

## FORMING AND OPERATING LEGAL ENTITIES IN THE U.S.

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## FORMING AND OPERATING LEGAL ENTITIES IN THE U.S.

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This article will try to provide you, the foreign investor, with a general overview of the organization of a new business in the United States. Please keep in mind that even though most of the states' business and corporate laws are similar, they are certainly not identical. Once you decide to go ahead and pick your principal place of business, we strongly urge you to consult with an attorney who is familiar with that state's laws and regulations.

### Section 1.01 Forms of Business Entities in the U.S.

A non-U.S. investor can choose among a variety of entities to do business in the U.S.

The main forms are:

**Corporation** ("Inc" or "Corp")

**Limited Liability Company** ("LLC")

**Partnership:** general, limited, or limited liability partnership.

A "joint venture" can take the form of either a corporation, a limited liability company, or a partnership.

### Section 1.02 Forming a Business Entity

Forming a corporation or LLC is a relatively straight forward process. The first step is the preparation and filing with the state authority the entity's charter document. It is also necessary to prepare the operating documents for the entity as well as certain other ancillary documents and instruments, such as the By-Laws or operating agreement, share certificates and resolutions.

Although there is no minimum capitalization requirement in the United States, for a corporation or LLC to be adequately capitalized, it is necessary for the entity to have adequate funds to be able to cover its operating expenses. If an entity is not adequately capitalized, then it is possible that a creditor or other third party could assert that its equity owners should be personally liable for its debts and obligations. This doctrine is called "piercing the corporate veil". The exact dollar amount of capital required to be adequately capitalized depends on the particular circumstances and is directly dependent upon the anticipated normal operating expenses of the entity. To the extent that a portion of the money contributed to the corporation is characterized as debt it is important to maintain a proper debt to equity ratio.



### Section 1.03 Main Considerations in the Choice of Entity

The principal advantage of each business entity is that the liability of the equity owner will generally be limited to the extent of its investment, provided that the entity is adequately capitalized and separate and distinct books and records are maintained. Each entity requires a certain formalized management structure (which, generally, is not burdensome) and permits a variety of managerial and administrative structures, including the appointment of a managing director or board with the authority and responsibility as the equity owners determine from time to time. Meetings of the equity owners and board members may be held outside the U.S.

An important consideration with respect to choosing the form of U.S. business entity is the effect of U.S. tax laws. The ownership structure that is recommended will depend upon the structure that is most tax efficient. Such analysis is fact sensitive and includes such factors as the type of business to be conducted, the timing of repatriation of income and the U.S. tax status of any partner or joint venturer in your U.S. entity. An LLC is typically a “pass-through” entity, that is, like a partnership a LLC does not pay U.S. income taxes - rather the income of the LLC is “passed-through” to its equity members who are obligated for their income tax liability. A non-resident alien who owns an interest in an LLC that is doing business in the U.S. will be treated as having “effectively connected income” taxable in the U.S. with respect to his or her share of the income.

There is a short list of the issues that the clients consider when choosing the type of business entity for their line of business.

### Section 1.04 Major Concerns from a Client’s Perspective in Entity Selection

**(a) COST ISSUES**-Tax efficiency, formation and ongoing maintenance costs.

**(b) LIMIT ON THE PERSONAL LIABILITY OF SHAREHOLDERS**

**(c) APPROPRIATENESS OF ENTITY FOR PLANNED GROWTH AND FINANCING OF BUSINESS:**

- 1) Will profits be distributed or retained?
- 2) Will there be initial losses that can be allocated to investors?
- 3) What types of financing are envisioned?

**(d) ABILITY TO ACCOMMODATE PLANNED OPERATIONAL MECHANICS**

**(e) TRANSFERABILITY OF INTERESTS AND LIQUIDITY CONSIDERATIONS**



## Section 1.05 Statutory Limitations on Entity Selection

### (a) STATUTORY AUTHORITY FOR ENTITY

- (i) All states have corporate and Limited Liability Company (“LLC”) statutes.
- (ii) The choice of state law can have substantial effects. Consideration should be given to the quality of courts and the thorough body of case law that are available in jurisdiction such as Delaware.

### (b) LIMITATION OF NUMBER OF OWNERS

- (i) No limitation on the number of owners for corporations.
- (ii) Some LLC statutes still require that LLCs have more than one member. Delaware and New York allows one member LLCs.
- (iii) Subchapter S Corporations (“S” Corps) - S Corps may only have 75 or fewer shareholders.

### (c) LIMITATION ON TYPE OF OWNERS

- (i) LLCs and Subchapter C Corporations (“C” Corps) have no limitations.
- (ii) S Corps have significant limitations - Only U.S. citizens, resident aliens, estates, certain types of trusts, and certain tax-exempt organizations may be shareholders.

### (d) CLASSES OF STOCK

- (i) S corps can only have one class of stock, common stock; all distributions must be pro-rata; care must be taken that debt will be recharacterized as equity, creating a second class of stock. The only classes of common stock permitted in an “S” corporation are “voting” and “non-voting”.
- (ii) LLCs and C Corps may have several classes of interests under New York and Delaware law. However, for corporations, all shares within a particular class of stock must be treated equally.

### (e) PERMISSIBLE BUSINESSES

- (i) Corporations and LLCs are permitted to engage in any lawful business.
- (ii) S Corps may not be banks, insurance companies or domestic international sales corporations.

## Section 1.06 Comparison: Corporation or Limited Liability Company

Below is a brief overview of the business entities that are available to non-U.S. investors.



**(a) CORPORATION**

**(i) In General**

The corporation is a legal person. It has separate existence from its shareholders. The corporate structure is usually the most complex and more costly to organize than the other business formations. Control depends on stock ownership. Persons with the largest stock ownership, not the total number of shareholders, control the corporation. With control of stock shares or 51 percent of stock, a person or group is able to make policy decisions. Control is exercised through regular board of directors' meetings and annual stockholders' meetings. Records must be kept to document decisions made by the board of directors. Small, closely held corporations can operate more informally, but record-keeping cannot be eliminated entirely. Officers of a corporation can be liable to shareholders for improper actions. Liability is generally limited to stock ownership, except where fraud is involved. One may want to incorporate as a "C" or "S" corporation. However, only U.S. citizens, resident aliens, estates, certain types of trusts, and certain tax-exempt organizations may be shareholders of an "S" corporation.

The corporation has perpetual duration. Interests in the corporation are freely transferable in the absence of an agreement to the contrary. The shareholders in a corporation have limited liability. There are exceptions where the "corporate veil" may be pierced. Typically this would occur in closely held corporation where the shareholders co-mingled corporate and personal funds or failed to pay employee withholdings or sales tax. In addition, when the company is not adequately capitalized the creditors would have a stronger argument to ask the Court to pierce the corporate veil.

The operations of the corporation are quite formal. Shareholders elect directors who set policy and appoint officers who operate the corporation.

**(ii) Advantages of the corporate format**

1. Liability of owners is limited to the capital contribution used to purchase shares.
2. Perpetual existence (*i.e.*: death of shareholder does not terminate corporate existence).
3. Interest easily transferable.
4. Management centralized; can hire people with expertise which owners may not have.
5. Corporation can own property in own name.
6. Flexibility in form of capital contribution.
7. May obtain capital by selling additional shares.

**(iii) Disadvantages of the corporate format**

1. Formation is costly and technical.
2. Operation is highly formalized.
3. Double taxation on profits.



**(iv) Typical uses of corporate format**

This format is useful where the risk of the business is significant, the owners want to reduce the risk of personal liability and, also, where the owners seek additional capital without necessarily sharing management responsibilities.

**(b) LIMITED LIABILITY COMPANIES**

**(i) In General**

The format is extremely flexible. It offers limited liability to the owners. It can have centralized management such as a corporation or decentralized such as partnership depending upon the operating agreement.

A limited liability company is formed by filing the entity's charter document with the appropriate state agency.

There might be additional procedures required by the states. For example in New York, publication of the LLC charter information once each week for six successive weeks in two newspapers is required. This requirement is currently subject to litigation in New York.

In LLCs as it is the case in corporations, capital contributions may be in form of cash, property or services.

**(ii) Advantages to the limited liability company format**

1. Owners of limited liability companies have limited liability. They are not personally liable for debts and obligations of the limited liability company.
2. Avoids double taxation of corporate profits.
3. Flexible governance - can be centralized and formal or decentralized and informal.
4. Very flexible in structure.

**(iii) Disadvantages to the limited liability company format**

1. Formation can be costly and technical.
2. Operation must be technically monitored so as to meet certain tax requirements to qualify for limited liability company treatment.
3. Format so new that there is little case law on "piercing the veil"; rights of minority owners; when limited liability company interest may be treated as securities.
4. Some states do not recognize the limited liability format and may not recognize the limited liability of members.

**(iv) Typical use of limited liability company format**

This format is useful for owners who seek to reduce the risk of personal liability but seek to avoid the double taxation of corporations.



## Section 1.07 Why Businesses Choose Delaware

Delaware has been preeminent as a corporate home for most of the twentieth century and, if anything, its incorporation business is growing. Approximately 300,000 corporations are incorporated in Delaware, approaching one corporation for every two residents of the state. Furthermore, while the sheer number of corporations organized in Delaware is significant, more significant still is the fact that so many important corporations are incorporated in Delaware. Of the corporations that make up the Fortune 500, almost 60% are incorporated in Delaware. Nearly one-half of the corporations having shares listed on the New York Exchange are Delaware corporations.

So why do businesses choose Delaware? There is not one answer but many. They include an advanced and flexible corporation statute and well-developed case law that facilitates business planning; the respected Court of Chancery to deal with complicated corporate law issues; an efficient Secretary of State's Office; and a legislature that puts a high priority on corporate law matters.

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### Disclaimer

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