Business & Corporate Planning Series

ESTABLISHING A PRESENCE IN THE UNITED STATES BY A FOREIGN COMPANY

Doing business in the United States can provide a Foreign company a significant competitive advantage over its foreign counterparts as well as U.S. based companies. To secure these advantages, it is important to have a proper legal structure for the U.S. operations and abide by certain formalities.

The preferred structure to establish a U.S. presence is through the formation of a wholly owned subsidiary in the U.S. Unlike a branch office, which exposes the Foreign parent company to the U.S. tax system, liability for U.S. operations and jurisdiction in U.S. courts, the use of a wholly-owned U.S. subsidiary will normally exclude the Foreign parent company from U.S. tax reporting obligations, insulate it from liability resulting from the subsidiary's wrongful acts or omissions, and exclude it from jurisdiction in the U.S. courts. The U.S. subsidiary's liability for claims will also normally be limited to the extent of its assets.

To reap all these benefits, the U.S. subsidiary needs to adhere to corporate formalities and maintain: (1) sufficient capitalization; (2) the separation of its employees from those of its Foreign parent; and (3) its independence.

Choice of State and Choice of Entity

Corporate law in the U.S. is regulated by the individual states, and corporations and other business entities are incorporated or otherwise established under state law. When deciding where to incorporate a subsidiary, a state's corporate law and the geographic scope of the business activities of the subsidiary should be taken into consideration.

There are typically two types of business entities used for a subsidiary, a corporation and a limited liability company, both of which provide limited liability. Corporations have been recognized for a long time, and the body of law governing them is familiar and extensive. Generally, a corporation is the preferred entity when the subsidiary is a wholly-owned subsidiary. Limited liability companies provide great flexibility with respect to the structure of management and allocation of distributions, and are very beneficial in situations where there are multiple owners. U.S. income taxation issues, including transfer tax issues, are also involved in the selection of the proper entity.

Incorporation

To form a corporation, a Certificate of Incorporation, is filed with the relevant corporate authorities in the state of incorporation. After the corporation is formed, the shareholder(s) will elect a board of directors, and the board of directors will appoint officers and adopt By-laws. Apart from the Certificate of Incorporation, the documents prepared are internal and are generally not a matter of public record.

If a business entity engages in activities in states other than the state where it is incorporated, it must become authorized to do business in that state. This typically involves the filing of a simple registration document in each state where business will be conducted.

Management

The shareholders of a corporation elect the board of directors, but otherwise shareholders only become involved in major decisions, such as mergers and dissolutions. The board of directors manage the corporation and elect the officers, (typically a president, treasurer and secretary) who are in charge of the corporation’s day-to-day operations within the scope of powers granted to them by the board of directors and the By-laws. The officers have individual authority to execute documents and contracts on behalf of the corporation. Generally, there are no restrictions with respect to the nationality of the directors or officers.

All corporate decisions affecting the U.S. subsidiary should be made under the U.S. subsidiary’s corporate structure rather than by the Foreign parent company directly. Also, if the goal is to limit the Foreign parent company’s liability exposure, it is best that the Foreign parent company conduct no direct business transactions in the United States.

Capitalization

Unlike many Foreign countries, there is generally no formal minimum capital requirements for a corporation, but because the owner of an underfunded business entity is at greater risk of being held liable for the subsidiary's debt in the event of an insolvency situation, it is recommended that, a new business entity be sufficiently funded to meet its obligations. A sufficiently funded business corporation is also more likely to be viewed as a bona fide business by the U.S. immigration authorities, which can be helpful if there are plans for having foreign nationals working in the U.S.

Tax Registration and Filing

All corporations are required to obtain a federal tax identification number referred to as an "employer identification number" or "EIN" and file an annual corporate income tax return. The EIN is used to identify the corporation.

The state where the U.S. subsidiary is incorporated and authorized to do business will also generally require it to file annual franchise tax returns. Depending on the business entity's activities, the U.S. subsidiary may also need to register for and may be liable for employment related taxes (at the state and federal level) and, with respect to goods and services sold, sales and use taxes at state level.

Corporate Formalities

It is generally recommended, and in some cases required, to have regular meetings of a corporation's shareholders and board of directors to document relevant decisions and to observe the corporate form. In lieu of such meetings, the shareholders and directors may approve corporate matters by a written consent. Directors and officers also have fiduciary duties and are required to perform their duties in an informed manner with the business entity's interests in mind. The state where the subsidiary is incorporated and any states where they are authorized to do business will also generally require a business entity to file an annual report. The reporting format varies considerably from state to state, and sometimes requires the disclosure of the names of directors and officers and financial information.

Maintaining the Legal Distinction Between the Foreign Parent Company and the U.S. Subsidiary / Transfer Pricing Issue

If the goal is to limit a Foreign parent company's liability, it is important to preserve the legal distinction between the U.S. subsidiary and the Foreign parent company. Transactions between the Foreign parent company and U.S. subsidiary should be transacted as close to "arm's length" as reasonably possible and transactions between the U.S. subsidiary and the U.S. Customer should be evidenced by agreements between those parties and not the Foreign parent company.

If the U.S. subsidiary will act as the parent's U.S. distributor, there should be contractual arrangements between the two corporations, with provisions similar to those between the Foreign parent company and an independent distributor. This arrangement should spell out the rights and duties of each party and provide a commercially reasonable compensation to the subsidiary for its U.S. sales. If customer support, service, maintenance or other services are provided by the Foreign parent company, the U.S. subsidiary should purchase these services from the Foreign parent company for a commercially reasonable consideration.

The amount of U.S. taxation, which will be paid by the U.S. subsidiary, will be greatly affected by the handling of transfer pricing issues in the transactions between the Foreign parent company and the U.S. subsidiary. It is therefore very important to carefully review these transfer tax issues and other U.S. tax matters with an experienced United States accountant.

Employment Law Considerations

Liability in employment matters has become of increasing concern for U.S. businesses. A Foreign parent company and its U.S. subsidiary should therefore consider their employment strategies in the United States at an early stage. From a tax and liability perspective, it is best to have the persons conducting business in the U.S. be employees of the U.S. subsidiary only. To the extent that it is necessary to involve employees or operations of the Foreign parent company in the U.S. subsidiary, it is preferable for the U.S. subsidiary to subcontract the services from the Foreign company for commercially reasonable consideration. The use of employment agreements for key personnel and employee manuals, with strong provisions to cover confidential information, inventions developed during employment and restrictive covenants are strongly recommended.

Conclusion

Given the right amount of planning, a Foreign company's connection to a foreign country may provide it a significant competitive advantage over its U.S. competitors. To secure these advantages, and to avoid fatal missteps, it is important to properly structure U.S. operations at an early stage with a United States based attorney and accountant. A proper structure can make the difference between success and failure of a foreign-based U.S. venture.

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