

**“WHAT TYPE OF AMERICAN LEGAL ENTITY
SHOULD I USE FOR MY U.S. BUSINESS
OPERATION?”**

A GUIDE FOR THE FOREIGN BUSINESS PERSON

BY

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Introduction

So, you are a foreign company or individual and are thinking about setting up a business in the United States. There are many points to consider. Among them is: What U.S. legal vehicle—legal entity-- should I use for my business?

As you will see from reading on, your choice will usually come down to two types of American legal entities: the “corporation” and the “limited liability company” (LLC). In this lawyer’s opinion, the “corporation” will, in the majority of cases, be the vehicle of choice.

Identifying and Evaluating the Available U.S. Legal Vehicles: An Overview

For the most part, there are only six types of legal vehicles which are available in the U.S.A. for your business:

1. a **corporation**, formed under the laws of one of our U.S. states;
2. a **limited liability company** ("LLC"), a legal entity available in all U.S. states;
3. a **general partnership**, requiring two or more legal or physical persons as owners (parties), all of which will be fully liable for the general partnership debts and liabilities;
4. a **limited partnership**, consisting of one or more general partners with unlimited liability and one or more limited partners with liability limited to its respective capital contribution; however, the limited partner cannot actively participate in the running of the limited partnership's business without becoming personally liable without limitation for the limited partnership's debts and liabilities;
5. a **branch** of a foreign (e.g. Japanese, French, English, German, Indian) company, whether formally registered in the U.S.A. as a branch or not.

Note: Nothing contained in this publication should be construed as legal or tax advice or as a substitute for the advice of qualified, competent legal and tax experts. Opinions and views

expressed herein are those of the author.

6. a **sole proprietorship**, which means that an individual--a physical person-- personally owns and operates the business.

In most situations, a foreign entrepreneur or firm desiring to set up a business in the USA should form a corporation under the laws of a U.S. state to carry on the business. The other forms will not normally fit the bill.

The general partnership will usually not be good choice for legal and tax reasons. The limited partnership likewise not, plus it will normally not be practical to use it. If there will be only one owner of the entity, then, of course, neither the general partnership nor the limited partnership could be used because both require at least two partners.

Sometimes, foreign companies or individuals enter into joint ventures, cooperation arrangements and similar transactions relating to the U.S.A or U.S. market, whether with American parties or not, without utilizing any legal entity (like a corporation) as the JV, cooperation or partnership vehicle. These can be risky, because they expose the foreign party to being sued in the USA, liability generally, and potentially negative tax consequences.

A "branch" in the U.S.A. is only an extension of the foreign (non-U.S.) company and exposes it to all types of liability, without limitation. A U.S. branch is not a separate legal entity conferring limited liability on its owner. It will be subject to the jurisdiction of the courts of the state in which it operates, and possibly other U.S. courts. One of the tax reasons not to use a branch is that the U.S. tax authorities can then require complete, detailed information on the world-wide operations of the non-U.S. company. It will have to obtain federal tax federal, state and possibly city tax ID numbers and file tax returns. Exceptions where a "branch" is often used is a "branch" of a foreign bank or insurance company, however those are special situations. **The great majority of foreign-owned enterprises should, in my view, not consider utilizing a "branch"**. If a foreign firm did want to open a U.S. branch, the legally proper way would be to comply with the applicable rules of the particular U.S. state(s) where the branch will operate: specifically, the completion and of certain forms, the translation of its foreign formation document to English (where applicable), and the filing thereof along with a fee.

Sometimes, foreign companies set up an office, workshop or other U.S. fixed base of operation but do not formally register it in the pertinent U.S. states as a branch. For the same reason as above and others, including possible risk of fines and penalties, this is a bad practice.

A foreign individual, particularly one that does not is not a U.S. permanent resident, should normally not operate its business as a "sole proprietorship". It is too dangerous from the

standpoint of personal liability. All of the debts and liabilities of the sole proprietorship are the personal responsibility of the sole proprietor. Also for tax reasons, this form of doing business in the USA is normally not advantageous.

The “Corporation” and the “Limited Liability Liability Company” (LLC): Similarities and Other Points

The “corporation” and the LLC are similar in these respects:

1. Both are legal entities---separate legal persons;
2. Both offer to their shareholder(s) or owner(s) the feature of limited liability. With only few exceptions, the shareholder(s) or owner(s) are not personally liable for the entity’s debts and obligations; rather, their liability is limited to their respective capital contributions to the entity. **You will normally want to select an entity form that offers this “limited liability” feature.**
3. There is no “federal” corporation or “federal” LLC. Each of the USA’s 50 states has its own company laws. So, one forms a corporation or LLC under the laws of a particular U.S. state. Thus, there are New York corporations, Delaware corporations, New York LLCs, Delaware LLCs, Florida corporations, Florida LLCs, and so forth.
4. Both entity forms can be and are used for businesses of all sizes and types. However, the “corporation” is more often used for larger operations and manufacturing, processing or assembly businesses. The powers and rights of a “corporation” and an “LLC” are virtually identical in all states.
5. For both entity forms, the owner(s), directors, officers, and managers (in the case of an LLC) can all be foreign citizens, without any requirement that any be U.S. domiciliaries or residents. Exceptions to that rule are very few.
6. A “corporation” as well as an LLC can have just one shareholder or owner.
7. Under most U.S. state laws, including New York’s and Delaware’s, there are no minimum capital requirements for a “corporation” or LLC. In those states that have such requirements, the minimum is very small.
8. In many countries of the world, there is only one document to prepare and file in order to form a stock corporation, limited liability company or similar entity. In the USA, to form and “organize” a corporation, several documents are

required. Only one of them, the Certificate (or Articles, in some states) of Incorporation, is filed with the appropriate state office and is a public record. By filing that document, the corporation comes into existence, legally, but does not have all of its body parts---those are supplied by the other documents. Those other private documents and related measures are referred to as the “organization” of the corporation. For an LLC, there will be at least two documents required for its formation/organization: a formation certificate which is a public document; an operating agreement (a private document); and, in certain cases, one or more other agreements (private documents). I should add that for both the “corporation” and the “LLC”, applications for tax identification numbers will have to be filed (public documents).

8. Just because you decide to operate your business operation in one particular U.S. state does not mean you must, or should, set up the corporation or LLC under that state’s law .In some cases, it might make sense to form the entity under another state’s law, such as Delaware’s or Nevada’s and register that entity in the state in which the business operations will occur to permit it to function there.

The “Corporation” versus the “LLC”: Pros and Cons

For several reasons, I usually recommend that foreign companies and individuals not utilize the LLC for its U.S. business operations. One is that it requires the foreign owner to file U.S. federal, state and possibly city tax returns –opening the door, potentially, for the U.S. authorities to demand information on or to audit its business activities not only in the USA, but even worldwide The LLC, while it must file tax returns and declare its income (or loss), is, tax-wise, a “pass-through” entity. The LLC’s profits and losses are attributed to the owner(s); if there are several, normally pro-rata to their ownership interests in the LLC. It is the LLC owner or owners who are subject to income tax in the USA. They must obtain federal, state and possibly city tax numbers and file tax returns. The sensible rule is for foreigner companies and individuals to avoid being directly subject to taxation and potential legal and tax liability in the USA, using whenever possible a legal entity offering limited liability and not subjecting them directly to the U.S. tax authorities. The “corporation” achieves that in large measure, but not the LLC. A corporation is a tax-paying entity, not a “pass-through” vehicle like the LLC. True, an LLC can “elect” to be taxed as a corporation. However, by the time it files such an election, its owner(s) may well have obtained US tax ID numbers; plus, other negative factors mentioned below may make the LLC not as appealing as the “corporation”.

An LLC does not have clear levels of management structure established and regulated by law, as does a corporation: no board of directors, no officers like a President, CEO, Vice President(s), Treasurer, Secretary, etc. Having such well recognized internal management structures is often important for structuring and controlling the company and its key personnel. The standard LLC has only one or more owners and one or more managers. While it is legally

possible to create, for an LLC, a board of directors and officers (as a corporation has), it must be done by contract essentially from scratch (normally in the operating agreement). Likewise for restrictions to be imposed on officers and managers. That will make the formation of an LLC considerably more complicated, time-consuming and expensive.

Also, if the manager of an LLC is someone other than the owner of the company, the LLC operating agreement (and/or some other written agreement) will have to be negotiated with and signed by the manager. In my experience, that is not necessarily a quick and easy process. Plus, each time there is a change in the management or operational structure of the LLC, the operating agreement will have to be amended and signed (and perhaps negotiated first with the manager).

Additionally, in certain U.S. states, there is a requirement to publish certain information in newspapers regarding a newly formed LLC. For an LLC formed under New York law, the publication must be made once each week for 4 successive weeks in 2 newspapers of the county in which the LLC's office is located. Under New York law, the names of the LLC owners must appear in the publications. This does not apply to a "corporation" (because there are no publication requirements for a corporation). Even if an LLC is formed in a US state other than New York and then is registered to do business in New York State, the same publication requirement applies as if the LLC had been formed under New York State law. That does not apply to a "corporation" formed in another US state and is then registered to do business in New York State. There is no comparable publication obligation for the formation of a "corporation" under, e.g., New York or Delaware law or the laws of the overwhelming majority (if not all) of the other U.S. states.

LLC publication requirements in various U.S. states cause LLC formation in those states to be substantially higher than for a corporation.

Another point is that it may be more difficult to transfer ownership interests in an LLC, as compared to shares of a U.S. corporation. That is especially true if there will be more than one class or type of ownership interests. An LLC does not normally issue any written evidence of ownership, like shares. It can issue ownership interest certificates, but that will have to be specified in the formation document and in the operating agreement.

If there will be two or more owners of the entity, it is often more complicated to deal contractually with restrictions on ownership transfers of various types (e.g., transfer restrictions and conditions of various kinds, options to purchase and sell, first refusal rights etc.) in an LLC than in a corporation.

Also, while difficult to prove, there appears to be a somewhat greater possibility of a U.S. court (i) "piercing the limited liability veil" of an LLC, as compared with a corporation, to hold the owner(s) liable for the entity's acts, obligations or liabilities; or (ii) applying some other theory to attach liability to one or more of the entity's owners. These situations occur only rarely so too much weight should not be attached to this point.

What about the tax benefits of the LLC? Some foreigners will like the fact that the LLC owner(s) will be able to take the LLC's tax losses as a deduction against its own tax liability (assuming its country allows that). That can admittedly be a factor in favor of the LLC.

Others will point out that a corporation's income will be taxed twice: once in the USA; and a second time when dividends are declared to the shareholder(s). On the dividend, there will be a U.S. withholding tax. It may be small if a tax treaty between the USA and the shareholder's country exists that reduces the normal U.S. rate; or 30% if no such treaty exists. However, typically, the withholding tax and the corporation's own U.S. income tax liability are accorded a tax credit against the tax on dividends in the shareholder's country (that should be checked in any particular case). Typically, the tax rate will be higher or at least not lower in the shareholder's country than in the USA so that, assuming an available tax credit, the overall tax treatment will not result in real double taxation. Or it will be only negligible.

Moreover, for a great many businesses operating as a "corporation", there will little or no dividends distributions. Other, creative ways will be found to pay out the corporation's revenues to the owner(s) that are deductible expenses to the corporation, thus reducing substantially its taxable income. These might be, for example, various expenses of the parent company or shareholder(s) chargeable to the U.S. business; royalties; salaries and bonuses; service or consulting fees; and interest payments on loans and advances.

There are situations that might make the LLC worth considering for a foreign investor. A few possible examples are:

1. If the owner will be a U.S. citizen or a foreigner with a U.S. permanent resident visa (green card), then the above mentioned tax-related reasons for disfavoring an LLC would not apply. That is because U.S. citizens and permanent residents are subject to U.S. income tax on their worldwide income, must obtain tax ID numbers and file tax returns. However, the other negatives of the LLC may still apply. However, if the owners are all U.S. citizens and permanent residents, they may be able to use a "subchapter S" corporation: a normal "corporation" that, by so electing, is taxed like an LLC (as a pass-through).

2. If a foreign company uses another controlled foreign (non-US) legal entity with only limited assets and operations as the owner of the U.S. entity, then certain of the negatives of using the LLC are dissipated.

3. U.S. real estate purchases, ventures or consortiums are often structured as LLCs. A foreigner investing in such an operation or venture might find it advisable to form and use U.S. legal entity as its investor. Whether that entity should be a corporation or an LLC will vary from case to case.

4. If, after proper research, it is clear that substantial tax advantages will accrue to the

foreign investor by using an LLC and that those clearly outweigh the negatives, the choice would be self evident.

Forming the Corporation or the LLC

Here are a few noteworthy points:

1. The desired name for the corporation or the LLC must be checked for availability (by your lawyer) and sometimes reserved in the chosen U.S. state of formation and that or those other states where the corporation will be registered to do business.

2. It will normally take between 2-10 days to form a corporation under the laws of most U.S. states, from the time your U.S. lawyer has received the required information from you. That is the "formation" in the strict narrow sense of causing it to exist legally. That involves collecting the necessary information, preparing and filing the corporation's Certificate (or Articles) of Incorporation with the US state in which it is being formed. However, to "organize" the corporation so that it can operate will take longer: there are, e.g., more documents to prepare and have signed; a federal and possibly state and city tax number to obtain; bank account(s) to open; the stated capital to pay in; and the share certificate(s) to be prepared and signed.

The time to form an LLC, in the same strict narrow sense, is essentially the same as for the corporation. There may be newspaper publication requirements (depending on the state of formation) as part of the "organization" process, plus the preparation, negotiation and signing of the operating agreement, possibly other LLC-related agreements and other steps in the organization process to complete thereafter.

If there will be more than one owner of the entity, a shareholders agreement or similar agreement for the LLC owners (typically, the operating agreement) will be required, plus other documents. These will take time to draft, negotiate and get signed.

3. Shares of stock of a corporation are normally registered shares, setting forth the owner's name. The shares may have a par value (e.g., \$1.00, \$10.00, \$100.00), or may be "no par" (which is most commonly used). A corporation issues "voting stock" (typically called "common stock"), but may also issue other types of stock (e.g., stock of different classes or conferring special rights on its owners, preferred stock, etc.), bonds and other securities and instruments. Not only money, but also property and rights can easily be contributed to a corporation's capital.

The same can apply to an LLC, if one creates ownership certificates, whether of one class or type, or multiple ones.

4. A corporation has 3 levels in its operational structure: (i) shareholders (the owners); (ii) the Board of Directors (which makes major policy decisions and others specified by law or in its organic documents); and (iii) officers, typically a President, possibly a CEO (optional); one or more Vice Presidents (optional), a Treasurer and a Secretary. Other officer posts can be created. Under many US state laws (e.g., Delaware, New York), the mandatory officers---the ones that the corporation must have---are a President, a Treasurer and a Secretary. Foreign citizens and non-residents of the USA can be shareholders, members of the Board and/or officers, with few exceptions. A corporation can have just one shareholder (or any number). The state laws governing business corporations contain provisions dealing rather extensively with this operational structure.

As stated above, by law, an LLC has its owner(s) and one or more manager(s), but by creative drafting one can create one's own LLC management structure.

Using a U.S. Lawyer versus Using a "Service Company" or Doing it Yourself

Using a Service Company instead of a Lawyer To Form Your U.S. Company.

Advertisements circulate in many countries offering to form a U.S. company for a very low price. You should not hire any such company. In this lawyer's experience, these service companies do not do the complete job required to form and (in U.S. lawyer's parlance) "organize" the company. That is particularly so when the company is a "corporation" formed under the laws of a particular U.S. state. Services companies typically do not attend to matters like the documentation to elect directors and officers, adopt bylaws, set forth and approve capital contributions, issue the shares, and certain other measures. In the case of an LLC, a service company will not have prepared and gotten signed a required, appropriate operating agreement, because it is not in the position to do so. The result is a defective and/or incomplete organization. I have been engaged many times to complete and bring up to date the organizational and other documentation of U.S. legal entities that clients have formed using "service companies". Generally, it will be more costly and complicated to fix up the deficiencies and defects after the fact than if the job had been done thoroughly and correctly in the first instance.

Also, some "service companies" claim in their ads that if you form a U.S. corporation or LLC, that entity (or its owner(s), in the case of an LLC) will not be subject to U.S. income tax if all of the entity's income is generated from activities occurring outside of the USA and/or if it is owned by non-U.S. citizens that are not U.S. tax residents. Those claims are false. You should be careful not to be fooled by them.

Forming and "organizing" the U.S. entity yourself. Forming and "organizing" a U.S. legal entity on your own, without using an experienced U.S. lawyer, is a risky process. Apart from other problems, it may well be more costly to have such a lawyer fix up your mistakes later than if you hired him initially to do the job.

Costs of Forming and Organizing the U.S. Entity

The foreign investor should keep the following points in mind:

1. Your U.S. lawyer should work hand in hand with you in planning and structuring your U.S. operation. Proper planning is critical to your operation. That includes the selection, formation and organization of the U.S. entity you will be forming. That process takes lawyer time and your lawyer will want to be paid for that. Frequently, the planning will (and should) take more time and effort than the actual formation and “organization” of the U.S. entity. So, when you ask U.S. lawyers how much will it cost to set up a U.S. company, one thing is the preparation of the formal documents to form and “organize” the entity, and register it in the pertinent state(s). Another is the lawyer’s time spent in the planning and structuring of the operation.

2. If there will be more than one owner of your U.S. company and you “do it right”, the legal costs will be considerably higher than if there were only one owner. That is mainly because there will be a shareholders or similar agreement (if the entity is an LLC) and special bylaws tailored to fit with that agreement (if the entity is a corporation) to prepare, negotiate and sign.

3. Above and beyond the formation and “organization” of the U.S. entity and 2. above, there will typically be much more for your U.S. counsel to do before your business is up and running. See, for example, the next section.

Getting the Business Going: Other Matters

OK, let us assume that your U.S. legal entity is formed and organized, and that any shareholders, operating or similar agreement has been negotiated and signed.

Some of the other legal matters typically involved in the process of establishing a business in the USA are listed below. It is not intended as a complete list, and no doubt it is not. Not all points will apply to every business. They are not presented in order of which should be done first, second etc., as that will vary from case to case. However, some of them should normally be done even before a U.S. legal entity is formed, like the first one.

- Filing of U.S. patents, trademarks, and copyrights for the intellectual property rights to be protected in the U.S.A. and possibly neighboring countries like Canada, Mexico, Central and South American countries; obtaining domain names, whether in the name of the foreign parent or the U.S. company (and possibly a license agreement from one to the other).
- Consulting the economic development office of the U.S. state or states that are target candidates for your investment, for advice, assistance and

possible incentives; consulting other public authorities within those state(s), at the city or county level, for example.

- Searching for and selecting the place for your business. Negotiating and signing a lease in the name of the U.S. entity, if you will be leasing. Or, purchasing the property. If construction on the property is necessary, arranging for architects, contractors and like and negotiating written contracts with them.
- Arranging for all necessary internal and external financing of the U.S. operation, and preparing, negotiating and signing all necessary contractual documents regarding the financing.
- Opening the U.S. corporation's bank account(s). This is usually not a routine procedure for several reasons, and the documentation required by the bank is considerable.
- Applying for necessary U.S. visas for non-U.S. personnel. In planning for the U.S. corporation, its capital, structure etc., the U.S. visa aspects can plan a critical role. Questions like who the owners of the U.S. entity will be and how much each will invest in its capital are key ones, particularly if a qualified foreigner might wish to apply for an "E-2" treaty investor visa or a investment-amount based permanent resident visa.

Preparation of employment contracts for key management and perhaps technical people. This is usually advisable for several reasons. One is that there is a trend in most states in favor of awarding an employee damages for wrongful dismissal based on a number of legal principles and in varying circumstances. An employment contract which is very clear regarding the circumstances under which the employer may terminate, even without cause, and limiting the compensation and benefits of the employee, should normally be legally enforceable. Experienced counsel will be able to advise you about potential problem areas and do's and don'ts to avoid legal problems connected with your employment policies and practices, hiring and firing procedures, and the like. Counsel can also advise about whether a consultant or independent contractor might be treated, legally, as your employee and when not.

It may also be advisable to have all U.S. personnel sign secrecy agreements (non-disclosure, non-use of company secrets and confidential information),

- Purchase or leasing of necessary machinery and equipment and contracts connected therewith .

- Preparation of supply, distribution, sales agency and other agreements with third parties.
- Preparation of Standard Terms and Conditions of Sale for the U.S. company.
- Inter-company contracts (e.g., license agreements; assets sale agreements; distribution, sales agency or commission agreements; technical, management or other service agreements).
- Obtaining various insurance policy coverage for your operation. One specific type to seriously consider is product liability insurance for the U.S. market, if you will be manufacturing, processing or selling goods. You may wish to obtain coverage for both your parent company and the U.S. business.

Again, these are only examples: depending on the circumstances, other measures, contracts, documents and items will be required.

