Malkan v. Commissioner, 54 T. C. 1305 (1970)

A sale of stock cannot be attributed to a trust for tax purposes if the taxpayer, rather than the trust, negotiated and controlled the sale.

Summary

Arnold Malkan attempted to attribute the sale of 10,500 shares of General Transistor Corp. stock to four family trusts he established, arguing he had transferred the shares to the trusts before the sale. However, the U. S. Tax Court determined that Malkan himself sold the shares, as he negotiated the sale terms before creating the trusts and actively participated in the sale's closing. The court applied the substance-over-form doctrine, holding that the trusts were mere conduits for the sale. Additionally, the court ruled that the basis for the sold shares should be calculated using the first-in, first-out (FIFO) method, starting from the shares Malkan placed in escrow before the public offering.

Facts

Arnold Malkan, an attorney and shareholder in General Transistor Corp. (GTC), decided to sell his GTC stock due to disagreements with management. Before the sale, he discussed creating trusts for his family. On June 26, 1958, Malkan agreed to sell 73,888 shares through a public offering and placed 16,000 shares in escrow. On July 15, he prepared trust instruments, but they were not executed until July 18. Negotiations continued, and by July 21, the terms of the sale were finalized. The trusts were reexecuted on July 21 to clarify their New Jersey situs. On July 22, Malkan signed the underwriting agreement as both an individual and trustee. The sale closed on July 29, with Malkan reporting the gain from the sale on his personal tax return.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Malkan's 1958 tax return, asserting that Malkan, not the trusts, sold the 10,500 shares and that the basis should be calculated using the FIFO method. Malkan petitioned the U. S. Tax Court, which heard the case and issued its opinion on June 17, 1970.

Issue(s)

1. Whether the sale of 10,500 shares of GTC stock was made by Arnold Malkan or by the four trusts he created as settlor-trustee.
2. What was the proper basis for the shares sold by Malkan?

Holding

1. No, because the sale was negotiated and controlled by Malkan personally before the trusts were created, and he actively participated in the closing as an individual.

2. The basis should be calculated using the FIFO method, starting from the 16,000 shares placed in escrow on July 14, 1958, because they were the first transferred shares.

Court’s Reasoning

The court applied the substance-over-form doctrine, emphasizing that the sale’s reality, not its formalities, determines tax consequences. Malkan negotiated the sale terms before creating the trusts and signed the underwriting agreement both personally and as trustee. The trusts were merely conduits for the sale, as Malkan intended them to hold the sale proceeds, not the shares themselves. The court cited *Commissioner v. Court Holding Co.* to support its decision, rejecting Malkan’s reliance on cases where trusts were found to have made sales independently. For the basis calculation, the court ruled that the 16,000 shares placed in escrow constituted a transfer under the FIFO rule, as Malkan relinquished control over them before the closing.

Practical Implications

This case underscores the importance of substance over form in tax law, particularly in transactions involving trusts. Taxpayers cannot use trusts to shift tax liability if they control the underlying transaction. Practitioners should advise clients to carefully structure transactions to avoid the appearance of using trusts as mere conduits. The FIFO method’s application to determine basis serves as a reminder to identify shares sold to avoid unfavorable tax consequences. Subsequent cases have cited *Malkan* in similar contexts, reinforcing its principle that the taxpayer who negotiates and controls a sale cannot shift the tax consequences to a trust.

