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OPERATING GUIDELINES FOR DELAWARE INVESTMENT HOLDING COMPANIES

by Gordon W. Stewart, Esquire

IN GENERAL

A Delaware investment holding company must be operated as a *bona fide* corporation separate and distinct from its parent and affiliates. All of its activities must be confined to Delaware. Such operational requirements are necessary in order (i) to establish the substance of the Delaware business, and (ii) to avoid any connection or "nexus" with other taxing jurisdictions. This means that the directors and shareholders should hold their meetings in Delaware. All of the assets of the holding company should be located in Delaware. All corporate decisions (including investment decisions) should be made in Delaware. All contracts should be executed in Delaware. The holding company should have officers and employees located in Delaware. The holding company should have office space in Delaware and maintain its corporate minute book, stock book and accounting records in Delaware. The Delaware address should be used for all purposes. Holding companies should have one or more bank accounts in Delaware in which all income is deposited and from which all payments are made.

BOARD OF DIRECTORS

The board positions ideally should be comprised of Delaware individuals independent of the holding company's parent (or other affiliates). It may be critical for state tax

purposes that the holding company *not* be under the common management and control of its parent or affiliates. Other business considerations, however, often dictate that certain holding company director positions be filled by directors, officers and/or employees of the parent or affiliates. Whoever comprises the board, the members selected should be qualified for the responsibilities appurtenant to the position and should be prepared to meet in Delaware on a regular basis (e.g., quarterly). It is of primary importance that the board meet physically in Delaware and that the board's investment and other business decisions be made while meeting in Delaware.

DELAWARE OFFICERS AND EMPLOYEES

Similar common control concerns, as noted above, pertain to the selection of officers and employees of the holding company. A holding company should have Delaware-based officers and employees who perform their services and duties at the Delaware office. Employees should have real and meaningful responsibilities (subject to appropriate controls) relating to the holding company's investment and/or property holding business, including without limitation, and as appropriate, check-signing authority, investment management authority, and bookkeeping and/or accounting responsibilities (unless delegated to another entity or service provider). The board should delegate to the Delaware officers and employees sufficient authority to deal with all holding company business between board meetings. This should minimize the need to contact the parent or affiliates. The holding company should pay salaries or other compensation to its officers and employees in amounts commensurate with the assigned responsibilities and duties. Federal, Delaware and local payroll taxes should be withheld and paid over to the proper taxing authorities. Information returns for such officers and employees (as well as information and tax returns for the corporation) should be prepared and filed as required by law.

DELAWARE OFFICE

The holding company should have Delaware office space with furniture and equipment designed to accommodate the corporate business. Although many companies simply share leased office space, furniture and equipment with unrelated entities, it may be preferable to

lease such assets (or to purchase them outright) individually and separately from other companies. The holding company should have its own telephone with a receptionist who answers the phone in the name of the holding company and who provides general receptionist services. It is not uncommon to hire a part-time (or shared) receptionist to the extent that a full time position is not warranted. Alternatively, a telephone answering service may be appropriate when no one is in the office. The telephone number should be listed in the local phone directory under the holding company name. Corporate stationery should reflect the holding company's name, address and telephone number. The holding company officers and employees should have business cards showing their respective titles and the holding company's name, address and telephone number. Additionally, the holding company may need a Delaware post office box for various business purposes, such as for lockbox services with a local financial institution. The Delaware office generally should be set up for true business purposes, providing necessary meeting space, offices for Delaware employees and filing and record-keeping capacity for all matters relating to corporate business.

CONTRACTS

All contracts should be negotiated and executed by the holding company in Delaware. To the extent that performance of a contract is required by the holding company, performance should be in Delaware. Some of the common contracts among holding companies include: (i) lease contracts for office space, furniture and equipment; (ii) employment contracts with Delaware employees; (iii) contracts for provision of financial, accounting and payroll services (including tax return preparation); (iv) investment/custodial agreements; (v) licensing or royalty agreements (and related service contracts); and (vi) loan agreements with affiliates.

BANKING SERVICES

Holding companies generally establish checking accounts, custody accounts, investment advisory accounts and other similar types of accounts at a financial institution located in Delaware. All income received by the holding company should be deposited in the Delaware accounts, and all payments by the holding company should be made from the Delaware accounts. In order to minimize the imposition of state corporate income taxes on holding company income, the holding company's "commercial domicile" should be in Delaware. Since Delaware investment holding companies (by statutory definition) are organized solely to hold and manage intangible assets (with certain exceptions for tangible property located outside of Delaware), the "situs" of the intangible assets should be in Delaware in order to demonstrate a Delaware commercial domicile for the entity. Making investment decisions with respect to such intangible assets in Delaware may be critical legally to establishing Delaware commercial domicile. Establishing custodial accounts in Delaware to hold all the intangible assets of the holding company may help significantly to establish Delaware "situs" for such assets and accordingly may firmly establish the desired Delaware commercial domicile. Similarly, establishing investment advisory accounts in Delaware could further substantiate a Delaware commercial domicile, especially when there otherwise is a risk of treasury "operations" continuing at the parent level for holding company funds. Conversely, custody of intangibles outside of Delaware (i) may permit non-Delaware taxing authorities to assert that the holding company lacks Delaware substance, and/or (ii) in certain jurisdictions may permit the taxing authorities to claim that sufficient nexus exists to tax the income earned on the assets held in custody outside of Delaware.

ACCOUNTING SERVICES

Typically, the holding company engages the services of a Delaware accounting firm or a Delaware or regional office of a national accounting firm. Financial reports should be prepared on a periodic basis for review by the Board at its regular Delaware meetings. Audits should be scheduled regularly. The accounting firm also may handle all payroll and related tax matters.

Finally, the accounting firm may prepare all necessary tax returns for the holding company (including an annual corporate information return for Delaware).

LEGAL AND OTHER SERVICES

As an independent operation confined to Delaware, the holding company should take all measures to minimize the risk that its operations can be linked with the operations of non-Delaware affiliates. On audit, various states have asked for information which specifically identifies those holding company service providers that also provide services to affiliates of the holding company. This audit inquiry is an attempt to show common management and control between the holding company and its parent and affiliates, giving rise to the connection or "nexus" (and thus taxing authority) in that particular state. Accordingly, for legal services the holding company generally should consider engaging Delaware counsel which is not general counsel to the parent of affiliates. Alternatively, the holding company should engage the local Delaware office of a national or regional law firm, so that the holding company personnel deal with different lawyers than those with whom the parent deals as general counsel.

EXPENSES

As a separately run, *bona fide* business, the holding company's professionals and service providers should invoice the holding company directly for services. The holding company should pay all expenses by check drawn on the holding company's Delaware account. The holding company generally would be responsible for all lease payments, all custodial and investment advisory fees, all utilities (phone, etc.), all equipment and supplies, all professional fees, including accounting and legal fees, and all other service fees.

AUDIT CONCERNS

Below is a list of questions and areas of particular concern that may arise in an audit situation. The items are provided to demonstrate the importance of properly operating the holding company within the parameters outlined above.

Actual Audit Questions/Requests (sampling only):

1. Employees:
 - (a) Compensation; examination of responsibilities versus level of compensation
 - (b) Record of which entity pays
 - (c) Job description/duties
 - (d) Copies of employment agreements
 - (e) Copies of payroll tax returns
2. Identification of common officers/directors with affiliates
3. Copies of phone bills and phone book entry
4. Proof of payments with respect to all notes and accounts receivables from affiliates
5. List of all suppliers and professionals paid by the holding company; copies of all invoices; identification of which suppliers and professionals also serve parent or affiliates of holding company
6. Amount paid to Delaware law firm (as opposed to parent's general counsel)
7. Persons responsible for investment decisions; proof of where investment decisions were made
8. Copies of all minutes and organizational documentation of holding company and of affiliates (reflecting discussion of affiliates); proof of location of all meetings and who attended
9. Description of bookkeeping functions and how cash needs are determined; copies of all bank statements, checks and deposit slips

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BIOGRAPHY OF AUTHOR

GORDON W. STEWART is a founding member of Stewart & Associates (now associated with The Stewart Law Firm LLLP), Wilmington, Delaware. His main emphases of practice are taxation and commercial transactions. A former partner in the Philadelphia-based law firm of Duane, Morris & Heckscher, he represents numerous regional, national and international corporations in connection with the organization and operation of Delaware holding companies and related tax incentives as well as with respect to other multi-state tax planning matters and state tax controversies generally. He received his undergraduate degree from Dartmouth College, his law degree, *cum laude*, from Washington & Lee University School of Law (where he served as Research Editor of the *Law Review*), and his Master of Laws (in Taxation) degree from New York University School of Law. Mr. Stewart is a member of the Section of Taxation and Section of International Law of the Delaware State Bar Association and the Section of Taxation of the American Bar Association. He has been a frequent speaker and has authored several publications in areas of federal and state tax laws.