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The Effect of Volatility on Wealth Transfer Strategies in Light of the 2001 Tax Act

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I.   **Introduction**

    A.   Until the passage of the 2001 Tax Act, there was never any question that, from a tax planning standpoint, making gifts was a good thing. Now, however, the scheduled repeal (and probable return) of the estate tax has made things far less clear. No one wants to pay gift tax to make a transfer that could be made at death free of tax. On the other hand, if the estate tax is reinstated before its repeal becomes effective, as would not seem unlikely (or if its repeal simply sunsets, which seems very unlikely), the traditional advantages of transferring wealth during life will still apply. This uncertainty puts the taxpayer in a quandary; to give or not to give, and if so, how?

    B.   Compounding this conundrum is the effect the nature of the potential donor's assets has on the determination of how best to transfer wealth. While most advisors are familiar with the mechanics of various gifting techniques and have a general idea of their relative merits, the comparative results they produce under a given set of circumstances are rarely quantified. When such an attempt is made, almost invariably a uniform rate of return is assumed for purposes of the comparison. In reality, of course, any investment strategy, no matter how conservative, involves a certain level of volatility; if there was ever any doubt of that fact, it has been erased by the events of the last year. That volatility can have a tremendous and often unexpected effect on the predicted results of a wealth transfer strategy. Considered together with the prevailing uncertainty about

transfer taxes in general, the choice of a gifting strategy becomes far more complicated than merely looking at the expected result for a given rate of return. Techniques involving the grantor's retention of an interest in the transferred property have long been extremely popular because of the opportunity they offer to leverage the gift by achieving a real return that is higher than the discount rate used to value the gift. Central to these methods is the ability to reduce the amount of gift tax paid. The new law, pursuant to which the estate tax (but not the gift tax) is scheduled to be phased out and ultimately disappear, makes the avoidance of gift tax now all the more attractive.

C.	In this outline, six common transfer techniques are compared using an assumed rate of return based upon the historical performance of an actual portfolio. That portfolio's predicted level of volatility is then applied to the projections to determine its effect upon the results of each strategy. Finally, the expected results of the various methods are analyzed along a continuum of hypothetical portfolios with rising rates of return and volatility.

## II.	Wealth Transfer Methods to be Compared

A.	We will consider four variations on the transfer with retained interest theme: a single grantor retained annuity trust ("GRAT") with level payments, a single GRAT over the same term with annual payments escalating the maximum allowable 20% per year, a series of cascading GRATs over the same term and a sale to an intentionally defective grantor trust ("IDGT"). In addition, outright gifts to a non-grantor trust and to an IDGT are included in order to provide a baseline for comparison.

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B.   Central to any meaningful comparison of methods is a consistent set of parameters. This outline assumes the following:

1.   A ten-year time frame.

2.   A 43.74% combined federal and state ordinary income tax rate.

3.   A 24.14% combined federal and state capital gains tax rate.

4.   A 55% combined federal and state estate and gift tax rate.

5.   A section 7520 rate of 6.2% (the 7520 rate, which changes each month, recently has been in the 5.6% - 8% range).

6.   A 50-year old grantor.

7.   A $10 million dollar initial investment of cash or full-basis liquid assets.

C.   All gift and income taxes are paid by the grantor with other funds (except for the income tax in the gift to a non-grantor trust scenario, which is paid out of the trust assets) and, after being subjected to estate tax, deducted from the amount ultimately available for the beneficiaries.

D.   As a base a portfolio consisting of 90% equities and 10% fixed income (having a taxable yield of 2.31% and an annual appreciation rate of 6.99% with 30% turnover each year) is used for assets both contributed to the gift structure and remaining in the grantor's hands and for purposes of calculating the opportunity cost of the grantor's paying gift and income taxes with other assets.

1.   Later, when transferred assets invested in other portfolios with different growth rates are considered, the base mix is still assumed for determining the opportunity cost of the grantor's tax payments. Of course, all

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assumptions are hypothetical and may never be realized in actual experience.

E.   It is assumed all transferred assets are readily marketable and that no discounts are taken, so as to focus on the mechanics of the various strategies; in practice, obtaining credible valuations of assets is critical.

III.   **Outright Gift to Non-Grantor Trust**

A.   Making an outright gift is the simplest form of wealth transfer and, as such, serves well as a basis for comparison of other techniques.

1.   Assume the grantor makes a $10 million gift and pays the accompanying gift tax from other funds. The transferred amount is then invested at the assumed combined appreciation and income rate and income and capital gains taxes paid by the trust.

2.   The cost to the beneficiaries of the grantor having paid gift tax is reflected by the amount of the tax growing at the after-tax base rate and, at the end of the term, reduced by the estate tax that would be payable if the grantor had retained those funds.

3.   The balance is subtracted from the amount in the trust to arrive at the net benefit to the beneficiaries.

4.   As shown by Table 1, the net amount available to the grantor's beneficiaries at the end of the ten-year term is $14,941,478.

B.   As the making of an outright gift is very straightforward, so are its benefits.

1.   The object of giving something away is to get assets out of the donor's taxable estate, and the outright gift accomplishes that goal completely.

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2.   There is a cost, however, and that is the relatively large amount of gift tax that must be paid. So long as performance is good, the gift tax expense is merely an offset against the gross benefit of the gift. If, however, returns are poor, the initial outlay to pay the tax becomes a very significant drag on the overall effectiveness of the strategy.

   a.   That fact is illustrated by Table 2, as a 5.29% rate of return (the return on a portfolio made up of 10% equities and 90% fixed income; the reverse of our base portfolio) on the gifted assets reduces the net benefit of the gift to $8,762,465 over the ten-year term, and by Table 3, where a growth rate of –7.99% results in the intended beneficiaries receiving nothing.

3.   Obviously, taken further, the overall result would be a net cost to the beneficiaries. Although the success of an outright gift is not so overtly tied to beating a particular rate of return as the other strategies discussed in this article, the large initial payment of gift tax magnifies the impact of poor performance and, accordingly, the risk element inherent in a volatile asset.

IV.   **Outright Gift to IDGT**

A.   The gift to an IDGT scenario is identical to that of a gift to a non-grantor trust, except that now the grantor pays the trust's income tax with outside funds, effectively making additional tax-free transfers to the beneficiaries.

1.   The money spent to pay those taxes does cost the beneficiaries something, because it would otherwise have grown in the hands of the grantor and, after the imposition of estate tax, passed to the beneficiaries.

2.   As shown by comparison of Table 4 with the corresponding table for an outright gift to a non-grantor trust (Table 1), however, the net benefit of using the IDGT is substantial, with $17,404,130 available to the beneficiaries, as opposed to $14,941,478 with the non-grantor trust.

B.   Leaving aside the advantages of using an IDGT, the fundamental nature of an outright gift is unchanged. The payment of a large gift tax still increases the risk associated with poor performance, albeit to a somewhat lesser extent, because by paying the trust's taxes the grantor increases the beneficiaries' real rate of return across the board. Thus, the impact of the gift tax expenditure is reduced.

V.   **Long-Term (Ten-Year) GRAT with Level Payments**

A.   The third alternative to be considered is a single GRAT for a relatively long term, in this case ten years.

1.   The GRAT is "zeroed out" in accordance with the holding of Walton v. Commissioner, 115 T. C. No. 41 (12/22/00), which held Example 5 of section 25.2702-3(e) of the regulations to be invalid, and the annuity is calculated using the assumed section 7520 rate of 6.2%. Walton is very significant for purposes of our analysis as it allows a GRAT, unlike any of the other structures, to be used to transfer property completely free of gift tax consequences. Should Walton be overturned, either judicially or legislatively, the performance of the GRAT relative to the other methods

would be somewhat worse, with the difference growing as the donor's age increases. Assuming <u>Walton</u> stands, all growth in excess of that rate inures to the benefit of the remaindermen. As shown by Table 5, using the assumed rate of return the beneficiaries would receive $10,691,867 at the end of the term.

2. Obviously, both of the outright gift scenarios produce better results, but the GRAT has the advantage of the gift tax cost being reduced dramatically, and with it the risk associated with a large initial outlay being followed by poor performance.

B. Although the GRAT only "works" if the actual return exceeds the discount rate (otherwise everything is paid back to the grantor and nothing is left for the remaindermen), the grantor's family is no worse off if that hurdle is not met than they would have been had he done nothing (except for any transaction costs and, if <u>Walton</u> is overturned, a small amount of gift tax paid).

1. Because the initial GRAT involves little or not gift tax outlay, the downside risk is drastically reduced when compared to an outright gift and the danger of paying an unnecessary tax if the estate and gift taxes are repealed or modified is eliminated.

2. Of course, inherent in a GRAT is the chance of the grantor dying before the end of the trust term. (That mortality risk is ignored for purposes of this purely numerical analysis. In that regard, however, it should be noted that in <u>Estate of Gribauskas v. Commissioner</u>, 116 T. C. No. 12 (3/8/01), the Tax Court held that for purposes of calculating the value of the annuity

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amounts includible in the estate of a lottery winner under section 2039, section 7520 applies. This situation is clearly analogous to a GRAT and suggests that so long as there is no reversion, which after <u>Walton</u> there should not be, only the actuarial value of the remaining annuity payments are includible in the taxable estate, not the entire corpus, as the Service has always argued in the past). The possibility of inclusion might also be addressed by having the grantor purchase the remainder interest (during the GRAT term) from the remainder beneficiary, thus removing the sales proceeds from the grantor's taxable estate, should he or she die prematurely. This strategy appears to work from a purely technical standpoint, although it would almost certainly be challenged by the Service as having no independent economic substance.

C.   The need to outperform the section 7520 rate in order for the strategy to be "successful," combined with the fact that a sizable portion of the initial investment comes back to the grantor in the form of an annuity, means that, although the ultimate downside risk is reduced, the expected return of the strategy from the beneficiaries' point of view is also lower. Thus, to the extent the goal of a transfer strategy is to get as much as possible out of the grantor's hands, a GRAT is relatively inefficient.

VI.   <u>Long-Term (Ten-Year) GRAT with Escalating Payments</u>

A.   The fourth structure is a variation on the third; a ten-year zeroed-out GRAT with annual payments that increase by 20% each year (the maximum increase allowed under Section 2702).

1. The potential of an escalating GRAT is dependent upon a steady increase in the value of the trust assets throughout the term. This allows a larger portion of the total amount retained by the grantor to be paid with more highly appreciated assets, thus leaving more in the trust at the end of the term. In other words, if the GRAT is funded with stocks, fewer shares will be required to meet the annuity commitment, leaving more shares for the remainder beneficiaries.

2. As shown by Table 6, using an escalating annuity instead of a level annuity results in the beneficiaries receiving $11,176,844 at the end of the term; nearly $500,000 more than they got under the standard GRAT scenario.

3. It should be noted that an escalating GRAT is clearly advantageous only when values rise. If there are downturns during the later years of the GRAT term, the escalating structure may produce worse results than would be bad with level payments.

VII. **Sale to IDGT**

A. Compared to a GRAT, a sale of assets to an IDGT in return for a note has the advantage that the note must carry interest at the applicable federal rate ("AFR") rather than the section 7520 rate, which is roughly equal to 120 percent of the mid-term AFR. Furthermore, the note can be structured as an interest-only loan with all principal repaid at the end of the term.

1. It must be noted that the strategy requires the trust to have sufficient other assets ("coverage") to reduce the loan-to-value ratio to realistic levels.

Generally, coverage equal to 10% of the loan amount is considered to be sufficient, although many practitioners are more comfortable with 20%. In order to make the comparisons as consistent as possible, the coverage amount is treated as a gift from the grantor. Thus, although the sale itself does not involve a gift, the overall strategy, when looked at as an alternative to other forms of transfer from the grantor, does have a gift element. Many practitioner feel comfortable relying upon the grantor's guarantee to fulfill the coverage requirement, which obviates the need for a gift. For our purposes, so long as performance is good (and bearing in mind that, if the estate tax repeal ultimately comes to pass, gift tax will have been paid unnecessarily, the relatively large gift (compared to the GRAT) enhances the effectiveness of the strategy, as more is given away and less returns to the grantor's estate as part of the retained interest.

2.   That fact, combined with the superior economics of a sale to an IDGT, make it better than a GRAT, on a purely numerical basis, with a net amount passing to the beneficiaries of $13,048,780, versus the $10,691,867 produced by the GRAT (see Table 7). Of course, if the estate tax ultimately is repealed, paying the tax on a larger gift will not have been advantageous.

B.   There are, however, several disadvantages to the sale.

1.   If the trust property depreciates, the grantor might be left with a receivable that is greater than the value of what remains in the trust to pay off the note. Thus, under certain circumstances, the strategy could create estate

tax liability based upon phantom assets. The note might be written down, but the burden would be on the executor to establish a value less than the face amount of the note. Although such a reduction should be allowed if the note is properly drafted, the close relationship of the parties and obvious tax-driven nature of the transaction virtually ensure close IRS scrutiny.

2. Similarly, unlike a GRAT, a sale to an IDGT does not have the imprimatur of the Code and regulations and, therefore, might be more subject to general attack by the Service (e.g., on the theory that it is not truly a sale, but instead a transfer with a retained interest that is neither a qualified annuity nor a qualified unitrust interest).

3. Finally, although not an issue in our example, which assumes a sale of unappreciated property (so as to focus only on the transfer tax aspects of the various strategies), the death of the grantor while the note is outstanding could result in the immediate recognition of gain because the trust loses its grantor status.

VIII. **Cascading Short-Term GRATs (nine two-year GRATs over a ten-year term)**

A. This strategy is a variation on the standard single GRAT. The grantor's initial investment is the same, but instead of committing for ten years, he establishes a GRAT with a two-year term and then rolls the first annuity payment into another GRAT, and so on, with the overall result of creating nine two-year GRATs over a ten-year period (annuities could be rolled into new GRATs indefinitely or the

grantor could abandon the strategy at any time; a ten-year time frame is used here in order to be consistent with our other models).

1.   Table 8 illustrates the structure of the cascading GRATs. To the extent any particular GRAT outperforms the section 7520 rate, that excess passes to a trust for the beneficiaries, which is itself an IDGT. Applying the assumptions we have used throughout (and assuming <u>Walton</u> is upheld), at the end of the ten-year period the beneficiaries would have $12,085,357 (see Table 9), a considerably better result than that produced by either of the single GRATs and approaching that of the sale to an IDGT.

B.   It should be noted that if Example 5 of section 25.2702-3(e) of the regulations applies, cascading GRATs involve the payment of more gift tax than a single GRAT (because instead of one gift there are nine, albeit smaller and largely deferred, gifts). In addition, GRATS must use a higher discount rate than the sale to an IDGT. Nevertheless, the fact that only the last annuity payment from GRAT 8 and both annuity payments from GRAT 9 return to the grantor ensure the superiority of the cascading GRATs over the single GRAT. Under <u>Walton</u>, all of the GRATs are zeroed out and the disadvantage of a larger aggregate gift with the cascading GRAT structure disappears. Also, the grantor has a better chance of surviving the term of each shorter GRAT, and thereby ensuring that the overall strategy will be at least partially successful (assuming that the assets in the trust grow sufficiently), than of living to the end of the entire ten-year period. Conversely, because each GRAT is a completely separate entity, the grantor assumes the market risk of rising discount rates by not locking in a favorable rate

at the outset. Of course, that could be a good thing, as rates can fall as well as rise.

IX.   **Comparison of Results**

A.   Comparing the various wealth transfer methods discussed above using the assumed base rate of return, an outright gift to an IDGT is the clear winner, followed by a gift to a non-grantor trust, a sale to an IDGT, cascading GRATs , a single long-term GRAT with escalating payments and a single long-term level-payment GRAT, in that order.

1.   That this should be the case is not surprising; making gifts is a good thing and the bigger the gift, the greater the benefit to the recipients. Both outright gift scenarios maximize the amount transferred and the use of an IDGT goes further by effectively allowing the grantor to make tax-free gifts of the income tax he pays on behalf of the trust, thus increasing the internal rate of return of the transferred assets.

2.   The other strategies all involve the retention by the grantor of some interest in the transferred assets as the price of reducing or eliminating the taxable gift. The smaller gift translates directly into a larger taxable estate for the grantor and, unless the actual rate of return is extraordinary, less for the beneficiaries.

3.   As the rate of return falls towards the discount rate, the various retained interest strategies edge closer and closer to doing nothing and leaving everything in the grantor's hands. That approach certainly reduces gift

tax, but the goal is not to reduce tax, it is to get as much as possible to the beneficiaries.

B.   Only when the rate of return is so high that the retained interest becomes insignificant, or so low that the cost of paying the greater gift tax overwhelms the benefit of the transfer itself, can the outright gift be beaten. That fact is not readily gleaned from traditional projections, which assume fixed performance, almost always at a rate somewhat, but not dramatically, higher than the prevailing section 7520 rate.

   1.   Illustrations can be done at very high or low rates (see Tables 10 and 11, comparing the various strategies at −10% and 50% rates of return), but generally are of largely academic interest, because virtually all portfolios can be expected to perform moderately well. Although some investments offer potentially astronomical returns, usually they are also the most likely to fail completely; accordingly, it is difficult to project an expected return for those investments without factoring in their volatility, as discussed below.

   2.   Similarly, very low or negative returns would never be projected as an expected result, but may well occur as the byproduct of that same volatility. It is the unexpected that must be taken into account; the extremes of performance that probably will not, but might, occur.

C.   Quantifying the likelihood of the entire range of possible results is fundamental to understanding the risk associated with any wealth transfer strategy. The interplay of risk and return is basic to portfolio theory, but usually ignored when analyzing

how best to pass wealth. As shown below, however, the introduction of volatility to the equation can dramatically change the potential and, in many cases, expected results of a strategy.

X. **The Mechanics of Volatility**

    A.   The term volatility is used in many contexts, but generally connotes unpredictability. In mathematics volatility dictates that, regardless of the expected rate of return, any individual result can occur randomly within a broad range of possible results. As more and more examples are added they form a bell curve, with the results normally distributed along the curve, and the statistical measures of mean and standard deviation can be used to describe that distribution. Thus, although any one result is indeed essentially unpredictable, the volatility of the asset itself and, therefore, the range of its probable performance, can be quantified.

    B.   The expected rate of return represents the mean of the sample distribution and is situated at the apex of the curve. The standard deviation is the basic tool for summarizing the randomness of a situation; it is the number that expresses the breadth of the band within which individual outcomes typically will occur.

        1.   The higher the standard deviation, the wider the range of probable results and the more volatile the portfolio. What this means in concrete terms is that 68.6% of the outcomes will fall within a range equal to one standard deviation on either side of the mean and 95% within a range equal to two standard deviations.

2.   The 90/10 equity/fixed income portfolio used as the base case throughout this outline has a standard deviation of 11.9%. Thus, 68.6% of the time the rate of appreciation will fall within a range of –4.91% to 18.89%, centered upon the expected appreciation rate of 6.99% (it is assumed the yield is fixed; although there might be some change over time, it would be caused and, theoretically, offset by the underlying market fluctuation already reflected in the volatility of the appreciation rate).

3.   Table 12 illustrates this distribution; the possible results of the portfolio lie within a very broad band, and the probable results within two standard deviations, with the likelihood of any single result increasing as it approaches the expected mean growth rate.

XI.   **The Effects of Volatility on a Transferred Assets Invested in a Particular Portfolio**

A.   Every portfolio, no matter how conservative, carries with it a certain level of volatility. Only if the effect of that volatility is taken into account can a projection of results assuming an expected rate of return be meaningful.

1.   As noted above, the strategies involving retained interests (GRAT, escalating GRAT, cascading GRATs, sale to an IDGT) exhibit high upside potential relative to the outright gifts, because at very high rate of return the grantor's retained interest, determined using the value of the applicable discount rate (either the AFR or the section 7520 rate) becomes less significant (see Table 11).

2.   Conversely, the possible downside of an outright gift is greater than that of any of the retained interest structures because, if things go badly (i.e.,

return is extremely low or negative), the beneficiary will receive very little, yet the family will be out-of-pocket the higher gift tax paid (see Table 10). The worst that can happen with a GRAT or sale to an IDGT (leaving aside the risk of dying during the term of the former) is that it does not "work," in which case the beneficiaries get nothing and the grantor is left with approximately what he would have had if he had done nothing. The only loss to the family is the much smaller gift tax, which, under Walton, is reduced to zero for the GRAT structures (and the transaction costs of setting up the strategy, an insignificant amount that has been ignored in our projections).

B. That the retained interest strategies have great upside potential and more limited downside risk generally does not alter the fact that outright gifts offer higher expected results for the same reasons discussed above. The introduction of volatility does not affect the internal mechanics of most of the structures; the ultimate outcome is dependent upon the average performance over the entire term. That fact is illustrated by Tables 13, 14, 15, 16 and 17, which show that the application of volatility to the outright gift, outright gift to an IDGT, long-term level-payment GRAT, long-term escalating GRAT and sale-to-IDGT strategies at the 9.30% base return has little effect.

C. The notable exception to this general rule is the cascading GRAT, as shown by Table 18. There, volatility only elucidates the possible results.

1. By dividing the overall term into a series of shorter terms, the result of each of the latter becomes significant, and the results of the strategy as a whole are a function of the aggregate results of those discrete terms.

2. A GRAT is successful whenever the performance over the term is greater than the pertinent discount rate. If that rate is not attained, the GRAT fails; it does not matter if the return was slightly less than the discount rate or disastrously low.

3. When volatility is taken into account, some years will be very good and some very bad. Because a cascading GRAT structure splits the overall term into a series of shorter terms, the effect of each good two-year period, which translates into a successful GRAT, inures to the benefit of the remaindermen, undiluted by the bad two-year periods, the effect of which is absorbed by the grantor. Had the same results occurred in a single GRAT, or any other strategy covering the same term, the bad years would drag down the good years, reducing the overall rate of return.

4. This is illustrated by two simple examples (Tables 19 and 20), which assume the grantor contributes $100 to a 5-year "zeroed-out" GRAT or, alternatively, that he creates a series of four 2-year "zeroed-out" GRATs over the same term.

5. With the single GRAT, nothing is left for the remaindermen, as the performance of the assets has been insufficient to cover the annuity payments due the grantor.

6. By splitting the single GRAT into a series of shorter-term GRATs, it is possible to take advantage of the positive performance of the first two-year period and the last two-year period (GRATs I and IV) without diminution by the second and third two-year periods (GRATs II and III), the negative effects of which are absorbed by the grantor. In other words, the remaindermen get the benefit of the spikes of good performance that occur over the course of the term, even though the average rate of return for the term as a whole is only 3.73%; well below the 6.2% section 7520 rate. Thus, when applied to cascading GRATs, volatility adds not only uncertainty and a quantification of the probable extremes of performance, it improves the expected results of the strategy for the beneficiaries by giving them more of the benefit of up-years and shifting more of the detriment of down-years to the grantor. Accordingly, the probability of an overall good result is increased and the risk of a bad result diminished as projected return, and the concomitant volatility, rise.

XII. **The Efficient Frontier of Wealth Transfer**

A. So far, this outline has considered the effect of a given portfolio's inherent volatility on the possible results of various wealth transfer strategies. The next step is to compare the expected results of those strategies along a continuum of increasing average return and volatility. In this way, the optimal portfolio can be chosen for a particular strategy, and vice versa, just as the portfolio itself is constructed to maximize expected return within the bounds of an acceptable level of volatility.

B.   Tables 21 and 22 chart the relationship of return and volatility and expected results of the various wealth transfer methods. At low to moderate return/volatility mixes, the outright gifts produce better results than any of the retained interest strategies because a low rate of return makes the gift element of the latter relatively small or, to the extent the discount rate is not met, nonexistent.

    1.   In addition, as the probability of extremely poor performance decreases, so does the risk of the benefit of an outright gift being outweighed by the cost of the gift tax paid. As return/volatility rises, so do the expected results of both GRAT and the sale-to-IDGT methods relative to those of the outright gifts (as shown in Table 21 by the flattening of the outright gift curves, while the sale-to-IDGT and GRAT curves rise).

    2.   That is because the real value of the retained interest becomes less and less significant and the gift element concomitantly greater. Also, the effect of possible bad results on a retained interest strategy is mitigated because of the relatively small gift tax outlay it entails.

C.   Statistically, expected return rises with increased volatility only to a certain point. Practically, however, that fact is somewhat misleading, as an investor in a risky venture, such as a young internet company, would be more interested in the potential for astronomical returns than the expected return, which would have to take into account the high probability of failure. Thus, although the acceptance of increased volatility does not result in an ever-rising expected rate of return, an investment in a risky venture with potentially great returns does entail high volatility.

D.   As illustrated by Table 22, at very high return/volatility ratios, the cascading GRAT looks significantly better than any of the other strategies because, in addition to the beneficial effects of rising rates, volatility itself becomes a positive force, as described above. Unlike the other methods, with respect to which increased volatility is merely a component of the attendant increased average rate of return, the cascading GRAT derives an independent advantage from the portfolio's volatility.

XIII.   **Conclusion**

A.   In analyzing the effectiveness of a wealth transfer strategy, the volatility of the assets in which the funds committed to the strategy are invested is just as important as their projected rate of return. Outright gifts start off with a substantial advantage over retained interest transfers at moderately low returns, which gradually lessens as returns rise (at a quickening pace once the discount rate is exceeded) and ultimately disappears as the value of retained interest becomes relatively insignificant. This trend is accelerated and intensified when the retained interest structure is divided into a series of short-term pieces, in the cascading GRAT scenario, thus turning volatility from a byproduct of rising returns into an independent component of the overall result calculation.

C.   Just as the benefit of rising returns is incrementally greater in the retained interest scenarios, so is the likelihood of a bad result because of the volatility attendant upon those higher rates reduced. By requiring the commitment of a smaller amount to pay gift taxes, the total amount at risk is less than is the case with an outright gift, especially in light of the scheduled repeal of the estate tax. Thus,

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even at levels where the expected result of an outright gift is more, the probability of an extremely good result is greater and of an extremely bad result less with a retained interest structure. This is doubly true with the cascading GRAT structure, where volatility becomes a positive force. Only by considering both the expected return and volatility of a portfolio can a meaningful assessment be made of how various transfer strategies using that portfolio will turn out. Similarly, unless volatility is taken into account, no projection of results at a given rate of return can be truly understood.