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REVITALIZING A STALE TRUST: IMPROVEMENT, IF NOT PERFECTION

*By James P. Lamping, Esq.**

“Humpty Dumpty sat on a wall,
Humpty Dumpty had a great fall.
All the king’s horses,
And all the king’s men,
Couldn’t put Humpty together again.”¹

I. INTRODUCTION

The administration of a two settlor trust when a substantial amount of time has passed since the death of the first spouse can present unique challenges.² This article will explore some of the most common problems associated with a stale trust administration, as well as offer possible solutions to the dilemmas posed by this scenario.³

From the outset, the parties to a stale trust administration should understand that it may be impossible to achieve perfection. Assets may have been sold, records may be missing, and a myriad of other events may have occurred which make it difficult to reconstruct where the trust should be today if it had been promptly administered. That does not mean that the trustee should give up. Instead, the goal of the trustee should be to do the best that she can with the information available to her. The fact that perfection cannot be achieved does not preclude the trustee from improving the situation.

II. THE CONSEQUENCES OF DELAY

The reasons for failing to promptly administer a two settlor trust after the death of the first spouse are varied. In some instances, it may have been caused by the surviving spouse’s aversion to paying the legal fees associated with the administration. Other cases may involve a surviving spouse who simply was not aware of her duty to take action.⁴ Whatever the reason, the attorney has the duty to identify the pertinent issues to the trustee, and to educate the trustee regarding the trust administration process.⁵

A substantial delay in administering a trust after the death of the first spouse may throw even the best drafted of estate plans into chaos. From an estate tax perspective, the assets that otherwise would have been funded into the credit trust may be included in the taxable estate of the surviving spouse.⁶ Moreover, the opportunity to remove appreciating assets from the estate of the surviving spouse may be lost.⁷ For example, a prompt funding may have permitted the surviving spouse to deplete her taxable estate by making

gifts of appreciating assets from the survivor’s trust, whereas that may only be accomplished on a prospective basis in a stale funding. It is also common for assets expected to rapidly appreciate to be allocated to the credit trust when it is anticipated the surviving spouse will have a taxable estate.⁸ However, a stale funding may require the assets be allocated on a pro rata basis, thereby removing the opportunity to remove both past and future appreciation from the surviving spouse’s estate.⁹ As discussed in more detail below, there may also be a number of income tax issues raised by the delay in funding.¹⁰

Apart from the tax consequences, the remainder beneficiaries may have a cause of action against the surviving spouse for breaching her fiduciary duties as trustee.¹¹ As a practical matter, the risk involved may depend upon the surviving spouse’s relationship with the remainder beneficiaries. In a harmonious nuclear family with common children of a long-term marriage, perhaps there is a lower risk of litigation. At the other end of the spectrum, a contentious relationship involving stepchildren or dysfunctional family members presents serious liability concerns from a litigation perspective.

Regardless of the circumstances, the fact that the trust has not been administered should not be ignored. If the attorney fails to identify to the surviving spouse that the trust should be administered, the attorney may be subject to malpractice liability.¹² If the failure to promptly administer the trust was caused by a prior advisor, the attorney may himself be subject to liability for failing to disclose that fact to the trustee.¹³ If the surviving spouse refuses to take corrective actions even after being advised of the necessity of administering the trust, the attorney should terminate the representation.¹⁴

It should be emphasized that the corrective actions required of the surviving spouse do not necessarily mandate funding the subtrusts. In some instances, the surviving spouse may be correct in her perception that undertaking this process will be an expensive and unnecessary waste of time.¹⁵ However, the solution in that circumstance is not to ignore the situation while it gets worse. Instead, the trustee should consider seeking a termination of the unnecessary subtrusts.

III. SHOULD THE CREDIT AND MARITAL TRUSTS BE TERMINATED RATHER THAN FUNDED?

A. Overview

Before plunging into the depths of a stale trust administration, a preliminary question is whether the subtrusts should be terminated, rather than funded. A number of factors should be examined in determining whether the funding will be appropriate under a given set of circumstances. One issue is the value of the surviving spouse’s estate. When the estate of the surviving spouse is relatively modest, and it is not anticipated that an estate tax will be imposed upon the surviving spouse’s death, the funding of a credit trust may actually increase the overall taxes ultimately imposed on the assets.



This is true because only the assets included in the surviving spouse's estate will receive a full step up in basis upon the surviving spouse's death, whereas the assets in the credit trust will not.¹⁶ As a result, a capital gains tax may be imposed when the assets of the credit trust are later sold. If no estate tax would have been imposed had the assets been included in the estate of the surviving spouse, the net result is that funding the credit trust actually creates a larger tax bill. This result is even worse when the expenses of administering the subtrusts on an ongoing basis are taken into account.¹⁷

The asset protection needs of the surviving spouse should also be considered. Generally speaking, assets held in a trust with spendthrift provisions will be protected from the creditors of the beneficiary.¹⁸ When it is anticipated that the surviving spouse may have creditor problems in the future, the maintenance of an irrevocable subtrust may make sense even in a modest estate. For example, if the surviving spouse was employed in a profession in which liability may extend many years into the future, maintaining a credit trust may still make sense.¹⁹

From the perspective of the remainder beneficiaries, there may be a number of factors which would militate in favor of funding the assets on the deceased spouse's side of the balance sheet into irrevocable subtrusts. If the remainder beneficiaries are the deceased spouse's children by a prior relationship, the obvious concern is that the surviving spouse would disinherit them.²⁰ However, this may also be a concern for the surviving spouse's biological children. If the surviving spouse remarries in the future, there may be concern that assets distributed outright to the surviving spouse would be left to a future spouse, rather than the children. A possible solution to this dilemma is for the surviving spouse to seek a termination of the subtrusts and an immediate distribution of assets.

The typical credit or marital trust provides that assets are to be held for the benefit of the surviving spouse during the surviving spouse's lifetime, and distributed to the remainder beneficiaries upon the death of the surviving spouse. In a blended family, this means that stepchildren will ordinarily need to wait until their stepparent dies in order to receive their inheritance. Depending upon the relative ages of the stepparent and stepchildren, this may mean that stepchildren may never see a distribution during their lifetimes.²¹ This may provide an incentive for the stepchildren to agree to the termination of the subtrusts.

One possible approach is for the stepchildren to agree to an immediate termination of the trust in exchange for an immediate distribution based upon the actuarial value of their remainder interest. For example, if the actuarial values of the surviving spouse's life estate and the interests of the remainder beneficiaries are ninety percent and ten percent, respectively (based upon the surviving spouse's life expectancy), the assets of the trust would be distributed in these proportions upon termination. While there may be some room for disagreement with respect to the manner in which these interests are calculated, this at least provides a conceptual framework for negotiations. Assuming that there is agreement be-

tween the surviving spouse and the remainder beneficiaries, there are two bases to seek a termination of an irrevocable trust, the consent of the beneficiaries and a change of circumstances.

B. Consent

The consent of all beneficiaries is one basis upon which a court can order the termination of an irrevocable trust. Probate Code section 15403(a) provides:

Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.

As a result, the general rule is that the consent of the surviving spouse and remainder beneficiaries is sufficient for the court to order that irrevocable subtrusts be terminated, rather than funded. However, the exceptions may swallow the general rule. Probate Code section 15403(b) states:

If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest as provided in Chapter 2 (commencing with Section 15300).

The "material purpose" exception in this statute usually will not preclude the termination of an irrevocable subtrust in the stale trust context. Ordinarily, one purpose of a marital or credit trust is to provide for the surviving spouse during her lifetime, and to ensure that the remainder beneficiaries ultimately receive at least some assets.²² Under most circumstances the outright distribution of assets will not impair this goal. Moreover, the fact that it may be unduly burdensome or expensive to reconstruct the proper funding of the subtrusts would appear to militate in favor of an outright distribution.

The larger problem is that consent of the beneficiaries may not be used as a basis to terminate the subtrusts where the trust contains a spendthrift provision.²³ Many drafters include a spendthrift provision in their boilerplate.²⁴ While it be difficult in many instances to fault the drafter for including a spendthrift provision in an ongoing trust such as a credit or marital trust, its inclusion may present a substantial impediment should it prove advantageous to terminate the subtrusts in the future.

Assuming that it is possible to terminate the subtrusts and distribute their assets based upon the consent of the beneficiaries, it is likely that all beneficiaries must consent in order for this approach



to work. In theory, a court could order the termination without the unanimous consent of all beneficiaries, but in that case the proportionate shares of the nonconsenting beneficiaries must be funded into the appropriate subtrusts.²⁵ This means that the trustee will need to go through the same steps as would be required to fully fund the subtrusts, and then divide the interest of the nonconsenting beneficiary. To a large degree, this would defeat the very purpose of seeking the termination.

Another issue is that the remainder beneficiaries may be unborn or unascertained. The typical credit or marital trust provides that assets are to be divided among surviving children and the issue of any predeceased children.²⁶ Of course, there is no way of knowing whether a particular child who is alive today will predecease the surviving spouse. Consequently, it may be necessary for the court to appoint a guardian ad litem. Probate Code section 15405 states:

For the purposes of Sections 15403 and 15404, the consent of a beneficiary who lacks legal capacity, including a minor, or who is an unascertained or unborn person may be given in proceedings before the court by a guardian ad litem, if it would be appropriate to do so. In determining whether to give consent, the guardian ad litem may rely on general family benefit accruing to living members of the beneficiary's family as a basis for approving a modification or termination of the trust.

In deciding whether to consent, a guardian ad litem may assume that a termination will benefit unborn children of the person receiving the resulting outright distribution:

This section recognizes that, where appropriate, a guardian ad litem may give consent to modification or termination on behalf of a beneficiary who lacks legal capacity (including a minor) or who is an unascertained or unborn person. The second sentence of the section permits a non-pecuniary quid pro quo as a basis for protecting the interests of the beneficiaries represented by the guardian ad litem. This provision is drawn from Wisconsin law. Wis. Stat. Ann. § 701.12(2) (West 1981). Under this rule, the guardian ad litem may rely on the assumption that a benefit conferred on potential parents will ultimately benefit a child who might be born into the family. . . .²⁷

As a result, a guardian ad litem may consent even when it means that the contingent interest of the person the guardian represents will be eliminated.

C. Change of Circumstances

When it is not possible to terminate the subtrusts based upon the consent of the beneficiaries,²⁸ it may nevertheless be possible to terminate the subtrusts if a change of circumstances has occurred. Probate Code section 15409(a) provides:

On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.

If the trust was created when the applicable exclusion amount was relatively low, the inclusion of marital or credit trust provisions may have made perfect sense to minimize estate taxes.²⁹ However, a subsequent change in the law increasing the applicable exclusion amount, or a substantial decline in the value of the assets held by the trust, may render the irrevocable subtrusts unnecessary for this purpose. It may also bear mention that the assets in the credit trust will not receive a step up in basis upon the death of the second spouse,³⁰ and additional administrative expenses will accompany the funding and maintenance of the irrevocable subtrusts.³¹

Another argument is that the settlor would not have wanted the subtrusts to be funded if he knew the complications that would arise from a stale funding situation. In particular, it may be argued that the continuation of the trust and the funding of the subtrusts will run counter to the settlor's intention to maximize the amount passing to family members, as to the legal and accounting fees associated with the stale funding may be substantial. This of course is based upon the premise that the failure to administer the trust promptly after the death of the first spouse was a circumstance that was not foreseeable to the deceased settlor.

While establishing that a change of circumstances has occurred requires a fact specific analysis, as opposed to simply obtaining the consent of the beneficiaries, the inclusion of a spendthrift clause in the trust instrument will not necessarily preclude the court from ordering a termination of the trust. Rather, the existence of a spendthrift provision is only one factor to be analyzed by the court. Probate Code section 15409(b) states:

The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.



Strictly speaking, the consent of the beneficiaries is not a factor in determining whether a change of circumstances has occurred. However, as a practical matter, it would seem likely that a court would be much more inclined to grant the petition when all beneficiaries have consented.

IV. ADMINISTERING THE STALE TRUST

A. Overview

In order to put the stale administration back on track, the trustee must ascertain what has actually occurred since the death of the first spouse, and then compare it to what should have happened. As a practical matter, it may never be possible to precisely reconstruct each and every transaction as it would have occurred if the trust had been administered properly. That said, the trustee can and should attempt to accomplish this result as nearly as possible taking into account practical considerations, such as materiality and the availability of records.

The administration of a stale trust involves many of the same issues as any other trust administration.³² However, the passage of time serves to complicate and confuse many of those issues. For example, the promptly administered trust usually requires the trustee to take a snapshot of the trust assets and liabilities as of the date of the first death, as well as the date that the subtrusts are funded.³³ A longer delay in administering the trust will increase the likelihood that assets existing as of the date of death have been sold, new assets have been acquired, and substantial amounts of income earned. It may therefore be more difficult to tell which assets are traceable back to the date of the first death, as opposed to

being acquired through some other method.

While it may be admirable to strive for perfection through a full forensic accounting, at some point, the costs of that approach will outweigh the benefits. Instead, a more realistic view is that the trustee should correct the administration to the extent that it is reasonably possible. The discussion that follows is not meant to be an exhaustive analysis of all aspects of a stale trust administration, but rather is intended to provide an overview of the salient issues often arising in this context. By identifying these issues at the outset, the stale administration can more readily be brought back on track.

B. Read the Manual: What is the Funding Clause Telling you to do?

As with any trust administration, the starting point for administering a stale trust is to look at the words of the document. The marital deduction formula will likely have a more dramatic impact on the final result of the stale administration than any other part of the trust document. This is true because the formula used will determine the subtrust to which appreciation since the first death will be allocated,³⁴ and in a stale administration, the appreciation can be substantial. For detailed examples of the operation of marital deduction formula clauses in the stale trust funding context, see California Trust Administration (Cont.Ed.Bar 2d ed. 2001) § 14A.26.

1. Date of Death or Date of Distribution?

While every administration following the death of the first spouse will start with the gathering of date of death asset values, in most instances, assets are funded using their values as of the

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date distribution.³⁵ When the document is silent, date of distribution values are used.³⁶ In the event that a date of death formula is used, appreciation and depreciation must be prorated between the subtrusts.³⁷ Regardless of the funding clause used, it is necessary to value assets both as of the date of death and the date of distribution in order to allocate appreciation and depreciation occurring between the date of death and the date of funding.³⁸

2. *Pecuniary Marital-Residual Credit*

In a pecuniary marital-residual credit date of distribution funding clause, the value of the marital trust is a fixed dollar amount determined as of the date of death.³⁹ Any appreciation, depreciation or income is allocated to the residual (credit) trust.⁴⁰ Of course, if many years have passed since the first death, the appreciation may be substantial. For example, suppose that assets with a date of death value of \$1.5 million in 2005 are allocable to the residual credit trust. If those assets have increased in value to \$7 million when funding occurs in 2010, the entire \$7 million is funded into the credit trust.⁴¹ Inasmuch as the assets of the credit trust pass free of estate taxes upon the death of a spouse, the use of this formula will likely maximize the amount passing free of estate taxes in a stale trust administration.⁴²

3. *Pecuniary Credit-Residual Marital*

A pecuniary credit-residual marital date of distribution funding clause uses the opposite approach. In other words, the amount passing to the credit trust is expressed as a fixed dollar amount as of the date of death, and the residue is allocated to the marital trust.⁴³ Ordinarily, this will mean that appreciation, depreciation or income will be allocated to the marital trust, and therefore taxed as part of the surviving spouse's estate.⁴⁴ In other words, the use of a pecuniary credit-residual marital funding clause may cause all of the appreciation occurring in the years since the death of the first spouse to be subject to estate taxes in the survivor's estate, whereas a pecuniary marital-residual credit would have protected that appreciation by causing it to be allocated to the credit trust. This can have a dramatic impact on the total estate taxes imposed following the death of the second spouse.

4. *Fractional Share and Fairly Representative Clauses*

In a trust with a fractional share formula or fairly representative funding clause, appreciation and depreciation are allocated proportionately between the credit and marital trusts based upon their respective shares as of the date of death.⁴⁵ This will ordinarily produce a result somewhere between a pecuniary marital-residual credit and a pecuniary credit-residual marital formula.

5. *Two Trust Divisions*

Some trusts are drafted to provide only for a survivor's trust and credit trust, without a provision for marital trust.⁴⁶ The amount passing to the credit trust will operate in much the same manner as in a three trust division; however, the amount not passing to

the credit trust will be allocated to the survivor's trust instead of a marital trust.⁴⁷

V. **KENAN GAIN, THE TAXATION OF LOSSES, AND PAYMENT OF INTEREST**

A. **What is Kenan Gain?**

Using appreciated assets to satisfy a pecuniary bequest may be a taxable event. This is generally referred to as "Kenan gain."⁴⁸ For example, suppose that a trust provides that \$10,000 is to be distributed to a particular beneficiary. Rather than distributing cash, the trustee decides to distribute stock that had a date of death value of \$9,000, but which has appreciated to \$10,000, to that beneficiary. For tax purposes, this is treated essentially as if the trustee had sold the stock, realized a capital gain, and then distributed the cash to the beneficiary.

As noted above, many marital deduction formula clauses often determine the division of assets based upon a pecuniary amount. When that is the case, the satisfaction of the pecuniary bequest with assets that have appreciated in value is treated the same as any other pecuniary bequest. In other words, the funding of a pecuniary subtrust with assets that have appreciated since the date of death will trigger capital gain.⁴⁹ This presents a particularly acute problem in a stale trust administration, as assets have likely appreciated substantially since the date of death.

B. **What About Losses?**

While a probate estate may recognize loss upon funding a pecuniary bequest with assets that have depreciated in value, a trust generally cannot.⁵⁰ When subtrust funding occurs relatively promptly, this problem can be avoided through an election for trust assets to be treated as part of the probate estate for income tax purposes.⁵¹ However, the length of time for which this election can be made is limited, and the time to make the election will likely have long since passed in a stale trust administration.⁵² Consequently, the 645 election likely will not be of assistance in this context.⁵³

C. **The Payment of Interest**

As discussed above, marital deduction formulas often cause a pecuniary amount to pass to a particular subtrust. Unless the trust instrument provides to the contrary, interest must be paid on pecuniary devisees from one year after the decedent's death until distribution. Probate Code section 12003 provides:

If a general pecuniary devise, including a general pecuniary devise in trust, is not distributed within one year after the testator's death, the devise bears interest thereafter.

The rate of interest is set forth in Probate Code section 12001:

If interest is payable under this chapter, the rate



of interest is three percentage points less than the legal rate on judgments in effect one year after the date of the testator's death and shall not be recomputed in the event of a change in the applicable rate thereafter.

In the current low interest rate environment, this means that the pecuniary trust will be owed seven percent simple interest starting one year after the date of death.⁵⁴ When many years have passed between the date of death and the date that the pecuniary trust is funded, the interest owed can be substantial.

VI. TRACING INCOME AND PRINCIPAL, AND ALLOCATING APPRECIATION

Once asset values have been established as of the death of the first spouse and the present, an attempt must be made to connect the dots between the two points. It might be tempting to assume that assets existing today were directly traceable to assets existing on the date of the first death. In the real world, that may not happen. For example, income generated by one asset may be used to acquire an additional asset.⁵⁵ When the trust provides for mandatory distribution of income to the surviving spouse, the substance of the transaction is that the surviving spouse received her income distribution outright and acquired the new asset.⁵⁶ In that event, the new asset should be allocated entirely to the survivor's trust.

By contrast, if one asset is sold and the proceeds used to acquire a new asset, the newly acquired asset would likely be traceable to principal. Another possibility is that new assets have been acquired with a combination of income and principal, which would require a detailed tracing from the date of death to the present in order to precisely reconstruct the proper allocation of each such asset. It bears emphasis that materiality should be taken into account in determining the level of precision required in such a tracing. When dealing with assets of relatively modest value, practicality must take precedence over precision at some point.

Once the interests in the various assets have been established, it is necessary to allocate the appreciation attributable to them. For example, if an asset was acquired using income exclusively and the surviving spouse was entitled to all income, all appreciation occurring following the acquisition of the asset would be attributable entirely to the surviving spouse. Conversely, appreciation attributable to a new asset acquired entirely with principal would result in appreciation being allocated entirely to principal, rather than exclusively to the surviving spouse.

The precise actions necessary to perform a tracing from the date of death to the present will vary widely from case to case. In many cases, it may be necessary to perform a full accounting from the date of death forward in order to properly reconstruct where the trust should be had it been properly administered following the death of the first spouse. However, depending upon the willingness of the remainder beneficiaries to waive an accounting, a full

accounting may be required in any event.⁵⁷

VII. COMPLETING THE FUNDING: DON'T GET CUTE

Under ordinary circumstances, the trustee may have the power to fund subtrusts on a nonprorata basis.⁵⁸ There is nothing in a stale funding that requires to the contrary as a matter of course. However, the trustee must recognize that she is in a precarious position from the outset. The position of the IRS has essentially been "we will most likely respect a stale trust funding if you are fair, but don't get cute."⁵⁹

For example, if the trustee attempts to allocate assets in such a way as to completely eliminate Kenan gains where a tax would otherwise be imposed, it is more likely that the funding will be subject to attack. The determination of what is "fair" under a given set of circumstances is a fact specific and often highly subjective determination. Pro rata funding may be the safest approach in a stale funding because it minimizes the argument that the trustee skewed matters in favor of the trust by disproportionately allocating assets to a particular subtrust. While pro rata funding is not absolutely required in a stale trust funding, as a practical matter it may be the least risky alternative.

VII. CONCLUSION

The administration of a stale trust can present unique challenges. It may not be possible to put the fractured pieces of a stale trust administration back together exactly as they would have been if the trust had been promptly administered. However, the trustee can substantially improve the situation, even if perfection cannot be attained.

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ENDNOTES

1. Opie and P. Opie, *The Oxford Dictionary of Nursery Rhymes* (Oxford: Oxford University Press, 1951, 2nd ed., 1997), pp. 213-215.
2. The focus of this article will be the delayed administration of a two settlor trust after the death of the first spouse, but before the death of the second spouse. If no administration has occurred at the time of the second spouse's death, many of the same issues exist, although the trustee will be undertaking two administrations.
3. For a more detailed examination of state trust administrations, see Cal. Trust Administration (Cont.Ed.Bar 2d ed. 2001)§ 14A.17 et seq.
4. This may in part be due to the fact that the surviving spouse believes in the "living trust myth," i.e. the belief that since there is a living trust, there is nothing to be done. Cal. Trust Administration, *supra*, at §§ 13.23 and 14A.17. It may also be the product of the attorney (or worse still, the trust mill) who drafted the trust not fully explaining its operation to the settlors at time it was created.
5. If the trustee refuses to take any action, the attorney should consider withdrawing from the representation. It is common for the stale funding to be identified when the surviving spouse desires to amend what she thought was a completely revocable trust. It is inadvisable for the attorney to even attempt an amendment of the survivor's trust where the surviving spouse refuses to



fund the other subtrusts, as the risk of litigation in this fact pattern is often extremely high.

6. For an example of a stale trust with this result, see *Estate of Hester v. U.S.* (WD Va 2007) 2007-1 USTC 60,537, 99 AFTR2d 1288; Cal. Trust Administration, *supra*, at § 14A.19. As of this writing, Congress has not enacted an estate tax for persons dying in 2010. For purposes of this article, it will be assumed that an estate tax law will be in effect upon the death of the second spouse.
7. *Id.* at § 14A.21.
8. *Id.* at § 14A.22.
9. *Ibid.*
10. See *infra* and Cal. Trust Administration, *supra*, at § 14A.23.
11. Cal. Trust Administration, *supra*, at § 14A.24. Among the duties implicated are the duty to administer the trust (Prob. Code, §16000), the duty to keep trust property separate and identified (Prob. Code, §16009), and the duty to provide information to beneficiaries (Prob. Code, § 16060 et seq.)
12. Cal. Trust Administration, *supra*, at § 1.5.
13. *Id.* at § 17.47.
14. An attorney may withdraw from representation if the client “(a) insists upon presenting a claim or defense that is not warranted under existing law and cannot be supported by good faith argument for an extension, modification, or reversal of existing law, or (b) seeks to pursue a course of conduct that is prohibited under these rules or the State Bar Act, or (c) insists that the member pursue a course of conduct that is illegal or that is prohibited under these rules or the State Bar Act, or (d) by other conduct renders it unreasonably difficult for the member to carry out the employment effectively,” and must withdraw if the attorney “knows or should know that continued employment will result in violation of the rules or of the State Bar Act.” (Rules to Prof. Conduct, rules 3-700(B)(2) and (C)(1).) Even if the circumstances of a particular case make withdrawal permissive, and not mandatory, the risk of malpractice liability and future litigation make continued representation a dangerous path when the surviving spouse refuses to administer a stale trust. Caution would dictate not only withdrawal, but heavy documentation of all communications with the surviving spouse.
15. See Cal. Trust Administration, *supra*, at § 17.65.
16. *Id.* at 7.30; Int. Rev.Code (IRC), § 1014
17. For example, ongoing trusts may result in accounting and legal fees, not to mention the expenses of correcting the stale administration.
18. Prob. Code, § 15300 et seq.
19. For example, an attorney may be subject to malpractice liability many years after retirement.
20. Even if a stepparent and stepchildren have a good relationship prior to the death of the parent-spouse, they may drift apart as the years pass. But see Complete Plans for Small and Mid-Size Estates (Cont.Ed.Bar 2006) § 4.11 (discussing the bypass trust as a source of friction between the surviving spouse and stepchildren).
21. This would likely be the case, for example, where the surviving spouse is younger than the stepchildren. Moreover, a relatively young surviving spouse may consume the assets during her lifetime if the trust includes a principal invasion power. See Complete Plans for Small and Mid-Size Estates, *supra*, at § 4.11.
22. See Drafting California Revocable Trusts § 14.1 (Cont.Ed.Bar 4th ed. 2003); Complete Plans for Small and Mid-Size Estates § 4.10 (Cal CEB 2006).
23. Probate Code § 15403(b).
24. See Drafting California Revocable Trusts (Cont.Ed.Bar 4th ed. 2003) § 19.12A; California Will Drafting (Cont.Ed.Bar 3rd ed. 1992) § 27.5.
25. Probate Code § 15404 provides:
 - (a) If the settlor and all beneficiaries of a trust consent, they may compel

the modification or termination of the trust.

- (b) If any beneficiary does not consent to the modification or termination of the trust, upon petition to the court, the other beneficiaries, with the consent of the settlor, may compel a modification or a partial termination of the trust if the interests of the beneficiaries who do not consent are not substantially impaired.
- (c) If the trust provides for the disposition of principal to a class of persons described only as “heirs” or “next of kin” of the settlor, or using other words that describe the class of all persons who would take under the rules of intestacy, the court may limit the class of beneficiaries whose consent is needed to compel the modification or termination of the trust to the beneficiaries who are reasonably likely to take under the circumstances.
26. Drafting California Revocable Trusts, *supra*, at § 8.51.
27. Cal. Law Revision Com., com., 54 West’s Ann. Prob. Code (1961 ed.) foll. § 15405.
28. For example, because the trust instrument includes a spendthrift provision – see *infra*.
29. With respect to the marital trust, see *Estate of Mellinger v. Commissioner* (1999) 112 T.C. 26 (interests of survivor’s trust and marital trust not aggregated for fractionalization purposes).
30. Cal. Trust Administration, *supra*, at § 7.30; IRC, § 1014.
31. To the extent that the trust contains an express recitation that its purpose is to minimize taxes and administration expenses, and the actual administration terms of the trust would produce a contrary result, it may be argued that an ambiguity exists. Where an ambiguity is found, the court may look to the decedent’s intent in interpreting the trust instrument. (*Ike v. Doolittle* (1998) 61 Cal.App.4th 51.)
32. For a discussion of subtrust funding generally, see Chapter 14 of Cal. Trust Administration, *supra*.
33. Cal. Trust Administration, *supra*, at §§ 14.16, 14.86, 14.89.
34. Cal. Trust Administration, *supra*, at § 14.31.
35. Cal. Trust Administration, *supra*, at § 14.31.
36. Prob. Code, § 21118.
37. Rev. Proc. 64-19, 1964-1 Cum. Bull. 682.
38. As discussed *infra*, appreciation must be allocated even when a fractional share of date of death funding clause is used.
39. Cal. Trust Administration, *supra*, at § 14.31.
40. Cal. Trust Administration, *supra*, at §§ 14.31, 14A.26, but see discussion regarding payment of interest on pecuniary gifts satisfied more than one year after death, *infra*.
41. See Cal. Trust Administration, *supra*, at § 14A.26.
42. *Ibid.*
43. Cal. Trust Administration, *supra*, at §§ 14.31, 14A.26.
44. A possible counter-argument is that, if all of the deceased spouse’s assets would have been funded into the pecuniary credit trust due to the size of the estate, no marital trust would have been created. Following this line of logic, all of the deceased spouse’s assets should be funded into the credit trust, notwithstanding the use of a pecuniary formula. See example discussed in Cal. Trust Administration, *supra*, at § 14A.26.
45. Cal. Trust Administration, *supra*, at § 14.29; 14.33.
46. As discussed in Cal. Trust Administration, *supra*, at § 14A.26, the wrong formula in a two trust division can have disastrous results in a stale trust administration.



47. *Ibid.*
48. The term “Kenan gain” is a reference to the holding in *Kenan v. Comm’r* (2d Cir. 1940) 114 F.2d 217.
49. Cal. Trust Administration, *supra*, at §§ 14.31.
50. IRC, § 267(a)(1) states:
 - (1) Deduction for losses disallowed. No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

IRC, § 267(b) provides, in relevant part:

 - (b) Relationships. The persons referred to in subsection (a) are:
 - (1) Members of a family, as defined in subsection (c)(4);
 - ¶¶ . . . ¶¶
 - (4) A grantor and a fiduciary of any trust;
 - (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
 - (6) A fiduciary of a trust and a beneficiary of such trust;
 - (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
 - ¶¶ . . . ¶¶
 - (13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.
51. See IRC, § 645, discussed in Cal. Trust Administration, *supra*, at § 11.53.
52. Cal. Trust Administration, *supra*, at §§ 11.53A and 11.53B.
53. Where that is the case, the trustee should consider selling the assets, recognizing the loss and then funding the pecuniary trust with cash.
54. Code Civ. Proc., § 685.010; *Westbrook v. Fairchild* (1992) 7 Cal App 4th 889.
55. The surviving spouse’s income tax returns are often an invaluable source of information for tracing principal and income. Cal. Trust Administration, *supra*, at § 14A.17.
56. Generally speaking, the beneficiary of a subtrust with a mandatory income provision is entitled to income earned on his share during the administration. Prob. Code, § 16345.
57. Even where the document purports to waive the accounting, that waiver is not valid if “it is reasonably likely that a material breach of the trust has occurred,” a showing that will almost certainly be met in the stale trust context. Prob. Code, § 16064.
58. Prob. Code, §§ 100, 101, 104.5, 16246.
59. Cal. Trust Administration, *supra*, at § 14A.23.



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