PROBLEM 13C

Jean Reinhard and Joseph Glid are presently highly paid engineers employed by General Electric Company. They are both subject to the highest marginal income tax rate. They derive their income primarily from their salaries, but both also have substantial investment income. They have, in their spare time, developed a device called the Tricometer, which is capable of automatically adjusting light intensity in a room as external illumination increases or decreases. Jean and Joe have determined that the market for this device will be very large and plan to form a corporation to produce and sell the device. Each will own 50% of the corporation's stock. There are a number of expenses which must be incurred with respect to the Tricometer. First, they must obtain a trademark for the Tricometer. Second, they must obtain a trade name — "Tricometer." Third, they must have the Tricometer patented. Finally, they will incur about $10,000 in other expenses in organizing the corporation.

Jean and Joe have come to you for your advice whether they should pay these expenses individually and then assign the trademark, trade name and patent to the corporation. Or, should they first form the corporation and have it pay the expenses out of the money they contribute to it together with their know-how and rights in the Tricometer, in exchange for their 50% interests in the corporation? Or, should they pay the Tricometer expenses individually, license the corporation to use the trademark, tradename and patent for reasonable fees to be paid to Jean and Joe, and have the corporation pay its organization expenses out of money which they contribute to the corporation? Advise them as to the best procedure from an income tax standpoint.

PROBLEM 23C

Jean Reinhard and Joseph Glid, your clients, some of whose problems you considered in Problem 13C, have decided to organize Tricometer Corporation. Only common stock, which is to be held equally by Jean and Joe, will be issued. The corporation is expected to have net taxable income of $100,000 a year for the first few years, after paying salaries of $60,000 each to Jean and Joe, who seek your advice whether the corporation should elect S corporation status.

Both Jean and Joe are married and file joint returns with their respective spouses. Jean and Joe each earn about $120,000 per year at General Electric where they are employed, and their spouses each earn about $100,000 per year from their respective jobs. In addition, both couples derive a substantial amount of income from their respective investments. Assume alternatively that they continue their employment with General Electric and operate Tricometer only during their free time, or that they quit their jobs with General Electric and devote all of their time to Tricometer. In the latter case, their taxable income would consist of their salaries from Tricometer and investment income of roughly $4,000 each.

Consider also the income tax ramifications of the following alternatives if the corporation elects S corporation status: (1) Jean and Joe conveyed the trademark, trade name and patent to Tricometer; (2) Tricometer by purchase acquired these assets for their fair market value; or (3) Jean and Joe acquired these assets and entered into an agreement with the corporation permitting it to use these assets in return for certain royalties.

If Tricometer elected S corporation status and Jean and Joe consented, prepare yourself to advise them of the effect on Tricometer's S corporation status of each of the following occurrences:

(1) Jean sells one-half of her stock to Tom Peters, a regional investment banker who refuses to consent to the election;

(2) Joe sells his stock to Southwest Properties, Inc., an investment banking firm operating in the corporate form;

(3) Joe conveys one-half of his stock to a trust under which income is distributed to his daughter Donna for twelve years after which the trust is terminated and the corpus returned to Joe;

(4) Joe conveys all the stock to himself as custodian or guardian for his three minor children;

(5) Jean dies, and the stock is temporarily transferred to her estate prior to distribution;

(6) Jean dies, and the stock is distributed to a marital trust. The Trust agreement provides that the income is distributed annually to Jean's surviving spouse for his life and, at his death, is distributed in a manner designated by Jean, in this case to her issue *per stirpes*; or

(7) Jean contributes her stock to a trust under which income is paid to her children for their lives and on their death the remainder is distributed to a charity.

Considering your conclusions, what might you suggest as appropriate provisions to be included in a shareholders' agreement between Jean and Joe as to the maintenance of S corporation status?

Case 23C/13C

1. What are the Federal income tax consequences to Tricometer, Jean Reinhardt & Joseph Glid of creating an S corporation:
A. by conveying the trademark, trade name & patent to Tricometer?
B. which purchases the trademark, trade name & patent from Jean & Joseph?
C. if Jean & Joseph license the trademark, trade name & patent to Tricometer which pays royalties to Jean & Joseph?

2A. What might you suggest as the appropriate provisions to be included in a shareholders's agreement between Jean & Joseph to ensure the S corporation status in perpetuity?
2B. What would be the effect on the S corporation election for each of the seven hypothetical occurrences provided in the facts?

3. What would be the Federal income tax consequences of the $10,000 organization expenses if:
A. paid out of $10,000 cash contribution by Jean Reinhard and Joseph Glid to Tricometer, an S contribution?
B. the $10,000 for organization expenses is paid by Jean & Joseph and contributed to Tricometer, an S corporation?

Legal authority:
Secs. 197, 248, 351, 357, 358, 362, 1361, 1362, 1363 & 1366

Case 26C
Legal authority:
Secs. 61, 162, 167, 168, 170, 179, 351, 357, 358, 362, 368, 444, 1361, 1362, 1363, 1368, 1371, 1377 & 1378.