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DOING BUSINESS IN THE STATE OF NEW YORK
A Legal Guide for Foreign Companies

Contents

THE JIN LAW GROUP, PLLC
99 Park Avenue, Suite 330, New York, NY 10016
Tel: 646 863 3403; Fax: 646 862 9620
www.jinlex.com

DOING BUSINESS IN THE STATE OF NEW YORK

A Legal Guide for Foreign Companies

The main purpose of this article is to provide foreign companies and individuals who plan to do business in New York with basic information on important legal issues. This article can also help any individual or company in the U.S. who conducts or plans to start a business in New York. The information contained herein is illustrative, not exhaustive, is intended as broad introductions to each subject matter discussed herein, and should not be viewed as legal advice. *Readers, therefore, are urged not to act on the information contained in this article but to consult with an attorney*.

I. CHOOSING A FORM OF ORGANIZATION

In the United States, a business entity is created under the laws of a particular state and there is no federal law governing business entity formation. A lay person who is setting up a business often assumes that the only sensible form of organization for the business is a corporation. However, like in most states, the laws of the State of New York provide a variety of company forms: Corporation, Partnership, Limited Liability Company and Sole Proprietorship. This article will examine some of the factors that should be considered in choosing among these entity forms.

A. Sole Proprietorship

New York law allows a person to do business as an individual without forming a separate legal entity, and this is referred to as a "sole proprietorship." In a sole proprietorship, the owner of the business carries on the business as an individual typically in his/her own name; s/he is directly liable for all the debts and liabilities of the business; and s/he reports gains and losses from the business on his personal income tax returns. If the business is to use a trade name, instead of the owner's own name, an Assumed Name Certificate must be filed in each county in the State of New York where the business is to be conducted.

A foreign individual can do business in his or her own name as a sole proprietor, subject to his/her visa restrictions (for example, a tourist visa doesn't allow the visitor to do business in the U.S.).

This entity form exposes the owner to a significant risk of personal liability for the debts and obligations of the business. Therefore, this form of entity is suitable to businesses with a very low risk and to business owners who don't have high personal net worth.

A sole proprietorship has no equity capital, no shareholders and it terminates upon the death of the owner; there is no continuity of the business after the death of the owner.

B. Partnership

A partnership is an association of two or more persons to carry on as co-owners a business for profit. Each person can be any U.S. or foreign individual or entity. There are three types of partnerships: General Partnership, Limited Partnership and Limited Liability Partnership.

1. General Partnership

In contrast to a corporation and a limited liability company, a general partnership can be created by *operation of law*, without the need to file any formal incorporation papers with the state authorities. The only paper needs to be filed is a certificate with the county clerk where the business is to be conducted. Thus, two people can create a general partnership by an oral agreement (i.e., without signing any written agreement between them) and without having to file any paper with the government.

The most significant aspect of a general partnership is that ***each*** partner is *personally liable* for ***all*** the debts of the partnership. In addition, each general partner can participate in the management (i.e., there is no centralized management even when there are 100 partners) and can legally bind the partnership as well as other partners without their consent.

Other drawbacks of a general partnership are: (a) compared with a corporation, partnership interests cannot be freely transferred; and (b) the partnership lacks continuity of operation because it will usually dissolve upon the death, bankruptcy or withdrawal of a partner.

2. Limited Partnership

A limited partnership must have at least one general partner with unlimited personal liability for the partnership's debts and liabilities and at least one limited partner with limited liability up to the amount of his/her capital contribution and with no management power. A limited partnership is governed by the New York Partnership Act and it can only be formed by filing a Certificate of Limited Partnership. Without such filing, the partnership will be treated as a general partnership, even if the written agreement between the partners provides otherwise.

The biggest advantage of a limited partnership is the limited liability for its limited partners (LPs). However, if an LP actively involves in the management of the partnership, such LP may be re-characterized as a general partner (GP) subjecting him/her to unlimited personal liability for the partnership's deabts. The GPs have management power of the partnership. Compared with a corporation, the partnership interest cannot be easily transferred.

From a tax standpoint, like a general partnership, a limited partnership's income and loss are ratably passed through to its partners, who then report them on their individual tax returns.

3. Limited Liability Partnership

Born in 1994 by a New York statute, a limited liability partnership affords all partners limited liability. In other words, there needs not be at least one general partner in the partnership, and no partner will be liable for the partnership's obligations just by virtue of being a partner. In order to form a limited liability partnership, the incorporator must file formal documents with the state authorities, and the partnership must indicate that it has LLP status by appealing some variant of the word "LLP" after its name.

The biggest users of LLP are professional service firms, such as law firms and accounting firms, because individual partners will not be liable for acts of malpractice committed by other partners.

Another major advantage of a limited liability partnership is that a limited partner will not lose his/her limited partner status by actively participating in the management of the partnership.

Like general partnership and limited partnership, income and loss of an LLP pass through the partnership to its partners, who then report them on their individual tax returns.

C. Corporation

1. General Characteristics

Corporations have been the most typical entity form in the business world and mostly preferred by companies who wish to go public. A corporation is a separate legal personality, with the power to own property and to sue and to be sued by others. As with other entity forms, corporations are governed by state laws and there is no uniform federal law under which a corporation can be formed.

Most favored state to form a corporation is Delaware. This is because Delaware statutes offer the greatest flexibility and its cases are well developed. Many companies, therefore, incorporate the corporation in Delaware and then file in the state where its principle place of business is located to qualify to do business in that state. The State of New York has relatively speedy and inexpensive incorporation process. The incorporator is required to file a Certificate of Incorporation with the Secretary of State of State of New York. The Certificate of Incorporation must include, among other things:

- The name of the corporation: The word “corporation,” “incorporated,” “limited” or an abbreviation of one of these words must be used in the name of the corporation;
- The purpose(s) of the corporation;
- The city/county in New York where its registered office will be located; and
- The aggregate number of shares that the corporation is authorized issue, the number of classes, the classes of these shares (common or preferred), and whether they have a par value.

Often, the Certificate of Incorporation is prepared and filed by an attorney who will also act as incorporator, draft the by-laws, appoint directors and prepare the required organizational meetings, procure corporate books and records, obtain a federal employer identification number, and apply for required licenses, permits and exemptions with federal or state authorities.

A corporation has the following characteristics: (a) perpetual existence, unless otherwise provided in the certificate of incorporation; (b) transferability of shares; (c) limited liability to all shareholders; (d) centralized management; and (f) easier access to capital markets.

2. Subsidiary v Branch

Foreign corporations often hope to set up a branch office rather than a separate U.S corporation which becomes their subsidiary. A branch office of a foreign company may qualify to do business in New York. However, by establishing a corporate subsidiary, the foreign company will erect a wall between the foreign parent company and its U.S. operations, protecting the parent company from liabilities and claims in a highly regulated and a litigation-prone environment. A subsidiary can also limit disclosure and reporting requirements under many federal and state statutes to the U.S. subsidiary.

3. C Corporation

The Internal Revenue Service treats corporations either as a “C Corporation” or an “S corporation” for tax purposes. A C corporation is a regular corporation that is subject to double taxation: the corporation is required to pay taxes on its corporate income and its shareholders are required to pay taxes on the dividend they received from the corporation after tax. All corporations are C corporations by default, unless it makes the election to be treated as an S corporation.

A C corporation has all characteristics of a regular corporation as described above.

4. S Corporation

If the shareholders of a corporation would like to be taxed only once as if they were partners in a partnership, they can achieve such objective by having their corporation elect to be treated as an S corporation. Unlike a C corporation, an S corporation does not pay taxes at the corporate level.

Not all corporations are eligible to be treated as S corporation. In order to be eligible, all three of the following requirements must be met: (a) there must be no more than 75 shareholders; (b) all shareholders must be individuals, estates or qualified trusts; and (3) there may be only one class of shares outstanding. Because of these limitations, it is not recommended that a foreign corporation set up an S corporation.

D. Limited Liability Company

The fast growing form of entity in recent years has been the limited liability company (LLC). All 50 states have enacted special statutes recognizing and regulating LLCs. In New York, LLCs were introduced in 1994.

An LLC offers greatest flexibility in terms of corporate governance as well as tax treatment. It can have more than one class of membership interest, such as common, preferred A and Preferred B. It can have a centralized management like a corporation or it can have decentralized, member-managed corporate governance similar to that of a partnership. An LLC offers all of its owners limited liability regardless of how much each owner is involved in the management. It can elect to have a board or it can appoint an owner as a managing-member to run the business. From a tax standpoint, by default it is a pass-through entity, meaning the LLC is not subject to entity level taxation (like partnerships), and its income and loss pass through the entity and are reported in each owner's individual tax return. However, the LLC can make an election to be treated as a corporation for tax purposes.

The LLC is formed by filing Articles of Organization with the Secretary of State of New York State, advertising of this filing in local new papers, and paying a fixed annual maintenance fee. Instead of having by-laws, an LLC's governing document is referred to as an "operating agreement" among the owners, which can be customized to suite the specific requirements and circumstances of the owners. The New York LLC law requires a written operating agreement and it should have provisions regarding who manage the LLC, how contributions to capital will be made, and whether and how members can transfer their ownership interests. The operating agreement needs not to be filed with the government.

Non-U.S. residents or corporations can be owners of an LLC. Any types of entities, such as corporations and partnerships, can be owners (members) of an LLC. An LLC can have one corporate owner and one individual owner. There is no restriction on the number of owners; in other words, a one member LLC is possible while there is no ceiling in numbers of owners that applies to the LLC. For this reason, in recent years, it is not uncommon for an LLC to go public.

II. TAXATION

A. General

One of the most important factors in choosing an entity form is tax considerations. As discussed in Section I above, partnerships and limited liability companies are tax-pass through entities, where income, profits and losses are passed through to the owners and taxed only individually. Each partner or member is treated as if s/he owns a fractional share of the partnership or the LLC, and s/he must pay taxes on his/her share of the entity's income, whether or not it was actually distributed to him/her.

For the purpose of monitoring the amount of taxable income, the Internal Revenue Code (IRC) uses an entity concept in order to compute the taxable income of the entity and each owner's share of such income. The partnership or the LLC is required to file an information return to the U.S. tax authorities, and each partner or member will report his/her distributive share of income, deductions and credits in his/her individual return, pursuant to his/her percentage of ownership and other terms provided in the partnership agreement or the LLC operating agreement.

Does this mean that a foreign parent (foreign individual or foreign company) needs to file annual tax returns on its share of the company? Most foreign parents (foreign individual or foreign company) do not want to have the obligation of filing annual tax returns in the U.S. In addition, when a U.S. company hopes to have foreign investors, it often is one of the concerns of foreign investors that they may need to file tax returns in the U.S. every year. In order to solve this issue, many foreign parents choose the form of an LLC (or a corporation). As discussion under Section I above, an LLC has the flexibility of making an election to be treated as a corporation for tax purposes under the federal check-the-box regulation, as opposed to being treated as a pass-through entity. When an LLC makes an election to be treated as a corporation for tax purposes, it is the LLC who files the tax returns and also pays taxes. As long as there is no distribution of income to the foreign parent, the foreign parent has no obligation of filing tax returns.

With respect to corporations, corporate earnings are taxed twice, once at the level of the corporation and a second time upon distribution of income to its owners. IRC has several measures to prevent undue accumulation of corporate earnings for the purposes of avoiding taxes at the shareholder level. One of these measures is the accumulated earnings tax on the undistributed earnings of the corporation if they exceed the reasonable needs of the corporation. Another measure is the personal holding company tax computed on the undistributed income of closely held corporations.

B. Transfer Pricing Issue

U.S. subsidiaries of a foreign corporation must pay special attention to the IRS inter-company pricing regulations which gives the IRS the discretionary power to monitor transactions between related corporations and re-allocate income between the foreign parent and the U.S. subsidiary if such transactions were not conducted at arm's length and resulted in an underreporting of income of the U.S. foreign-owned subsidiary. The IRS imposes significant penalties for under-reporting of income, and imposes further reporting requirements for U.S. corporations that have at least one foreign shareholder with at least 20% of ownership in the company. It is extremely important for any foreign company to consult with U.S. attorneys and accountants with transfer pricing expertise in order to minimize the possibility of an IRS audit and penalty.

C. US taxation on Branches

A foreign corporation can set up a branch office in the Unites States, as opposed to incorporating a subsidiary, and apply for authority to do business in the State of New York by filing an Application for Authority pursuant to Section 1304 of the Business Corporation Law. However, the foreign parent company will be fully taxed on the income which is effectively connected with its trade or business in the United States, subjecting the parent company to U.S. tax liabilities. Upon identifying the "effectively connected" income, the foreign parent company operating in the United States as a branch will pay taxes, at regular corporate income tax rate, on that income in the same manner as a U.S. corporation.

In addition to the corporate tax on its effectively connected income, the U.S. branch of a foreign corporation may also be subject to the branch profits tax. The branch profits tax is imposed on a foreign corporation's after-tax net profit. One simple example of calculating the branch profits tax is: Calculate the foreign corporation's profits derived from U.S. investments or business operations; pay regular corporation income tax on that profit; and pay 30% of the after-tax net income as the branch profits tax.

D. New York State Tax

The State of New York imposes franchise tax on corporations, including foreign corporations doing business in New York through an office. An S corporation can avoid paying franchise taxes if all of its owners agree to pay New York State personal income taxes.

A foreign company who sells tangible personal property and services in New York is required to register with the New York State sales tax authorities and collect sales taxes, even if it doesn't have a permanent establishment in New York, as long as it has a "nexus" with the State of New York. According to the New York Court of Appeals, there is a "nexus" if employees of a foreign company make occasional visits to New York customers to find out how they can improve their business relationship or enhance their satisfaction with their products. Foreign companies should review their sales practices because they may be subject to sales tax obligations even when they sell their goods to resellers in New York.

III. FRANCHISING

Franchising is governed by both the U.S. Federal Trade Commission (FTC) and by state regulators. Based on FTC rules, franchising is a type of licensing arrangement in which (a) the franchisee is given the right to distribute goods and/or services that bear the franchisor's trademark, service mark, trade name, logo, or other commercial symbol; (b) the franchisor has significant control of, or provides significant assistance to the franchisee's method of operation, in particular marketing and the quality of the products and/or services; and (c) the franchisee pays the franchisor fees, such as franchise fees, royalties, training fees, payments for services, and payments from the sale of products.

There are two categories of franchise laws in the United States: One category of law requires disclosure and registration with a state agency; the other category of law regulates the relationship between franchisors and franchisees.

The FTC Franchise Rule requires franchisors to provide each prospective franchisee with a disclosure document, which is referred to as an offering circular. The franchisor must give the disclosure documents to the prospective franchisee at the earlier of:

- the first face-to-face meeting with the prospective franchisee involving a discussion about the sale of a franchise;
- at least 10 business days before the prospective franchisee signs any agreement with the franchisor; or
- at least 10 business days before the prospective franchisee pays any money to the franchisor.

New York law requires franchisors to make disclosure similar to those required by the FTC, and requires that franchises, business opportunities and seller-assisted marketing plans must be registered with the state before they can be sold in New York. The franchise offering circular required under the FTC Rule and New York law must contain, among other things, a detailed explanation of the prospective franchisee's rights and obligations under the franchise agreement, information regarding the directors and principle officers of the franchisor, and the litigation and bankruptcy history of the franchisor. The offering circular must also contain audited financial statements of the franchisor and copies of all agreements the franchisee may be asked to sign. New York law also requires that the franchise offering being filed with and approved by the state Attorney General's office.

The franchisor must provide the prospective franchisee with a complete version of the franchise agreement at least 5 business days before the prospective franchisee signs any agreement or pays any money. The franchisor must obtain signed and notarized acknowledgements of receipt from prospective franchisees.

A franchise agreement typically provides the relationship between the franchisor and the franchisee. Unlike some other states, New York has no law that can override the parties' franchise contract on the subject of termination, transfer or non-renewal of the contract. In these respects, New York law favors the freedom of contract. In reality, however, a franchise agreement in New York often prohibits termination or non-renewal by the franchisor except for good cause, and often requires good cause to refuse consent to the franchisee's transfer of the franchise

Franchising is subject to ongoing compliance requirements and coordination with state regulatory authorities, including annual preparation of audited financial statement.

IV. CONTRACTS AND COMMERCIAL LAW

A. General

Contracts are governed by state law in the U.S. and are governed mostly by common law which is a product of accumulated court decisions on the cases before them. Parties have great freedom of contract in the U.S., and the terms thereof are mostly honored by courts; however, there are limits on what the parties can agree. Not all contract terms are enforceable. For example, some contract provisions may violate antitrust laws, employment laws, intellectual property laws, securities regulations or environmental laws. Certain statutory requirements may override contract terms and limit the effect of certain positive and/or negative covenants of the parties to the contract.

B. Sale of Goods

1. Types of Arrangements:

If a company enters into a contract with another company or person for the sale of goods in the U.S., such contract is generally a distributorship agreement, if the buyer is to resell the goods. If under the contract, the buyer is to find customers for the seller, such contract is generally a principle-agent arrangement or sales representative arrangement. In a principle-agent arrangement, the principle is liable for actions of its agents under New York law. In a sales representative arrangement, the seller is not liable for actions of its sales representative, because a sales representative is an independent contractor and the seller has the right to accept or reject the purchase orders generated by the sales representative.

2. Governing Laws:

Contracts between U.S. companies or individuals for the sale of goods are generally governed by the Uniform Commercial Code (UCC). Each state has adopted its own version of UCC (except Louisiana). The UCC governs the formation of a contract, effect of a contract, implied warranties, remedies for breach of contract, assignment of a contract, and termination of a contract.

Cross-border sale of goods are mostly governed by the United Nations Convention on Contracts for the International Sale of Goods (CISG). The CISG applies when the buyer and seller have their places of business in different countries that have adopted the CISG. Countries that have ratified the CISG include, the U.S., China, P.R., Hong Kong, Japan, Korea, Italy, Germany, France, Canada, Australia and Argentina. The United Kingdom is not a signatory to the CISG, and a few participating countries have made reservations on certain provisions. For example, China declared reservations on certain articles of the CISG, such as article 11, which provides that a contract of sale of goods need not be concluded in or evidenced by writing and is not subject to any other requirement as to form.

3. Delivery Terms

Delivery terms are an important part of a contract for the sale of goods. They include the name of the delivery port, shipping and insurance terms, the place and time of transfer of risk from the buyer to the seller, among other things. Most commonly used delivery terms are Free On Board (FOB) and Cost, Insurance and Freight (CIF).

The delivery terms of a contract between two U.S. parties are often governed by the UCC. Because the CISG doesn't define delivery terms, an international contract often uses, for its delivery terms, International Commercial terms (INCOTERMS) published by the International Chamber of Commerce (ICC), even though the contract itself is governed by the CISG.

C. Sale of Service and Other Type of Contract

The UCC does not govern the sale of service and other types of contracts, such as shareholder agreement, partnership agreement or an LLC agreement, agreements related to intellectual property, and agreements related to labor/employment. Generally, the parties have the freedom to choose the governing law of their contract; however, a connection is often required in order for the choice-of-law clause to be enforceable. For example, a transaction for purchasing a real estate is often governed by the laws of the state where the real estate is located; and an employment law contract, in general, is often governed by the location of the employer. Also, if, for example, a California corporation and a Chinese corporation negotiate a contract that chooses New York law as its governing law, because neither the contract nor either of the parties has any contact with New York, there is a risk that such choice-of-law clause is unenforceable due to lack of a nexus.

When it comes to commercial contracts, however, some states, most notably New York, do not require a nexus (a connection) between the contract and the jurisdiction chosen in a choice-of-law clause if certain conditions are met. In order to keep its preeminent status as arbiters of national and international commercial transactions, New York passed a law providing that New York law will apply to most commercial contracts valued in excess of $250,000 that contain a New York choice-of-law clause, even when neither the contract nor any of the parties to it has any relationship to New York (see N.Y. Gen. Oblig. Law §1401). California, Delaware and Texas have similar provisions.

V. DISPUTE RESOLUTION

A. Choice of Law and Choice of Forum

Deciding which jurisdiction's law to apply to the agreements and unforeseen disputes arising therefrom has been a major issue when negotiating international commercial agreements. In many cases, the parties – each fearful of giving an advantage to the other – may want to choose the law of a neutral jurisdiction having no connection to the parties or the agreement. However, the contractual designation of the law of an unrelated jurisdiction creates the risk that such choice-of-law clause is unenforceable due to lack of a nexus. While there is no guarantee, however, the choice of the law of an unrelated jurisdiction will stand the best chance of being honored if it is coupled with a choice-of-forum clause designating the same jurisdiction as the venue of the dispute resolution.

As mentioned above, New York courts will honor a choice of law clause designating New York law as the governing law of a commercial contract if certain conditions are met. However, New York's statutory choice-of-law rules will not assist a party litigating in a non-New York forum. Similarly, the liberal choice-of-law rules of some states and foreign countries will be of little use when a litigant faces a forum whose laws on choice-of-law rules limit the enforceability of such liberal choice-of-law clauses. For this reason, in order to take advantage of liberal choice-of-law rules, parties to international contracts should give careful consideration to another contractual provision – the choice-of-forum clause.

U.S. courts, including New York courts, generally enforce forum-selection clauses, following the Supreme Court's decision in *M/S Bremen v. Zapata Off-shore Co.*, 407 U.S. 1 (1972). In *Bremen*, a forum-selection clause is presumed to be valid and may be overcome only by a clear showing that it is "unreasonable under the circumstances." Such a showing requires that a clause be induced by fraud or overreaching, be so inconvenient that the complaining party will "for all practical purposes be deprived of his day in court."

New York codified the recognition of choice-of-forum clauses in General Obligations Law §5-1402, which preempts the doctrine of forum non convenience and requires New York courts to assume jurisdiction over most commercial disputes involving more than $1 million that designate both New York law and New York as a forum.

By combining choice-of-law and choice-of-forum clauses, parties to an international agreement can enhance the chances that their chosen law will control the interpretation of the agreement and subsequent disputes arising therefrom.

B. Arbitration and Mediation

Arbitration is a common method of resolving international dispute. The U.S. is party to several international treaties, and U.S. federal and New York laws favor the enforcement of arbitration provisions. In order for an arbitration clause to be effective, the parties must specify in writing that arbitration is the method of their dispute resolution, the applicable procedural rules for the arbitration, the venue of the arbitration, the method by which the arbitrators will be selected, and the substantive law that will govern the arbitration.

Arbitration is less formal then litigation and may take less time and cost less than litigation. It doesn't require the procedural rules that call for extensive pre-trial discovery, which means that there is no deposition and there will be a limit to the extent to which each part will be required to produce copies of relevant documents. Arbitration is often conducted in a confidential manner when litigation is often public. The decision of the arbitrators is generally final and binding and cannot be appealed.

The American Arbitration Association, which is based in New York, is frequently the body that administers international and domestic arbitration in the U.S. Another organization based in New York is the CPR Institute for Dispute Resolution. Both organizations have panels of qualified arbitrators in all fields.

Mediation is an alternative to litigation and arbitration. In mediation, parties seek to resolve their dispute with the assistance of a trained and impartial mediator. Mediation is not binding. Compared with litigation and arbitration, mediation has a reduced level of animosity and confrontation between the parties; it often, therefore, is used by parties who desire to continue their business relationship (or some form of other relationship) rather than completely end it. Most organizations that provide arbitration also offer mediation services.

To discuss further any issues contained in this article, please consult our attorneys.

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