

TRUSTS & ESTATES

QUARTERLY

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A goal of the *Quarterly* is to foster the free flow of ideas regarding trust and estate law. Accordingly, individual authors may offer their own opinions about or interpretations of the law. The views of the authors do not necessarily reflect the views of the editors, the California Lawyers Association, or its Trusts and Estates Section.

Please direct any inquiries regarding republication of any article in the *Quarterly* to the Editor-in-Chief. Such permission is generally granted on the condition that initial publication attribution be given to the *Quarterly*.

LETTER FROM THE CHAIR

Written by Judith P. Hehir*

The Editor-in-Chief has gently reminded me that it is time for my Letter from the Chair.

As I write this, we are in a heat wave here in Marin County, and it feels like summer is winding down. Even though it is early August, school is back in session for many, and fall is around the corner. I find myself thinking about how quickly time passes and how everything keeps changing. It is a cliché, but an accurate one, and I am feeling it very profoundly. I have never been a fan of change.

I have been practicing law for over 40 years. Even after all this time, I find there is always something new to learn. Even though some days I feel as though I have seen it all, I am reminded on a regular basis of how much I do not know.

We deal with change every day in our practices. Some of us work with clients to plan for the unexpected and the inevitable. Some of us help clients navigate planned and unplanned major life changes. Some of us help find solutions when there are disagreements or differences of opinion within families. We offer valuable assistance to our clients throughout the many chapters of life and in times of need. I find a great deal of satisfaction in this practice.

Much of that satisfaction comes from the opportunity to work with the community of professionals in trusts and estates law. It is a collegial network, encouraging collaboration with a commonality of high regard for our clients and the work we do.

I have been a member of TEXCOM for nine years. I had no idea when I joined that it would be such an amazing and enriching experience. TEXCOM members practice all over California, in solo, small,

medium, and large firms and organizations with comprehensive expertise in trusts and estates law. The engagement and synergy of this group is special.

We welcome new members every fall, and at the same time, we bid farewell to members who have completed their six-year term and “roll off” of TEXCOM. Six years seems like a very long time, yet it passes too quickly.

The members “rolling off” this year have contributed greatly to the practice of trusts and estates law in California and to TEXCOM. We will miss each of them, not only for their contributions, but also for the energy, intellect, and personality they have brought to the group. Each has been a strong leader of TEXCOM.

Kimberly McGhee is Chair of the Incapacity Committee. We have relied on Kim for her expertise to navigate issues related to incapacity for her entire tenure on TEXCOM. Kim offers invaluable guidance and practical assistance on matters relating to conservatorships, incapacity, and elder law. She conducted review and analysis of proposed legislation and provided her wisdom and knowledge in the application of the law in protective proceedings and all issues related to incapacity. Kim has a high level of specific expertise and has generously shared it through presentations and webinars to bring attention and insight into these important matters. Kim has contributed to the *Quarterly* and has served as a moderator and as a guest on TEXCOM's “Trust Me!” podcast, sharing her experience and providing education and practical advice. Kim is bright, energetic, and caring; and she has enlightened all of us with her dedication and perspective and brought tremendous energy to TEXCOM during her tenure.

Anna Soliman is Chair of the Trusts & Estates Administration Committee. Anna has been instrumental in advancing legislative proposals by TEXCOM that were ultimately enacted by our Legislature. She worked on the California Uniform Directed Trust Act, the virtual representation statute, and led the effort resulting in revision of the small trust termination statute, to name only a few of her legislative accomplishments. She managed the process with steadfast patience, and clear communication, working with fellow TEXCOM members and stakeholders, never losing sight of the purpose of the legislation.

Anna served as Co-Chair of the committee that is now known as Membership & Engagement. She had the responsibility of managing the “Trust Me!” podcast. She organized and moderated the podcast and arranged for speakers on various topics of interest to trusts and estates practitioners. As a result of Anna’s efforts, the “Trust Me!” podcast is very successful and a source of pride for TEXCOM. Anna is a frequent speaker on estate and tax issues and has contributed articles to the *Quarterly*.

Anna is also our unofficial (and self-appointed) social director and has successfully created opportunities for TEXCOM to connect as a group. Anna is smart, dynamic, and enthusiastic; and her contributions will be remembered for years to come.

Judith Tang is Chair of the Estate Planning Committee, served as Chair of the Ethics Committee, and served as Chair of the Uniform Laws Committee. Judith advocated on behalf of TEXCOM for revisions to legislation to ensure that proposed laws do not negatively impact our members or their clients. She led the effort to update the durable power of attorney statute, which was an unexpectedly complicated project. Judith persevered, kept the legislation on track, and saw it through to the end.

Judith has a high level of legal and practical knowledge and an impressive attention to detail. As a result of her meticulous review and monitoring of legislation, she identified problematic issues and worked with TEXCOM members, legislators, and stakeholders to improve proposed legislation on many occasions. Judith brings experience and skilled analysis to her work on TEXCOM.

Judith has elevated TEXCOM through her leadership, listening skills, and thoughtful participation. She is conscientious, organized, articulate, and engaging. If there were an attendance award, it would go to Judith, who has rarely missed a meeting.

Ryan Szczepanik is Chair of the Litigation Committee. He has served as Co-Chair of the Legislation Committee, is a member of the *Quarterly* editorial board, served as TEXCOM’s liaison to the Probate and Mental Health Advisory Committee (PMHAC), and served as the TEXCOM representative for the California Law Revision Commission (CLRC). Ryan is a regular contributor to the *Quarterly*. He has made presentations at in-person events and webinars. He has worked on countless projects to improve California law. Ryan is the person called on to get things done when necessary. He has a high level of expertise and is knowledgeable in many areas of trusts and estates law. He is intelligent and thorough and explains complex issues with ease. Ryan has a gift for connecting authentically with others and putting them at ease, both professionally and personally. He has represented TEXCOM with expertise, diplomacy, and grace.

Mary deLeo, our esteemed former officer, is rolling off TEXCOM after 11 years. Mary is a strong committed leader and mentor. Mary served as Chair of TEXCOM, and as highlights, Mary served as Chair of the Legislation Committee, Chair of the Education Committee, Editor-in-Chief of the *Quarterly*, Chair of the Litigation Committee, and TEXCOM liaison to the Probate and Mental Health Advisory Committee (PMHAC), just to name a few of her accomplishments. Mary has also contributed to the *Quarterly* and has been a guest on the “Trust Me!” podcast. We have Mary to thank for providing an opportunity for CLE credit in each issue of the *Quarterly*. Mary has been the heart of TEXCOM during her tenure. She has participated fully at every level and has given generously of her time and knowledge to TEXCOM, and somehow made it look easy. It is hard to imagine TEXCOM without Mary.

Erin Norcia will relieve me as Chair of TEXCOM in October. Erin presently serves as Vice Chair and Treasurer of TEXCOM, is on the Long Range Planning Committee, served as Editor-in-Chief of the *Quarterly*, and was Chair of the Litigation Committee. Erin

brings a great deal of experience and knowledge and is a valued member of TEXCOM. She is capable, thoughtful, focused, and very positive and witty. I am looking forward to Erin's year as Chair.

Matt Owens, Editor-in-Chief of the *Quarterly*, will become Vice Chair of TEXCOM in October. Matt has served as Chair of the Membership & Engagement Committee, and Vice Chair of the Litigation Committee. He is a regular contributor to the *Quarterly*, has participated in webinars and speaking engagements, and served as a guest and as a moderator on the "Trust Me!" podcast. Matt works at a high level and has made significant contributions to TEXCOM, always with a smile and easy manner. Matt and Erin will be a great team.

Thank you to the trusts and estates community and to the TEXCOM members who give their time in

service to the profession and our colleagues. Many of you have been part of TEXCOM, as members or volunteers, writing articles for the *Quarterly*, participating in webinars, volunteering as guests on the "Trust Me!" podcast, and contributing in countless other ways. We cannot do the work we do without your support and participation.

It has been a privilege to serve as Chair of TEXCOM. My goal this year was full participation. We achieved that goal and had a productive and successful year. In the process, I was able to listen and learn, and enjoy the expertise, gifts, and talents of our incredible committee members.

It was a joy. Thank you!

**Attorney at Law, Novato, California*



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LETTER FROM THE EDITOR-IN-CHIEF

Written by Matt Owens*

That's a wrap! This is my final Letter from the Editor-in-Chief (EIC) as this TEXCOM year is coming to a close in October. The *Quarterly* will be in good hands next year when Kristin Yokomoto takes over the EIC role. For my final issue as EIC, I am pleased to say we are closing out strong with four excellent articles, in addition to the perennially timely and informative Tax Alert and Litigation Alert.

We begin with *Proposition 40: California Billionaires in the Crosshairs*. With Proposition 40 headed to California's November ballot, authors Ryan Szczepanik and Jennifer Scharre offer a timely and detailed examination of the 2026 Billionaire Tax Act—a first-of-its-kind wealth tax that would impose a one-time five percent tax on residents with a net worth of at least \$1.1 billion, with a reduced rate for net worth exceeding \$1 billion but below \$1.1 billion. The proposed billionaire tax may be the hottest topic of the season, and this article serves as an efficient way to get yourself up to speed and into the conversation with clients and colleagues.

Next up is *Before We Proceed: Confronting the Tax Consequences of Trust and Estate Settlements*. In this article, Brandon Spivack and Kevin Holt cover five real-world settlement scenarios, revealing how—absent proper consideration of tax consequences—each one can quietly undermine an otherwise favorable deal. Complete with detailed examples and practical checklists at the end of each section, the article makes a compelling case for bringing tax counsel to the table before settlement terms are finalized, not after.

We then turn to *Breslin v. Breslin Mediations, Five Years Later: Valuable but Vastly More Complicated*. In this article, the Honorable Mary Thornton House (Ret.) shares her insights on the impact that *Breslin* has had on mediations since the case was first published in 2021. Judge House examines trustee liability for notice failures, fiduciary duty breaches, attorney malpractice risks, and ethical violations under the California Rules of Professional Conduct. Packed with practical tips for every stage of the process, the article helps readers anticipate and prepare to defend against challenges to settlements reached at *Breslin* mediations.

Rounding out the articles is *Sliding Scales and Davy Jones: How Complex Is Your Will?* In this article, John Rueppel tackles the thorny issue of the sliding scale of capacity from the *Andersen v. Hunt* case, which told us simpler, will-like documents only require testamentary capacity while more complex documents like trusts require contractual capacity. The author contends the *Andersen* framework has created fertile ground for costly litigation over the subject document's complexity, creating a new topic for expert witness testimony. The article proposes a bold fix—eliminating Probate Code section 6100.5 in favor of the sliding-scale standard of sections 810-812—so courts can evaluate capacity based on a document's true complexity, regardless of whether it is labeled as a will or a trust.

As always, this issue includes both a Tax Alert and a Litigation Alert, covering recent developments in those areas. The Tax Alert is from my colleagues at Sheppard led by my friend and law partner, Jenny

Bratt. The Litigation Alert is from the Withers team led by Michael Brophy and Courtney Sorensen. I greatly appreciate the teams at both firms for taking the time to keep us all updated on important developments through the high-quality and timely alerts.

Before I sign off as EIC, I would like to thank the editorial board of the *Quarterly* for all their hard work over the past year, particularly executive editors Ryan Szczepanik and Kristin Yokomoto. We had a lot of work to do this year to restore the *Quarterly* to its regular publication schedule, and everyone on the team stepped up, responding to my countless—and surely annoying—check-in emails on assignments and editing rounds. The volume of volunteer attorney hours that goes into the *Quarterly* each year is truly astounding, and would undoubtedly outrage all of our

law firm CFOs and managing partners if they knew how much otherwise billable time we spend on this beloved publication!

Finally, thanks to all of you for your continued interest in the *Quarterly*. It was my honor to carry on the EIC tradition this past year. As *Quarterly* editors, we know there is a loyal and dedicated audience out there—populated with smart, experienced trust and estate lawyers—that has read and valued this publication for years. We hope we did our part to deliver quality, interesting content as we endeavored to keep this longstanding TEXCOM tradition alive.

Now, please enjoy this issue!

** Sheppard Mullin Richter & Hampton LLP,
San Diego, California*

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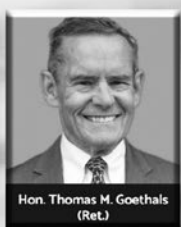
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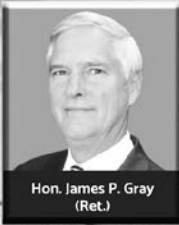
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PROPOSITION 40: CALIFORNIA BILLIONAIRES IN THE CROSSHAIRS

Written by Ryan J. Szczepanik, Esq.* and Jennifer Scharre, Esq.**

I. SYNOPSIS

In November, California voters will get to decide if we really get to eat the rich or at least get them to pay for food stamps. Proposition 40, called the “One-Time Wealth Tax for State-Funded Healthcare, Education, and Food Assistance Programs Initiative,” also known as the 2026 Billionaire Tax Act (the “Act”) represents a potential seismic shift in modern American tax policy. The Act proposes a wealth tax, not an income or wealth transfer tax. The tax is imposed on “the activity of sustaining excessive accumulations of wealth.”⁰¹ Perhaps we are living too long, or planners have become too effective, but the Act rejects the idea that the traditional levers of taxation are adequate.

The Act imposes a one-time tax on the net worth of individuals who are California residents on January 1, 2026, and have a net worth exceeding \$1 billion as of December 31, 2026. Married couples are evaluated on their combined net worth. The Act exempts from net worth some assets including real property held personally or in a revocable trust and most traditional retirement account assets (subject to value limitations). Importantly, the net worth of an individual includes the value of assets in certain irrevocable trusts funded by that individual.

The tax rate is 5 percent if the individual’s net worth is at least \$1.1 billion. That 5 percent rate is reduced by 0.1 percent for each \$2 million by which a person’s net worth is less than \$1.1 billion, making the rate at exactly \$1 billion 0.0 percent. Other than a modest \$5 million exclusion for some property, there is no exemption like a traditional estate tax.

As of the time the authors wrote this article, it is uncertain whether the Act will become law. The Act will appear on

California’s November 3, 2026 election ballot and, if it receives a 50 percent plus one vote, and no competing measures on the ballot receive more votes,⁰² it will take effect after the secretary of state certifies the election results. The story may not end there, however. Court challenges likely will be filed on several grounds that may delay or invalidate the Act.

From a substantive perspective, the Act contains several provisions that may be susceptible to multiple interpretations or operate to create an unexpected result. In contrast to legislation, the ballot initiative does not have legislative history that may be used to interpret such provisions. No court has issued a decision interpreting any provision of the Act. Accordingly, taxpayers must navigate the implications of the tax with only the text of the Act as a guide. This article attempts to assist in that effort.

II. THE PROPOSED ACT

A. The Wealth Tax Debate

It is not unusual to tax a taxpayer’s growth. A capital gains tax does just that but is imposed only upon realization. So long as an asset is held, appreciation is not taxed, regardless of how long that appreciation accumulates. In an era of longer lives and intergenerational planning, holding appreciated assets for long periods of time can compound gains free of tax.

Publicly traded securities typically are not held for such long periods of time, because of market dynamics and asset allocation positioning in reaction. However, tools such as tax loss harvesting are available to limit the taxation of gains on their disposition. Further, where growth is significant, taxpayers have also become adept at the buy, borrow, die

strategy to take advantage of use of the assets without imposition of capital gains tax and obtain a step up in basis at death. While this strategy may trigger estate tax, it avoids the combined income and estate tax hit on that wealth.

Closely held businesses and unique assets, on the other hand, are often held for decades, which can eliminate the tax on their gains entirely. Control, dividends, borrowing power, and lifestyle consumption can all be extracted without triggering realization. These assets are also often structured in a way that when transferred at death, their values can be heavily discounted to decrease the true rate of tax on that wealth.

Death historically served as a backstop. Even if gains were never realized during life, the owner's passing would trigger a substantial estate tax. Today, however, the lifetime estate and gift tax exemption has risen to a historic \$15 million level. The Joint Committee on Taxation estimates the loss of revenue due to the increased exemptions to be almost \$167 billion over 10 years.⁰³ Planning techniques can further mitigate the estate tax for individuals with a net worth exceeding the lifetime exemption. Planners have become adept at accomplishing extensive wealth transfer without triggering significant tax. In short, the death backstop has weakened and given substantial longevity gains, it takes much longer to get there.

Proponents of a wealth tax have relied on this rationale to argue that the time is ripe for such a tax. They argue that when wealth behaves so that it is persistent, appreciating, and untethered to realization, the traditional tools of taxation lose traction, and a wealth tax is the only cure for a society marching toward yet greater wealth inequality.

Critics contend that a wealth tax discourages investment, is administratively impracticable including through valuation disputes and prohibitive costs, and the inevitable reaction is the migration of entrepreneurs and businesses out of state resulting in the frustration of innovation and a vastly diminished tax base. They point to deleterious economic data of wealth tax regimes in Europe and elsewhere. They warn that a wealth tax triggered at a \$1 billion threshold creates an easily adaptable blueprint for a more widely applicable future tax triggered at a lower threshold.

B. The Purpose of the Act

The stated purpose of the Act is to raise funds to replace the federal government's cuts to Medi-Cal, the Supplemental Nutrition Assistance Program ("SNAP"), and other federal programs. It is clear from the text of the Act, however, that motivations for the Act include growing wealth inequality and large amounts of untaxed, unrealized asset appreciation among the wealthy.

The Act arrives against the backdrop of several wealth tax proposals having recently been introduced at the federal level. In 2025, several Democratic lawmakers including Senator Ron Wyden introduced the "Billionaires Income Tax Act" that proposes a mark-to-market tax on annual capital gains of tradeable assets for taxpayers with a net worth exceeding \$1 billion or who earn more than \$100 million in annual income. In 2026, Senator Bernie Sanders and Representative Ro Khanna introduced the "Make Billionaires Pay Their Fair Share Act" that proposes a 5 percent annual tax on taxpayers with a net worth of at least \$1 billion. That same month, several Democratic lawmakers including Senator Elizabeth Warren introduced the "Ultra-Millionaire Tax Act of 2026" that proposes a 2 percent annual tax on the net worth of households and trusts over \$50 million, a 1 percent annual surtax (for a 3 percent tax overall) on the net worth of households and trusts above \$1 billion, and anti-avoidance measures including a 40 percent exit tax on the net worth above \$50 million of any U.S. citizen who renounces their citizenship.

More recently, several Democratic lawmakers including Senator Wyden introduced the "Fair Trusts for Fiscal Responsibility Act" that proposes an annual withholding tax on trusts with an asset value of at least \$50 million that is creditable against future estate tax liability. Even Governor Gavin Newsom who has spoken out against the Act advocates for a federal wealth tax of some kind.⁰⁴

While several states also have recently proposed or passed legislation (such as Massachusetts and Washington) that increases taxes on the wealthy, those measures increased the income tax. California's proposal, in contrast, imposes a wealth tax, a totally new type of tax regime.

C. Who Is Subject to the Tax?

Planning requires moving past the Act's rhetoric and into its mechanics including who is covered. The tax is imposed on an "applicable individual" with \$1 billion of net worth or more measured as of the "valuation date," which is December 31, 2026,⁰⁵ and on "applicable trusts."⁰⁶ An applicable individual is anyone who is a resident of California on the "tax obligation date,"⁰⁷ which is January 1, 2026.⁰⁸

The Act therefore is governed by two dates and two questions: who is subject to the tax, and when that determination is made:

- *January 1, 2026* — the tax obligation date, used to determine whether a taxpayer is a California resident and thus an applicable individual. Residency after January 1, 2026, is irrelevant for purposes of applicability. A taxpayer who moves out of California on January 2, 2026, remains an

applicable individual for the entire tax regime. The determination of residency in California is a complex and fact-sensitive analysis that is outside the scope of this article.

- *December 31, 2026* — the valuation date, used to determine whether that applicable individual's net worth satisfies the \$1 billion threshold and to calculate the amount of tax due. The \$1 billion test is applied on a worldwide basis, without regard to the situs of assets. A married couple is treated as a single taxpayer, with net worth aggregated.

An applicable trust is any trust other than a “grantor trust”⁹ or “tax-exempt trust”¹⁰ if an applicable individual still living with a net worth of \$1 billion or more as of December 31, 2026, has transferred property to such trust. The value of an applicable trust is subject to a 5 percent tax in that circumstance. It is irrelevant whether the trust is resident in California or whether that trust itself has more than \$1 billion.¹¹ Note that, as discussed in greater detail below, some rules in the Act addressing the value of assets held in trusts apply only to a determination of whether a grantor or beneficiary who is an applicable individual crosses the \$1 billion net worth threshold but those assets are not included for purposes of determining the amount of tax owed by that applicable individual. Those rules may create some further ambiguities.

One important consideration is that the Act provides for adjustment of the dates identified above to conform with constitutional requirements.¹² So, while most of this article will focus on strategies and outcomes assuming the dates above, the potential adjustment to those dates might impact the benefit of particular planning and should be considered carefully before taking any action.

D. How Are Trusts Handled?

The trust rules are among the most complex and far-reaching features of the Act. The value of the assets in a grantor trust is always included in the grantor's net worth and subject to tax against the grantor. The value of the assets in a non-grantor trust may be included, as further explained below.

1. Grantor Trusts

An applicable individual's net worth includes the net worth of any grantor trust of that applicable individual regardless of whether they are a beneficiary of that trust.¹³ Thus, all the assets of a grantor trust are included when determining whether an applicable individual has a net worth of \$1 billion or more.¹⁴ Caution that this rule could create the unattractive result of an applicable individual being taxed on assets held by a trust where they are not the beneficiary

and have no access to the assets.¹⁵ On the other hand, having the applicable individual who is the grantor pay the tax is effectively a further tax-free gift to such trust that allows the assets of the trust to continue to grow unencumbered by tax while reducing the grantor's estate tax exposure through depletion of the grantor's estate.

To the extent the assets of any trust are distributable to a beneficiary, the beneficiary includes those assets in calculating the beneficiary's net worth to determine if that beneficiary is subject to the tax.¹⁶ The value of the grantor trust therefore could be included in the net worth of both the grantor and the beneficiary, potentially resulting in double taxation. While the Act does not define “distributable,” other sources of California law indicate that distributable means that the beneficiary has a current right to the asset, whether or not actually distributed.¹⁷ Certainly, however, the term distributable in the Act could be interpreted differently, for example, that all assets in a trust are allocated to a beneficiary. Taxpayers should plan for either interpretation.

The trust can make an applicable trust election to avoid double taxation, in which case the trust must pay the tax on its assets. That election, however, should be made only where not making the election would result in the tax applying to both the grantor and the beneficiary, because each of their net worth is \$1 billion or more.

2. Non-Grantor Trusts

Contradictory language in the Act makes it unclear how much of the value of the assets in a non-grantor trust should be used in calculating the net worth of an applicable individual who transfers assets to that trust. Section 50303(c)(6)(B) states that, for purposes of determining whether an applicable individual's net worth exceeds \$1 billion, net worth includes the value of property held by any trust (other than a grantor or tax-exempt trust) to which the applicable individual “transfers or has transferred” property. That provision may be interpreted to include all property ever transferred to a non-grantor trust. Imagine the result where a gift of \$1 million 30 years ago to a non-grantor trust has appreciated significantly into \$300 million. Under one interpretation of this section, the value of the assets in that trust is included for purposes of determining whether an applicable individual crosses the \$1 billion net worth threshold, even though the value of that applicable individual's personally held assets is nowhere near the \$1 billion threshold.

Consider the following example: an applicable individual who made the aforesaid \$1 million gift 30 years ago has \$800 million in personally held assets and the non-grantor trust has \$300 million in assets. Under one interpretation of section 50303(c)(6)(B), the \$300 million value of the

non-grantor trust is included for determining net worth and thus this person has a net worth of \$1.1 billion. Then, section 50308(b) provides that the non-grantor trust is an applicable trust because the taxpayer is an applicable individual. However, the tax payment provisions at section 50301(b) indicate that the applicable individual has a net worth of only \$800 million and therefore has no tax, while the \$300 million non-grantor trust is taxed at 5 percent as an applicable trust. It is not clear if that result is intended and the interplay of the Act's provisions may lead to confusion.

To further add to the confusion, the latter portion of section 50303(c)(6)(B) states that 100 percent of any 2026 transfers to the trust and 75 percent of any 2025 transfers to the trust shall be used in calculating the net worth of the applicable individual who transferred assets to the trust. That language would appear to be unnecessary if the broad language of section 50303(c)(6)(B) already captured all prior transfers. Trying to harmonize the language by including 100 percent of pre-2025 transfers, but only 75 percent of 2025 transfers, would favor transfers in 2025 over transfers before 2025, which does not seem to make sense. The result is an ambiguity in the statutory language. Principles of statutory construction suggest that the latter, specific language in section 50303(c)(6)(B) controls,¹⁸ but the issue remains uncertain and could drag in unsuspecting, non-billionaire applicable individuals resulting in a taint to their non-grantor trusts.

As in the context of grantor trusts, to the extent the assets of a non-grantor trust are distributable to a beneficiary, the beneficiary must include those assets in calculating the beneficiary's net worth to determine whether that beneficiary is subject to the tax. The trust can make an applicable trust election in which case the trust must pay the tax on its assets.

3. Tax Exempt Trusts

Tax exempt trusts are defined in the Act as those trusts that are exempt from federal income tax under Internal Revenue Code ("IRC") section 501.¹⁹ Tax exempt trusts are excluded from calculations of net worth²⁰ and thus exempt from the tax itself. For purposes of this article, it is assumed that section 501 is the IRC provision that exempts charitable trusts from federal income taxation, notwithstanding that sections 501(c)(3) and 501(c)(4) do not use the term trust, and that term is used in a limited manner throughout the rest of section 501.²¹

A taxpayer who wants to contribute assets to a tax exempt trust to reduce the taxpayer's net worth must consider other provisions of the Act that suggest the contribution may not reduce net worth. The Act states that "net worth shall include the value of any property the individual transferred (other than property transferred to a trust described above)

for less than fair market value after October 15, 2025, if such property either considered alone or together with substantially interchangeable transferred items has a fair market value in excess of \$1 million."²² The Act also states that "a pledge to make a subsequent contribution to a charitable or philanthropic organization shall not reduce net worth unless such pledge is legally enforceable by the organization to which such contribution is pledged, and in any event no such pledge may reduce net worth if such pledge is entered into after October 15, 2025."²³ The language in those sections may be interpreted to mean that it is too late to contribute assets to a tax exempt trust and avoid inclusion of the value of those assets in net worth.

Finally, split interest trusts such as charitable remainder trusts are exempt from federal income tax under IRC section 664, not IRC section 501.²⁴ Accordingly, it is uncertain whether the value of split interest trusts is included or excluded from the calculation of net worth. The Act provides no clear method about how to include the value of a split interest trust.

E. How Is Net Worth Determined?

The Act adopts an inclusion-first approach: all assets are included unless specifically excluded. Assets are valued at fair market value, using a willing buyer-willing seller standard, subject to statutory presumptions and limitations.²⁵

1. Included Assets

Included assets span nearly every category of wealth commonly held by ultra-high-net-worth taxpayers, including publicly traded securities, ownership interests in private companies, private equity and venture capital interests, intellectual property rights, receivables and financial instruments, tangible personal property located in California, grantor trust assets, and certain non-qualified deferred compensation arrangements. Worldwide assets are considered for purposes of net worth.²⁶

The Act includes the following specific valuation rules:

a. Entity Interests (Not Public Securities)

- **Valuation Discounts.** Traditional valuation discounts are limited. For instance, shareholder rights plans (and similar arrangements) cannot be considered where a "significant purpose" of that feature is to reduce the appraised value of the asset.²⁷ Valuation discounts cannot be considered if such discount would reduce the value below the taxpayer's pro-rata portion of the value of the entire asset.²⁸
- **Sole Proprietorships.** Sole proprietorships are ignored and the taxpayer is treated as holding each

of the proprietorship's assets as the taxpayer's own asset and valued accordingly.²⁹

- LLCs, Partnerships, and Corporations. The percentage of the entity owned by the taxpayer is determined;³⁰ the book value of the entity is determined at the end of the tax year using Generally Accepted Accounting Principles (GAAP);³¹ and the book profits of the entity in the tax year are determined using GAAP. The value of the entity is presumed to be the book value plus a present value multiplier of 7.5x annual book profits as averaged over the current tax year and the preceding two tax years in accordance with GAAP. Note that neither the Financial Accounting Standards Board (FASB), the entity that creates the GAAP rules, nor the California Revenue and Taxation Code define "book profits." Further guidance will likely be needed to determine whether "book profits" means net income pre-tax or something else. The presumed value of the entity is then multiplied by the percentage interest in the entity owned by the taxpayer at the end of the tax year.³² If the taxpayer lacks the information regarding book value and book profits, and lacks the right to obtain that information, the taxpayer must instead submit a certified appraisal of the taxpayer's interest in the entity.³³
- Private Equity. A private equity interest must be valued at a minimum at the pro rata portion of the underlying portfolio's fair market value.³⁴
- Voting Rights Special Rules. If a taxpayer has interests in an entity that confer voting or other direct control rights, the percentage of the business entity owned by the taxpayer shall be presumed to be not less than the taxpayer's percentage of the overall voting or other direct control rights.³⁵ Voting rights concentrated in a way that deviates from interest in profits can result in a determination of value that differs significantly from economic realities.
- Profits Interest Special Rules. Where profits interests are being valued, the percentage of the entity owned by the taxpayer shall be presumed to be not less than the maximum such percentage interest of the entity's profits the taxpayer may earn, without regard to whether such profits interest is subject to a condition precedent that has not yet been met.³⁶ This provision will apply to any carried interest owned by a taxpayer.
- Certified Appraisals. If the taxpayer (or Franchise Tax Board ("FTB")) can show with clear and convincing evidence that the presumed values would substantially overstate or understate

the value of the business entity owned by the taxpayer or the percentage owned by the taxpayer, either the taxpayer or the FTB may submit a certified appraisal value in place of the presumed percentage method.

- Funding Rounds. Value for a business entity cannot be less than the valuation reflected in any funding round or other sale of equity that occurred within two years of the valuation date unless the taxpayer can show by clear and convincing evidence that such valuation would significantly overstate the value of the entity.³⁷

b. Appraisals Required

For any asset or group of interchangeable assets, other than a publicly traded security or an entity, a certified appraisal is required if the value exceeds \$1 million.³⁸ Practically speaking, this provision will primarily apply to tangible personal property, intangible assets, and real property (to the extent not held personally or in a revocable trust, in which case it would be excluded from net worth, as explained below).

c. Insured Assets

The value of an asset cannot be less than the insured value for that asset.³⁹ Taxpayers should review insurance policies to determine if values are accurate or overstated before the end of 2026.

d. Assets of Dependents

Assets of any person who can be claimed as a dependent of a taxpayer and which exceed \$50,000 in aggregate shall be deemed to be assets of the taxpayer who can claim them as a dependent.⁴⁰ Note that the analysis hinges on whether the dependent can be claimed, not whether the taxpayer is actively claiming such dependent. Determination of what support the dependent is receiving other than from the taxpayer will be key to this analysis.⁴¹ So, where a child of an applicable individual is a beneficiary of a trust with a large amount of assets, it is possible that such assets could be considered as part of the net worth of the applicable individual if they would be considered assets of the dependent.

2. Excluded Assets

The most notable excluded asset is real property that is personally held or held in a revocable trust.⁴² Real property held through an entity, such as an LLC or partnership, does not qualify for this exclusion. Similarly, real estate in any sort of irrevocable trust will not qualify. The taxpayer who holds real property in an entity or irrevocable trust therefore should explore restructuring.

Other excluded assets include qualified retirement assets, with a cap on Roth accounts above \$10 million in present value;⁴³ certain deferred compensation, particularly where not vested or payable by year end;⁴⁴ up to \$5 million of discretionary personal property such as art, collectibles, intellectual property rights, vehicles, non-publicly traded financial instruments, and debts;⁴⁵ and tangible personal property located outside of California for at least 270 days.⁴⁶

It also appears that assets transferred for less than fair market value are excluded from net worth if such property, either considered alone or together with other substantially interchangeable transferred items, has a fair market value that does not exceed \$1 million.⁴⁷

3. Debts and Liabilities

Debt reduces net worth only to the extent it is genuine, recourse, and negotiated at arm's length.⁴⁸ It is not clear whether tax liabilities for 2026 that would be due in 2027 are included. For all other debts, the following limitations apply:

- non-recourse debt reduces net worth only to the extent of the value of the assets that collateralize the debt included in the taxpayer's net worth;⁴⁹
- debts of a sole proprietorship reduce net worth as if they were the taxpayer's debts;⁵⁰
- debts of other business entities only reduce net worth to the extent the liabilities of the business are allocated to the taxpayer, except to the extent that the taxpayer is personally liable for such debt or other liability in which case they are treated as recourse debt;⁵¹
- debts owed to related persons do not reduce net worth, with "related person" defined in IRC sections 267 and 318;⁵²
- debts where market interest rates are not charged do not reduce net worth;⁵³
- charitable pledges do not reduce net worth unless they are legally enforceable, except that no pledge entered after October 15, 2025, reduces net worth;⁵⁴ and
- debts of a taxpayer (such as capital calls) for which the taxpayer is entitled to receive future benefits or ownership rights only reduce net worth if the value of those future benefits or ownership rights are included in the taxpayer's net assets or if the taxpayer can demonstrate through clear and convincing evidence that the amount of that debt or liability exceeds the benefits or ownership rights that are not included in the taxpayer's net assets.⁵⁵

F. When Is the Tax Due?

The tax is reported with and due at the same time as the taxpayer's California 2026 income taxes,⁵⁶ which is on Thursday, April 15, 2027. At that time, every California resident must either file a declaration asserting that the taxpayer's net worth is less than \$1 billion as of the valuation date or submit a declaration of the amount of additional tax due under the Act together with appraisals or other evidence of value.⁵⁷ If an applicable individual is not required to file a California income tax return for 2026, that taxpayer must still file the declaration regarding tax due under the Act together with appraisals or other evidence of value.⁵⁸

The Act includes options to defer payment of the tax.⁵⁹ First, the taxpayer can elect to make payments in five equal installments beginning with the 2026 payment.⁶⁰ A 7.5 percent deferral charge applies on the tax payment deferred, however.⁶¹ Second, the Act provides that if a taxpayer's publicly traded assets are less than the tax due, the taxpayer may establish an optional deferral account ("ODA") by which the taxpayer can defer payment by effectively attaching the tax liability to specific illiquid assets.⁶² A taxpayer who establishes an ODA must submit to the FTB comprehensive annual reports and agree to be subject to the personal jurisdiction of California for purposes of satisfying those reporting requirements and paying the tax.⁶³

G. Enforcement and Audit Risk

The Act grants the FTB broad authority to audit, value, and recharacterize assets.⁶⁴ The Act has a broad anti-avoidance rule and states that if a transaction or a series of transactions lack economic substance or a substantial purpose for any transaction or series of transactions was to obtain a tax benefit with respect to the Act, the FTB may determine the tax consequences to any person in a manner that is reasonable in light of all the facts and circumstances in order to deny such benefit.⁶⁵ The rule additionally states that a transaction or series of transactions will be deemed to lack economic substance if the person does not have a valid and substantial nontax business purpose for entering into the transaction or series of transactions, taking into account the overall economic effect of the transaction or series of transactions apart from state and federal tax effects.⁶⁶

The following penalties are authorized: (1) a 20 percent penalty of the understated amount of the tax for a substantial understatement, meaning more than \$1 million or 20 percent of the tax shown on the original return; (2) a 40 percent penalty of the understated amount of the tax for a gross understatement, meaning more than \$10 million

or 40 percent of the tax shown on the original return; and (3) the FTB may impose a penalty on the appraiser of up to 2 percent of the understated amount of the tax for a substantial understatement and a penalty on the appraiser of up to 4 percent of the understated amount of the tax for a gross understatement.⁶⁷

III. PLANNING IN THE SHADOW OF THE BILLIONAIRE TAX

Taxpayers may consider several options to mitigate the application of the Act. In considering any option, taxpayers must first evaluate whether that option may violate the Act's anti-avoidance rule. Additionally, taxpayers should consider what happens if constitutional benchmarks are moved or constitutional challenges become a lengthy process. In that case, what were thought to be temporary changes may become more permanent or may provide opportunities for planning that were thought to be closed.

From a practical standpoint, taxpayers are much better off if their planning can get them to a situation where they can assert that the tax does not apply. If a taxpayer is in a position only to argue about constitutionality or valuation, they will likely need to pay the tax and sue for refund to avoid significant negative consequences. In the meanwhile, they may incur significant liquidity issues, disruption of operating businesses, and diminished future investment opportunities. Accordingly, whether the core goal is tax mitigation or tax avoidance should be determined as early as possible.

A. Direct Ownership of Real Property

The Act exempts from net worth personally held real property or real property held in a revocable trust. By contrast, the Act includes within the definition of net worth real property held in an entity such as an LLC or an irrevocable grantor trust. Thus, the taxpayer should consider moving real property out of those entities so that the taxpayer or the taxpayer's revocable trust directly owns it. For real property held in an irrevocable grantor trust that includes a power held by a grantor to substitute assets for assets of an equivalent value, the grantor should consider exercising that power.

This power of substitution would move the real property into the grantor's personal ownership exempting it from the net worth calculation. By way of example, if a grantor has cash of \$1 billion and the value of a grantor trust is \$100 million all held in real property, the grantor could transfer \$100 million of cash into the grantor trust in exchange for the \$100 million in real property. Because the real property is excluded once held by the grantor individually, the grantor has assets with a total value of \$900 million (instead of \$1

billion) and a grantor trust with a total value of \$100 million. The grantor's net worth would be \$1 billion instead of \$1.1 billion, thereby avoiding the tax. Note that for California real property, such a transfer could trigger a reassessment.

The taxpayer must carefully consider property tax, privacy, lender, and liability consequences before removing real property from an entity. Removal of California real property from an entity could trigger a reassessment depending on the ownership structure. The privacy benefits of an LLC are likely to be lost upon removal of the real property. In addition, the taxpayer will need to confirm with lenders that removal of that real property from the LLC will not adversely impact outstanding loans.

Lastly, rental and commercial real property is often held in an entity such as an LLC to protect the taxpayer's personal assets from liabilities associated with the property and its operation. That liability protection may be lost if the property is removed. Removing the property from the entity and then transferring it back to an entity after 2026 may trigger the anti-avoidance rule. An option may be to subject the property removed from the entity to a ground lease. For example, the taxpayer may consider having the LLC (where the property had been held) lease from the taxpayer and have all the operations and rental through the LLC, so that the business activities remain insulated from liability but some of the value is pulled out of the entity by way of the transfer of the underlying property.

B. Change Asset Mix

A taxpayer may convert non-exempt assets, such as investments in stocks and bonds, to exempt assets, such as directly owned real estate investments. The taxpayer would have to consider the income tax consequences of disposing of liquid assets to purchase real property. A taxpayer could also consider leveraging assets to purchase exempt assets but would need to consider the cash flow impacts of such a choice.

For example, the real property may be purchased near the end of 2026 and then contributed to an LLC that is formed in the beginning of 2027 for the non-tax reason of protecting the taxpayer's personal assets from claims of tenants. The taxpayer could consider additional liability insurance for the short period that the property was owned directly. However, the taxpayer should consider whether a transfer back into an entity should be completed given the potential that the valuation date could change.

C. Distribute Assets from Trusts to Beneficiaries Before Year-End

To the extent that the value of the assets of a trust to which a grantor transferred assets is included in calculating

the grantor's net worth or creates an applicable trust, distributions to beneficiaries may eliminate or mitigate the tax due. If the trust permits distributions to beneficiaries, the trustee of the trust should consider making distributions to reduce the value of the trust on the valuation date. It would be prudent to avoid situations in which the grantor, who is an applicable individual, acts in a manner that can be deemed as directing or making these distributions to mitigate the anti-avoidance rules.

This strategy is best used for trusts that are not exempt from the generation-skipping transfer tax ("GST"). Distributions from GST exempt trusts will leave those trusts with less value that can pass transfer tax-free from generation to generation of beneficiaries. It may not make sense to avoid a one-time 5 percent tax on trust assets if that means losing the ability to avoid a 40 percent tax for generations to come.

D. Convert Grantor Trusts to Non-Grantor Trusts Before Year-End

As discussed above, it is unclear whether, for a non-grantor trust, only the value of the assets transferred to the trust in 2026 and 75 percent of the value of the assets transferred to the trust in 2025 count toward the grantor's net worth.⁶⁸ Converting a grantor trust to a non-grantor trust could reduce the value of the grantor's net worth below the \$1 billion net worth threshold and such trust would then avoid being characterized as an applicable trust. However, it is not clear whether turning off grantor trust status would be considered a "transfer" in 2026, making the assets includible in the net worth calculation.

E. Review Beneficial Interests of Existing Trusts

Because of the uncertainty surrounding pot trusts and whether a beneficiary is charged with any portion of trust assets, it may be prudent to ensure that applicable individuals are not beneficiaries of existing trusts that would put them over the \$1 billion net worth threshold. Some trust documents may have provisions that would permit an independent trustee to accelerate termination of a trust such that a new generation becomes the current beneficiaries. Some trusts should be divided so that each beneficiary has their own distinct interest.

If the value of the trust's assets may be used to determine a beneficiary's net worth and the beneficiary's net worth may be at least \$1 billion, the trust can make the applicable trust election to avoid inclusion of the value of those trust assets in the beneficiary's net worth.

Where the value of trust assets is significant, and a trust beneficiary is a potential dependent, those assets of the

potential dependent could be included in the taxpayer's net worth. Consider ensuring that at least 50 percent of the beneficiary's support is from a source other than the taxpayer to avoid their classification as a dependent. The trust assets set aside for the benefit of the potential dependent are a perfect source of this other support. To the extent the taxpayer already directly provided support for the potential dependent, the taxpayer may want to consider whether they should be reimbursed for expenses from that trust to ensure they fall below the 50 percent threshold.

F. Review Tangible Personal Property Value and Location

The value of tangible assets outside of California for at least 270 days in 2026 will not be included in net worth. While the timing of this publication means that there may no longer be an opportunity to move assets out of California for the required days, review whether any such assets have already spent an amount of time outside of California such that the 270-day threshold could be reached by the end of the year. This strategy also may remain relevant if the applicable date changes.

The taxpayer will not be able to claim a value of personal property lower than its insured value. Because personal property, especially valuable art, is often insured for more than its fair market value to accommodate for other costs of replacing it, taxpayers should review insurance riders to understand the insured values of those assets and adjust those values before the valuation date.

G. Review Corporate Voting Structures

Many organizational structures vest voting rights in one or very few shareholders for control and efficiency purposes. However, this can create a very lopsided valuation issue given the rules in the Act that require inclusion of value of the entity equal to the voting rights held. This issue is particularly applicable to unique and illiquid assets such as sports franchises, media and entertainment companies, and other privately held companies. Taxpayers should review whether these ownership and control structures can be accomplished in another way that does not subject their assets to potentially significant overvaluation.

H. Trigger Other Tax Obligations

Taxpayers may consider reducing net worth below \$1 billion by making a taxable gift, even if doing so triggers federal gift tax. Since the wealth tax applies only if net worth is over \$1 billion, the "cost" of paying a federal gift tax may be justified to avoid a 5 percent wealth tax on the remaining estate. This approach may be most helpful where a taxpayer has other applicable trusts that may be taxed even though they are non-grantor trusts.

However, for purposes of reducing net worth, taxpayers may be limited to gifts of assets with a fair market value of \$1 million or less, given that the Act states that

net worth shall include the value of any property the individual transferred (other than property transferred to a trust described above) for less than fair market value after October 15, 2025, if such property either considered alone or together with other substantially interchangeable transferred items has a fair market value in excess of \$1 million.⁶⁹

In other words, by stating that transfers exceeding \$1 million are included in calculating net worth, the implication is that transfers of \$1 million or less are exempt. This implication is uncertain, and even if the implication is correct, it is unclear how many transfers of \$1 million or less may be made or how much time must pass between transfers.

Additionally, in many cases, if a tax was due, income tax would be triggered to liquidate assets to pay the tax. So, instead of paying both income tax and the tax under the Act, it might be prudent to take only the income tax hit if that would drive net worth below the \$1 billion threshold. This approach could be coupled with charitable contributions to limit the income tax liability while still driving down net worth. The taxpayer should consider payment of the income tax before year end 2026 given the uncertainty over whether an unpaid tax liability reduces net worth, although there is no guarantee that such prepayment will be excluded from net worth.

I. Buy U.S. Obligations

The Act does not provide an exception from inclusion in net worth for U.S. Treasury Bills, Notes, and Bonds ("Treasury securities"). Such assets, however, may be exempt from the wealth tax under 31 United States Code section 3124(a). Thus, if California imposed the 5 percent tax on Treasury securities that would otherwise be deemed to be part of a taxpayer's or applicable trust's net worth, that tax may be deemed to violate section 3124(a). It is unclear whether Treasury securities would still be included in the calculation of "net worth" for purposes of determining whether a taxpayer has more than \$1 billion.

Section 3124(a) provides that a state cannot tax Treasury securities, not that the value of Treasury securities cannot be included in determining whether the tax can be imposed on other assets. Subsection (2) of section 3124(a) excepts an estate or inheritance tax from the rule that a state cannot tax Treasury securities. Section 3124(a) codified early twentieth century Supreme Court decisions that consideration of the value of Treasury securities for determination of a tax was not a tax of the federal obligation itself.⁷⁰ With little legislative history

available, it is not clear if a wealth tax would fall under this exemption or whether an "estate" is limited to a deceased person only.

Assuming Treasury securities are exempt from the wealth tax, selling stocks or other non-exempt assets and purchasing Treasury securities may produce gain on the sale that the taxpayer would want to avoid. Alternatively, the taxpayer may consider a loan against stocks to generate the cash to purchase the Treasury securities. The loan may reduce net worth, and the possibility exists that the value of the Treasury securities would not be included in net worth.

J. Charitable Contributions

A taxpayer may consider contributing assets to charitable organizations to reduce net worth. The Act states, however, that "net worth shall include the value of any property the individual transferred (other than property transferred to a trust described above) for less than fair market value after October 15, 2025, if such property ... has a fair market value in excess of \$1 million."⁷¹ The Act also states that "a pledge to make a subsequent contribution to a charitable or philanthropic organization shall not reduce net worth unless such pledge is legally enforceable by the organization to which such contribution is pledged, and in any event no such pledge may reduce net worth if such pledge is entered into after October 15, 2025."⁷²

The language in those sections may be interpreted to mean that it is too late to contribute assets to charity and avoid inclusion of the value of those assets in net worth. Whether that language applies to transfers to charitable trusts is unclear. The Act excludes the value of assets held by tax-exempt trusts from the "net worth" computation and also excludes tax-exempt trusts from the definition of applicable trust.⁷³ When all of the aforesaid provisions are read together, the Act may be interpreted to mean that the value of transfers to tax-exempt trusts on or before October 15, 2025, may be excluded from net worth, but the value of transfers after October 15, 2025, are included in net worth.

K. Marital Dissolution

Married couples are treated as one person for purposes of determining net worth. If a couple divorces and divides assets before December 31, 2026, one or both of their respective net worths could fall below \$1 billion each and the tax may be avoided in part or in whole. That situation may be more likely where one spouse has significant separate property or already lives out of state. Of course, the risk of a potential attack under the anti-avoidance rules must be considered.⁷⁴ Complications would include getting the divorce finalized before the end of 2026. However, if constitutional challenges result in a change in deadlines,

reducing net worth through marital dissolution may become more realistic.

L. Change of Residence

While a move out of California is likely no longer an option given the current verbiage of the Act, the Act itself does contemplate that some of the dates and deadlines would be moved.⁷⁵ In the case of a taxpayer that is likely to be a newly minted billionaire or one that would have left had they known the rule, a departure from California after January 1, 2026, should not be ruled out as an option. However, the sooner the better, to avoid missing future deadlines.

IV. POTENTIAL COURT CHALLENGES

If the voters approve the Act on election day, a flurry of legal challenges likely will swiftly appear on the California court dockets. The Act anticipates constitutional challenges, provides for expedited judicial review, and authorizes courts to reform key dates if necessary to preserve enforceability.⁷⁶

One potential challenge is that the tax constitutes a property tax that conflicts with Proposition 13 that limits property taxes to 1 percent of a property's assessed value, capped at a 2 percent maximum annual increase, with reassessment to current market value only upon ownership change or new construction. To brace for that challenge, the Act characterizes the tax as an excise tax on the activity of sustaining excessive wealth, rather than a direct tax on property.⁷⁷ A due process challenge under the 14th Amendment to the U.S. Constitution may be asserted on the basis that California cannot apply the tax retroactively to persons residing in California as of January 1, 2026.

The Act's apportionment rules may also give rise to a legal challenge. For applicable individuals, the tax is apportioned 100 percent to California by default, regardless of where assets are located or where wealth was accumulated.⁷⁸ The Act permits alternative apportionment only upon a showing by clear and convincing evidence that the standard method is unfair or unconstitutional.⁷⁹ This approach reflects a policy judgment that residency alone provides a sufficient basis for taxation. The absence of meaningful apportionment based on historical contacts or asset location may increase risk of a challenge under the 14th Amendment to the U.S. Constitution, the right to interstate travel, and/or the dormant commerce clause, on the basis that California cannot tax assets with an insufficient nexus to California.

V. CONCLUSION

The Act introduces a new and complex wealth tax regime for the stated purpose of filling the state's coffers that have been left depleted by reductions in federal funding. The

language of the Act exposes an additional policy problem it seeks to solve—subjecting to tax the excessive wealth accumulation that the proponents contend is immune to the traditional forms of income and wealth transfer taxation. It is an attempt to reintroduce an endpoint into a system where proponents argue endpoints have largely disappeared. Time will tell whether the Act, if it becomes law and prevails against anticipated court challenges, discourages investment, results in a massive reduction in the state's tax base from migration, and is administratively untenable.

Meanwhile, the planning must go on. The structure of the Act is intentionally narrow and precise. The tax applies once. Applicability depends on residency on January 1, 2026, net worth on December 31, 2026, and asset composition and trust structures. Within those parameters, and with careful attention to anti-avoidance rules, meaningful planning opportunities exist.

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- 01 California Proposition 40, One-Time Wealth Tax for State-Funded Healthcare, Education, and Food Assistance Programs Initiative ("Prop. 40"), at section 50301(a).
- 02 California Proposition 41 called "Prohibit Excluding New State Taxes from Spending Limit and Require Special Tax Audits Initiative," and California Proposition 42 called "Prohibit New Taxes on Retirement Holdings, Personal Assets, and Savings and Limit Retroactive Taxes Initiative," would invalidate Prop. 40 if either Proposition 41 or Proposition 42 receives more votes on election day.
- 03 Joint Committee on Taxation, Expiring Provisions of Pub.L. No. 115-97 (Jan. 1 2018) (the Tax Cuts and Jobs Act): Economic Issues, Report R48286.
- 04 Kuang, *Newsom's populous act: Oppose state billionaire tax, embrace federal one*, CalMatters.com (July 22, 2026), <<https://calmatters.org/politics/2026/07/newsom-balancing-act-wealth-tax-billionaires/>> (as of July 29, 2026).
- 05 Prop. 40, at sections 50301(a) & 50308(o).

- 06 Prop. 40, at section 50301(a). Note that the 5 percent tax is imposed on the net worth of applicable trusts whatever their value. The \$1 billion threshold only applies to individuals.
- 07 Prop. 40, at section 50308(a). Determination of residency is to be made under sections 17014 & 17015.5 of the California Revenue and Taxation Code. Key considerations are where you maintain your domicile; physical presence and patterns of living; location of family, property, and business interests; and whether you meaningfully re-established residency elsewhere prior to January 1, 2026. As a general rule, a person in California for a purpose other than a temporary or transitory purpose is a resident.
- 08 Prop. 40, at section 50308(n).
- 09 Prop. 40, at section 50308(e), states that the term “grantor trust” includes both a trust that is a grantor trust for income tax purposes and a trust the assets of which would be included in the grantor’s estate for federal transfer tax purposes.
- 10 Prop. 40, at section 50308(m), defines a “tax-exempt trust” as a trust that is exempt from federal income tax under IRC section 501.
- 11 Prop. 40, at section 50308(b).
- 12 Prop. 40, at section 50311(b).
- 13 Prop. 40, at section 50303(c)(6)(A).
- 14 *Ibid.*
- 15 While some grantor trusts routinely have tax reimbursement clauses, these clauses are generally narrowly drafted to reference income taxes and would be unlikely to apply. Further, reimbursement to a grantor for a wealth tax might have unexpected impacts for gift or estate tax purposes.
- 16 Prop. 40, at section 50303(c)(6)(C).
- 17 Rev. & Tax. Code, section 17745, see also *Union Bank and Trust Co. of Los Angeles v. McColgan* (1948) 84 Cal.App.2d 208, 211-212.
- 18 Code Civ. Proc., section 1859.
- 19 Prop. 40, at section 50308(m).
- 20 Prop. 40, at section 50303(c)(6)(B).
- 21 Internal Revenue Code (“IRC”) sections 501(c)(3) & 501(c)(4), which cover public charities, supporting foundations, private foundations, and social welfare organizations, refer only to corporations, organizations, and foundations, not trusts. Private foundations can be created by a trust instrument, but those IRC sections do not use the term “trust.” Given the Act’s reference to IRC section 501 to define a tax exempt trust, and the lack of reference in IRC sections 501(c)(3) and 501(c)(4) to trusts, it is not clear how the Act will apply to tax exempt trusts. In fact, the term “trust” is used in a limited manner throughout IRC section 501. Even internal references may create confusion. By way of example, IRC section 501(q)(1)(E)(iii) references “a trust which is an organization described in subsection (c)(3)” but subsection (c)(3) does not use the term “trust.” In fact, the most common use of the term “trust” throughout section 501 is related to employee plans and black lung funds, in IRC sections 501(c)(17), (18), and (21). Nonetheless, the reference by IRC section 501(q)(1)(E)(iii) to a trust in IRC section 501(c)(3) suggests that a trust could qualify as tax exempt under IRC sections 501(c)(3) or 501(c)(4).
- 22 Prop. 40, at section 50303(c)(11).
- 23 Prop. 40, at section 50302(f).
- 24 IRC, section 664(c)(1).
- 25 Prop. 40, at section 50303(a).
- 26 Prop. 40, at section 50308(f).
- 27 Prop. 40, at section 50303(b).
- 28 *Ibid.*
- 29 Prop. 40, at section 50303(c)(2).
- 30 Prop. 40, at section 50303(c)(3)(A)(i).
- 31 Prop. 40, at section 50303(c)(3)(A)(ii).
- 32 Prop. 40, at section 50303(c)(3)(E).
- 33 Prop. 40, at section 50303(c)(3)(B).
- 34 Prop. 40, at section 50303(c)(3)(E).
- 35 Prop. 40, at section 50303(c)(3)(C).
- 36 Prop. 40, at section 50303(c)(3)(D).
- 37 Prop. 40, at section 50303(c)(10).
- 38 Prop. 40, at section 50303(c)(9). Section 50305 provides that the Franchise Tax Board shall adopt regulations or publish guidance detailing the requirements for a certified appraisal and for a certified appraiser, and that such rules and guidance shall be based on the qualified appraisal and qualified appraiser rules of section 1.170A-17 of Title 26 of the Code of Federal Regulations, which relate to substantiating income tax deductions for gifts to charity.
- 39 Prop. 40, at section 50303(c)(10).
- 40 Prop. 40, at section 50303(c)(12). Section 50308(d) states that “dependent” shall have the same meaning as that term is defined in IRC section 152. To qualify as a dependent under section 152, the person must (a) be a child, stepchild, foster child, adopted child, brother, sister, stepbrother, stepsister, or a descendant of any of the above, (b) be under age 19 at year-end, or under 24 and a full time student, or any age if permanently and totally disabled, (c) have lived with the taxpayer for more than half the year (temporary absences for school and medical care count as living with the taxpayer), (d) did not file a joint return with a spouse, and (e) did not provide more than half of their support. For example, a trust established by grandparent for the minor child of grandparent’s child (the taxpayer) would count toward the taxpayer’s net worth for purposes of the Act.
- 41 26 CFR section 1.152-1(2)(i).
- 42 Prop. 40, at section 50303(c)(4). In valuing a sole proprietorship, the taxpayer is treated as owning the assets of the sole proprietorship directly. A single member LLC is disregarded for tax purposes, and the taxpayer reports the tax items of that LLC directly on the taxpayer’s tax return. However, it appears that a single member LLC will not be disregarded for purposes of determining under the Act whether real property is directly owned. Thus, real property owned by an LLC that is a disregarded entity will not be treated as directly owned. The real

property must be owned in the name of the individual or their revocable trust.

43 Prop. 40, at section 50303(c)(7).

44 Prop. 40, at section 50303(c)(7)(C).

45 Prop. 40, at section 50303(c)(9).

46 Prop. 40, at section 50303(5).

47 Prop. 40, at section 50303(c)(11).

48 Prop. 40, at section 50302(a).

49 Prop. 40, at section 50302(b).

50 Prop. 40, at section 50302(c).

51 *Ibid.*

52 Prop. 40, at section 50302(e).

53 *Ibid.*

54 Prop. 40, at section 50302(f).

55 Prop. 40, at section 50302(g).

56 Prop. 40, at section 50301(c).

57 Prop. 40, at section 50301(d).

58 Prop. 40, at section 50301(d)(2).

59 Prop. 40, at section 50304.

60 Prop. 40, at section 50301(c).

61 *Ibid.*

62 Prop. 40, at section 50304.

63 Prop. 40, at section 50304(a).

64 Prop. 40, at section 50312.

65 Prop. 40, at section 50312(k)(1).

66 Prop. 40, at section 50312(k)(2).

67 Prop. 40, at section 50305(c).

68 This issue depends on how the ambiguity in section 50303(6)(B) is resolved.

69 Prop. 40, at section 50303(c)(11).

70 *Plummer v. Coler* (1900) 178, U.S. 115, 123; *Greiner v. Lewellyn* (1922) 258 U.S. 384, 387.

71 Prop. 40, at section 50303(c)(11).

72 Prop. 40, at section 50302(f).

73 Prop. 40, at sections 50303(c)(6)(B) & 50308(b).

74 Couples that dissolve their marriage but are interested in remarrying in the future should consider changing their living arrangements upon divorce and remaining divorced for a meaningful period (at least until after the statute of limitations runs on the 2026 income tax returns).

75 Prop. 40, at section 50311(b).

76 Prop. 40, at sections 50311 & 50314.

77 Prop. 40, at section 50301(a).

78 Prop. 40, at section 50306(a).

79 Prop. 40, at section 50306(b).

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BEFORE WE PROCEED: CONFRONTING THE TAX CONSEQUENCES OF TRUST AND ESTATE SETTLEMENTS

Written by Brandon Lee Spivack, J.D., LL.M. and Kevin L. Holt, J.D., M.Acc.*

I. SYNOPSIS

Parties to trust and estate disputes often assume that how they characterize a transaction controls how the IRS treats it. It does not. This article examines various tax consequences that counsel should evaluate before any settlement agreement is executed.

Part II addresses financing arrangements that commonly structure settlement transactions: installment sales, promissory notes, and intrafamily transfers of business interests. Part III illustrates the tax complexity that can follow when alleged fiduciary misconduct results in a redistribution of estate assets, including transfers of life insurance and court-ordered reformations of retirement account beneficiary designations. At the end of each section, we provide a checklist of specific tax factors to consider.

A common premise connects each scenario: *what the parties call the transaction is the beginning of the tax analysis, not the end of it.*

A. Installment Sales: Hidden Costs of Deferral

Installment sales can defer gain recognition, expanding financing possibilities for the parties, but section 453A of the Internal Revenue Code ("IRC") imposes an interest charge on deferred gain above \$5,000,000. This charge cannot be offset by losses or deductions, and any disposition of the note accelerates the gain under IRC section 453B.

B. Promissory Notes: The Gift Presumption Trap

Private loans from one or more family members may serve as an alternative to commercial loans. Keep in mind that intrafamily promissory notes that do not satisfy IRC section 7872's applicable-federal-rate requirement will be recharacterized as gifts, and even compliant notes face IRS scrutiny if they lack the hallmarks of arm's-length lending.

C. Intrafamily Transfers: Special Valuation Rules Under Chapter 14

Family businesses are hotbeds of disputes and innovative gift strategies. Remember that transfers of closely held business interests among family members may trigger the special valuation rules under IRC sections 2701 through 2704, resulting in inflated gift or estate tax valuations.

D. Life Insurance: Transfer-for-Value and Estate Inclusion Risks

Life insurance policies may be transferred as settlement consideration. Be aware that such policies are subject to the transfer-for-value rule under IRC section 101(a)(2), potentially converting tax-free death benefits into taxable income, and may cause estate tax inclusion under IRC section 2035 if the insured dies within three years.

E. Retirement Account Beneficiary Designations: When Will the IRS Respect a Reformation?

A settlement might lead to a court-ordered reformation of retirement account beneficiary designations. But a state court order is not binding on the IRS.⁰¹ The reformation

will be respected for tax purposes only if the settlement satisfies the bona fide settlement factors developed under federal case law.

F. The Case for Early Tax Counsel Integration

Although these scenarios cover only a small sample of the innumerable tax questions that may arise, they illustrate the complexity—and the counterintuitive results—that make early collaboration between litigation counsel and tax counsel essential. The checklists that follow are a place to start.

II. FINANCING ARRANGEMENTS: INSTALLMENT SALES, PROMISSORY NOTES, AND INTRAFAMILY BUSINESS TRANSFERS

Installment sales, intrafamily promissory notes, and gifts of family-controlled businesses each carry tax consequences that are easy to overlook when the parties are focused on reaching an agreement—from hidden interest charges on deferred gain to gift recharacterization to inflated asset valuations. The scenarios in this part illustrate several common traps.

A. Installment Sales: The Section 453A Interest Charge and Note Disposition Rules

Most practitioners know that using an installment note to facilitate a transaction allows the seller to defer the recognition of income. What may come as an unwelcome surprise is that the IRS charges taxpayers interest for this privilege.⁰² Practitioners should also know that if the seller transfers the note, the gain is accelerated.⁰³

1. Scenario

Bruno and Sacha—no family relationship—are partners in a closely-held business. Bruno purchases Sacha's entire interest for \$15,000,000. As part of the sale, Bruno agrees to pay Sacha the purchase price over the course of five years through annual installment payments. Three years after executing the sale, Sacha assigns her interest in the installment note to Dev, in full satisfaction of a debt Sacha owes him. What are the income tax consequences of executing the installment note? Does Sacha's subsequent assignment of the installment note to Dev create any tax issues?

2. Discussion

Start with the basics. Under the installment method, payments are made over multiple tax years, and, in each year, a taxpayer recognizes a portion of the gain from the sale. The amount of gain recognized in each year is the

proportion equal to (A) the payments received in that year divided by (B) the total sale price.⁰⁴ The installment method may be used for most sale transactions.⁰⁵ However, for several types of sales—including sales of depreciable property to related parties,⁰⁶ as well as sales of inventory,⁰⁷ dealer dispositions,⁰⁸ and the sale of publicly traded property (like securities)—the installment method is prohibited. If eligible, the installment sale applies unless the taxpayer affirmatively elects out.⁰⁹

a. IRC Section 453A Interest Charge

While the installment method has obvious advantages, it triggers underappreciated tax costs in larger transactions. If a taxpayer has more than \$5,000,000 of outstanding installment note receivables, the IRS *charges the taxpayer interest* to defer the income tax on gains. Specifically, IRC section 453A assesses a tax to “nondealer” taxpayers when the sales price of the property exceeds \$150,000 and the face amount of all installment obligations held by the taxpayer (that arose during the current year or that remain outstanding from prior years) exceeds \$5,000,000 at the close of the tax year.¹⁰ For purposes of section 453A, a “nondealer” is a person that does not regularly sell or otherwise dispose of personal or real property on the installment plan.¹¹ The tax is calculated as interest owed by the seller to the IRS on the deferred tax liability. Because the tax narrowly targets the seller's deferred gain, and is not a tax on realized income, it is unaffected by income-related deductions, credits, or losses.¹²

b. Analysis: IRC Section 453A Interest Charge

In the installment sale scenario, Sacha sold her interest in a closely held company to Bruno, an unrelated party, and Sacha did not elect out of the installment method. Sacha is considered a “nondealer” because she does not routinely sell business interests. Consequently, the tax imposed under IRC section 453A is applicable.

To illustrate the tax consequences, assume Bruno makes annual payments of \$3,000,000 to Sacha. Further assume that Sacha has a \$5,000,000 basis in the business interest she sold to Bruno. Sacha's tax liability under section 453A would be calculated as follows:

Step 1: Determine the Outstanding Debt at Year-end

After year 1, \$3,000,000 of the debt is paid;
\$12,000,000 of the debt is outstanding.

After year 2, \$6,000,000 of the debt is paid;
\$9,000,000 of the debt is outstanding.

After year 3, \$9,000,000 of the debt is paid;
\$6,000,000 of the debt is outstanding.

Step 2: Determine the Applicable Percentage¹³

Applicable Percentage = Amount over \$5,000,000 / Total Outstanding Obligation

Year 1: $(\$12,000,000 - \$5,000,000) / \$12,000,000 = 58.33\%$

Year 2: $(\$9,000,000 - \$5,000,000) / \$9,000,000 = 44.44\%$

Year 3: $(\$6,000,000 - \$5,000,000) / \$6,000,000 = 16.67\%$

Years 4-5: Outstanding debt is below \$5,000,000 = 0.00%

Step 3: Determine the Deferred Tax Liability¹⁴

Original sale price: \$15,000,000

Seller's basis: \$5,000,000

Total gross profit: \$10,000,000

Gross profit ratio: 66.67% [$\$10,000,000 / \$15,000,000$]

Deferred gain:

Year 1: $\$12,000,000 \times 66.67\% = \$8,000,000$

Year 2: $\$9,000,000 \times 66.67\% = \$6,000,000$

Year 3: $\$6,000,000 \times 66.67\% = \$4,000,000$

Assuming tax rate of 23.8%, the deferred tax liability is:

Year 1: $\$8,000,000 \times 23.8\% = \$1,904,000$

Year 2: $\$6,000,000 \times 23.8\% = \$1,428,000$

Year 3: $\$4,000,000 \times 23.8\% = \$952,000$

Step 4: Apply the Underpayment Rate¹⁵

Assume 5.0% Underpayment Rate

Step 5: Calculate the Interest Charge¹⁶

Additional Tax under IRC section 453A = Applicable Percentage x Deferred Tax Liability x Underpayment Rate

Year 1: $58.33\% \times \$1,904,000 \times 5.0\% = \$55,533.33$

Year 2: $44.44\% \times \$1,428,000 \times 5.0\% = \$31,733.33$

Year 3: $16.67\% \times \$952,000 \times 5.0\% = \$7,934.92$

Over the first three years, a total of \$95,201.58 of interest is owed to the IRS—in addition to as much as \$1,428,000 of capital gains tax. After year three, Sacha no longer has any tax liability under section 453A because her outstanding obligation is less than the statutory threshold of \$5,000,000. While the capital gain recognized may potentially be offset by losses, deductions, and credits as part of the calculation of individual income tax liability, the interest charge under section 453A is calculated

independently and is applied even if the capital gain is entirely offset.

c. Acceleration of Gain on Subsequent Disposition

Finally, consider the overlooked “opportunity cost” of the deferred gain. That is, Sacha must continue to hold the note if she wishes to defer the income tax. IRC section 453B provides that if an installment note is distributed, sold, or otherwise disposed of, the taxpayer must recognize gain (or loss) to the extent of the difference between the basis of the obligation and (1) the amount realized or (2) the fair market value of the obligation at the time of the distribution. Any gain or loss recognized upon disposition of an installment obligation inherits the same character it would have had if the original property had been sold directly.¹⁷

d. Analysis: Gain on Subsequent Disposition

Assuming Sacha assigns the installment note to Dev at the end of year two to discharge a \$9,000,000 debt Sacha owes him, and that Sacha's basis in the installment note is then \$3,000,000,¹⁸ Sacha's assignment of the installment note will trigger \$6,000,000 of capital gain taxable in the year two assignment. Consequently, the \$1,428,000 deferred tax liability outstanding at the end of year two will be accelerated and fully recognized on the sale of the installment note.

While deferring payments and corresponding gain recognition by means of an installment sale may provide economic advantages to one or more parties in a settlement, the parties must also consider the significant tax costs that come with it.¹⁹

3. Installment Sale Checklist

Before structuring a settlement as an installment sale:

- Determine whether the parties are eligible for installment treatment (sales of depreciable property to related parties are ineligible);
- Evaluate the full cost of deferral under IRC section 453A, including the interest charge on deferred gain when outstanding obligations exceed \$5,000,000; and
- Confirm that no party's anticipated disposition of the note will trigger accelerated gain recognition under IRC section 453B.

B. Promissory Notes: Bona Fide Loan Analysis and Imputed Interest

If it is not feasible to enter an installment financing arrangement, the purchaser may turn to family members, friends, and business partners as alternatives to commercial financing. But, while private loans may avoid the scrutiny and expense of third-party lenders, they often invite the scrutiny of the IRS.

1. Scenario

To resolve a dispute, Bruno agrees to purchase Sacha's entire interest in the business, leaving Bruno as the sole owner. Before executing the purchase, Bruno receives a loan from his mother, Miriam, to finance the transaction. Bruno and Miriam execute a promissory note whereby Bruno agrees to pay interest at the mid-term applicable federal rate for nine years, when full repayment is due. Bruno pledges no security but has a strong credit score and makes timely interest payments. What are the potential tax consequences to Bruno and Miriam following the execution of the promissory note?

2. Discussion

Practitioners must be aware of three tax concepts related to promissory notes: the gift presumption, the bona fide loan factors, and imputed interest income.

a. Gift Presumption

The IRS may scrutinize transfers between related parties as potential disguised gifts.²⁰ In practice, this places a burden on the transferor to prove receipt of "adequate and full consideration in money or money's worth."²¹ The scrutiny is particularly strict for transfers between family members, which are subject to a strong presumption of donative intent.²²

b. Bona Fide Loan Factors

To prove that a transfer is a legitimate loan, and not a disguised gift, the taxpayer must clearly establish a bona fide loan relationship under all facts and circumstances. To analyze such transactions, the tax court in *Miller v. Commissioner* developed and applied a nine-factor test.²³ In *Miller*, a mother transferred \$100,000 to each of her two adult sons and characterized each transfer as a loan.²⁴ Both sons signed non-interest-bearing promissory notes payable on demand or within three years, and the mother systematically "forgave" portions of the notes each year in amounts calibrated to the gift tax annual exclusion.²⁵ The tax court held that the transfers were gifts, not loans, after analyzing nine factors: (1) whether a promissory note or other evidence of indebtedness existed, (2) whether

interest was charged, (3) whether the obligation was secured by collateral, (4) whether a fixed maturity date was set, (5) whether a demand for repayment was made, (6) whether actual repayment occurred, (7) whether the borrower had the ability to repay,²⁶ (8) whether records maintained by the parties reflected the transaction as a loan, and (9) whether the manner in which the transaction was reported for federal tax purposes was consistent with a loan.²⁷ Although signed promissory notes existed, the court found the remaining factors weighed decisively against loan treatment, particularly the absence of interest, collateral, and any meaningful repayment.²⁸

In contrast, in the *Estate of Barbara Galli v. Commissioner*, a mother transferred \$2.3 million to her son pursuant to a demand note bearing interest at the applicable federal rate.²⁹ The IRS claimed that the loan was a gift because it was unsecured and the borrower did not demonstrate adequate ability to repay the loan principal.³⁰ In the tax court proceeding, the son, as executor of his mother's estate, submitted the signed note, bank records showing the amount of the loan and payment of interest, and income tax returns reporting interest income.³¹ Because the IRS failed to produce any evidence of the son's inability to repay, the court found the IRS's opposition pleadings "wholly inadequate," and granted the estate's motion for summary judgment that no gift occurred.³²

Together, these cases establish a conceptual framework to evaluate loans between family members. In addition to charging appropriate interest, an intrafamily promissory note used to finance a settlement transaction should be properly executed, include a fixed payment schedule, and require timely interest payments. While *Galli* suggests that unsecured notes will not automatically be characterized as gifts, collateral remains a crucial factor for larger loans.³³ Perhaps most importantly, complete records—including information proving the borrower's ability to repay—must be kept and preserved to produce in any eventual IRS or tax court proceedings.

One final caution: if the parties agree at the time of the loan that the lender will forgive principal annually using the gift tax exclusion, the IRS may treat the entire loan as a gift from inception, rather than a series of annual gifts.³⁴ Practitioners should therefore avoid building forgiveness terms into the settlement agreement or any contemporaneous side agreement.

c. Imputed Interest Income for Below-Market Loans

Even if a bona fide note exists, the IRS may scrutinize whether adequate interest is paid. IRC section 7872 governs the tax consequences of "below-market" loans. A loan that forgoes interest, or charges interest below the

applicable federal rate, triggers both gift and income tax consequences. First, the loan will be classified as a gift from the lender to the borrower to the extent of the foregone interest.³⁵ Second, imputed interest will be included in the lender's gross income at the applicable federal rate.³⁶

3. Analysis

Applying the bona fide loan framework to the promissory note scenario, Bruno's note appears legitimate. It charges the mid-term applicable federal rate, carries a fixed nine-year repayment term, and is supported by Bruno's strong credit score and history of timely interest payments.

The sole vulnerability is the absence of collateral. Where the loan is substantial, practitioners should consider securing the note with a pledge of the acquired business interest or other available assets. Where security is genuinely unavailable, contemporaneous documentation of the borrower's creditworthiness is essential, and should be preserved in the file at the time of execution.

4. Promissory Note Checklist

To minimize the risk of gift recharacterization, practitioners should address each of the following considerations before issuing an intrafamily loan to finance a settlement transaction:

- Confirm the applicable federal rate as of the date of execution and ensure the note charges at least that rate;
- Include a fixed payment schedule and require timely payments;
- Assess the borrower's creditworthiness, consider requiring collateral for larger obligations and, where collateral is unavailable, preserve contemporaneous documentation of the borrower's ability to repay;
- Monitor ongoing compliance with the loan terms—a loan valid at inception can be recharacterized as a gift if the lender loses any reasonable expectation of repayment;
- Ensure the settlement agreement contains no prearranged forgiveness provisions, including side agreements to forgive principal using the annual gift tax exclusion; and
- Document all of the foregoing, because the IRS will look beyond the interest rate to determine whether the transaction reflects a bona fide arm's-length loan.

C. Intrafamily Transfers: Chapter 14 Special Valuation Rules

Most often in trust and estate matters, family members are not merely a financial backstop. They are principal parties on both sides of any transaction. Since dealings between family members do not always mirror those between independent parties, in 1990, Congress enacted the "special valuation rules" under Chapter 14 to prevent family members from exploiting valuation principles as applied to intrafamily transfers of business interests.³⁷

Specifically, the Joint Committee of Taxation identified structural features common in "estate freeze" transactions among family members—including undervaluation of preferred interests and retained control rights—and raised concerns that the default "willing-buyer, willing-seller" presumption³⁸ was inadequate to capture the economic realities of such family arrangements.³⁹ In response, Chapter 14 of the IRC imposes strict valuation constraints on intrafamily transfers to prevent tax avoidance by individual taxpayers and their family members.⁴⁰

1. Scenario

Part 1: Farid owns all the shares of X corporation. His son, Samir, is an employee of the corporation. In resolution of an ownership dispute between Farid and Samir, Farid agrees to re-organize X corporation so that Farid owns 100 shares of voting stock and 100 shares of nonvoting stock. Farid also agrees to gift all the shares of nonvoting stock to Samir.

Part 2: Same facts as above. In addition, the corporation bylaws are amended to provide that (i) liquidation requires the unanimous vote of the shareholders and (ii) Farid's voting rights lapse when Farid dies.

How will the transfer of shares and lapse of voting rights be valued for gift and estate tax purposes?

2. Discussion

The valuation constraints in Chapter 14 are designed, in part, to prohibit the family partnership planning at issue in *Estate of Harrison v. Commissioner*.⁴¹ In this 1987 Tax Court case, immediately before his death, the decedent held all of the limited partner interests in a partnership, while the decedent and two of his children each held a general partnership interest.⁴² Each general partner held a right to liquidate the partnership.⁴³ Crucially, the right lapsed on the partner's death.⁴⁴ The tax court concluded that, because of the lapse, the decedent's liquidation right was not included in the decedent's gross estate for purposes of determining estate tax.⁴⁵ As a result, for estate tax purposes, the decedent's limited partner interest was valued as \$33,000,000 instead of \$59,555,020.⁴⁶

From Congress's perspective, the problem with the *Harrison* family partnership structure was that, because of the lapse, decedent's power to demand the limited partner share of the company's net assets was completely disregarded, substantially depressing the estate tax value of decedent's interest compared to the fair market value of the underlying partnership assets—both in the hands of the decedent (immediately before death) and in the hands of his family members (immediately after death).⁴⁷ More broadly, Congress intended the special valuation rules to prevent artificial distortion of gift valuations and limit opportunities for disguised gifts unique to family business dealings—specifically identifying preferred classes of ownership as an area of concern.⁴⁸

a. IRC Section 2704(a): Lapsing Liquidation and Voting Rights

To understand how the special valuation rules now prevent taxpayers from using certain transfers of family-controlled businesses to avoid estate tax, first consider IRC section 2704. This section governs the effect of certain voting or liquidation rights on the valuation of interests in family-controlled entities for transfer tax purposes. Subsection (a) sets out the gift or estate tax consequences of the lapse of voting or liquidation rights where the taxpayer and members of the taxpayer's family hold control of the entity both before and after the lapse. If the lapse occurs during the transferor's lifetime, the lapse is a gift transfer equal to the excess of the value of all interests held by the transferor immediately *before* the lapse (determined as if the voting and liquidation rights were nonlapsing), over the value of such interests immediately *after* the lapse.⁴⁹ If the lapse occurs on the transferor's death, the transfer is included in the transferor's gross estate.⁵⁰ If IRC section 2704 had applied to taxpayers in *Harrison*, the lapse of the decedent's liquidation right would have itself constituted a taxable transfer included in the decedent's gross estate, substantially increasing the estate tax liability.

b. IRC Section 2704(b): Transfers of Interests Subject to Liquidation Restrictions

On the other hand, IRC section 2704(b) attributes zero value to certain *valuation discounts* applicable to the transfer of a family-controlled business interest to a family member. Although the statute reserves broad discretion to the Treasury to expand the scope of disallowed discounts, the law currently applies only to the extent that the operating agreement imposes constraints on *liquidation*—and then only to the extent that those constraints are more restrictive than the default terms under federal or state law. For example, under the Corporations Code, a California limited liability company is dissolved by the vote of 50 percent or more of the voting interests.⁵¹ Accordingly,

subsection (b) applies only to disregard the portion of a valuation discount that corresponds to any additional constraint on liquidation *over and above* the 50-percent-of-voting-interests standard.⁵² To the extent applicable, the result is to inflate the value of the transferred interest for gift tax purposes. Although section 2704(b)'s current impact on planning is fairly limited, its possible expansion is a risk of which practitioners should be aware.⁵³

c. IRC Section 2701: Transfers with Retained Preferred Interests or Lapsing Voting Rights

Section 2701 functions similarly to section 2704(b), but the impact may be substantially more dramatic. Section 2701 applies when a taxpayer transfers a subordinate equity interest in a family-controlled entity to a family member while retaining economically senior rights.⁵⁴ For this purpose, senior rights include preferred distribution rights (such as cumulative dividends), liquidation preferences, or lapsing voting rights but exclude mere differences in nonlapsing voting power.⁵⁵ The effect of section 2701 is to attribute zero value to the interest retained by the transferor, inflating the gift tax value and accelerating transfer taxes that otherwise would have been payable on death under section 2704(a). While section 2704(b) may disregard a valuation discount, if section 2701 is triggered, the gift is effectively valued as though the transferor's entire retained interest is included in the gift.

d. Risk of Double Taxation Under IRC Sections 2701 and 2704(a)

Moreover, because both section 2701 and section 2704(a) apply to lapsing voting rights, in some cases the tax imposed by both sections may overlap. For example, section 2701 may apply to a lifetime transfer, causing retained lapsing voting rights to be attributed zero value and inflating the value of the lifetime gift.⁵⁶ If the transferor later dies, triggering the lapse of the voting rights, the lapsed rights are fully included in the transferor's gross estate.⁵⁷ In other words, the retention of the voting rights at the time of the lifetime transfer may not merely accelerate transfer taxes, but may significantly increase them overall.

To address this issue, Congress included a coordination rule under IRC section 2701(e)(6), which provides that if there is a subsequent transfer or inclusion in the gross estate of any interest that previously triggered IRC section 2701, then appropriate adjustments shall be made to reflect the increase in the amount of any prior taxable gift. However, this adjustment is not self-executing and must be asserted by the preparer of the subsequent estate or gift tax return.⁵⁸ Otherwise, double taxation may occur.⁵⁹

e. Combined Effect of IRC Sections 2701 and 2704

In summary, by deeming a lapse of liquidation and voting rights on death to be a gift transfer, IRC section 2704(a) directly nullifies the *Harrison* holding and the artificial undervaluation of family-controlled business in a decedent's estate due to lapsing powers. At the same time, while sections 2704(b) and 2701 target different mechanisms—to varying impact—when a lifetime or testamentary transfer is made, they each tend to cause more business value to be captured in the transferred interest, accelerating transfer taxes that would not otherwise be owed until death. Together, the three provisions provide a broad “belt-and-suspenders” solution to tax avoidance by *Harrison*-type family business structures, and, in some cases, their overlap may result in double taxation.

3. Application of Special Valuation Rules

The scenario illustrates how triggering the special valuation rules can produce dramatic tax consequences. In Part 1, IRC section 2701 does not apply because Farid's retained interest is of the *same class* as the transferred interest. While voting and nonvoting shares represent different classes for operational purposes, nonlapsing voting rights are disregarded under section 2701.⁶⁰

In Part 2, the outcome is radically different. Now, Farid's voting rights are no longer *nonlapsing*, since the bylaws have been changed to cause his voting rights to lapse on his death. Accordingly, Farid's 100 retained shares are attributed zero value under section 2701. Thus, for gift tax purposes, the transfer is not valued based on the actual rights exchanged—i.e., 100 shares of non-voting stock to Samir, with Farid retaining 100 shares of voting stock. Instead, Farid effectively must value the gift as though he transferred the entire corporation to Samir.

Moreover, any valuation discount that might otherwise apply due to the unanimous voting standard for liquidation is disregarded and attributed zero value under section 2704(b). In this instance, since the value of the entire corporation is already deemed to be transferred under section 2701, section 2704(b) has no effect on the value of Farid's taxable gift.

If Farid subsequently dies while continuing to hold the 100 shares, then the shares will be fully includible in Farid's gross estate under section 2704(a). To avoid double taxation, his estate must affirmatively claim an adjustment for the amount of prior taxable gifts made by Farid under section 2701(e)(6). Because the lapse of the voting rights is treated as a transfer included in Farid's gross estate, none of the value of the 100 shares will escape taxation.

In light of the harsh legal fictions imposed by Chapter 14,⁶¹ practitioners must carefully consider the tax consequences of any settlement agreement involving the transfer or modification of subordinate interests, voting rights, or liquidation rights of closely-held business interests.⁶²

4. Intrafamily Transfer Checklist

Before settling a dispute through the transfer of a closely-held business interest to a family member:

- Determine whether the transferor or a family member will retain an interest of a different class than the transferred interest, which may trigger the zero-retained-value rule under IRC section 2701;
- Review the entity operating agreement to determine whether the voting standard to liquidate the entity is higher than the Corporations Code default—50 percent of the voting interests—and determine valuation discounts accordingly;
- Identify any voting or liquidation rights that will lapse as a result of the settlement, and evaluate the gift or estate tax inclusion required under IRC section 2704; and
- Document the valuation methodology used for the transferred interest and confirm that the settlement terms reflect arm's-length considerations, as the IRS will scrutinize intrafamily transfers for consistency with general valuation principles.

III. FIDUCIARY BREACHES: SETTLEMENTS WITH LIFE INSURANCE AND BENEFICIARY DESIGNATION REFORMATIONS

Family businesses are not the only sources of trust and estate litigation. Allegations of fiduciary misconduct or undue influence are all too common. In these disputes, delicate family dynamics and complex tax consequences combine to present a recurring challenge to practitioners. The following scenarios involving life insurance and beneficiary designations of retirement accounts illustrate the tax complexity that arises when parties attempt to remedy an alleged fiduciary breach.

A. Life Insurance: IRC Section 101(a)(2) and the Three-Year Rule

Life insurance provides financial stability and liquidity to a trust or estate and is often transferred during its administration. If a life insurance policy is offered as consideration in a settlement agreement, income and estate tax consequences will inevitably follow.

1. Scenario

Marta was Stefan and Daphne's mother. For a period of years before her death, Marta was incapacitated. During that period, Stefan served as Marta's attorney-in-fact, as well as the successor trustee of Marta's Trust. Following Marta's death, Daphne alleged that Stefan misappropriated a significant portion of Marta's assets. To resolve this dispute, Stefan agreed, in part, to transfer ownership of a life insurance policy to Daphne. Stefan is the insured party under the policy. The death benefit for the policy is \$3,000,000. What are the income and potential estate tax consequences of this transaction?

2. Discussion

A key feature of life insurance is that its fair market value at the time of a transfer may be far less than the death benefit. That same feature, however, creates a significant risk of inadvertent inclusion of the death benefit proceeds in either a taxpayer's gross income or a decedent's gross estate.

Begin with the income tax risk. It is a foundational principle of federal tax law—codified in the Revenue Act of 1913—that death benefit proceeds of life insurance policies are exempt from income tax.⁶³ Over time, while the policy has stood firm, the rule has been refined to discourage speculative investment in life insurance by third parties.⁶⁴ In its current form, the “transfer-for-value” rule states that if a taxpayer acquires a life insurance contract for valuable consideration, then the net death benefit proceeds (in excess of the consideration and premiums paid) are *included* in the taxpayer's gross income.⁶⁵ Inversely, the death benefit proceeds are *excluded* if a taxpayer's tax basis in a life insurance contract is determined—in whole or in part⁶⁶—by reference to the transferor's basis, for example, as a gift or family inheritance.⁶⁷ This “carry-over basis” exception does not apply unless the transferee has a substantial family, business, or financial relationship with the insured independent of the transferee's interest in the life insurance contract.⁶⁸

In addition to the carry-over basis exception, the transfer-for-value rule is subject to four additional “safe harbors” for particular transfers presumed to serve legitimate insurance and business purposes. The death benefit proceeds are excluded from gross income—notwithstanding a transfer for value—if the recipient is any of the following: (1) the insured, (2) a partnership in which the insured is a partner, (3) a partner in such partnership, or (4) a corporation in which the insured is a shareholder or officer.⁶⁹

In the context of a settlement, a dollar value of released claims should be thoroughly supported by documentation of the merits and potential damages to withstand IRS scrutiny.⁷⁰

a. Analysis: Transfer-for-Value Rule

In the life insurance scenario, there is a transfer for value. Stefan (the insured party) transfers the life insurance policy to Daphne (who is not a member of a protected class) and Daphne expressly releases her claims against Stefan in return for the policy. Consequently, if Daphne survives Stefan, the \$3,000,000 death benefit will be included in her gross income, reduced only by the amount of consideration and premiums paid by Daphne. For example, if Daphne's claim is valued at \$950,000 and Daphne pays \$50,000 of premiums, then the remaining \$2,000,000 of the \$3,000,000 life insurance proceeds will be included in Daphne's gross income.

b. Three-Year Rule

Next consider the estate tax implications. Under IRC section 2035, the full death benefit of a life insurance policy will be included in the gross estate of a decedent if the decedent transferred the policy within three years of death.⁷¹ The third-year anniversary marks a bright line. Afterwards, the policy is completely excluded from the estate tax calculation.

The jeopardy to the estate is avoided if the transfer is part of a bona fide sale for adequate and full consideration in money or money's worth.⁷² Here, the consideration is measured against the fair market value of the policy at the time of transfer—not the death benefit.⁷³ Under the applicable Treasury regulations, fair market value of a life insurance policy during the insured's lifetime may be approximated by adding the “interpolated terminal reserve value”—the statutory reserve value the life insurer is required to hold against the policy—to unearned premiums.⁷⁴ This reserve value may be considerably less than the death benefit amount.

Consistent with the all-or-nothing nature of section 2035, if *less* than adequate and full consideration is received, and the transferor's death occurs within three years of the transfer, the death benefit proceeds are *included* in the gross estate.⁷⁵ Arguably, the transferor's estate may reduce the death benefit value by the amount of consideration received, though this is unlikely to fully offset the death benefit amount.⁷⁶

c. Analysis: Three-Year Rule

Returning to the scenario, if the value of Daphne's claim equals or exceeds the sum of the unearned premiums and the interpolated terminal reserve value of the policy on the date of transfer, then the death benefit (\$3,000,000) will not be included in Stefan's estate. Alternatively, if Stefan dies within three years of the transfer to Daphne, and the value of Daphne's claim is less than the sum of unearned

premiums and the interpolated terminal reserve value, then the death benefit will be included in Stefan's estate, though likely partially offset by the value of Daphne's claim.

The takeaway for practitioners is that the carry-over basis exception generally does not apply to life insurance transferred as part of a settlement agreement. Accordingly, the transfer is likely to trigger substantial income tax consequences to the transferee while representing a sizeable lingering risk to the transferor's estate.

d. Alternative Strategies

Given the potential tax consequences, it is worth considering alternative strategies. One possibility may be for the policy owner to establish an irrevocable grantor trust (otherwise known as an "intentionally defective grantor trust" or "IDGT") for the benefit of the opposing party and sell the policy to the irrevocable grantor trust for full consideration.

In Revenue Ruling 2007-13, the IRS determined that a transfer of a life insurance policy to a grantor trust is not a transfer for value for purposes of IRC section 101(a)(2) because, for income tax purposes, the grantor and the grantor trust are treated as the same taxpayer. At the same time, as discussed above, a sale for full and adequate consideration removes the policy from the transferor's gross estate. But caution is warranted. Revenue Ruling 2007-13 was issued in the context of transfers between trusts established by the insured—not in the context of a trust created for the benefit of an adversarial party as part of a litigation settlement. No published authority has addressed this application. In particular, the step-transaction doctrine may pose a risk if the trust is created solely as a conduit to effectuate the settlement. Under that doctrine, the IRS may disregard intermediate steps in a series of formally separate transactions and treat them as a single integrated transaction where the intermediate steps lack independent economic substance apart from tax avoidance.⁷⁷ If the trust is a grantor trust, then the sale of the policy to the trust for the ultimate benefit of the opposing party may be treated as a single prearranged transfer and the grantor trust step could be disregarded, potentially triggering the transfer-for-value rule under section 101(a)(2) and defeating the sale exception under section 2035(d).

Other tax considerations—including the modified endowment contract rules, the potential application of IRC section 1035 tax-free exchanges, and the interplay of community property laws with policy ownership—may also affect the tax treatment of life insurance transfers in a settlement context.

3. Life Insurance Checklist

Before transferring a life insurance policy as part of a settlement:

- Determine whether the transfer is for valuable consideration and, if so, whether an exception to the transfer-for-value rule under IRC section 101(a)(2) applies, including the carry-over basis exception (which requires the transferee to have a substantial family, business, or financial relationship with the insured independent of the policy) and the safe harbors for transfers to the insured, a partner of the insured, or a corporation in which the insured is a shareholder or officer;
- If no exception applies, quantify the income tax exposure by comparing the death benefit to the sum of the consideration paid and any premiums the transferee will subsequently pay;
- Evaluate whether the consideration received for the policy equals or exceeds its fair market value at the time of transfer, so that IRC section 2035 does not cause estate tax inclusion if the insured dies within three years; and
- Document the dollar value of released claims with sufficient detail to withstand IRS scrutiny of the consideration exchanged, including the merits and potential damages underlying the claims.

B. Reformation of Retirement Account Beneficiary Designations

Settlements involving fiduciary misconduct do not always require the transfer of an asset. Sometimes the remedy is to undo a transaction that should never have occurred. When undue influence taints a beneficiary designation, the parties may seek a court-ordered reformation. But even a successful reformation raises a separate question: will the IRS respect it?

1. Scenario

Hiro had three children—Kenji, Nori, and Yuki—and named his spouse Mei as the primary beneficiary of Hiro's Individual Retirement Account ("IRA"), with no contingent beneficiaries. Mei predeceased Hiro, then Hiro died shortly afterward, aged 70, before Hiro had begun to receive required minimum distributions ("RMDs") from his IRA. Following Hiro's death, it was discovered that Hiro named Kenji as sole beneficiary of Hiro's IRA. Nori and Yuki filed a lawsuit against Kenji claiming Kenji exerted undue influence over their father. Ultimately, the parties settled and the court issued an order retroactively reforming the IRA beneficiary designation to name Nori and Yuki as equal beneficiaries. Each of Kenji, Nori, and Yuki are entitled to

equal shares of Hiro's estate under Hiro's will. Will the IRS accept this beneficiary reformation?

2. Discussion

Whether the IRS will respect a retroactive state court reformation depends on the facts and circumstances, interpreted under the *Bosch* "proper regard" standard and a four-part bona fide settlement test. The tax consequences are determined under federal law governing qualified retirement plans.

a. *Bosch* and the "Proper Regard" Standard

Under *Commissioner v. Estate of Bosch*, the IRS and federal courts are not bound by state trial court adjudications of property rights and must independently determine applicable state law. In doing so they must give only "proper regard" to state trial court rulings.⁷⁸ In exercising this authority, the taxing authorities tend to favor finality of completed transactions, and disfavor "collusive" state court modifications that may leave federal tax liabilities unsettled.⁷⁹ The result is a sliding scale approach: state court orders receive greater deference when they clarify pre-existing legal relationships or resolve bona fide disputes, and less deference when they reflect an effort to retroactively improve outcomes for taxpayers.⁸⁰

A review of private letter rulings related to retirement account beneficiary designations reinforces this understanding. Two particular patterns stand out. First, while the IRS may in certain cases respect a retroactive state court reformation when it involves an administrative mistake (e.g., by a financial institution),⁸¹ the IRS generally dismisses reformation to correct taxpayers' unforced errors.⁸² Second, the IRS tends to respect reformations resulting from bona fide settlements between adverse parties, provided the terms respect certain principles established by federal courts.⁸³

b. Four-Part Test for Bona Fide Settlement

In particular, the IRS and federal courts have applied various tests to distinguish bona fide settlements from collusive schemes to obtain tax benefits.⁸⁴ For settlement agreements, the taxing authorities look to see (1) whether there is a real dispute resulting in an arm's-length resolution; (2) whether the amounts received are based on an enforceable right under state law; (3) whether the amounts received by the parties are not greater than what they could receive by proceeding to a final judgment on the merits; and (4) whether the amounts received by the parties are of the same character and nature as if the proceeding continued to a final judgment on the merits.⁸⁵ The IRS will look at all the facts and circumstances. Formal court proceedings do not, in themselves, establish that a genuine dispute exists.⁸⁶

c. Tax Consequences for Required Minimum Distributions

At stake in a proceeding to reform a beneficiary designation for an IRA is not only the inheritance of the account itself but also the ensuing tax consequences. With the passage of the SECURE Act and SECURE Act 2.0, Congress has eliminated the possibility to "stretch" RMDs for an individual beneficiary's life expectancy—except for certain categories of eligible designated beneficiaries, including surviving spouses and disabled or chronically ill individuals.⁸⁷ Now the entire account must be distributed to an individual designated beneficiary within a mandatory 10-year period. However, if the plan participant died before beginning to receive RMDs and any non-individuals are designated beneficiaries of the IRA, including decedent's estates, a mandatory five-year rule applies.⁸⁸ Since RMDs are taxed as ordinary income,⁸⁹ a proceeding to reform a designation to name individual beneficiaries, as opposed to the decedent's estate, can avoid a significant acceleration of tax.

Separate and more dramatic tax consequences—such as possible sale treatment, income in respect of decedent, gift tax, generation-skipping transfer tax, or penalties for failure to satisfy RMD requirements—may also apply to reformations of IRA beneficiary designations.⁹⁰ A full treatment of the income, transfer, and excise tax consequences of IRA beneficiary designation reformations is beyond the scope of this article.

Other post-mortem planning alternatives to reformation may exist in certain situations. For example, for purposes of determining RMDs, beneficiaries are identified as of September 30 of the year following the plan participant's death.⁹¹ Accordingly, disclaimers or distributions made before that date may remove non-individuals to allow a more favorable 10-year distribution schedule to apply for individual beneficiaries.⁹²

d. Analysis: Bona Fide Settlement Factors

In the beneficiary designation reformation scenario, even if a genuine dispute exists between the siblings, the IRS will still scrutinize the resolution under the other bona fide settlement factors. First, the IRS may point to the discrepancy between what Nori and Yuki receive under the reformation of the IRA designation (each receive one-half) versus under Hiro's will (each receive one-third). If Nori and Yuki end up receiving a greater overall share of Hiro's estate under the settlement agreement than they would have in the absence of the alleged undue influence (i.e., their equal share under Hiro's will), then the IRS may argue that the additional amount received is not an economically fair result (factor one), is not based on an enforceable state law right (factor two), and/or is more than what Nori and Yuki could

have received by proceeding to a final judgment on the merits (factor three).

In contrast, if the settlement agreement provides that Nori and Yuki each receive one-third of the IRA and the remaining one-third continues to be held by Kenji, then the settlement is arguably within the range of fair outcomes (factor one), proportional to the parties' rights under state law (factor two), no more than what the parties could receive by full adjudication (factor three), and of the same character and nature as what the parties could receive by full adjudication (factor four).

If all of the factors are documented, then the IRS will likely respect the court's retroactive reformation of the beneficiary designation. As a result, Nori and Yuki will be treated as the designated beneficiaries of the IRA and be entitled to "stretch out" the distributions over 10 years instead of five years, deferring ordinary income recognition.⁹³

Ultimately, the tax consequences of settlements involving retirement accounts are rarely clear cut, and any attempt to reform the beneficiary designation must be made with careful attention to the SECURE Act's RMD requirements, the *Bosch* proper-regard standard, and bona fide settlement factors.

3. IRA Beneficiary Designation Checklist

Before entering a settlement agreement that would reform beneficiaries under an IRA:

- Confirm that a genuine dispute exists between adverse parties—active court proceedings alone are not sufficient;
- Evaluate whether the proposed settlement satisfies all four bona fide settlement factors: (i) the resolution is economically fair and at arm's length; (ii) the amounts received are based on enforceable rights under state law; (iii) no party receives more than what it could obtain by proceeding to a final judgment on the merits; and (iv) the amounts received are of the same character and nature as a final judgment;
- Document all of the foregoing—the IRS and Tax Court will independently evaluate whether the state court order reflects a bona fide dispute or a collusive scheme to obtain tax benefits;
- Determine the schedule of RMDs for reformed beneficiaries; and
- Complete all post-mortem planning—including disclaimers and distributions—before the

beneficiary finalization date (September 30 of the year following the account owner's death).

IV. CONCLUSION

Negotiating a settlement agreement only to have it unraveled by a tax attorney upon review is a costly outcome that can be avoided with proper planning. As the scenarios in this article demonstrate, the gap between what the parties agree to and what the IRS will respect is wide—and the consequences of falling into it are severe. A family loan may be recharacterized as a gift. An installment sale may carry hidden interest charges that no deduction can offset. An intrafamily transfer of business interests may trigger special valuation rules that inflate the gift or estate tax well beyond what the parties anticipated. A life insurance policy transferred as settlement consideration may generate taxable income the recipient never expected. And a court-ordered reformation of a beneficiary designation may be disregarded entirely if it does not satisfy the IRS's bona fide settlement requirements.

The common thread is the premise we identified at the outset: what the parties call the transaction is the beginning of the tax analysis, not the end of it. Each of the five scenarios presented—from the financing of the deal, to the tax treatment of intrafamily transfers, to the IRS's scrutiny of court-ordered reformations—illustrates a different dimension of that principle.

Although California generally conforms to the federal provisions discussed in this article, practitioners should not overlook the state-level income tax impact. California's top marginal rate of 13.3 percent applies to installment sale gains, imputed interest, and IRA distributions alike, amplifying the federal consequences in each scenario and making early identification of these issues all the more critical.⁹⁴

This article is not a substitute for a careful, fact-specific analysis by qualified tax counsel. Each section addresses selected provisions that frequently arise in settlement negotiations, not the full tax landscape applicable to any given transaction. This article is, however, intended to make the case for a team approach to dispute resolution. Early conversations between litigation counsel and tax counsel—before settlement terms are finalized—allow the team to identify tax exposure, structure the transaction to minimize unnecessary cost, and present the client with a settlement that will withstand IRS scrutiny after the ink has dried.

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- 01 *Comr. v. Estate of Bosch* (1967) 387 U.S. 456, 465.
- 02 IRC, section 453A.
- 03 IRC, section 453(b).
- 04 IRC, section 453(c).
- 05 IRC, section 453(a).
- 06 IRC, section 453(g); see also IRC, section 453(e) (providing an acceleration rule for related-party resales within two years).
- 07 IRC, section 453(b)(2)(B).
- 08 IRC, section 453(b)(2)(A); see also IRC, section 453(l) (defining dealer dispositions).
- 09 IRC, section 453(d).
- 10 IRC, section 453A(a)-(c).
- 11 IRC, section 453(l)(1).
- 12 Reported as an additional tax on IRS Form 1040, Schedule 2, Part II, line 17. Because the interest charge under IRC section 453A is computed independently—as an additional tax on the deferred tax liability, not as an item of income—it is not reduced by deductions, losses, or credits that otherwise offset income tax liability. See IRC, section 453A(c)(1) (imposing the interest charge on the “deferred tax liability”); IRC, section 6601(e) (1) (providing that the interest is assessed and collected in the same manner as tax). For noncorporate taxpayers, the interest is nondeductible personal interest under IRC section 163(h). See Instructions to IRS Form 6252 (2024).
- 13 IRC, section 453A(c)(4).
- 14 IRC, section 453A(c)(3).
- 15 IRC, section 6621(a)(2).
- 16 IRC, section 453A(c)(2).
- 17 IRC, section 453B(a). See also *Rushing v. Comr.* (5th Cir. 1971) 441 F.2d 593.
- 18 This amount is Sacha’s remaining basis in the note: her \$5,000,000 original basis, less \$2,000,000 of basis recovered (33.33 percent of the \$6,000,000 of principal collected through the end of Year 2). See Treas. Reg. section 15a.453-1.
- 19 Additional tax consequences—such as related-party recharacterization under IRC section 453(e), cancellation-of-debt income upon note forgiveness, and passive activity limitations—may also arise in installment sale transactions.
- 20 IRC, section 2512(b).
- 21 Treas. Reg. section 25.2512-8.
- 22 *Miller v. Comr.* (1996) 71 TCM (CCH) 1674, affd. (9th Cir. 1997) 113 F.3d 1241 [1996 Tax Ct. Memo Lexis 5], citing *Harwood v. Commissioner*, (1984) 82 T.C. 239, 258, affd. (9th Cir. 1986) 786 F.2d 1174, cert. den. (1986) 479 U.S. 1007.
- 23 *Miller v. Comr.*, *supra*, 1996 TCM Lexis 5, at pp. *22-*40.
- 24 *Id.* at pp. *4-*16.
- 25 *Ibid.*
- 26 In *Estate of Bolles v. Comr.* (9th Cir. 2024) 133 A.F.T.R.2d 2024-1235, affg. (2020) 119 TCM (CCH) 1502 [2024 U.S. App. Lexis 7612], the Ninth Circuit affirmed the tax court’s finding that intrafamily advances totaling over \$1 million were gifts—not loans—once the lender lost any reasonable expectation of repayment. *Bolles* underscores that the ability to repay must be sustained over the loan’s duration, not merely present at its inception. See also *Estate of Van Anda v. Comr.* (1949) 12 T.C. 1158, 1162 (holding that a “real expectation of repayment and intention to enforce the collection of the indebtedness” are the threshold requirements for bona fide debt characterization).
- 27 *Miller v. Comr.*, *supra*, 1996 TCM Lexis 5, at pp. *22-*40.
- 28 *Id.* at pp. *22-*40.
- 29 *Estate of Barbara Galli v. Comr.* (Mar. 5, 2025, No. 7003-20) 2025 TNTF 47-34 [2025 U.S. Tax Ct. Lexis 554, *2].
- 30 *Id.* at pp. *2-*5.
- 31 *Id.* at p. *7.
- 32 *Id.* at p. *6-8.
- 33 Akers & Hayes, *Estate Planning Issues With Intra-Family Loans and Notes* (2012) 38 ACTEC L.J. 207 (comprehensive analysis of structuring intrafamily loans to withstand IRS scrutiny, including collateral requirements and enforceability considerations).
- 34 Rev. Rul. 77-299, 1977-2 C.B. 343 (finding that loans forgiven as part of prearranged plans are gifts from inception); but see Rev. Rul. 81-264, 1981-2 C.B. 185; see generally Akers & Hayes, *supra* (discussing IRS treatment of prearranged forgiveness as completed gift from inception).
- 35 IRC, section 7872(f)(3).
- 36 IRC, section 7872(a). The applicable federal rate for a term loan is the applicable short-term, mid-term, or long-term rate in effect under IRC section 1274(d) as of the date on which the loan is executed, compounded semiannually. See IRC, section 7872(f) (2)(A). For a demand loan, a floating rate applies, equal to the applicable short-term rate in effect under section 1274(d) for the period for which the interest is being determined, recalculated and compounded semiannually. See IRC, section 7872(f)(2)(A).
- 37 H.R.Rep. No. 101-964, 2d Sess. pp. 516-527, 1130-1138 (1990) (replacing former IRC, section 2036(c) with new Chapter 14 special valuation rules to address estate and gift tax valuation abuse arising from estate freeze transactions).
- 38 Rev. Rul. 59-60, 1959-1 CB 237.
- 39 Staff of Joint Com. on Taxation, Present Law and Proposals Relating to Fed. Transfer Tax Consequences of Estate Freezes, 101st Cong., 2d Sess. (June 22, 1990) pp. 10-19 (JCS-21-90) (cataloguing specific intrafamily transfer structures and concerns that motivated Chapter 14). In particular, note the discussion on page 11: “All these rights are valued under the willing buyer, willing seller standard, without regard to how the parties actually holding the rights, in fact, will exercise them.”
- 40 H.R. Rep. No. 101-964, *supra*.
- 41 *Estate of Harrison v. Comr.* (1987) 52 TCM 1306 [1987 TCM Lexis 8].
- 42 *Id.* at pp. *4-*5.
- 43 *Id.* at p. *6.

- 44 *Ibid.*
- 45 *Id.* at pp. *11–*17.
- 46 *Id.* at p. *17.
- 47 2016 Federal Register preamble (REG-163113-02, 81 Fed. Reg. 51413).
- 48 Staff of Joint Comm. on Taxation, Present Law and Proposals Relating to Federal Transfer Tax Consequences of Estate Freezes, *supra*, p.10-12 (JCS-21-90, June 22, 1990).
- 49 IRC, section 2704(a).
- 50 IRC, section 2704(a)(1)(B).
- 51 Corporations Code, section 17707.1.
- 52 Note that the scope of IRC, section 2704(b)'s "applicable restriction" rule has been significantly narrowed by case law. In *Kerr v. Comr.* (1999) 113 T.C. 449, *affd.* (5th Cir. 2002) 292 F.3d 490, the tax court held that section 2704(b) applies only to restrictions on the ability to liquidate the entire entity, not to restrictions on an individual partner's right to liquidate his or her own interest. Following *Kerr*, numerous states amended their default partnership statutes to be at least as restrictive as typical partnership agreement provisions, effectively rendering section 2704(b) inapplicable to many family limited partnership transfers. See 2016 Federal Register preamble (REG-163113-02, 81 Fed. Reg. 51413).
- 53 IRC, section 2704(b)(4). In 2016, the Treasury issued proposed regulations (REG-163113-02, *supra*) that would have dramatically expanded the class of restrictions disregarded under section 2704(b), effectively eliminating most minority and marketability discounts for intrafamily transfers of interests in family-controlled entities. The proposed regulations drew over 28,000 overwhelmingly negative comments (see McDermott Will & Schulte, *Treasury Withdraws Proposed Regulations Aimed at Minimizing Valuation Discounts* (Oct. 2017), <https://www.mcdermottlaw.com/insights/treasury-regulations-valuation-discounts/> (as of Aug. 21, 2026), and were withdrawn entirely in October 2017 following Executive Order 13789.
- 54 IRC, section 2701.
- 55 *Ibid.*
- 56 IRC, section 2701.
- 57 IRC, section 2704(a).
- 58 Treas. Reg. section 25.2701-5(a)(2)–(3) (providing that the initial transferor "may reduce" the amount of taxable gifts, and the executor "may reduce" the amount of adjusted taxable gifts; the reduction must be claimed on the applicable gift or estate tax return and is not applied automatically).
- 59 Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions* (Mar./Apr. 2019) Fla. Bar J. (discussing the adjustment rules of Treas. Reg. section 25.2701-5 as mitigating double taxation in freeze partnership structures, while noting the reduction is limited to the lesser of the section 2701 increase and the duplicated amount). See also Written Comments of the American College of Trust and Estate Counsel on Proposed Regulations Under Sections 2701, 2702 and 2704 (1991) (demonstrating through worked examples that the credit-type adjustment under Proposed Treas. Reg. section 25.2701-5 fails to fully eliminate double taxation unless the taxpayer has already made sufficient prior taxable gifts to be taxed in the highest transfer tax bracket).
- 60 IRC, section 2701(a)(2)(C).
- 61 This article's discussion of Chapter 14 is limited to IRC sections 2701, 2704(a), and 2704(b). Other Chapter 14 provisions—including IRC section 2702, which governs transfers with retained income interests, and IRC section 2703, which may disregard certain buy-sell agreements and restrictions on property for transfer tax purposes—may also apply to settlement transactions involving closely-held business interests.
- 62 For comprehensive treatment of how the Chapter 14 provisions interrelate, see Quigley & Brown, *Unpacking the Myths and Mysteries of Chapter 14: Part I—Code Secs. 2701 and 2702* (Feb. 2017) Taxes—The Tax Magazine, (discussing the "winding nature" of IRC, sections 2701 & 2702 and their interaction with IRC, sections 2703 & 2704); see also ACTEC, *Family-Owned Business and IRC Chapter 14, Parts 1–3* (2025), <<https://actecfoundation.org/podcasts/>> (distinguishing between the "deemed gift" provisions of Chapter 14 (sections 2701, 2702, 2704(a)) and the "disregarding" provisions (sections 2703, 2704(b)) and describing section 2704(a) as the "Anti-Harrison Rule").
- 63 Revenue Act of 1913, ch. 16, section II(B), 38 Stat. 114, 167.
- 64 IRC, section 101(a)(3)(B), added by Tax Cuts and Jobs Act of 2017 (Pub.L. No. 115-97, section 13522 (Jan. 1, 2018) 131 Stat. 2054, 2151), defining a "reportable policy sale" as an acquisition of an interest in a life insurance contract by a person with no substantial family, business, or financial relationship with the insured—effectively disabling the traditional exceptions to the transfer-for-value rule for speculative third-party purchasers. For a detailed explanation, see Staff of Joint Com. on Taxation, General Explanation of Pub.L. No. 115-97 (JCS-1-18, Dec. 2018) pp. 241-244.
- 65 IRC, section 101(a)(2).
- 66 The phrase "in whole or in part" is significant. Under IRC section 101(a)(2)(A), the carry-over basis exception applies not only to pure gifts (where the transferee takes the transferor's full basis) but also to mixed transactions involving both a gratuitous element and valuable consideration—provided the transferee's basis is determined at least in part by reference to the transferor's basis. (IRC, section 101(a)(2)(A); Treas. Reg. section 1.101-1(b)(1)(ii)(A).) Where a transfer is in part for valuable consideration and in part gratuitous, each part is treated as a separate transaction for purposes of determining excludability. (Treas. Reg. section 1.101-1(b)(2)(iii).) In the settlement context, this rule means that a transfer of a life insurance policy that is partly compensatory and partly donative may still preserve the income-tax-free treatment of the death benefit—for the gratuitous transfer portion, only—so long as the basis computation retains a carryover component. Counsel should document the basis allocation carefully to support reliance on this exception.
- 67 IRC, section 101(a)(2)(A).
- 68 IRC, section 101(a)(3)(B).
- 69 IRC, section 101(a)(2)(B).

- 70 Because the valuation of released claims as consideration lacks a bright-line standard, practitioners should document the merits, litigation risk, and potential damages underlying the claims to establish their fair market value under the willing-buyer, willing-seller standard of Treas. Reg. section 20.2031-1(b); see also IRC, section 6662 (accuracy-related penalties for substantial understatement of income tax).
- 71 IRC, section 2035(b).
- 72 IRC, section 2035(d).
- 73 IRC, section 2035(d) (excepting bona fide sales for adequate and full consideration). The adequacy of consideration is measured against the fair market value of the policy, not the death benefit. See PLR 9843024 (interpolated terminal reserve plus unearned premium constitutes adequate consideration for sale of policy between trusts); PLR 199905010 (interpolated terminal reserve value or cash value constitutes adequate consideration). But see TAM 8806004 (taking the position that consideration must equal the face amount of the policy, relying on *United States v. Allen* (10th Cir. 1961) 293 F.2d 916).
- 74 Treas. Reg. section 20.2031-8(a)(2); Treas. Reg. section 25.2512-6(a).
- 75 IRC, section 2035(b).
- 76 See IRC, section 2043(a). The IRS has generally accepted that section 2043(a) applies to section 2035 inclusions to provide this offset for partial consideration. See *Estate of Gregory v. Comr.* (1996) TCM 1996-423 (applying section 2043 offset in a section 2035 context).
- 77 See *Gregory v. Helvering* (1935) 293 U.S. 465 (establishing that transactions lacking economic substance apart from tax avoidance may be disregarded); see also *McDonald's Rests. of Ill., Inc. v. Comr.* (7th Cir. 1982) 688 F.2d 520 (applying the step-transaction doctrine under the "end result," "interdependence," and "binding commitment" tests).
- 78 *Comr. v. Estate of Bosch* (1956) 387 U.S. 456, 465.
- 79 *Estate of La Meres v. Comr.* (1992) 98 T.C. 294, 312 (quoting *Van Den Wymelenberg v. United States* (7th Cir. 1968) 397 F.2d 443, 445).
- 80 See *Estate of La Meres v. Comr.*, *supra*, 98 T.C. at pp. 311–314 (describing the continuum of deference and noting that state court decrees entered by consent receive less weight than adjudications of genuinely contested rights).
- 81 PLR 200616039 (IRS accepted court reformation because affidavit of account custodian's employee established that taxpayer's instructions were received but not implemented due to administrative error resulting in omission of daughters as contingent beneficiaries).
- 82 PLR 200742026 (IRS rejected court reformation because daughter was not named as designated beneficiary at the time of decedent's death).
- 83 PLR 200127027 (IRS respected state court reformation of IRA beneficiary designation where original designation was procured through undue influence); PLR 200707158 (IRS accepted court reformation where beneficiary designation was found to have been signed under undue influence of the named beneficiary).
- 84 *Lyeth v. Hoey* (1938) 305 U.S. 188, 195–196 (holding that property received by an heir in settlement of a will contest is "acquired by inheritance" for federal tax purposes, and that "the distinction sought to be made between acquisition through . . . a judgment after a trial and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound"); *Ahmanson Found. v. United States*, (9th Cir. 1981) 674 F.2d 761, 774–775 (holding that "either a good faith settlement or a judgment of a lower state court must be based on an enforceable right, under state law properly interpreted," in order to qualify for the estate tax marital deduction).
- 85 For a detailed analysis see Fredkin & Szczepanik, *Tax Issues When Settling a Trust or Estate Dispute: A Guide for the Litigator*, Cal. Trusts and Estates Q. (2019, Vol. 25, Issue 3), in which they explain the history and rationale of the four-part test the Internal Revenue Service applies when evaluating the merits of a settlement agreement.
- 86 See *Estate of Redstone v. Comr.* (2015) 145 T.C. 259, 271–277 (applying a six-factor test to determine whether an intrafamily settlement was bona fide, including as a threshold inquiry "whether a genuine controversy existed between the parties," and examining whether the parties were represented by counsel, engaged in adversarial negotiations, were motivated by the desire to avoid litigation costs, and whether the settlement was under judicial supervision—none of which is dispositive standing alone).
- 87 See IRC, section 401(a)(9)(H)(i)-(ii), added by the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), Pub. L. No. 116-94, section 401 (Dec. 20, 2019) 133 Stat. 2534, 3155 (eliminating the life-expectancy stretch for most individual designated beneficiaries and imposing a 10-year distribution requirement). See also SECURE 2.0 Act of 2022, Pub. L. No. 117-328, div. T (Dec. 29, 2022) 136 Stat. 4459, 5275 (further modifying the RMD rules by increasing the required beginning date age from 72 to 73 for individuals attaining age 72 after December 31, 2022, and to 75 after December 31, 2032; adding a new surviving spouse election under IRC, section 401(a)(9)(B)(iv); and reducing the excise tax for missed RMDs from 50 percent to 25 percent under IRC, section 4974(a)). For the definition of "eligible designated beneficiary"—including surviving spouses, minor children of the employee, disabled individuals, chronically ill individuals, and individuals not more than 10 years younger than the employee—see IRC, section 401(a)(9)(E)(ii). See also Treas. Reg. section 1.401(a)(9)-4, Q&A-1 through Q&A-3 (defining designated beneficiary); Treas. Reg. section 1.401(a)(9)-5 (RMDs from defined contribution plans after death of employee).
- 88 IRC, section 401(a)(9)(B)(ii) (requiring distribution of the entire interest within five years of the employee's death where no designated beneficiary exists as of the beneficiary finalization date); see also IRC, section 401(a)(9)(B)(iii) (providing an alternative life-expectancy method where distributions began before the employee's death). The five-year rule applies when the account owner dies before the required beginning date, and no individual is a designated beneficiary. (See Treas. Reg. section 1.401(a)(9)-3, Q&A-1 and Q&A-2; Treas. Reg. section 1.401(a)(9)-4, Q&A-3 (treating the estate as not a designated beneficiary).)

- 89 IRC, section 408(d)(1) (providing that distributions from individual retirement accounts are included in gross income as ordinary income to the extent not attributable to nondeductible contributions); see also IRC, section 408(d)(2) (special rules for distributions rolled into another IRA); IRC, section 72(t) (10 percent additional tax on early distributions from qualified retirement plans, applicable to IRA distributions before age 59 and one-half unless an exception applies). For inherited IRAs, see IRC, section 691(a)(1) (income in respect of a decedent).
- 90 The tax consequences at issue in a beneficiary designation reformation proceeding extend beyond the applicable distribution period. Among other issues not addressed in this article, practitioners should be aware of the following: (1) the potential for sale or exchange treatment under IRC section 1001 where a beneficiary relinquishes an interest in the IRA in exchange for other property or consideration, which could trigger gain recognition rather than ordinary income treatment; (2) gift tax exposure under IRC sections 2501 et seq. where the reformation results in one party receiving a disproportionate share relative to their enforceable legal entitlement; (3) generation-skipping transfer tax implications where the reformation alters beneficial interests across generational lines; (4) excise taxes under IRC section 4974 for failure to satisfy RMD requirements during the pendency of the proceeding; (5) prohibited transaction concerns under IRC section 4975; and (6) income in respect of a decedent considerations under IRC section 691 affecting the character and timing of distributions. Each of these issues warrants independent analysis based on the specific facts presented, and this article should not be read as an exhaustive treatment of the federal tax consequences implicated by a reformation proceeding.

- 91 Treas. Reg. section 1.401(a)(9)-4(c)(1) (providing that the employee's designated beneficiary is determined based on beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death).
- 92 Treas. Reg. section 1.401(a)(9)-4(c)(2)(ii)-(iii) (providing that a beneficiary is not taken into account in that determination if, by that Sept. 30, the beneficiary disclaims entitlement pursuant to a qualified disclaimer satisfying IRC, section 2518 or receives the entire benefit to which the beneficiary is entitled).
- 93 The framework discussed herein for evaluating IRS deference to court-ordered reformations and settlement agreements is a simplified overview of a highly fact-intensive inquiry. The weight accorded to each factor, and the conclusions drawn from their application, will vary depending on the particular circumstances, governing state law, and the nature of the underlying proceeding. Where the stakes are significant, practitioners may wish to consider seeking a private letter ruling before advising clients to rely on a reformation or settlement agreement for federal tax purposes.
- 94 Rev. & Tax. Code, section 17024.5, subd. (a)(1) (providing that, for taxable years beginning on or after January 1, 2025, California conforms to the IRC as of January 1, 2025); Rev. & Tax. Code, section 17501 (conforming to federal retirement plan distribution rules under IRC, section 401 et seq.). The specified date of conformity was updated from January 1, 2015, to January 1, 2025, by the Conformity Act of 2025 (Stats. 2025, ch. 231) (Sen. Bill No. 711 (2025-2026 Reg. Sess.)).



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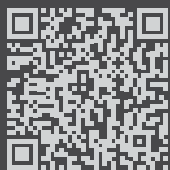
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BRESLIN V. BRESLIN MEDIATIONS, FIVE YEARS LATER: VALUABLE, BUT VASTLY MORE COMPLICATED

Written by Judge Mary Thornton House (Ret.)*

I. SYNOPSIS

When *Breslin v. Breslin*⁰¹ was decided over five years ago, its impact on court-ordered mediations and subsequent rulings on petitions to confirm “*Breslin*” settlements was uncertain.⁰² Although no appellate case has cited *Breslin* to date, recent cases alleging a breach of fiduciary duty on behalf of a trustee reflect an ever-expanding creativity with respect to theories of what constitutes a fiduciary breach.⁰³ A *Breslin* error falls squarely within this expanding scope of theories subjecting trustees and counsel to allegations of a breach of fiduciary duty and attorney malpractice. Furthermore, in the course of the preparation for and conduct during a mediation, unwitting violations of the Rules of Professional Conduct may occur. Mediators and counsel need to be mindful of these potential ethical pitfalls and take steps to avoid post-mediation allegations of an ethical violation.

When mediators and lawyers are asked to describe the impact of court-ordered *Breslin* mediations, they share this common sentiment: while *Breslin* mediations are valuable, they are vastly more complicated. This complexity arises from the intricacies of the notice, the due diligence required, and the pre-mediation preparation needed by clients and mediators.

This article provides guidance on these issues with practice tips to avoid errors that could result in breach of fiduciary duty claims, attorney malpractice claims, and allegations of ethics violations. If followed, the guidance provided herein comprises a ready template in support of a defense when the actions of a lawyer and trustee are challenged.

RUTH: A COMMON FACT SITUATION, PART I

Ruth never married. When she passed away at age 94, she left no natural heirs except for her niece, Jill. She created a trust in her early 60s that provided for eight close friends to receive her considerable assets. Jill was named as successor trustee and was a beneficiary of the original trust. Ruth amended her trust seven times prior to her death. Some original beneficiaries remained and others were deleted. New beneficiaries were named. Jill, an original beneficiary, was never removed. Due to the amendments, distributions for each named beneficiary over time were either greater, smaller, or remained the same. Jill's share of the trust assets in the seventh amendment was smaller than those listed in the fourth, fifth, and sixth amendments to the trust.

Dan, a young man in his 30s when he met Ruth, started as her driver, began to be her personal assistant, and ultimately moved next door to Ruth's apartment complex and remained available to assist her. Their relationship was described by many of the beneficiaries as close—i.e., the son Ruth never had. In the fourth amendment, Dan was made a beneficiary, and his original distribution was \$500,000. In the seventh amendment, Dan's distribution increased from \$500,000 to \$1,500,000, which comprised approximately 50 percent of the trust's assets.

Jill firmly believes that Dan took advantage of Ruth, claiming Ruth lacked capacity to change her trust in the last three years of her life and that Dan exerted undue influence upon Ruth that resulted in a significant increase in his trust distribution. She further alleged that he was not the “son she never had,” but a conniving caregiver, and therefore the burden would shift to him to prove by clear and convincing evidence that Ruth had testamentary capacity and was not unduly influenced.

II. THE SCOPE OF TRUSTEE LIABILITY BASED ON “*BRESLIN* ERROR”

A. Determination of the Identity of the Beneficiaries Entitled to Notice

A trustee's failure to communicate information necessary for a beneficiary to enforce their rights constitutes a breach of trust.⁰⁴ In the context of a *Breslin* mediation, if a trustee fails to provide notice to beneficiaries whose identities and addresses are known or reasonably ascertainable, the legal consequences are severe. Holders of future property interests, including remote or contingent beneficiaries, are entitled to notice as a matter of due process if their property interests are inevitably affected by a proceeding. California law does not differentiate between present and future property interests.⁰⁵

Regardless of their status, all beneficiaries are indispensable parties. Failure to bring indispensable parties before the court constitutes a jurisdictional defect, rendering any subsequent court order or decree affecting their interests void. Beneficiaries whose rights are inevitably affected by a proceeding are considered indispensable parties.⁰⁶ *Res judicata* becomes inapplicable, allowing excluded remote beneficiaries to attack the void settlement or order at any time.⁰⁷

Beneficiaries who receive a proper *Breslin* notice of the court-ordered mediation but fail to participate may be bound by a resulting settlement.⁰⁸ A defective notice or total failure to provide notice deprives all beneficiaries of the opportunity to protect their interests. Once a trustee is prevented from enforcing the settlement agreement arising out of the mediation because of notice errors, a trustee faces allegations of a breach of fiduciary duty and specifically the duty to keep beneficiaries informed of the trust and its administration.⁰⁹

The requirement to provide notice to remote beneficiaries is subject to several basic and necessary stricter notice requirements dependent upon the facts of any individual case.¹⁰ There are standards for what constitutes reasonable diligence and guidelines for the exercise of a trustee's discretion. A trustee is not required to provide notice to a beneficiary who is unknown to the trustee, or who is known but cannot be located after the trustee exercises “reasonable diligence.” Further, in the absence of a final judicial determination of heirship, a trustee has the discretion to make a good faith determination of the heirs of a deceased settlor by any reasonable means.¹¹

B. Reasonably Ascertainable Standard

Under California law, when a trustee is identifying beneficiaries who must receive notice of trust proceedings, the “reasonably ascertainable” standard is rooted in constitutional due process requirements. If a proceeding will adversely affect a beneficiary's property interest and the individual is reasonably ascertainable, California law holds that it is neither unreasonable nor onerous to require a trustee to give notice either by mail or another method.¹²

C. Issues Raised About Ruth in the Common Fact Situation

Jill, as successor trustee of Ruth's trust, is required to give notice to all beneficiaries. It is unknown what facts will be presented at trial. There are allegations of lack of capacity, undue influence, and financial elder abuse surrounding the later amendments. Query whether deleted beneficiaries claim the later amendments are fraudulent, Ruth was subjected to undue influence, or they have extrinsic evidence of a mistake? What is known is this: 30 years separate the original trust from the final amendment in which named beneficiaries were added and deleted and their distributive shares were also modified. Therefore, is notice of the mediation required both by *Breslin* and by federal and state standards of constitutional due process to all beneficiaries contained in the original trust and subsequent amendments? Answer: to survive judicial scrutiny, yes.

In this scenario, Jill appears to be initiating litigation at the expense of the trust to further her own interests and perhaps those who suffered a similar fate due to the seventh amendment. On its face, a conflict is apparent. In discussing *Breslin* mediations with counsel and mediators, this scenario is quite common, as it raises the issue of when you have a trustee who is also a beneficiary, what conflicts can and do exist? Jill is petitioning the court to invalidate the amendments that reduced her share. Other beneficiaries may wish to join in the petition because their shares were deleted or reduced, while other beneficiaries may desire that their unchanged share(s) stated in the fifth, sixth, and seventh amendments be distributed to them.

When counsel state that “overall *Breslin* mediations are valuable, but vastly complicated,” this fact pattern is the poster child of this sentiment. However, this scenario embodies the true value of a *Breslin* notice requirement and the probate court's ability to order the parties to mediation. Once the trustee has conducted the required due diligence in ascertaining the identity and whereabouts of all beneficiaries and served them with a *Breslin* notice, the mediation presents a global opportunity to resolve this matter early in this stage of the proceedings that would

not otherwise present itself absent the principles behind a court-ordered *Breslin* mediation.¹³

PRACTICE TIP: Engage in extensive and meaningful pre-mediation preparation. Pre-mediation preparation should be extensive and calculated, as it is critical for a successful outcome. Suggested steps that should be taken are as follows: (1) Contact the selected mediator to schedule an initial pre-mediation conference call and subsequent conferences; (2) Educate the mediator in that first call regarding the allegations in the petition(s) that are the subject of the mediation and the status of identification and location of beneficiaries who will be given a *Breslin* notice; (3) Inquire of the mediator what materials they may need to begin preparation for the mediation and comply with their requests. For example, this fact pattern cries out for a chart that diagrams the original trust and the amendments (include dates), the beneficiaries and their bequests included in each amendment, and if aware of a beneficiary's status (dead, living in Montana, etc.) include that information as well. Continuing to update this chart as information is received would be invaluable; (4) Schedule a conference at least a week prior to the mediation to advise the mediator of the response(s) to the *Breslin* notice and indicate what parties intend to appear (Zoom, telephonic, or in-person) and whether additional lawyers for beneficiaries have contacted counsel.

This information prepares not only the mediator but their staff. "Vastly complicated" is the appropriate label for these mediations that usually have in-person appearances, Zoom/telephonic appearances, and multiple counsel. Other issues are: Will interpreters be present? Are some participants appearing pursuant to a power of attorney? Do some participants need technological assistance? Will participants also include family members or support persons?

III. ENSURING COMPLIANCE WITH DUE DILIGENCE WHEN IDENTIFYING PRESENT AND REMOTE BENEFICIARIES ENTITLED TO A *BRESLIN* NOTICE

Under California law, a trustee must exercise reasonable diligence to identify and locate trust beneficiaries, including those with remote or future interests, to satisfy due process requirements when providing notice of proceedings that could affect their property rights.¹⁴ To ensure compliance with due diligence requirements when identifying and locating remote beneficiaries for a *Breslin* notice, a trustee should take the following steps:

A. Conduct a Thorough and Systematic Investigation

To satisfy the "reasonable diligence" required, a trustee must conduct a thorough, systematic investigation and inquiry in good faith.¹⁵ This inquiry cannot rely solely on generic searches if more specific information is available.¹⁶ The trustee's search should include:

1. Inquiries of Known Contacts

Actively questioning relatives, friends, acquaintances, and former employers of the beneficiary.¹⁷

PRACTICE TIP: Use this important opportunity to question these known contacts to find out additional information about beneficiaries who require a *Breslin* notice. Mediations are completely derailed when it is revealed for the first time at the mediation that beneficiaries are incapacitated by a conservatorship, mental health hold, confinement to a skilled nursing facility or memory care, without permanent housing, are deceased or subject to other legal or societal impediment to attendance. Most of these circumstances would likely require the appointment of a guardian ad litem. The suspension and continuation of the mediation from these revelations result in unnecessary expense and delay, which could have been easily avoided with an early inquiry.

PRACTICE TIP: These interviews provide excellent opportunities to discover whether there are "camps or coalitions" among beneficiaries and parties. Often, there are alliances or feuds between beneficiaries that are unknown to counsel, the trustee, and the mediator. This knowledge, when provided to the mediator in a pre-mediation conference call, is invaluable to the mediator in sorting out Zoom or physical rooms and the approach to take with the beneficiaries and parties. It is particularly critical for both counsel and the mediator when communicating with unrepresented parties.

PRACTICE TIP: Notify the mediator immediately if there are concerns for the safety of the participants. Probate mediations are highly emotional with lifelong resentment and animosity among the beneficiaries. Counsel should meet and confer over a solution to this issue, such as splitting the cost of a security guard or arranging a hybrid mediation with some beneficiaries appearing via remote access.

2. Database and Internet Searches

Conducting comprehensive internet searches and utilizing relevant online search engines.¹⁸

3. Public Records Investigations

Investigating appropriate city and telephone directories, the voters' register, and the real and personal property

indexes at the County Clerk and Recorder's Office or County Assessor's Office near the beneficiary's last known address.¹⁹

4. Localized and Fact-Specific Searches

Investigators should utilize specific clues known to the trustee (such as unique names, birth years, or geographical locations) to narrow search results, rather than relying strictly on generalized computer databases.²⁰

PRACTICE TIP: Knowledge that beneficiaries are now living outside of California requires all of these steps to be taken in their state or country of residence.

B. Identify and Account for Remote and Future Interests

The trustee must not limit the due diligence search to current income beneficiaries. Due process protections apply to both present and future property interests, including contingent remaindermen. If a court determines that there was a due diligence failure in conducting searches for beneficiaries, the settlement is subject to being unwound, even years after it was approved.²¹

C. Document Search Efforts if the Need for a Formal Declaration or Court Testimony Arises

If a remote beneficiary's location cannot be found after conducting a diligent search, the trustee must be prepared to demonstrate those efforts to the court. Such efforts are initially required in a declaration of the person who engaged in the comprehensive search. Local court rules, such as those in Ventura County, require the filing of a specific declaration detailing the exact efforts made to locate the beneficiary before the court will dispense with notice or prescribe an alternative method of notice.²² Detailed notes of the search(es) are critical. An investigator or associate who conducts these searches may later be needed to explain their procedures in court or by a declaration.

PRACTICE TIP: Detailed records of the sites and public records visited by the investigator must be kept. If there is a challenge to the *Breslin* notice based upon a failure to exercise due diligence in locating a beneficiary, a detailed declaration of the steps taken is required. Special attention should be given to those courts with local rules that require this information. If those local rules are used as a template, they provide a roadmap for a judge's analysis of due diligence in those counties without such a rule.

PRACTICE TIP: It is advised that this task be turned over to an experienced investigator. This approach guards against the risk of an attorney's credibility being called into question as to their experience and expertise with respect to the

search and the adequacy of the results. It also enables counsel to qualify the investigator as an expert.

D. Parameters of Due Diligence: A Case-By-Case Analysis

A trustee is not required to provide notice to any beneficiary who consents to the proposed action in writing, or who is unknown and cannot be located after reasonable diligence.²³ The scope of due diligence required of a trustee is not governed by a single formula. The showing of diligence in a given case must rest on its own facts.²⁴ While trustees must make a "reasonably diligent effort" to avoid liability for damages, costs, and attorney fees,²⁵ they are not required to engage in impracticable, extended, or highly burdensome daily searches for remote or ephemeral contingent beneficiaries whose existence cannot be ascertained through reasonable means.²⁶ If a trustee truly has no reasonable means of knowing of a beneficiary's existence, the failure to provide statutory notice will not violate due process.²⁷

IV. REQUIREMENTS OF THE *BRESLIN* NOTICE

A. Minimum Requirements

At a minimum, the notice must contain the following operational and case-specific details:

1. Mediation Details and Logistics

The date, time, and physical place of the mediation, or the use of remote technology if appropriate.²⁸

PRACTICE TIP: Using the 28-line pleading format, label the pleading as follows:

NOTICE OF MEDIATION PURSUANT TO *BRESLIN* v. *BRESLIN* (2021) 62 Cal.App.5th 801²⁹

2. Case Identification

Clear identification of the case and the specific issues being mediated.³⁰

PRACTICE TIP: It is not uncommon for multiple petitions to be deemed related or consolidated, some of which might be pending outside of the probate court, i.e., elder abuse, unlawful detainers, requests for restraining orders, and injunctive relief. The pleading caption should include all petitions and civil actions and their case numbers if applicable. This approach will put all participants on notice, at a minimum, of the specific issues being mediated and, if later contested, demonstrate to the court that more than

adequate notice of the subject matter of the mediation was provided.

PRACTICE TIP: A short summary of the predominant issues should be included. For example: “You are advised that these petitions include allegations that [insert summary of allegations, i.e., invalidation of the trust, fraud, undue influence, lack of capacity, elder abuse, unlawful detainer, etc.] and will be discussed at the mediation for the purpose of reaching a [global] resolution without the necessity of future hearings in these matters.”

3. Right to Appear

An explicit statement that the recipient has the option of appearing and participating in the mediation, either with counsel (for represented parties) or personally (for unrepresented parties).³¹

PRACTICE TIP: Use the language found in the *Breslin* court of appeal opinion that specifically noted the following is recommended: “[The notice] stated that nonparticipating persons or parties may be bound by the terms of any agreement reached at the mediation, and the rights of trust beneficiaries or prospective beneficiaries may be lost by the failure to participate in the mediation.”

4. Contact Information

Contact information for the trustee’s counsel if the beneficiary has further questions.³²

PRACTICE TIP: The following language is suggested: “If you are represented by counsel, please have them contact us. Through them, we can answer your questions. If you are not represented by counsel, please note that we cannot give you legal advice, as it is not permitted by law; however, limited discussions regarding date, time, availability, and procedures are permitted. We can be contacted at [phone number, email/U.S. postal address].”

5. Notice of Intent to Appear

Instructions requiring parties who intend to participate to advise the sender of their intention to attend by email or U.S. Mail, specifying that notification via telephone will not be accepted.³³

PRACTICE TIP: The following language is suggested:

It is important that you advise us of your intention to attend the mediation. Please respond to us in writing at [insert address] if by U.S. mail or send us an email at [insert the email address]. Further, please advise us whether you will be appearing in person. There will be remote access via [insert platform (Zoom, Teams)]. Therefore, please provide

us with an email address for us to send you the link. Please let us know as soon as possible whether you will need technical assistance in order for us to arrange for that help.

PRACTICE TIP: At the start of a mediation using a remote platform, it is common for parties, both represented and unrepresented, to have technical difficulties. Resolving those technical difficulties causes unnecessary delays, frustration, and anxiety for all participants. Many law firms do a dry run with their clients the day before the mediation. Most mediation vendors are more than willing to assist as well. This proposed language gives the unrepresented beneficiaries an option to seek assistance well before the date of the mediation, which should be encouraged.

B. Best Practices to Survive Judicial Scrutiny

To ensure the notice survives judicial scrutiny and successfully binds non-participating beneficiaries to any settlement or asset distribution reached during mediation, the trustee or noticing party should implement the following additional best practices:

1. Include Explicit Warning Language

The notice must explicitly warn recipients of the consequences of non-participation. It should state that mediation may result in a settlement agreement distributing the trust assets and awarding attorneys’ fees.³⁴ Crucially, it must advise that non-participating persons who receive notice may be bound by the terms of any agreement reached at mediation without further action by the court or further hearing, and that the rights of trust beneficiaries may be lost by the failure to participate.³⁵

PRACTICE TIP: The outcome of the *Breslin* court of appeal opinion supports this warning. An example of this warning is as follows: “Mediation may result in a settlement of the matters that are the subject of the above-referenced cases and of any and all interested persons and parties who may have an interest in the matters. Settlement of the matter(s) may result in an agreement for the distribution of assets of the above-referenced Trust, but not necessarily in the manner in which they are now held. Further, settlement of the matter may result in an award of attorneys’ fees to one or more parties, thereby reducing any distributive share to parties and beneficiaries.”

PRACTICE TIP: Some notices bold or capitalize this language to emphasize its importance. This emphasis is visually persuasive when a trial court is ruling on an objection to a settlement agreement made by a noticed beneficiary who did not participate.

2. *Provide Timely and Prompt Notice in Accordance with Statutory Requirements*

Notice should be sent as soon as the mediation's time, date, location, and format are decided to give all parties adequate time to adjust their schedules and conduct pre-mediation preparation.³⁶

PRACTICE TIP: Timely and prompt notice is critical to ensure that a court would find that adequate notice is given. The strict requirements under Probate Code section 16061.7 for a trustee to provide certain information should not be confused with the procedural notice requirements of a court-ordered mediation.³⁷ Probate Code sections 1200 through 1230 should be consulted and observed. In general, California courts apply strict standards when evaluating proof of service, and a failure to strictly comply with statutory service standards can deprive a court or tribunal of jurisdiction to act.³⁸

PRACTICE TIP: Notice should include all potential and remote beneficiaries.³⁹

3. *How to Address Continuances*

If the mediation is postponed, continued, or suspended, formal notices of all continuances and new dates must be systematically sent to all beneficiaries to preserve the binding effect of the eventual proceeding. A phone call or email advisement is not adequate to satisfy notice requirements.⁴⁰

V. IMPACT OF COURT-ORDERED *BRESLIN* MEDIATIONS ON THE MEDIATION PROCESS

RUTH: A COMMON FACT SITUATION, PART II

Dan appeared at the mediation represented by counsel. Five of the original beneficiaries appeared in addition to two of the three later-added beneficiaries. All were unrepresented and none had legal training. They were a mix of high school graduates, college attendees, and college graduates. During the pre-mediation conference, the mediator had learned that all beneficiaries were at least acquaintances and some were close friends and some had passed away. The mediator arranged four rooms, loosely aligned with the beneficiaries' perceived unity, with reserved rooms to further separate the parties if needed. Both Dan's counsel and trustee's counsel were observed entering the beneficiaries' rooms. At one point, Dan's counsel approached the mediator and said, "This is exciting, I'm building coalitions for my client." Counsel for the trustee approached the mediator and commented, "I asked them what you had said about our

case, and I wasn't too happy with the response they told me you made."⁴¹

A. *Breslin* Mediations Test Time Management and Adherence to Ethical Rules in Communicating with Unrepresented Beneficiaries

Court-ordered *Breslin* mediations involve a greater number of unrepresented beneficiaries who have little or no knowledge of probate and trust proceedings or the law.⁴² This dynamic presents multiple challenges for the mediator and counsel. Time management is tested because extra care is required by lawyers and mediators when communicating with unrepresented beneficiaries. Extra care in this context means not only mediating the case but doing so in a manner that ensures the ethical duties required by the Rules of Professional Conduct are followed.

Typically, mediators first explain the mediation privilege to unrepresented beneficiaries. Next, they advise that they cannot give them legal advice because no attorney-client relationship exists. In most situations, the beneficiaries who attend the mediation pursuant to a *Breslin* notice have no knowledge about the litigation other than the summary provided in the notice. These necessary advisements consume a great deal of the mediator's time. If a proposed resolution is reached, the mediator must again explain the complex settlement terms to the beneficiaries, which again will consume additional time.

Due to the formality of the *Breslin* notice and the presence of a retired judge as mediator, many self-represented beneficiaries arrive at mediation believing it is a court proceeding in which decisions will be made by "the judge." Whether by Zoom or in person, beneficiaries are in a law office setting, realizing they have only a layperson's understanding of the law plus the basic advisements given by the mediator. Just like a criminal suspect who waives his right to an attorney but during questioning invokes his right to counsel, a beneficiary will often realize they need advice from their own counsel. This realization can come early in the day, but most often happens when presented with a complicated settlement agreement, typically at the end of the day.

PRACTICE TIP: This dawning realization by unrepresented beneficiaries that they should retain counsel often results in a day spent without a resolution. At the pre-mediation conference call, counsel should explore reserving a date for a second session in the event a resolution cannot occur because unrepresented beneficiaries want to consult with an attorney. This approach avoids unnecessary delays due to counsel and mediator unavailability. Additionally, suggest a Zoom follow-up to cut down on costs.

PRACTICE TIP: Advise your clients that if one or more unrepresented beneficiaries are expected to attend the mediation, they should anticipate greater delays between your sessions with the mediator. Providing that advisement may avoid at the outset any feelings that a mediator is ignoring your client.

B. The Ethics: *Integrity Is What You Do When No One Is Looking*

California's strict statutory mediation confidentiality framework generally prevents the disclosure or admission of conduct, communications, or writings that occur during a standard mediation to support disciplinary proceedings for violations of the Rules of Professional Conduct.⁴³ The California Supreme Court has recognized that this strict confidentiality framework creates a direct tension between the policy of encouraging mediation and the state's interest in enforcing professional responsibility to protect the public from incompetent or unscrupulous attorneys.⁴⁴

Licensed California lawyers and retired judge mediators,⁴⁵ when interacting with self-represented litigants, must strictly maintain professional independence, correct any misconceptions about their neutrality, refrain from giving legal advice when interests conflict, and avoid seeking confidential information.⁴⁶ Adherence to the purposes of the mediation privilege during a mediation with a self-represented beneficiary is critical and complex. While these rules appear self-explanatory and clear to lawyers, dealing with self-represented litigants in a court-ordered *Breslin* mediation is precariously nuanced. Simply, attorneys and mediators are not mind-readers and cannot gauge what a person without legal training is capable of understanding.

Nothing prohibits counsel from interacting with an unrepresented beneficiary during the mediation. However, their interaction implicating unethical conduct, even if protected by the confidentiality afforded by the mediation privilege, violates a lawyer's oath to uphold the law and adhere to the highest ethical standards required of the legal profession.

In the area of a perceived or actual conflict, a lawyer is prohibited from giving legal advice or "advice" that would be perceived as legal to an unsophisticated, unrepresented beneficiary, if the lawyer knows or reasonably should know that the unrepresented person's interests conflict with the interests of the lawyer's client. The lawyer must not give legal advice to that person, other than advising them to secure counsel, which the lawyer may but is not required to do.⁴⁷

There is little or no likelihood of State Bar discipline or civil liability arising from conduct occurring during a mediation. However, a State Bar complaint or public civil filing for

malpractice containing such allegations risks reputational damage in addition to the costs of defense to assert the mediation privilege and defeat the allegations.

VI. APPLICATION OF THESE RULES TO THE COMMON FACT SITUATION, PART II

Both comments by the attorneys to the mediator suggest that they may have stretched or exceeded some ethical boundaries. When Dan's counsel approached the mediator and said, "This is exciting, I'm building coalitions for my client," one hopes that the "coalition" building did not trigger any application of the Rules of Professional Conduct regarding neutrality and was not based upon obtaining confidential or privileged information. One further hopes that there was not a violation of ethics or, if a violation occurred, it was made by counsel unintentionally and simply, unmindful of a conflict or potential conflict with the beneficiary and Dan.

Trustee's counsel's comment, "I asked them what you had said about our case, and I wasn't too happy with the response they told me you made," is troublesome. What the mediator discussed with the beneficiaries is confidential under the mediation privilege. The Rules of Professional Conduct prohibit seeking confidential information from unrepresented parties.⁴⁸

VII. CONCLUSION

Ultimately, these practice tips offer a practical framework—not a guarantee—for conducting due diligence, drafting case-specific *Breslin* notices, and preparing the mediator and clients for ethical, meaningful resolution discussions. Because probate courts sit in equity, a court may still deny a petition to confirm a court-ordered mediation resolution where the absence of a noticed beneficiary undermines fairness or due process. But when the trustee undertakes diligent investigation, provides proper notice, prepares thoughtfully for mediation, and adheres to the highest ethical standards, those efforts create a strong record in support of the trustee's actions if later challenged.

** Alternative Resolution Centers, Los Angeles, California*

01 *Breslin v. Breslin* (2021) 62 Cal.App.5th 801.

02 This uncertainty was predicted in Reiser & Ross, *Breslin v. Breslin: Does the 'Seamless Fabric' Need Tailoring?*, Volume 29, Issue 3, *Trusts & Estates Q.*, Fall 2023, at 44: "Whether *Breslin* is the appropriate means toward that end [use of compulsory ADR] in light of fairness and due process concerns remains to be seen." That article is an excellent companion to this one and read together, they provide a linear and comprehensive view of the *Breslin* legacy to date.

- 03 The decisions in *Breslin v. Breslin*, *supra*, 62 Cal.App.5th 801; *Zahnleuter v. Mueller* (2023) 88 Cal.App.5th 1294; and *Key v. Tyler* (2024) 102 Cal.App.5th 365 share central legal and ethical themes concerning the duties of trust administration, the boundaries of fiduciary neutrality, and the forfeiture of beneficial rights or trust assets resulting from a party's strategic litigation decisions. This article focuses solely on *Breslin* duties, but it is recommended that all three cases be read in order to understand the evolving theories regarding allegations of a trustee's breach of fiduciary duties.
- 04 *Salter v. Lerner* (2009) 176 Cal.App.4th 1184, 1187-1188.
- 05 *Roth v. Jelley* (2020) 45 Cal.App.5th 655, 673-674.
- 06 *Estate of Reed* (1968) 259 Cal.App.2d 14, 22.
- 07 *Roth v. Jelley*, *supra*, 45 Cal.App.5th at p. 676.
- 08 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 809.
- 09 Prob. Code, section 16060; *Estate of Reed*, *supra*, 259 Cal. App.2d at p. 22.
- 10 See Section III, *post*.
- 11 Prob. Code, section 16061.7.
- 12 Under California trust and probate law, meeting statutory notice requirements does not automatically satisfy federal due process. If a beneficiary has a cognizable property interest that will be inevitably or adversely affected by a proceeding, notice by mail is a minimum constitutional precondition if that party's identity and address are reasonably ascertainable. *Roth v. Jelley*, *supra*, 45 Cal.App.5th at p. 673.
- 13 The conflict issue is raised here to demonstrate that should the trustee be sued for a breach of fiduciary duty, a pristine *Breslin* notice backed by a solid demonstration of due diligence requirements may eliminate or present a solid defense to future petitions alleging a breach of fiduciary duty based upon a failure to keep beneficiaries informed of trust proceedings.
- 14 *Roth v. Jelley*, *supra*, 45 Cal.App.5th 655.
- 15 *In re A.H.* (2022) 84 Cal.App.5th 340, 357-358.
- 16 *In re Jayden G.* (2023) 88 Cal.App.5th 301, 308.
- 17 Super. Ct. Ventura County, Local Rules, rule 10.04.
- 18 *Ibid*.
- 19 *Kott v. Super. Ct.* (1996) 45 Cal.App.4th 1126, 1137; Super. Ct. Ventura County, Local Rules, rule 10.04.
- 20 *In re Jayden G.*, *supra*, 88 Cal.App.5th 301.
- 21 *Estate of Lacy* (1975) 54 Cal.App.3d 172; *Roth v. Jelley*, *supra*, 45 Cal.App.5th 655.
- 22 Super. Ct. Ventura County, Local Rules, rule 10.04.
- 23 Prob. Code, section 16501.
- 24 *Kott v. Super. Ct.*, *supra*, 45 Cal.App.4th at p. 1137.
- 25 Prob. Code, section 16061.9.
- 26 *Estate of Lacy*, *supra*, 54 Cal.App.3d at pp. 186, 188, 189-191.
- 27 *Id.* at p.190.
- 28 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th 801; Matthew Bender Practice Guide: Cal. Trust Litigation, 16.15 Ground Rules for Mediation Session Must Be Established.
- 29 This caption is taken from the *Breslin* notice template that is used by attorneys Mark Lester and Eric Hirschberg, the original *Breslin* attorneys who prevailed in the trial court and in the appellate court.
- 30 Matthew Bender Practice Guide: Cal. Trust Litigation: 16.15 Ground Rules for Mediation Session Must Be Established.
- 31 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 805; Matthew Bender Practice Guide: Cal. Trust Litigation, 16.15 Ground Rules for Mediation Session Must Be Established.
- 32 Matthew Bender Practice Guide: Cal. Trust Litigation, 16.15 Ground Rules for Mediation Session Must Be Established.
- 33 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 805.
- 34 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 805.
- 35 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 805; Matthew Bender Practice Guide: Cal. Trust Litigation, 16.15 Ground Rules for Mediation Session Must Be Established.
- 36 Matthew Bender Practice Guide: Cal. Trust Litigation, 16.15 Ground Rules for Mediation Session Must Be Established.
- 37 It should be noted that a mediation noticed via general civil motion practice requires a minimum of 16 court days' notice and can be a guide. When service of these notices is made by mail, the notice period must be extended by five calendar days if the mailing and destination addresses are within California, with longer calendar-day extensions of 10, 12, or 20 days applying if the mail crosses state or national borders. Code Civ. Proc., sections 1005, 1013.
- 38 *Oats v. Oats* (1983) 148 Cal.App.3d 416, 420.
- 39 See Section II.A, *supra*.
- 40 *Breslin v. Breslin*, *supra*, 62 Cal.App.5th at p. 805.
- 41 This scenario is inspired by actual events.
- 42 Counsel and mediators report that a beneficiary will retain their family lawyer or a lawyer friend to represent them solely at the mediation. This approach may be helpful to the mediation but can also be a hindrance. Trust and probate law is a specialty area that requires experience, a working knowledge of the law, and an understanding of the unique nature of a probate court, which is defined as a "court of equity."
- 43 Evid. Code, sections 1115-1119; *Campagnone v. Enjoyable Pools & Spas Service & Repairs, Inc.* (2008) 163 Cal.App.4th 566, 571; *Wimsatt v. Super. Ct.* (2007) 152 Cal.App.4th 137, 151-153.
- 44 *Wimsatt v. Super. Ct.*, *supra*, 152 Cal.App.4th at p. 151.
- 45 Retired judges acting as mediators are required to activate their license and are therefore subject to the Rules of Professional Conduct. If acting as a referee or arbitrator, they must also adhere to the Canons of Judicial Conduct.
- 46 Rules Prof. Conduct, rules 3.3 and 4.1.
- 47 Rules Prof. Conduct, rule 4.3.
- 48 Rules Prof. Conduct, rule 4.3.

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SLIDING SCALES AND DAVY JONES: HOW COMPLEX IS YOUR WILL?

Written by John S. Rueppel, Esq.*

I. SYNOPSIS

In 2014, the case of *Andersen v. Hunt*⁰¹ considered what level of mental capacity was required to execute a trust amendment: testamentary capacity or contractual capacity. The *Andersen* court came to a typical legal conclusion: “it depends.”⁰² Very simple “will-like” documents would require at least testamentary capacity, while the mental capacity required to execute more complex documents would be found on a sliding scale between testamentary and contractual capacity.

However, the realities of estate planning on the ground do not conform well to this judicial framework. In day-to-day life, wills drafted by attorneys may resemble trusts in their complexity. They may even contain testamentary trusts themselves. *Andersen* does not directly describe what a will is. This article attempts to discern what the court in *Andersen* meant by the term “will-like,” so that courts and practitioners can more meaningfully judge the required level of capacity. The article also proposes a statutory change: doing away with the separate statutory language defining the capacity required to execute a will in Probate Code section 6100.5.

II. THE FRAMEWORK CREATED BY *ANDERSEN V. HUNT*

In the main case on the level of complexity required to execute a trust amendment, *Andersen v. Hunt*,⁰³ the appellate court famously held that if a document is “will-like,” then the testamentary standard of capacity applies, and if it is more complex than a will, then a sliding scale of contractual capacity applies.⁰⁴ Indeed, in trust contests across the state, the parties argue over just this issue: how complex is a given trust or trust amendment? Predictably, experts will be called to testify that the document is “simple” like a will,

and that the boilerplate (normally argued to be “everything except the dispositive provisions”) does not matter in terms of complexity.⁰⁵ Others may, rightly, point out that the boilerplate is there exactly because trusts are more complex animals, that trustors have to understand much more than testators, and that trusts tend to be more complex because they can accomplish many more things than a will.

By adopting the holding described above, the court in *Andersen* solved one problem, but created another. The unspoken, and mostly unexplored question created by the *Andersen* formula is: “How complex is a will?” *Andersen* appears to assume that everyone knows what a will is like. This article will endeavor to determine what sort of “will” the court in *Andersen* was considering when it talked about testamentary capacity: a ten-page attorney-drafted will, or a one-page holographic version, extremely low on “boilerplate?” This author believes, based on the explicit language of *Andersen*, that it must be the latter.

Not clarifying this issue forces trust and estate litigators to spend considerable time and effort, and large amounts of their clients’ money, litigating the issue of the complexity of the trust. When the cost of experts is included, this issue can easily become one of the most expensive parts of a trial.

A. *Andersen’s* Reasoning

The court in *Andersen* reasoned that the capacity required to execute a trust amendment depends on Probate Code sections 810 to 812.⁰⁶ It noted that those code sections do not create a single standard of capacity, but rather a sliding scale. The court explained that the amount of capacity required depends upon the complexity of the task at issue:

Accordingly, sections 810 to 812 do not set out a single standard for contractual capacity, but rather

provide that capacity to do a variety of acts, including to contract, make a will, or execute a trust, must be evaluated by a person's ability to appreciate the consequences of the particular act he or she wishes to take. More complicated decisions and transactions thus would appear to require greater mental function; less complicated decisions and transactions would appear to require less mental function.⁰⁷

This author believes the reasoning above is perfectly logical. The court went on, and is worth quoting here:

When determining whether a trustor had capacity to execute a trust amendment that, in its content and complexity, closely resembles a will or codicil, we believe it is appropriate to look to section 6100.5 to determine when a person's mental deficits are sufficient to allow a court to conclude that the person lacks the ability "to understand and appreciate the consequences of his or her actions with regard to the type of act or decision in question." ([section] 811, subd. (b).) In other words, while section 6100.5 is not directly applicable to determine competency to make or amend a trust, it is made applicable through section 811 to trusts or trust amendments that are analogous to wills or codicils.⁰⁸

Section 6100.5 requires a testator to (1) understand the nature of the testamentary act; (2) understand and recollect the nature and situation of the property; and (3) remember and understand their relations to living descendants, spouse, parents, and others whose interests are affected by the will.⁰⁹ The testator must not be having mental delusions or hallucinations that affect their dispositive choices.¹⁰

Andersen's reasoning has guided practitioners since 2011. It does not, however, provide guidance on what "analogous to wills or codicils" means, and therein lies our difficulty.

B. What Is "Boilerplate" in an Estate Planning Context?

Neither *Andersen* (nor its progeny, *Lintz v. Lintz*, discussed below) use the word "boilerplate," but the term is used in appellate opinions on trusts.¹¹ "Boilerplate" is defined as "[r]eady-made or all-purpose language that will fit in a variety of documents," or as "[f]ixed or standardized language that the proposing party views as relatively non-negotiable."¹² One meaning of the word "boilerplate" in the context of trusts might be "one size fits all."

Common examples of "boilerplate" provisions could be spendthrift clauses, no-contest clauses, or a rule against perpetuities provision. While no testator or trustor would likely be expected to understand exactly how each of these provisions works, they would at least have to understand

what they do: protect the beneficiaries, protect the trust, keep the trust valid, respectively. These particular provisions could be highly important in a given trust administration, and the failure to include them might be considered malpractice. These factors mitigate against a court finding that such provisions, just because they are commonly used, do not increase the complexity of a will or trust.

In addition, some of these "boilerplate" provisions might have required significant fine-tuning or hand-drafting to conform them to the particular needs of a client. If the client's needs or requests are complex, wouldn't that render even a will more complex?

C. Why Does It Matter?

Whether a court finds a trust amendment is will-like or contract-like can have a determinative impact in a trust contest, because traditionally the standard of capacity required to execute a will is bedrock low. In *Estate of Lingenfelter*, a testatrix was found to have sufficient mental capacity to execute a will even though she would "disintegrate emotionally," scream and yell, become glassy-eyed, weep uncontrollably, was weak-willed and easily led, extremely excitable, unreasonably jealous, psychoneurotic, having severe head pains, and actually committed suicide.¹³ In *Estate of Wright*, the testator was found to have mental capacity even though he was dirty, gave a witness a fish soaked in kerosene, turned a hose on children, was generally drunk, had a head injury that affected his personality, left the house partly dressed, picked up garbage and hid it in his house, failed to acknowledge his grandson, held his breath, and appeared to be dead.¹⁴

In other words, courts interpreting the requirements of section 6100.5 refer to examples such as those above when assessing whether someone had the capacity to execute a will. If a court finds that a trust amendment is will-like, invalidating it will be extremely difficult.

D. What Was in the *Andersen* Court's "Mind" When it Discussed the Simplicity of Wills?

Under statutory law and case law, wills have very few requirements. They must be in writing,¹⁵ the testator must be at least 18 years of age,¹⁶ and the will must be signed by the testator (or someone else at the testator's direction).¹⁷ Typewritten wills must be signed by two witnesses who, being present at the same time, witnessed the signing or the testator's acknowledgment of the signing, and understood that the testator intended the will to constitute the testator's will.¹⁸ A holographic will, on the other hand, need not have witnesses if the signature and material provisions are in the testator's handwriting.¹⁹ It does not even need to be dated, although including a date helps.²⁰ Finally, a will has to be executed with "testamentary intent."²¹

Case law is replete with descriptions of wills, most of which satisfied the requirements for validity. One valid will was a letter to a friend, stating “I want you to see that all my bills are paid and that Dot does not get thing. I want you to have all of my after my bill are.”²²

In *Estate of Taylor*,²³ the decedent wrote a letter to his friend, which constituted a valid will, and included the following:

Anyway what I wanted most of all to see you about was getting a new bank book remember I told you about me loosing mine also in case Davie Jones gets me out in the South Pacific ocean in other words lost at Sea I would very much like to turn my Bonds & cash in the bank also the pay I will have coming in the navy over to Betty Black

Similarly, in *Estate of Del Val*,²⁴ the following constituted a will:

Thursday April 14, 55

1666 W. 28th St.,

Los Angeles, Cal

That I Gregorio Del Val of a sound mind, if there is anything happen to me to night I leave all my belongings to Mr. B. V. Dison and to his wife Mrs. Victoria Dison including my money in The Banks of America #21

Gregorio Del Val

And in *Camperi v. Chiechi*,²⁵ the court described the following valid will:

Ciro's last will, a very brief and simple document, devised and bequeathed his estate as follows: To his children Joe and Lucy and his granddaughters Frieda Hanson and Colleen Camperi the sum of \$ 1.00 each; the residue, in equal shares, to his remaining children, Anna, Ross and Anthony.

In *Estate of Williams*,²⁶ the document described in the following was found to be a valid will:

The words “Last Will, Etc. or What? of Homer Eugene Williams” appear at the top of the document, followed by the decedent’s address. The document then names Deborah Cox and Lorna Williams as executors, states their relationships to the decedent (stepdaughter and sister-in-law, respectively), and includes their addresses. It then states, “Power of Attorney: Now Deborah Cox.” This is followed by a disposition of the decedent’s collectibles. The document says, “All My Collictables: Everything including two pistols and two rifles, none fired: to Nephew Kirk Bell.”

Kirk Bell’s address is included. Next is a paragraph stating, “In the event of a serious sickness or accident: I do not want to be kept alive by life support means. I name my executors to see to my wishes are carried out.” Then there is a heading entitled “My Estate.” This is followed by two items – “House” and “Bank Account.” The present market value of the house is stated to be “\$225,000 to \$350,000.” The bank accounts include “Checking and Savings,” but no balances are stated. The final paragraph states, “I would like my step daughter, Debra Cox to be able to live in the house as long as she wants before putting it up for sale.”

Similarly simple wills have been upheld in too many cases to mention, including *In re Estate of Koch*,²⁷ and *In re estate of Lovejoy*.²⁸

As a meaningful aside, California has a statutory will, with statutory definitions and instructions.²⁹ The statutory will is six pages long, has 20 to 30 separate boxes which can receive a signature, the name of a beneficiary, or a gift amount. The instructions on the first page state, “READ THE WILL. Read the whole Will first. If you do not understand something, ask a lawyer to explain it to you.”³⁰

The statute contains a section called “Questions and Answers about this California Statutory Will,” with 21 separate questions and responses explaining how to fill out the Statutory Will.³¹ The preamble to the question and answer section states, helpfully, “This Will is in a simple form.”³² As any trust and estate practitioner will be well aware, estate planning forms can often be filled out incorrectly, causing a great deal of heartache and litigation. Axiomatically, the statutory will is “attorney drafted” and is far from simple when compared to some of the wills described above.

The takeaway from these examples is that wills can be extraordinarily simple and still be wills. Let us assume that the various opinions of the appellate courts above regarding the validity of wills were in the mind of the *Andersen* court, when it wrote the opinion (although it does not cite them).

E. *Andersen’s Progeny: Approval Without Clarification*

How much did the court in *Andersen* describe the amendment at issue? In two words: not much. The court wrote that, “In the present case, while the original trust document is complex, the amendments are not. Indeed, none of the contested amendments does more than provide the percentages of the trust estate Wayne wished each beneficiary to receive.”³³ The court then concluded: “In view of the amendments’ simplicity and testamentary nature, we conclude they are indistinguishable from a will or codicil”³⁴

If we take the court in *Andersen* at its word, then we are forced to conclude that the trust amendments at issue *do not have “boilerplate” language*. As the examples cited above demonstrate, wills can be incredibly simple. We must take the *Andersen* court at its word. It meant wills that contain no “one size fits all” provisions.

Lintz v. Lintz touches upon the same considerations.³⁵ *Lintz* applied the reasoning of *Andersen* to several trust amendments:

Adopting the reasoning of *Anderson* [sic], we conclude that the probate court erred by applying the Probate Code section 6100.5 testamentary capacity standard to the trusts and trust amendments at issue in this case instead of the sliding-scale contractual standard in Probate Code sections 810 through 812. The trust instruments here were unquestionably more complex than a will or codicil. They addressed community property concerns, provided for income distribution during the life of the surviving spouse, and provided for the creation of multiple trusts, one contemplating estate tax consequences, upon the death of the surviving spouse.³⁶

A minimum of guidance is provided by another case. In *Eyford v. Nord*,³⁷ another trust contest, the appellate court opined:

By its terms, section 6100.5 applies only to wills. Relying on *Andersen v. Hunt* (2011) 196 Cal.App.4th 722 [126 Cal. Rptr. 3d 736], appellants contend section 6100.5 also applies to trusts or trust amendments that, in content and complexity, closely resemble a will or codicil. (*Andersen*, at p. 731.) We agree and see no reason why section 6100.5 should not apply where, as here, a trust amendment reallocates the trust estate by disinherit one set of possible beneficiaries and giving the entire estate to another beneficiary. (See *Lintz v. Lintz* (2014) 222 Cal.App.4th 1346, 1352 [167 Cal. Rptr. 3d 50].) Respondents do not contest *Andersen*’s applicability here.

Eyford does not mention the existence of any boilerplate in the amendment at issue.

As someone with some estate planning experience, when this author reads the opinion in *Lintz* about the source of the complexity in those amendments, what comes to mind is “boilerplate,” as community property concerns, income distributions, multiple trusts, and estate tax consequences are all very common terms of countless revocable trusts drafted every day by experienced practitioners. Putting these cases and their guidance together, this author is forced to conclude that, according to the appellate courts, “boilerplate” equals complexity. An amendment without

boilerplate is “will-like”; a trust amendment with boilerplate is more “complex.”

III. WEAKNESSES OF THE ANDERSEN RULING

In the humble opinion of this author, the holding of *Andersen* causes certain problems for practitioners and for the general public at large. One significant problem is the fact that the holding may encourage, rather than discourage, financial elder abuse. For someone who wishes to inherit a large amount of money from a vulnerable elder, the easiest way to accomplish this objective is to have the elder sign a *very simple* trust amendment: one page, a few gifts, signed and notarized. Under *Andersen*, such a document is very hard to successfully challenge.

Nowadays, there is far more litigation over trusts than wills, because most people with significant property set up a trust to avoid probate. It is therefore all the more important to clarify what constitutes “complexity” in a somewhat clear and predictable manner.

There are very good reasons to generally find that trust “boilerplate” makes a trust or trust amendment complex. In the first place, leaving aside the length of a particular trust document, or the number of separate provisions, trusts are simply more complicated in conception. To create a trust, you must manifest the intent to create a trust.³⁸ There must be trust assets to create a trust, whereas you can make a will without owning anything.³⁹ A trust is not an entity. Instead, it is a relationship.⁴⁰ A trustee owes various onerous duties to the trust beneficiaries.⁴¹ Unlike a will, assets must be affirmatively placed into a trust. Thus, extra work is required aside from signing the document.⁴² On the contrary, generally speaking, all of one’s estate is encompassed by a will, with no affirmative separate act required.

This author believes that a person who executes a trust must understand what it means to be a trustee. Trusts can continue in effect for years or decades, unlike wills which are generally effective only for a brief time after death. A settlor signing a run-of-the-mill trust is almost certainly nominating a successor trustee. The trust generally provides that the successor trustee must provide for the settlor’s support during the settlor’s lifetime. To adequately understand this sort of provision, the settlor must understand that the successor trustee would owe duties to the settlor (and could breach them). If the settlor’s trust also includes a provision releasing trustees from liability for good faith mistakes (as is extremely common), the settlor should understand that their successor trustee may avoid accountability if they negligently administer the trust.

To put it simply, there is a world of difference between saying “I give my car to Fred” and “I give my car to Joan, to hold in trust for Fred, and to give it to him when he turns 25, but not to turn it over to his creditors, and the trust has to terminate before Fred’s grandchild dies, etc., etc.”

These are not minor considerations. They are crucial aspects of the protective matrix of most trusts that must be included to be enforceable. Trusts for married couples commonly state that the couple’s separate and community property maintains its character when contributed to or removed from the trust. To sign such a trust, the couple should have some understanding of what community and separate property is, especially because the nature of the property will (usually) determine the funding of sub-trusts after the death of the first spouse.

While an estate planner might not review every single provision of a trust with their client prior to signing, it is arguably malpractice not to explain these important operative provisions and how they interact and may affect the settlor. If a document requires significant attorney explanation to sign it, this author submits that the document is not “simple.”

One other consideration is that most people with trusts also have a pour-over will that often includes a provision stating that if the trust has been deemed invalid, its provisions are incorporated by reference into the will, thereby acting as a backup. If a will has such a provision, then arguably the will has just become as complex as the trust document it is incorporating.

Right now, courts have no guidance to assess the complexity of a will as considered in *Andersen*. They are faced with the reality that wills come in all shapes and sizes. A modern, attorney-drafted will can be *complicated*. Such a will can be 10-15 pages in length, and it may include any number of potentially “trust-like” provisions. It is hard to escape the conclusion that even a will may be complex, especially if it nominates guardians for minor children, contains the exercise of a power of appointment, or even contains a testamentary trust. On the other hand, if we adhere closely to the language of *Andersen* and *Lintz*, we must understand that those courts were referring to simple wills as they knew them, and as reflected in the sample cases referenced above.

This author suggests that if a court compares a 15-page trust to an attorney-drafted 15-page will, applies *Andersen*, and then determines that the trust is *not complex*, it is undermining the reasoning of *Andersen*, which is to tie the level of capacity required to the complexity of the act or decision the settlor is making.⁴³ A trust document is complex not solely because of the variety of provisions

included, but also because of the legal concepts that surround all trusts. In other words, all trusts require some level of sophistication to understand.

Probate Code section 812 states that a person lacks the capacity to make a decision unless the person can understand and appreciate “all of the following:”

- a. The rights, duties, and responsibilities created by, or affected by the decision.
- b. The probable consequences for the decisionmaker and, where appropriate, the persons affected by the decision.
- c. The significant risks, benefits, and reasonable alternatives involved in the decision.⁴⁴

This author submits that the level of capacity to execute a trust is very similar to the capacity *required to act as a trustee*, because all reasonably competent trustees will need a fairly sophisticated understanding of any trust they administer. To say it another way, if a trustee must juggle (perhaps) 30 or 40 separate legal and practical considerations to properly administer an average trust, then a trustor, to meet the requirements of section 812, *would have to have roughly the same abilities. The trustor at least must have a decent sense of what the legal and practical considerations are, or that they even exist.* In fact, almost every settlor of a revocable trust also serves as trustee, whereas no one acts as executor of his or her own will.

IV. POSSIBLE RESOLUTIONS

One possible way to improve this situation is to eliminate section 6100.5. In this modern day, when wills are used less often than trusts, and trusts become as complex as time and attorney fees allow, there is no reason to have more than one standard of capacity for testamentary documents. Doing away with section 6100.5 would allow the “sliding scale” of *Andersen* to go all the way down. In other words, a 3-sentence will can be compared to a 20-page trust on an even playing field. A 15-page will can be more accurately compared to a 15-page trust. This approach would also be consistent with the Legislature’s strong statement of policy in its enactment of financial elder abuse legislation: to promote the protection of elders by ensuring that improperly obtained trust amendments are not made impenetrable to challenge *just because they are short*. Sections 810 to 812 can be applied to any action, from buying a lawnmower to setting up a private foundation. There is no reason wills should be exempted from this scheme.

Another way to resolve this problem would be for a court to hold that even if an amendment is short, when it modifies a long, complicated trust, the capacity required to execute the

amendment is higher. To understand the “rights, duties and responsibilities created by, or affected by, the decision,”⁴⁵ the settlor would have to have some understanding of how the original, complicated trust worked.

Eliminating section 6100.5 in favor of sections 810 to 812 would still preserve the relative invulnerability of true simple wills to attack. As with the valid wills described above, the courts would naturally find that the level of capacity to execute them is quite low. Holographic testators would still be able to breathe easy: if Davy Jones does catch them, their wishes will remain secure.

V. CONCLUSION

As they currently stand, case law and statutory law provide unclear guidance for courts and practitioners who must evaluate the question of whether a decedent could actually understand the decisions involved in executing estate planning documents. This unclear guidance can lead to miscarriages of justice and lower protective hurdles against financial elder abuse. It would be helpful to clarify the judicial framework so that simple wills remain strongly protected, while undeniably more complex documents are rightly subjected to a higher standard.

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01 *Andersen v. Hunt* (2011) 196 Cal.App.4th 722.
02 *Ibid.*
03 *Andersen, supra*, 196 Cal.App.4th at p. 722.
04 *Id.* at p. 731.
05 There will likely also be arguments as to whether “complexity” is the proper province of expert opinion, or whether a trier of fact can assess complexity without assistance. (See Evid. Code, section 801, subd. (a).)
06 *Andersen, supra*, 196 Cal.App.4th at p. 730.
07 *Ibid.*
08 *Id.* at p. 731.
09 Prob. Code, section 6100.5.
10 *Ibid.*

11 *Graham v. Lenzi* (1995) 37 Cal.App.4th 248, 256; *DeMille v. Ramsey* (1989) 207 Cal.App.3d 116, 126.
12 Black’s Law Dict. (3d Pocket ed. 2006) pp. 74-75.
13 *Estate of Lingenfelter* (1952) 38 Cal.2d 571, 577-582.
14 *Estate of Wright* (1936) 7 Cal.2d 348, 348-358.
15 Prob. Code, section 6110, subd. (a).
16 Prob. Code, section 6100.
17 *Ibid.*
18 *Ibid.*
19 Prob. Code, section 6111.
20 *Ibid.*
21 *Estate of Geffene* (1969) 1 Cal.App.3d 506, 512.
22 *Estate of Wong* (1995) 40 Cal.App.4th 1198, 1206 (citing *In re Smilie’s Estate* (1950) 99 Cal.App.2d 794, 796 (errors in original)).
23 *In re: Taylor’s Estate* (1953) 119 Cal.App.2d 574, 577. The author acknowledges there are misspellings in the block quotes in this section, but they have not been corrected or marked with a customary “[sic]” because the errors help demonstrate the simplicity of these wills that were upheld.
24 *In re: the Estate of Gregorio Del Val* (1958) 159 Cal.App.2d 600, 603.
25 *Camperi v. Chiechi* (1955) 134 Cal.App.2d 485, 491.
26 *Estate of Williams* (2007) 155 Cal.App.4th 197, 202-203.
27 *In re Estate of Koch* (1908) 8 Cal.App. 90, 91.
28 *In re Estate of Lovejoy* (1940) 38 Cal.App.2d 69, 70.
29 Prob. Code, section 6200 et seq.
30 Prob. Code, section 6240.
31 *Ibid.*
32 *Ibid.*
33 *Andersen, supra*, 196 Cal.App.4th at p. 731.
34 *Ibid.*
35 *Lintz v. Lintz* (2014) 222 Cal.App.4th 1346.
36 *Id.* at pp. 1352-1353.
37 *Eyford v. Nord* (2021) 62 Cal.App.5th 112, fn. 6.
38 Prob. Code, section 15201.
39 Prob. Code, section 15202.
40 *Han v. Hallberg* (2019) 35 Cal.App.5th 621, 632.
41 Prob. Code, section 16000 et seq.
42 *Estate of Heggstad* (1993) 16 Cal.App.4th 943, 948.
43 It is also possible that what might seem complex to a layperson will not seem complex to a trained jurist. A judge who reads complex documents all day long might possibly not be in the best position to analyze the complexity of a document from the point of view of a layperson viewing the same document for (potentially) the first and only time in his or her life.
44 Prob. Code, section 812.
45 Prob. Code, section 812, subd. (a).

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TAX ALERT

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This alert summarizes selected developments in federal and state taxation since the last issue of the *Quarterly* that may be of interest to trust and estate attorneys. “IRC” refers to the Internal Revenue Code of 1986, as amended. “Treas. Reg.” refers to any treasury regulation. “IRS” refers to the Internal Revenue Service.

I. FEDERAL CASES AND RULINGS: INCOME TAX

A. Fifth Circuit Rejects IRS’s “Passive Investor” Test for Limited Partners

Sirius Solutions, L.L.L.P. v. Comr. (5th Cir. Jan. 16, 2026, No. 24-60240)

The Fifth Circuit held that the term “limited partner” in IRC section 1402(a)(13) refers to a partner in a limited partnership who enjoys limited liability. In doing so, the court rejected the IRS’s position that a partner’s eligibility for the self-employment tax exception depends on the partner’s level of participation in the partnership’s business and vacated the tax court’s decision.

Sirius Solutions, L.L.L.P. was organized as a Delaware limited liability limited partnership and operated a business consulting firm. During the tax years at issue, Sirius allocated its ordinary business income to its individual limited partners and excluded those distributive shares from self-employment income pursuant to IRC section 1402(a)(13), reporting no net earnings from self-employment. Following an audit, the IRS determined that the individual partners did not qualify as “limited partners” under IRC section 1402(a)(13) because they actively participated in the partnership’s business, and that their distributive shares were therefore subject to self-employment tax. The tax court upheld the adjustments.

On appeal, the Fifth Circuit reversed. Because the statute does not define “limited partner,” the court examined the ordinary meaning of the term at the time of enactment in 1977 and concluded that the defining characteristic of a

limited partner was limited liability, not the partner’s level of participation in the partnership’s business. The court rejected the tax court’s passive-investor interpretation, holding that the phrase “as such” merely clarifies that the exception applies to a partner acting in the capacity of a limited partner rather than in the capacity of a general partner.

Accordingly, the Fifth Circuit concluded that the tax court erred by applying a “passive investor” test. The ruling is the first federal appellate decision to reject the IRS’s interpretation of IRC section 1402(a)(13). Notably, the court clarified in a footnote that its holding does not address whether members of other entity types, such as limited liability partnerships or limited liability companies, may qualify for the limited partner exception. Although binding only within the Fifth Circuit, the decision creates a direct conflict with the tax court’s interpretation. Appeals of similar rulings are currently pending in the First Circuit and the Second Circuit, raising the prospect of a circuit split and potential Supreme Court review.

B. Nevada Asset Protection Trust Fails to Shield IRS Judgment Lien

United States v. Huckaby (E.D.Cal. Mar. 2, 2026, No. 2:23-cv-00587-DAD-JDP) 2026 U.S. Dist. Lexis 43613.

Robert Huckaby and Joyce Tritsch owned California real estate in a Nevada Asset Protection Trust (“NAPT”). Robert and Joyce were settlors, beneficiaries, and sole trustees of the NAPT. In 2018, a judgment was entered against Robert for failure to honor IRS levies.

The IRS sought declaratory relief that its judgment could be enforced against the property, that defendants as trustees held title as alter egos or nominees of themselves individually, and that the transfer of the property to the NAPT was void. The court granted the IRS’s motion for summary judgment seeking a declaration that its judgment lien encumbered Robert’s one-half interest in the property and permission to submit a proposed foreclosure order. The result in this case begs the question as to whether the result

would have been different if the real estate had been held by an LLC with the NAPT merely holding a membership interest versus the the NAPT directly holding the real estate.

C. Life Insurance Policy Termination Creates Taxable Income Even Without a Cash Distribution

Sawyer v. Comr. (Apr. 16, 2026, TCM 2026-33)

Jonathan Sawyer purchased a \$200,000 life insurance policy in 1982, which included an automatic premium loan option that allowed the insurer to borrow against the policy's cash surrender value to pay premiums and prevent the policy from lapsing. On occasion Sawyer failed to pay the premiums and the insurer exercised the option (the "Premium Loans"). In 2009, Sawyer borrowed \$80,000 against the policy (the "Policy Loan") and deposited the funds into the bank account of Henry N. Sawyer ("HNS"), his family printing business.

By 2015, the balance of the Premium Loans and Policy Loan, together with accrued interest, exceeded the policy's cash surrender value. The insurer terminated the policy and applied its entire cash surrender value against the outstanding debt. The insurer issued Sawyer a Form 1099-R in the amount of \$160,900.39, the difference between the cash surrender value at the time of the termination and the amount of premium payments actually made by Sawyer. Believing the 1099-R was inaccurate, Sawyer reported the information on his federal income tax return for 2015. The IRS issued a Notice of Determination based on the 1099-R, and Sawyer timely appealed to the tax court.

The tax court noted that IRC section 72(e)(5) includes in gross income a non-annuity amount received under a life insurance contract to the extent the amount exceeds the taxpayer's investment in the contract. The court rejected Sawyer's argument that he did not actually receive any cash, as the insurer's application of the cash surrender value to the policy loans was properly treated as a distribution to Sawyer followed by a payment by him of the outstanding loan balances.

With respect to the interest that had accrued on the loans, the tax court held that the interest attributable to the Policy Loan was deductible investment interest, as the loan proceeds had been deposited directly into HNS's account. Since the HNS stock was capable of producing dividend income, it constituted property held for investment. In contrast, the tax court held that the interest attributable to the Premium Loans was nondeductible personal interest.

The tax court also rejected Sawyer's argument that HNS was the owner of the policy and sustained the IRS's failure to file penalties, but granted relief from the failure to pay

penalties based on Sawyer establishing payment would have caused undue hardship.

D. Unlimited Charitable Deduction Allowed for Estate Income to Residual Charitable Beneficiaries

PLR 202618006 (Released May 1, 2026)

Decedent's will provided for a percentage of the residue of decedent's estate to be distributed to charitable organizations. Under the laws of decedent's state, income not arising from specifically bequeathed assets must be paid pro rata to residuary beneficiaries. The estate obtained a probate court order confirming this distribution. As such, the estate distributed a corresponding percentage of the gross income allocable to the estate's residual beneficiaries to the residual charitable organizations. The estate then claimed a deduction for such payments under IRC section 642(c)(1), which allows for a deduction for gross income of an estate that is distributed to charitable organizations pursuant to the governing instrument. Even though the decedent's will was silent on the treatment of income from the estate, the IRS allowed the estate to take an unlimited charitable deduction for income distributed to charitable organizations pursuant to state law.

II. FEDERAL CASES AND RULINGS: ESTATE TAX, GIFT TAX, AND GENERATION-SKIPPING TRANSFER TAX

A. IRS Rules on Tax Consequences of Proposed Trust Modification

PLR 202619008 (Released Feb. 9, 2026)

The IRS considered whether a proposed modification to an irrevocable trust established prior to September 25, 1985, would trigger adverse estate, gift, or GST tax consequences.

Grantor established an irrevocable trust prior to September 25, 1985, for the benefit of daughter. Under the original trust terms, daughter was entitled to receive annual distributions of a percentage of net income, with any remaining income accumulated and added to principal. Upon daughter's death, the remaining trust estate was to be distributed to her then-living issue, per stirpes, and held in further trust until a specified age.

Grantor, daughter, and all contingent beneficiaries of the trust executed a modification agreement to modify terms of the trust, effective upon the issuance of a favorable PLR and a court decree approving the modification. The modification provided that, upon daughter's death, distributions to her then-living issue would remain in

lifetime trusts (each an “Issue Trust”), instead of being distributed outright at a certain age, with the Issue Trusts terminating upon the earlier of: (i) the beneficiary’s death, or (ii) the day prior to the date that is twenty one (21) years after the death of the last to die of grantor’s children. The modification also granted each beneficiary of an Issue Trust a testamentary general power of appointment. Finally, the modification provided for certain administrative modifications to the trust provisions governing trustee resignation and the spendthrift clause, and to clarify that the trustee’s discretionary power to make payments of income or principal directly to a beneficiary or indirectly on behalf of a beneficiary applies in the case of payments to or on behalf of daughter’s issue or the issue of the grantor.

The trust was exempt from GST tax because it was created prior to September 25, 1985, and the grantor represented that no actual or constructive additions to the trust had been made following the date of execution. The IRS concluded that the proposed modifications did not impermissibly shift any beneficial interest to a lower generation because daughter and contingent beneficiaries have the same interests before and after the proposed modification except that property previously distributed outright at a specified age now remains in lifetime trust. The IRS concluded that the proposed modification did not extend the time for vesting of any interest because of the grant of the general power of appointment to each beneficiary of an Issue Trust. The IRS also concluded that the modifications to the administrative provisions of the trust applied equally to all Issue Trusts and, therefore, did not shift beneficial interests or extend the vesting period. Accordingly, the trust’s GST exempt status was preserved.

The IRS also concluded that the grantor retained no interest in or power over the trust property, therefore, the proposed modification did not result in inclusion of trust property in the grantor’s gross estate. Finally, the IRS concluded that, based on the facts submitted and representations made, the proposed modifications did not subject grantor, daughter, or any remainderman to gift tax.

B. IRS Grants Extension To Elect out of Automatic GST Exemption Allocation

PLR 202622003 (Released Mar. 2, 2026)

Taxpayer established an irrevocable trust (Trust A) for the benefit of his children and later issue. Thereafter, the taxpayer established multiple GRATs that paid annual annuity amounts to the taxpayer during the annuity term, with the remaining trust assets passing to Trust A. The terms of Trust A provided that the trustee may distribute all of the net income and principal of Trust A to or for the benefit of any one or more of taxpayer’s living issue from time to time, in such amounts or proportions, and to

the exclusion of any one or more of them, as the trustee determines in the trustee’s absolute discretion. After each GRAT terminated and the remainder was transferred to Trust A, the trustee of Trust A distributed the assets received from the GRAT outright to the taxpayer’s children.

The taxpayer represented that he never intended to allocate GST exemption to transfers made to the GRATs because the assets were always intended to pass to his children. However, the taxpayer’s accountant did not realize that the automatic allocation rules applied to the remainder interests passing from each GRAT to Trust A. As a result, neither the accountant nor the taxpayer’s attorneys advised the taxpayer to elect out of the automatic allocation, and no timely elections were made on the Forms 709 filed for the years at issue.

The error was discovered eight years after the GRAT program commenced when the taxpayer’s accounting firm merged with another firm and the original accountant had retired. While preparing the taxpayer’s Form 709, the new accountant identified the missed elections. The taxpayer also represented that no taxable distributions, taxable terminations, or other GST tax events had occurred with respect to the trusts.

The taxpayer requested relief and the IRS determined that the taxpayer acted reasonably and in good faith and that granting relief would not prejudice the interests of the government. The IRS found that the taxpayer reasonably relied on qualified tax professionals, was unaware of the automatic allocation rules despite exercising reasonable diligence, and did not seek to use hindsight or benefit from any intervening taxable events. The IRS granted the taxpayer a 120-day extension from the date of the ruling letter to file amended forms and elect out of the automatic allocation of GST exemption.

C. IRS Grants Estate Additional Time to Make a Portability Election

PLR 202616005 (Released Apr. 17, 2026)

The estate represented that, based on the value of the decedent’s gross estate and taxable gifts, the estate did not need to file Form 706. However, the decedent had an unused portion of the applicable exclusion amount that could benefit the surviving spouse. For various reasons not identified in the PLR, the estate did not timely file Form 706 and did not make a portability election.

Because the estate did not otherwise need to file Form 706, the regulations fixed the time for making the portability election. The Commissioner therefore had discretionary authority to grant the estate an extension of time to elect portability. Relief required that the estate acted reasonably

and in good faith, that the requirements of the regulations were satisfied, and that granting the extension would not prejudice the interests of the government.

Based on the information, affidavits, and representations submitted by the estate, the IRS concluded that the estate had satisfied the requirements for relief and granted the estate an extension of time to make a portability election.

D. IRS Grants Estate Additional Time to Make QTIP and Reverse QTIP Elections

PLR 202616005 (Released Apr. 17, 2026)

Decedent's trust created marital trusts intended to qualify for the estate tax marital deduction. The estate timely filed Form 706 under extension. However, the accountant reported the marital trust assets as "All other property" rather than "QTIP property" on Schedule M. The accountant listed the GST exempt marital trust for a reverse QTIP election on Schedule R. The election was ineffective because the return did not make the underlying QTIP election.

The taxpayer requested an extension of time to make a QTIP election with respect to the marital trusts and an extension of time to make a reverse QTIP election with respect to the GST exempt marital trust.

Based on the facts and representations submitted, the IRS concluded that the estate had satisfied the requirements for relief. The IRS granted the estate a 120-day extension to file an amended Form 706 making the QTIP election for the marital trusts and the reverse QTIP election for the GST-exempt marital trust.

E. Accountant's Failure to File Gift Tax Return Does Not Preclude Late GST Exemption Allocation Where Taxpayer Acted in Good Faith

PLR 202618003 (Released May 1, 2026)

Prior to 2001, taxpayer established a trust for the benefit of taxpayer's children and their descendants, divided into two equal shares, Trust A and Trust B, each providing lifetime benefits to one child with remainder to more remote issue. Taxpayer made gifts of cash and securities to Trust A and Trust B. Taxpayer had retained an attorney for GST planning purposes, and contemporaneous communications between taxpayer and counsel reflected a clear intention to allocate taxpayer's available GST exemption to those transfers. Taxpayer also retained an accountant to prepare and file the required gift tax return. The accountant prepared the return, but had no record of it being filed, and taxpayer later confirmed with the IRS that no return was filed.

The IRS may grant extensions of time to make a late allocation of GST exemption and must consider all relevant circumstances, including evidence of the transferor's intent as reflected in the trust instrument or other transfer documents. An extension will be granted where the transferor establishes that he or she acted reasonably and in good faith, and that the grant of relief will not prejudice the government's interests. Here, the IRS granted a 120-day extension of time to a taxpayer to allocate GST exemption to the transfers, finding that the requirements for relief had been satisfied.

F. Modification of GST Grandfathered Trust Did Not Impact Trust's GST Exempt Status

PLR 202622002 (Released May 29, 2026)

The IRS ruled on a proposed modification to a GST grandfathered trust established before September 25, 1985. The trustee and beneficiaries of the trust sought a modification to the trust updating the trustee provisions and permitting the advisory committee of the trust to direct the trustee as to the investments of the trust. The IRS ruled that the proposed modifications allow for the trust to continue to be GST exempt because they were administrative in nature and beneficial interests were not shifted to lower generations. Further, the IRS ruled the proposed modifications do not cause the advisory committee of the trust to possess a general power of appointment because the trustee has no discretionary power with respect to distributions of income and principal and the advisory committee could not remove and replace the trustee. Finally, the IRS ruled the proposed modifications will not cause the trust or beneficiaries to be subject to gift tax or to realize a gain or loss under IRC section 1001.

III. FEDERAL CASES AND RULINGS: TAX EXEMPT ORGANIZATIONS AND TRUSTS

A. Transfer of LLC Interest to Charitable Entity Disregarded

IRS Chief Counsel Memo. 20260401F (Jan. 23, 2026)

The IRS analyzed a purported transfer by a husband and wife of a substantial non-voting membership interest in an LLC to a charitable organization. The taxpayers formed the LLC with voting and non-voting units, with the husband serving as sole manager. After the taxpayers contributed cash and marketable securities to the LLC, they transferred the non-voting units to a donor advised fund ("DAF") and retained control through the voting units. The taxpayers claimed a charitable contribution deduction and excluded the LLC's income from their taxable income. The IRS

concluded that the transaction lacked economic substance under IRC section 7701(o), finding no substantial non-tax purpose for the LLC. The IRS disregarded the transfer to the DAF and determined that the charitable organization was not a bona fide partner. The charitable contribution deduction was disallowed, the assignment of income doctrine was applied, and all income from the LLC was allocated to the taxpayers.

B. Early CLAT Termination

PLR 202614004 (Released Apr. 3, 2026)

The IRS permitted the early termination of a Charitable Lead Annuity Trust ("CLAT") by allowing the CLAT to make accelerated annuity payments to the CLAT charitable recipient, a DAF. Because the CLAT assets significantly outperformed expectations, the trustee proposed distributing the remaining annuity payments to the DAF in an undiscounted lump sum and terminating the CLAT.

The IRS ruled that such accelerated payments to the DAF were not an act of self-dealing under IRC section 4941, not a taxable expenditure under IRC section 4945, and not subject to tax under IRC section 507(c) (the tax imposed when a private foundation terminates its status as a private foundation).

Because the DAF was administered and maintained by a sponsoring organization which was recognized as an organization described in IRC section 501(c)(3), and the payment fulfilled the CLAT's charitable purpose, early termination of the CLAT was allowed.

IV. FEDERAL CASES AND RULINGS: PARTNERSHIP AND CORPORATE TAX

A. IRS Allows Late Qualified Subchapter S Trust (QSST) Election

PLR 202607012 (Released Feb. 13, 2026)

A shareholder of two corporations with valid S elections died and his shares poured into a trust pursuant to his will. IRC section 1361(b)(1) provides that an S corporation may not have as a shareholder a person who is not an individual, other than an estate, a qualifying trust described in section 1361(c)(2), or an organization described in section 1361(c)(6). A testamentary trust receiving stock pursuant to a will is a permitted S corporation shareholder, but only for the two-year period after the stock is transferred. To continue to be regarded as a qualifying trust thereafter, the beneficiary of the trust must make an affirmative QSST election.

To continue to hold S corporation stock as a qualifying shareholder after the two-year grace period, the trust must

qualify either by the current income beneficiary making an affirmative QSST election under IRC section 1361(d)(2), or by the trustee making an affirmative ESBT election under IRC section 1361(e)(3).

Although the trust that received the stock was eligible to make a QSST election, the beneficiary of the trust failed to make the election on a timely basis causing the trust to become an ineligible shareholder and terminating the S corporation elections of both corporations.

IRC section 1362(f) provides that if an S election terminates due to an inadvertent failure to meet the requirements of IRC section 1361(b), the IRS may treat the corporation as an S corporation. The IRS determined that the terminations of the two corporations' S elections were inadvertent, and concluded that the corporations will be treated as S corporations from the date of termination forward (provided their elections otherwise remained valid in effect).

B. No Gain Recognized on Contribution of Investment Assets to Partnership

PLR 202622001 (Released May 29, 2026)

Six taxpayers, four trusts, and two individuals proposed to contribute cash and diversified portfolios of stocks and securities to an LLC taxed as a partnership. The LLC asked for a ruling under IRC section 721 that the proposed partners would not recognize gain or loss on the proposed contributions of assets to the LLC.

The LLC represented that immediately after the receipt of the contributed cash and investment assets, the LLC would qualify as an investment company for purposes of IRC section 351(e)(1). The LLC also represented that the investment assets to be contributed were diversified portfolios of stocks and securities within the meaning of IRC section 368(a)(2)(F)(ii), and that the cash contribution would constitute no more than a specified percentage of the total value of assets contributed.

The IRS ruled that if the LLC was created as described, it would qualify as an investment company under IRC section 351(e)(1). However, the IRS further ruled that the proposed contribution of the specifically identified assets would not result in diversification of the transferors' interests. Therefore, no gain would be recognized by the transferors under IRC section 721 on their contribution of investment assets and cash to the LLC.

** Sheppard, Mullin, Richter & Hampton LLP*

LITIGATION ALERT

Written by Michael S. Brophy, Courtney A. Sorensen, Sara Z. May,
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REFUSAL TO REGISTER TRUST SHARES IN THE NAMES OF PROBATE-COURT- CONFIRMED SUCCESSOR COTRUSTEES IS UNPROTECTED CONDUCT AND SURVIVES A SPECIAL MOTION TO STRIKE

Clapkin v. Levin (2026) 119 Cal.App.5th 222

The Second District Court of Appeal held that causes of action for denial of voting rights and breach of fiduciary duty brought by successor cotrustees of a revocable family trust against co-shareholders who refused to register the trust's shares in the successor cotrustees' names survived a special motion to strike under Code of Civil Procedure section 425.16 (the anti-SLAPP statute), because the claims arose from the co-shareholders' unprotected conduct in denying the successor cotrustees their right to vote the trust's shares, not from protected litigation activity.

A grandfather owned all shares of a closely held family real estate corporation. He distributed them all to his children, including a son and a daughter. The daughter transferred her shares into a revocable inter vivos trust naming herself and her husband as trustees, and their five children (the "Clapkins") as successor cotrustees and beneficiaries. The son died in February 2022, leaving his shares to his two daughters (the "Levins"). A dispute over corporate control ensued between four of the Clapkins and the Levins, and between June and September 2022 they filed four actions against each other. In October 2022 the daughter's husband resigned as trustee with respect to the trust's interest in the corporation, and in November 2022 the daughter's physicians declared her incapacitated. The Clapkins contended this triggered the trust's successor cotrustee provisions. The Levins disputed this. In May 2023, the trial court presiding over the now six pending civil actions ruled that the probate court had exclusive jurisdiction to determine the trustees of the trust, ordered the Clapkins to file a petition in probate court, and stayed the civil actions. In January 2024 the probate court suspended the

daughter and appointed her children as interim successor cotrustees, and in May 2024, confirmed them as cotrustees regarding the corporation's shares as of November 2022. The day after the probate court appointed them interim successor cotrustees, the Clapkins asked the Levins to register the trust's shares in the successor cotrustees' names. Instead, the Levins filed a new action (number nine) alleging breach of the buy-sell agreement and seeking an order compelling the sale of the trust's shares. The Clapkins filed a cross-complaint asserting causes of action for violation of Corporations Code sections 700 and 708 and for breach of fiduciary duty, and the Levins moved to strike on the grounds that the causes of action were based on protected litigation activity, arguing that their refusal to register the trust's shares in the Clapkins' names and that the registration and voting of the trust's shares were squarely in dispute in five pending actions. The trial court denied the special motion to strike, ruling the controversy existed separate and apart from the preexisting litigation and concerning the parties' current rights to vote in matters concerning the corporation. The Levins appealed.

The appellate court affirmed. Under settled anti-SLAPP principles, a cause of action may be stricken "only if the protected speech or petitioning activity itself is the wrong complained of, and not merely evidence of liability." The first three causes of action arose from the Levins' unprotected activity in denying the Clapkins their right to vote the trust's shares at annual shareholders' meetings by refusing to register those shares in the names of the successor cotrustees. The Levins' litigation activities did not supply any element of those causes of action. Even if there had been no previous litigation between the parties, the Clapkins could have asserted the same causes of action based solely on the Levins' refusal to allow the successor cotrustees to vote the trust's shares. Although the cross-complaint referenced the Levins' litigation conduct at length, those references did not form the basis of the claims. The court further rejected the argument that the claims necessarily arose from the litigation merely because the cross-complaint was filed after extensive parallel

proceedings were underway, noting that a compulsory cross-complaint ordinarily arises from the underlying dispute alleged in the complaint, not from the litigation process itself, and would rarely qualify as a SLAPP suit arising from petitioning activity.

A TRUST PROVISION DEEMING A BENEFICIARY TO HAVE “PREDECEASED” A SETTLOR IF THE BENEFICIARY DOES NOT SURVIVE FOR A SPECIFIED PERIOD IS NOT ENOUGH BY ITSELF TO DEFEAT CALIFORNIA’S ANTILAPSE STATUTE

In re Tung Trust (2026) 121 Cal.App.5th 1

The Second District Court of Appeal held that the Probate Code’s antilapse statute applies to preserve a deceased beneficiary’s gift for his children where a trust provision regarding when a beneficiary would be deemed to predecease the settlor did not create a survival requirement and did not express a sufficiently clear contrary intent to override the antilapse statute.

The settlor’s son, a primary beneficiary under her trust, died before the settlor, leaving three children. After the settlor’s death, a dispute arose over whether the son’s children inherited his share under California’s antilapse statute or whether the gift lapsed because the son predeceased the settlor. The trust contained a provision deeming a beneficiary who failed to survive the settlor by 30 days to have predeceased the settlor. The probate court held that the trust’s 30-day survivorship provision reflected a contrary intent sufficient to negate the antilapse statute, causing the son’s gifts under the trust to lapse rather than pass to his children. The son’s children appealed.

The appellate court reversed the probate court’s order granting a motion for summary adjudication and directed the probate court to enter a new order denying the motion. The appellate court found that the probate court erred in finding the trust expressed a “contrary intention” to override application of the antilapse statute under section 21110, subdivision (b). The survivor provision deemed a beneficiary to have predeceased the settlor if the beneficiary did not survive by 30 days, but it did not state that the gift under the trust was conditioned on the beneficiary’s survival, and therefore did not express the contrary intent required to override the statute. In the absence of clear language indicating settlor’s contrary intention to disinherit the son’s issue, the antilapse statute applied.

A NOTICE OF SANCTIONS MOTION THAT FAILS TO STATE THE HEARING DATE IS FATALY DEFECTIVE

J.N. v. Goldberg (2026) 120 Cal.App.5th 544

The Second District Court of Appeal held that an electronic court reservation system flaw does not excuse a party seeking sanctions under Code of Civil Procedure section 128.7 from strictly complying with statutory notice requirements, and serving a notice of motion that fails to state the hearing date is fatally defective and prevents the 21-day safe harbor period from beginning.

The plaintiffs filed a complaint for financial elder abuse by way of fraud or undue influence and intentional misrepresentation, which also alleged they were entitled to an award of attorney fees and costs. In response, the defendant served a motion for sanctions based upon the frivolity of the complaint. The defendant served notice to begin the statutory 21-day safe harbor period permitting the plaintiff time to withdraw the action. The defendant failed to include a hearing date, however, because the superior court’s mandatory electronic Court Reservation System (CRS) required motions to be filed within three days of reserving a hearing date and would cancel the reservation if the defendant waited to file until after the safe harbor period. The trial court found the plaintiffs’ complaint to be factually frivolous and legally meritless and awarded the defendant fees and costs. The trial court rejected the plaintiffs’ argument that the notice was defective, ruling that the electronic filing system’s limitations exempted the defendant from the hearing notice requirement and that pre-CRS strict compliance case law was outdated. The plaintiffs appealed.

The appellate court reversed and remanded. The court determined under de novo review that strict compliance with the notice provisions of Code of Civil Procedure sections 1010 and 128.7 is mandatory and cannot be excused by electronic filing system constraints, as the defendant could have filed an ex parte motion to request a waiver of the e-filing timing restrictions. Because the served notice of motion failed to state when the motion would be made, it was fatally defective, the mandatory 21-day safe harbor period never commenced, and the doctrine of harmless error could not salvage the procedurally noncompliant motion.

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