PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers Case Studies in Tax

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The Ohio State University

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<u>**PwC Case Studies in Tax**</u>

We are pleased to provide updated versions of the PricewaterhouseCoopers Case Studies in Tax. The series was first introduced in January 1989 and now includes seventeen full cases. No new cases have been added this year, but facts have been changed in many to reflect changes in the law since previous editions.

The case studies in this series were developed under the expert guidance of editor William A. Raabe, Ph.D., Professor of Taxation at the Ohio State University. Previous editors in this series include Betty R. Jackson, Ph.D., Professor of Accounting at the University of Colorado at Boulder and Sally Morrow Jones, Ph.D., Professor of Accounting at the University of Virginia. In preparing the case studies, we endeavored to provide tax educators and students with "true-to-life" situations based on actual experiences of PricewaterhouseCoopers tax practitioners.

All cases have been reviewed and modified, as appropriate, due to revisions to the Internal Revenue Code, Regulations and Revenue Rulings through July 2005.

September 2005

Case XV
HAWAIIAN MEMORIES, INC.

Hawaiian Memories, Inc. (HMI) is a C corporation that was formed in 1986 in Maui. The company's business is marketing specialty products of the islands of Hawaii. The initial incorporators were Angie Lee and Bob Lin, who now own 1,000 shares of voting common stock and 100 shares of preferred stock each. The company has eight employees who collectively own 500 shares of nonvoting stock. Most of the employees have worked for the company for several years and purchased the stock when offered at the end of each year. Two own 100 shares each; the other six own 50 shares each. All individual shareholders are native Hawaiians except for Inge, who is Swedish and has worked for HMI for three years. She plans to move back to Sweden in one year and try to develop markets for the products there. Another stockholder is the Plantation Sugar Partnership (PSP). PSP owns 500 nonvoting shares and supplies raw sugar in bulk to HMI. Bob and his brother Jon each own 50% of PSP.

The corporation uses a June 30 year end. The year was chosen arbitrarily. All shareholders use calendar years. Financial statements for the year ended June 30, 2004 are attached. This was the first year of losses in some time. The corporation elected not to carry the losses back because the tax rate paid in those years was lower than they expect to pay in the future. Bob and Angie expect one or two more years of losses and then steady increases in net income.

Bob lives in Hawaii and manages operations there. Angie moved to San Francisco in 2003 to develop mainland markets for their products. Both earn salaries of $150,000. The shareholders and all employees are provided accident and health insurance. The company contributes 10% of each employee's salary to a defined contribution pension plan each year.

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On October 1, 2004, Bob and Angie came to your office for the first time. They have just filed the corporate return for the fiscal year ended June 30, 2004 and are interested in having you take over all the future tax work for the corporation. They inform you that they read §1362 and filed an election to be an S corporation on July 1, 2004. Bob and Angie signed the consent because they were the only shareholders with voting stock. Their reasoning for making the S election is that they expect losses for a year or two as they try to expand, and they would like to use the losses already incurred as well as prospective losses against their other income. Review all relevant information and identify any issues related to conversion to S status. Advise Bob and Angie about the conversion.