

ABA Section of Taxation
2018-2019 Law Student Tax Challenge
Official LL.M. Division Problem

“I can’t believe this,” you think to yourself on the helicopter ride to Westworld. It’s September 4, 2018. The news was all over the world: The park’s founder and (until recently) key employee, Robert Ford, is no longer with the company due to what you understand were “irreconcilable” differences. The Westworld theme park had been in chaos for weeks. That is until yesterday, when Delos Corp. finally got it under control. You’ve wanted to go ever since it opened. Who wouldn’t want to live out a western fantasy with “host” robots you can’t tell apart from humans? But given recent events, you wonder if it was for the better that you never went.

The park’s corporate owner, Delos Corp., called your firm requesting a one-person Preliminary Tactical Tax Response team. Your firm, Gordon, King & Wurtzebach, LLP (GK&W), was so impressed with your credentials that they sent you. “Or they were all too scared to go themselves,” you can’t help but think. Rather than ponder the possible danger ahead, you dive into the background file GK&W provided.

Delos, Inc. (Delos) is a privately held US corporation and parent of a consolidated group of US corporations (Delos US Consolidated Group) and a worldwide group of corporations (Delos Worldwide Group). However, Delos Inc. has publicly traded debt, and so is a publicly traded company within the meaning of section 162(m) of the Internal Revenue Code. All entities in the Delos Worldwide Group are accrual method, calendar year taxpayers. A copy of the group organizational chart has been provided for your reference.

Delos is in the business of developing intellectual property (IP) through its subsidiaries and using the IP in its core business operation of managing state-of-the-art amusement parks, primarily the famous Westworld. Delos is trying to recover from a technical glitch relating to its IP, which resulted in catastrophic physical damage to its assets, as well as to the Westworld brand – the same glitch that got Robert Ford fired.

As you step off the helicopter at the park’s central base, Delos’s Vice President of Response, Jeanne Darnell comes to greet you. “Thanks for coming in,” she says in a serious tone. “We’d like your assistance in working out the mess Robert Ford left behind. Our accounting artificial intelligence began sorting through the park’s records once Ford passed. It’s flagged several issues which should be resolved immediately. That’s all we’re paying you to do – help us deal with the mess in front of us. I don’t care what tax year it is – just let me know if there is a problem.

“Given the highly confidential nature of our business, we’ve taken the liberty of redacting and omitting some information. But sometimes my staff gets a little too liberal with the marker. To the extent you need more information to give us informed advice, just put it in a memo. I’ll be too busy sorting through this mess to take a phone call.”

After handing you a stack of folders, she walks off in a hurry. Before you can even eek out a question, you hear your phone ring. It’s Liam McNally, the senior partner to whom you report. “How bad does it look?” he asks. “I’ve just received a stack of folders,” you respond. “Alright, then get on top of this ASAP. Write me up a ten-page memo with your theories on how to address the issues. And draft a letter for Ms. Darnell, too. She won’t want to be bogged down in the details, just explain how we’ll resolve this mess. Keep that to three pages. Oh, and one more thing: Draft your materials only using authority published as of September 3, 2018. I will have another associate track down all of the pesky new issues that come up after that.”

“Okay,” you answer just before he hangs up. With the folders in hand, you clear off a table and start to read.

File 01

Ms. Darnell wants to reincorporate Wyatt, Inc., currently a California corporation, in Delaware to take advantage of more favorable corporate laws. However, she wants to avoid reincorporating the Business B assets, but instead have the Sweetwater Partnership directly hold the Business B assets going forward. The company's tax director is not an expert on corporate reorganizations, but believes this could be a tax-free transaction because it is simply a mere change in the place of incorporation, notwithstanding a distribution of the Business B assets to the Sweetwater Partnership. To accomplish Darnell's goals, the tax director proposed the following plan:

1. Wyatt, Inc. creates a new corporation organized under the laws of the State of Delaware (Wyatt NewCo). Wyatt NewCo has no pre-existing assets.
2. Wyatt, Inc. contributes Business A assets to Wyatt NewCo in exchange for 100% of Wyatt NewCo's stock.
3. Wyatt, Inc. distributes the Wyatt NewCo stock and Business B assets to Sweetwater Partnership in complete liquidation, and Wyatt, Inc. ceases to exist.

Sweetwater Partnership has an adjusted basis of \$15M in the stock of Wyatt, Inc., which has a fair market value (FMV) of \$90M. The Business A assets have an adjusted basis of \$10M and FMV of \$81M, and the Business B assets have an adjusted basis of \$5M and FMV of \$9M, equaling 90% and 10% of the total FMV of Wyatt, Inc., respectively. Wyatt, Inc. holds no assets other than the Business A and Business B assets and will have no liabilities at the time of the transaction. Wyatt, Inc. will have a total of \$3M of current and accumulated earnings and profits, including any potential interim earnings and profits, at the time of the transaction and at end of the tax year.

Please advise the tax director whether this transaction qualifies as a tax-free reorganization. Describe any requirements that must be satisfied and advise whether these requirements are met. If you believe there is gain or loss to be recognized in the transaction, the tax director requests a calculated estimate for his consideration and records. If you need additional information to reach a conclusion, please advise the tax director on what information is needed.

File 02

Ms. Darnell also has grand plans to expand Business A and anticipates that Wyatt NewCo will sustain a net operating loss (NOL) in 2018. If everything goes as planned, the tax director would like to amend the Delos US Consolidated Group's 2017 tax return to carry back Wyatt NewCo's anticipated 2018 NOL and offset Wyatt, Inc.'s 2017 income, which the tax director believes is a result permitted by the corporate reorganization rules, but he was not sure if that "tax reform stuff" might be relevant. However, in his initial diligence review, the tax director discovered that Wyatt, Inc. has not been a member of the Delos US Consolidated Group since its incorporation, which he finds very puzzling.

The tax advisor would like you to confirm which entities in the Delos Worldwide Group should join in filing a US consolidated tax return. In addition, he would like you to address whether the exclusion of Wyatt, Inc., and subsequently, Wyatt NewCo, from the Delos US Consolidated Group is proper. Finally, if Wyatt, Inc. (and therefore, Wyatt NewCo) should be properly included in the Delos US Consolidated Group, may the tax director amend the group's 2017 consolidated return to include Wyatt Inc. in order to carry back Wyatt NewCo's anticipated 2018 NOL?

File 03

“Amazing,” you say to yourself as you sort through the third file. Host Personality Co. (HPCo.) is incorporated in the park’s foreign host nation. It is 100% owned by Delos Corp. HPCo.’s primary assets are the global patent rights to the artificial intelligence and associated technology used in the theme park. It continues to develop the technology and licenses it exclusively to Delos-owned businesses. Included with the file is a robust transfer pricing analysis supporting the 2010 intra-group sale of these assets to HPCo. and an Advance Pricing Agreement entered into by the IRS and Delos permitting HPCo. to charge Delos companies \$100M per year in the aggregate through 2018 to license its assets. The host country has agreed to exempt all income attributable to HPCo.’s intellectual property. “This host nation gave up one hell of a sweetheart deal,” you think to yourself.

Suddenly, one of the host robots sits up. While you are frozen in terror, it states “these guilty delights have guilty ends” before powering down. “Sorry about that!” an engineer chirps. “Didn’t mean to turn it on, just meant to test it.” As your heart rate comes down, you get back to the file.

“No debt at all,” you think aloud. Then you realize HPCo. had few assets outside of its core intangibles: For 2018, HPCo. held tangible assets with a basis of \$50M, all of which were used in the business. Inside the building it owned, HPCo. engineers code the artificial intelligence technology onto unique processors and memory units using HPCo.-owned hardware. On the basis of previous years’ spreadsheets, it seemed HPCo.’s accountants had a knack for incurring capital expenses so that HPCo.’s basis in its tangible assets averaged \$50M each quarter – a trend you expect to continue. Their depreciation calculations all check out too. “Phew,” you think to yourself, “at least I don’t need to correct a depreciation schedule.” Further, HPCo. made no dividend payments and in 2017 or 2018 and will not make any dividend payments before 2018 ends.

Darnelle wants you to check if any new legislative developments might affect the licensing arrangement. She would especially appreciate an estimate of any new liability the Delos control group might incur under the new tax law. If there were new legislative developments, McNally would like you to bring him and the other senior partners up to speed, explaining what is different now versus last year. After you text McNally a question about the Advanced Pricing Agreement, he writes back “Some of the best people at our firm got them that APA. Assume it binds the IRS.”

File 04

The Delos AI flagged a possible deduction issue. Robert Ford's compensation was considerable, but the system thinks Delos might not be able to deduct it for this year and may have incorrectly deducted it in previous tax years. The AI has provided a table of actual payments made to Ford since 2010. It also provided several documents, produced below. There's also a "no change letter" from a previous IRS audit of Delos in 2015 with some notes. It looks like McNally worked the case, and that the IRS put the section 409A plan document under serious scrutiny, but ultimately agreed it was a valid plan document and that the plan was operated in compliance with section 409A.

Darnell wants to know was Delos Inc. entitled to deduct the entire amount paid in 2017? Should Delos Inc. amend its return to adjust the deduction for this compensation? And what compensation can it deduct in 2018 and moving forward?

ACTUAL PAYMENTS TO ROBERT FORD (2010-PRESENT)

Year	Amount	Explanation
2010	\$2,000,000	Base salary
2011	\$2,000,000	Base salary
2012	\$2,000,000	Base salary
2013	\$2,000,000	Base salary
2014	\$2,000,000	Base salary
2015	\$2,000,000	Base salary
2016	\$2,000,000	Base salary
2017	\$52,000,000	Base salary + nonqualified deferred compensation
2018	\$1,000,000	Base salary (through separation from service)

DELOS CORP. EXECUTIVE COMPENSATION AGREEMENT

This agreement is made on the [redacted] day of the month of [redacted] of the year [redacted] between the Delos Corporation and Robert Ford (hereinafter referred to as Corporation and Executive, respectively).

WHEREAS Executive has been employed by Corporation for [redacted] years, during which time Executive has performed valuable services;

ARTICLE I – ELECTION TO DEFER COMPENSATION

Upon entering this agreement, Executive will defer \$100,000,000 of compensation for future services rendered.

This agreement has been drafted to comply with and will be governed by Internal Revenue Code section 409A and the regulations thereunder. The Corporation shall administer this Agreement with the intent to comply with section 409A, as interpreted in accordance with the regulations thereunder.

ARTICLE II – PERFORMANCE CONDITIONS FOR PAYMENT

Executive will not be eligible for any benefit under this agreement unless and until all performance conditions are met.

The first performance condition is that, under Corporation's reasonable method of accounting, Corporation and any Corporation-owned entities operating host parks shall achieve at least \$10,000,000,000 in aggregate revenues in a single taxable year.

The second performance condition is that, under Corporation's reasonable method of accounting, Corporation and any Corporation-owned entities operating host parks shall achieve at least \$3,000,000,000 in aggregate profits in the same taxable year that the first performance condition is achieved.

ARTICLE III – SCHEDULED PAYMENTS OF PLAN BENEFITS

The parties agree that, upon the satisfaction of the performance conditions, benefits payable under the plan shall be paid upon the following schedule:

- (1) On March 1 of the calendar year following the calendar year in which the performance conditions are both satisfied, Corporation shall pay Executive \$25,000,000 in the form of Corporation common stock (within the meaning of section 305 of the Internal Revenue Code), the value of which shall be determined on the day of such payment. Such shares in

the Corporation shall have the same rights and obligations as all other shares of outstanding shares in the Corporation.

- (2) On December 31 of the calendar year following the calendar year in which the performance conditions are both satisfied, Corporation shall pay Executive \$25,000,000 in cash.
- (3) On December 31 of the calendar year that is two years subsequent the calendar year in which the performance conditions are both satisfied, Corporation shall pay Executive \$25,000,000 in cash.
- (4) On March 1 of the calendar year that is six years subsequent the calendar year in which the performance conditions are both satisfied, Corporation shall pay Executive \$25,000,000 in the form of Corporation common stock (within the meaning of section 305 of the Internal Revenue Code), the value of which is determined on the day of such payment. Such shares in the Corporation shall have the same rights and obligations as all other shares of outstanding shares in the Corporation.

ARTICLE VII – FORFEITURE OF BENEFITS

After achieving both performance conditions, Executive’s rights to the benefits provided in this plan shall become irrevocable.

ARTICLE VIII – NO ACCELERATION OF BENEFITS

No benefit available under this plan may be accelerated or paid at a time earlier than herein specified, neither at the option of Executive nor Corporation.

_____/s/_____

Robert Ford

January 1, 2010

_____/s/_____

[redacted]

January 1, 2010

MODIFICATION OF DELOS CORP. EXECUTIVE COMPENSATION AGREEMENT

In consideration of services provided to Corporation, the DELOS CORP. EXECUTIVE COMPENSATION AGREEMENT dated January 1, 2010, entered into between Delos Corp. (Corporation) and Robert Ford (Executive) is hereby modified to include the following additional provision.

ARTICLE XIV – SUBSEQUENT DEFERRAL ELECTION

Upon achieving both performance conditions, Executive shall have the unilateral right to elect to defer the final \$25,000,000 installment to the date of his 75th birthday. Upon such election, Executive shall be entitled to an additional \$5,000,000, payable in cash on his 75th birthday.

_____/s/_____

Robert Ford

December 20, 2017

_____/s/_____

[redacted]

December 20, 2017

Delos Worldwide Group Organizational Chart

