to the value of the property transferred to the GRAT (a so-called zeroed-out GRAT). (*Cf.* reg. section 25.2702-3(e),

⁹ The example states, in part: "No additional contributions were made to the trust after [the grantor's] transfer at the creation of the trust." The reason for that statement is uncertain, and the statement is misleading. First, it does not seem that the amount included under section 2036(a)(1) is dependent on the timing of contributions. Second, the example states, in effect, that the GRAT is one described in "section 2702(b)," which by definition must prohibit additional contributions. Reg. section 25.2702-3(b)(5). Although it is probably superfluous, the statement quoted above could be read to suggest that a GRAT described in section 2702(b) could permit additional contributions.

¹⁰ The preamble to the proposed regulations suggests the section 7520 rate in effect on the alternate valuation date should be used.

Example 5, for an illustration in which the grantor retains a unitrust stream for a term of years for herself or, if she dies during the term, for her estate.)

Indeed, the annuity payments from a GRAT described in reg. section 25.2702-3(b)(1) need not be fixed, although, for purposes of determining the value of a retained annuity interest for gift tax purposes, only increases not in excess of 20 percent per year are considered. Many GRATs that qualify under section 2702(b) do provide for the annuity payments to increase by 20 percent each year. In cases in which section 2702 does not apply (for example, a GRAT with remainder over to a niece or nephew that is not subject to the provisions of section 2702), the annuity payments may increase by more than 20 percent each year. In any case, the amount of the inclusion under section 2036 presumably will be based on the maximum annuity amount the grantor might ultimately be entitled to receive (with an appropriate subtraction for the present value of any outstanding interest at the time of the grantor's death, such as an unpaid annuity payment due the grantor that presumably would be included in the grantor's gross estate under section 2033). Another approach would be to compute the actuarially equivalent fixed (nonincreasing) annuity on the date of the grantor's death and compute the percentage of the trust includable based on an income interest equivalent to the recalculated annuity. Unfortunately, as indicated, the proposed regulations do not deal with such commonly used increasing annuity arrangements. An illustration should be added to the proposed regulations to address such increasing (and, perhaps, decreasing) annuity payment GRATs.

Another issue, as indicated above, seems to arise for GRATs (or GRUTs) that provide for the payments to be made for a fixed term to the grantor or, if the grantor dies during the fixed term, to the grantor's estate: How, if at all, do future payments due the grantor's estate affect the part of the trust included in the grantor's estate? The proposed regulations, as indicated before, do not deal with such a GRAT or GRUT. It may be that the current value of the future payments due the grantor's estate is included in the grantor's estate under section 2033.¹¹ Obviously, it would be inappropriate to impose double taxation through a combined application of sections 2033 and 2036.¹²

¹¹ Cf. Portfolio 836-2d at A-46 (stating that the actuarial value of the balance of the annuity payments or unitrust payments payable to the grantor's estate is included in the grantor's gross estate, as would a reversion).

¹² Cf. Rev. Rul. 84-25, 1984-1 C.B. 191 (indicating that, to provide double taxation, it would be inappropriate to include the same item in the gross estate under section 2033 and in adjusted taxable gifts); see also *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, 84 TCM 374, Doc 2002-22023, 2002 TNT 188-7, *aff'd*, 382 F.3d 367, Doc 2004-17577, 2004 TNT 171-8 (3d Cir. 2004); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 TCM 1641, Doc 2002-11394, 2002 TNT 95-11 (indicating that, when a family limited partnership is disregarded under section 2036, the limited partnership units must otherwise be disregarded for estate tax purposes). One well respected commentator has suggested that in that case only the proportion of the annuity payable from the nonincluded portion of the GRAT should be included under section 2033. See C. McCaffrey, "Planning With GRATs," *Trusts & Estates Wealth Management Conference* at p. 21 (Oct. 20, 2003).

The final regulations therefore should address whether, and to what degree, payments due the grantor's estate following the grantor's death from a GRAT or GRUT will affect the portion of the trust included in the grantor's gross estate.

Another question is whether section 2036(a)(1) applies at all in a situation in which the value of the annuity stream retained in a GRAT is equal to (or greater than) the value of the property transferred to the GRAT by the grantor. As an actuarial matter, the grantor may retain an annuity stream for a fixed term (payable to the grantor, or, if the grantor dies during that term, to the grantor's estate) and make the current value of the annuity stream equal to the value of the property transferred to the GRAT. (Cf. reg. section 25.2702-3(e), Example 5, for an illustration in which the grantor retains a unitrust stream for a term of years for herself or, if she dies during the term, for her estate.) For example, if the section 7520 rate is 6 percent and the grantor retains for herself (or, if she dies, for her estate) the right to an annuity payable at the first anniversary of the transfer to the trust equal to 51 percent of the gift tax value of the property transferred and the right to an annuity payable at the second anniversary of the transfer to the trust equal to 59 percent of the gift tax value of the property transferred, the value of the annuity stream would equal the value of the property transferred to the trust. It would seem more correct to construe a zeroed-out GRAT as nonetheless a transfer with a retained interest, even though the value of the gift is equal to zero for tax purposes, but the matter should be clarified. Even if a zeroed-out GRAT were construed as a transfer with a retained interest, such a GRAT might also be considered an exchange for full and adequate consideration, falling outside the scope of section 2036.¹³

There is no express prohibition in the tax law on creating a zeroed-out GRAT, but there is no authority expressly permitting such a GRAT to be created.¹⁴ Even if a taxpayer is denied the right to use the actuarial value of the retained annuity stream in determining the value of the gift made in creating the GRAT on the grounds that a GRAT cannot be zeroed out, the amount included in the grantor's gross estate under section 2036 presumably would be based on the amount of the retained annuity.

Other questions are also left unanswered. In the preamble, the IRS may be suggesting that there may be cases in which an annuity arrangement, other than a GRAT or a CRAT, could be viewed as a transfer with a retained interest falling under section 2036. In making that suggestion, however, the preamble fails to describe the nature of the circumstances that would make inclusion appropriate.¹⁵ Even assuming a transaction could be viewed as a transfer with a retained interest, there remains the possibility that the application of section 2036 could be negated on the grounds that the transfer was made in a bona fide sale or exchange "for full and adequate

¹³ Cf. *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985).

¹⁴ Cf. TAM 200245003, *Doc 2002-24973*, 2002 TNT 218-22, indicating that the preamble to the section 2702 regulations contemplates that a GRAT may not be zeroed out. See generally Portfolio 836-2d at A-56 and A-88.

¹⁵ Compare *Becklenberg Est. v. Commissioner*, 273 F.2d 297 (7th Cir. 1959), with *Ray*, 762 F.2d 1361 (9th Cir. 1985).

consideration in money or money's worth."¹⁶ The proposed regulations fail to address that issue as well.

Example 3 deals with a CRUT and illustrates both the amount of the CRUT that is included in the grantor's gross estate as well as amount of the charitable estate tax deduction allowed. The example ends by stating that all the results (other than those relating to the charitable deduction) apply to a GRUT. But apparently unlike a CRUT described in section 664, the unitrust percentages in a GRUT also may increase or decrease from year to year. The regulations should discuss the effect of an increasing or decreasing unitrust payment, as well as the consequences of estate tax inclusion when the unitrust payments continue for the grantor's estate.

Example 4 deals with a so-called grantor retained income trust, or GRIT (a trust from which the grantor has retained the right to the income for a term of years). Although the example seems to conclude correctly that the entire trust is included in the grantor's estate if the grantor dies during the term, the way in which the example is drafted may mislead some taxpayers and advisers into thinking that creating a GRIT for family members is acceptable. Of course, the gift tax consequences of creating a GRIT for members of one's family are quite adverse under section 2702(a). It would be helpful if the example provided that the remainder on expiration of the term was to pass to the grantor's niece or nephew (a person not a member of the grantor's family under section 2702) or, if the niece or nephew failed to survive, to a charity over which the grantor had no control and to explain (perhaps by a parenthetical sentence) that the special valuation rules of section 2702(a) would apply if the trust was to benefit a member of the grantor's family.

Example 5 deals with a qualified personal residence trust, or QPRT, described in reg. section 25.2702-5(c). The example concludes that the entire fair market value of the QPRT's assets is included in the grantor's estate if the grantor dies during the retained term. Presumably, the reference to the QPRT's assets and not just to the personal residence is to demonstrate that if assets in addition to the residence were in the trust at the grantor's death (for example, cash or a policy insuring the home), they too would be included. It would be more helpful if the example were expanded explicitly to cover those assets. The example fails to state what portion of the trust would be included in the grantor's gross estate if the trust had ceased to be a QPRT and had "converted" into a GRAT before the grantor's death as permitted in reg. section 25.2702-5(c), especially if the conversion occurred within three years of the grantor's death.

Conclusions

The proposed regulations, in acknowledging that section 2039 does not apply to a GRAT, GRUT, CRAT, CRUT, or QPRT, as well as limiting inclusion in the grantor's

¹⁶ See, e.g., Michael D. Whitty, "Heresy or Prophecy: The Case for Limiting Estate Tax Inclusion of GRATs to the Annuity Payment Right," 41 *Real Prop. Prob. & Tr. J.* 381 (2006) (suggesting that the bona fide sale exception might be a basis for rejecting inclusion under section 2036 with respect to a zeroed-out GRAT).

gross estate based on the principles in Rev. Ruls. 76-276 and 82-105, are helpful to taxpayers and their advisers in many ways. However, as demonstrated, the proposed regulations in some ways seem incorrect and in other ways seem incomplete. The proposed regulations should be modified to address the outstanding issues described in this article. In any case, the proposed regulations as written would have virtually no impact on the amount included in the grantor's estate with respect to most GRATs created today in which the grantor dies during the annuity term. Most GRATs provide very high payouts for very short terms. For example, if the annuity represents 50 percent of the initial value of the assets contributed to the GRAT, the trust property would have had to increase by the time of the grantor's death by more than five times its initial FMV to result in any part of the trust being excluded from the grantor's estate, even if the section 7520 rate were 10 percent. The lower the section 7520 rate, the greater the increase would have to be to result in any exclusion.