***Estate of Craft v. Commissioner*, 68 T.C. 249 (1977)**

In cases before the Tax Court requiring state law interpretation of legal rights and interests in written instruments, the state's parol evidence rule, considered a rule of substantive law, will be applied to determine the admissibility of extrinsic evidence.

Summary

The Tax Court addressed whether trust assets were includable in a decedent's gross estate and the deductibility of executor's fees. The decedent had created a trust, retaining the power to add beneficiaries and alter beneficial interests. The court held that these retained powers caused the trust assets to be included in the gross estate under sections 2036 and 2038 of the IRC. The court also addressed the admissibility of parol evidence to contradict the trust terms, establishing that state parol evidence rules apply in Tax Court when interpreting state law rights. Finally, the court allowed the deduction of the full executor's fees as an administration expense, finding the Florida non-claim statute inapplicable.

Facts

James E. Craft (decedent) established a trust in 1945, naming himself as trustee and transferring property into it along with his wife and two sons. The trust instrument reserved to the grantors (including decedent) the right to add beneficiaries and change beneficial interests, excluding decedent as a beneficiary. Decedent resigned as trustee shortly after and appointed successors. Upon his death in 1969, the trust assets remained for the benefit of two minor children. Decedent's will specified a $5,000 executor fee for his son, Thomas Craft. However, Thomas performed substantial executor duties exceeding initial expectations and was later awarded $63,722.66 in executor fees by a Florida Probate Court.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in estate tax, arguing for inclusion of the trust assets in the gross estate and limiting the deduction for executor's fees to $5,000. The Estate of Craft petitioned the Tax Court, contesting these determinations.

Issue(s)

1. Whether the value of assets in a trust, where the grantor (decedent) retained the power to add beneficiaries and change beneficial interests, is includable in the decedent's gross estate under sections 2036 and 2038 of the Internal Revenue Code.
2. Whether extrinsic evidence should be admitted to interpret the trust instrument and determine the decedent's intent regarding retained powers, despite the parol evidence rule.
3. Whether executor's fees of $63,722.66, as approved by a Florida Probate Court

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but exceeding the $5,000 specified in the will, are fully deductible as an administration expense under section 2053(a)(2) of the Internal Revenue Code, or limited to $5,000 due to Florida's non-claim statute.

Holding

1. Yes, because the decedent retained the power to designate who would enjoy the trust property, the trust assets are includable in his gross estate under sections 2036(a)(2) and 2038(a)(1).
2. No, because under West Virginia law (governing the trust), the trust instrument was unambiguous and therefore, the parol evidence rule, as a rule of substantive law, bars extrinsic evidence to contradict its clear terms.
3. Yes, because executor's fees are considered administration expenses and not claims against the estate under Florida law, the Florida non-claim statute does not apply, and the Probate Court-approved fees are deductible under section 2053(a)(2).

Court's Reasoning

The court reasoned that the express language of the trust instrument clearly reserved to the grantors, including the decedent, the power to add new beneficiaries and to change the distributive shares. Citing *Lober v. United States*, the court affirmed that such powers trigger inclusion under sections 2036 and 2038. Regarding parol evidence, the court addressed conflicting approaches within the Tax Court concerning the parol evidence rule. It explicitly adopted the approach that when the Tax Court must determine state law rights and interests, it will apply the state's parol evidence rule as a rule of substantive law. The court found the trust instrument unambiguous under West Virginia law, thus excluding extrinsic evidence of contrary intent. For the executor's fees, the court distinguished between "claims or demands" and "expenses of administration" under Florida probate law. It held that executor's fees are administration expenses, not subject to the Florida non-claim statute's 6-month filing deadline. The court relied on authorities from other jurisdictions supporting this distinction and allowed the full deduction as approved by the Florida Probate Court.

Practical Implications

Estate of Craft provides critical guidance on the application of the parol evidence rule in Tax Court, particularly in estate tax cases involving interpretations of wills and trusts governed by state law. It clarifies that the Tax Court, when determining state law rights, will adhere to state-specific parol evidence rules, treating them as substantive law. This decision limits the admissibility of extrinsic evidence in Tax Court when state law dictates its exclusion due to unambiguous written instruments. The case also reinforces the importance of carefully drafting trust instruments to avoid unintended retained powers that could trigger estate tax inclusion. Furthermore, it distinguishes between claims and administration expenses in

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probate, impacting the deductibility of executor’s fees and similar costs, particularly concerning state non-claim statutes. Later cases must consider both federal tax law and applicable state law, including evidentiary rules, when litigating estate tax issues related to trusts and estate administration expenses.

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