



# Governance of Delaware Investment Holding Companies

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**D**elaware law exempts investment holding companies from payment of Delaware corporate income tax. The state corporate income tax rate for Delaware is 8.7% of taxable income – other states have comparable taxes (although rates differ). Additionally, if a holding company leases the assets back to its parent company, a further reduction in the parent company’s taxable income may be achieved.

Holding companies must limit their activities to the maintenance and management of intangible investments, which include among others, stock, bonds, notes and other debt obligations, patents and trademarks. A holding company may lose its tax status if it engages in other activities. For an investment holding company, this means limiting activities to investment management.

In order to reclaim the taxes exempted by Delaware law, state taxing agencies have recently been pursuing “phantom” Delaware holding companies. Thus, it is very important for a holding company to have sufficient Delaware presence and operations so that taxing authorities from another state will respect its separate existence and operation. In ensuring this Delaware presence and operations, certain issues arise in the management of a holding company. This article highlights some of the more common issues in the governance of a holding company. *(continued on p. 18)*

## Holding Companies

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### Nexus to Delaware

When reviewing a holding company's connection to Delaware, it is important to look to the reality of a company's operations. Courts in most states will go beyond the corporation's filings and analyze whether the subsidiary is, in fact, operating in Delaware. Courts will consider several different aspects of the holding company: whether the holding company has any physical presence in Delaware; whether the company has employees in Delaware; whether the company's expenses are proportional to its income; and, whether the holding company follows corporate formalities.

One important aspect of physical presence is having an operating office in the State. While this can be accomplished by a nexus service provider which can provide a Delaware address and/or a single office in Delaware, some state courts have questioned this practice. Courts will not simply look at whether a holding company has an office in Delaware; they will review practical operational questions such as whether the office has a sign on the outside of the building or is otherwise listed in the building directory, whether there are telephone lines and a telephone listing, and whether the building receptionist is aware of the company's existence.

Along with an office, a holding company should have other assets, besides those it is holding or managing. The holding company should have its own bank account – preferably with a bank in Delaware. Any agreements, such as the lease of office space and furniture, or other equipment should be in the holding company's and not the parent's name.

Another important consideration is whether the holding company has employees in Delaware. Courts are more likely to disregard a holding company without any employees.

Some state courts also require that the management decisions and administrative tasks, such as funds transfers, be performed in Delaware.

Finally, it is important for the holding company to observe corporate formalities. The company must hold board and stockholder meetings according to the company's by-laws. Meeting minutes must be kept, and officers and directors need to be properly elected. Some courts have found it important that the minute books be stored in Delaware.



### Practical Operations

While, in theory, it should be simple for a holding company to operate, in practice there are practical obstacles to establishing and operating a holding company with sufficient presence and operations that a foreign court will not disregard its separate existence and operation for tax purposes. There are two primary reasons for these obstacles. First, most companies that are sufficiently large to have a substantial holding subsidiary would prefer to take advantage of already existing parent resources, as it is economically sound to use such services for its subsidiaries. Second, most holding companies are of a size that the expense of operating it as a large company does not seem economically or practically feasible.

The holding company should have policies and procedures in place to ensure that the holding company is performing properly as a stand alone entity. In the case of a bank account, check signing authority must be clearly defined. For leases and other agreements the company must have safeguards in place to ensure that the agreements are drafted properly, being followed while they are in place, and being properly terminated when they are complete. For management and investment decisions it is important for a holding company to have adequate safeguards that it is protecting the assets it is holding. Consider whether investment decisions should be made by a designated individual or committee, with such activity reflected in minutes. Also, procedures should be in place to ensure that the decisions of such individuals or committee are properly followed.

Corporate formalities are another issue in operating a holding company. Formalities, although perhaps straight forward tasks, can be overlooked. While these tasks should be no more difficult for a holding company than any other company, they may be far more important. There is a risk that the holding company may be challenged by a state tax department, and when it is challenged, the corporate records will be thoroughly examined. Some common corporate formalities include holding annual meetings, holding regular board meetings and keeping minutes, ensuring a quorum for board meetings, maintaining accurate stock records and records of directors and officers, and updating corporate governance documents, such as by-laws.

Staffing the holding company is a further issue to consider. Employees should have defined duties, annual reviews, adequate supervision within the holding company, and be compensated by the holding company. There must be employees to perform tasks, procedures in place to verify the tasks were performed, and management

to verify that the procedures are working over a period of time. Some of the operational and administrative tasks may be performed by the parent company, but an arm's-length agreement should be in place defining the services to be performed, and commercially reasonable fees should be paid for these services.

## Conclusion

The solution to these issues calls for an investment holding company to be more robust than the minimum structure necessary to perform the administrative tasks of holding assets. Tax savings representing a significant percentage of income can be achieved by placing assets in a Delaware holding company. Although it may require a substantial investment to do it correctly, it can be worth the price.



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*The author would like to acknowledge and thank James C. Strum, Esq., and Samuel C. Fiechter for their assistance with this article.*

