

Legal Commentary

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Setting Up A Subsidiary in the US – A Guide for Chinese Investors

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In the global business landscape, many Chinese companies seek to establish a presence in the U.S. market. The available strategies include forming joint ventures, establishing branch offices, creating subsidiaries, or acquiring existing entities.

Business Establishment Options

I. Joint Ventures/Contracts

Joint ventures with U.S. partners involve collaborative business arrangements where two or more parties combine resources for a particular project or business activity. Key aspects include:

- **Collaborative Nature:** Joint ventures allow for pooling of expertise, resources, and market knowledge, fostering innovation and expanding business capabilities.
- **Shared Risks:** Risks are shared between the parties, which can mitigate the impact on any single entity. However, this also means shared responsibility for losses or failures.
- **Legal Complexities:** They often involve complex legal agreements detailing the structure, roles, responsibilities, profit-sharing, and management of the joint venture. Navigating different regulatory environments, especially across international borders, adds to the legal intricacies.
- **Cultural and Operational Integration:** Integrating different corporate cultures and operations can be challenging and requires careful management.
- **Exit Strategy:** Provisions for dissolution or exit from the joint venture are critical and must be clearly outlined in the agreement.

Joint ventures require careful planning, clear agreements, and ongoing management to balance collaboration with individual business goals. Effective joint ventures are often built on strong, long-standing relationships where partners have developed mutual trust and clear communication channels. Without a history of collaboration, misunderstandings and misalignments in business practices and objectives are more likely.

II. Branch Offices

Operating a business as a branch company in the U.S. carries certain liabilities and risks:

- **Direct Liability:** Unlike a subsidiary, a branch office does not offer a separate legal entity status. This means the Chinese head company is directly liable for the actions and debts of the branch. If the branch faces legal issues, the Chinese head company's assets may be at risk.
- **Tax Implications:** Branches are subject to U.S. tax on their income earned in the U.S. This can lead to double taxation – both in the U.S. and in China.
- **Regulatory Compliance:** Both branches and subsidiaries must comply with both federal and state regulations in the U.S., However, unlike the subsidiary, a branch, being a foreign entity, might face additional reporting requirements and scrutiny particularly in areas like banking and financial services. Non-compliance can result in legal and financial penalties.
- **Jurisdictional Exposure:** Operating as a branch exposes the Chinese head company to U.S. jurisdiction, meaning it can be sued in U.S. courts. This can involve costly legal proceedings and potential damages.
- **Reputation Risk:** Since the branch is not a separate legal entity, any negative publicity or legal issues in the U.S. can directly impact the Chinese head company's reputation worldwide.

III. Subsidiaries

The main benefits for Chinese companies in setting up a subsidiary to operate a business in the U.S. include:

- **Limited Liability Protection:** A subsidiary, as a separate legal entity, limits the Chinese parent company's liability. This means that the liabilities of the subsidiary do not extend to the Chinese parent company.
- **Tax Benefits:** Subsidiaries can take advantage of U.S. tax laws and treaties, potentially reducing the overall tax burden.
- **Operational Independence:** A subsidiary can operate independently, with its own management and operational strategies tailored to the U.S. market.
- **Market Perception:** A U.S.-based subsidiary can enhance the brand's image and credibility in the U.S. market, potentially leading to increased customer trust and business opportunities.
- **Access to Funding:** Subsidiaries may have better access to U.S. financing options, including loans and investment opportunities.
- **Compliance and Regulatory Advantages:** Navigating U.S. laws and regulations can be more straightforward with a U.S.-based subsidiary, as it is subject to U.S. jurisdiction and legal standards.

IV. Acquiring existing U.S. Businesses

Chinese companies may also set up their businesses in the U.S. by acquiring existing U.S. businesses

through asset purchases, stock purchases, or mergers. When considering asset purchases, stock purchases, or mergers, key factors to consider include:

- **Due Diligence:** Assess the financial, legal, and operational aspects of the target company.
- **Legal and Tax Implications:** Understand how each option impacts taxation and liability. Asset purchases can offer tax benefits and less liability risk, while stock purchases involve acquiring all the company's liabilities.
- **Integration:** Consider the ease of integrating assets, operations, and culture, especially in mergers.
- **Financing:** Evaluate how the transaction will be financed and its impact on cash flow and balance sheet.
- **Regulatory Approvals:** Ensure compliance with all necessary regulatory requirements and approvals.
- **Future Value:** Consider the long-term strategic value and potential growth of the acquired assets or company.

Most buyers establish a new entity for transactions, particularly in mergers and acquisitions, for several reasons:

- **Liability Isolation:** A new entity can isolate liabilities, ensuring that the buyer is not directly exposed to the liabilities of the target company.
- **Financing and Investment Structure:** Establishing a new entity allows for more flexible structuring of financing and investment, accommodating different investor needs and risk profiles.
- **Operational Flexibility:** A new entity may offer operational flexibility, making it easier to integrate assets, manage operations, and eventually divest if needed.
- **Tax Considerations:** A new entity can be structured in a way that optimizes tax implications for the transaction.
- **Regulatory Compliance:** It can also simplify regulatory compliance and approvals, especially in complex transactions involving multiple jurisdictions.

These considerations are aimed at maximizing the transaction's strategic value while minimizing potential risks.

For many of the above reasons and considerations, most of the Chinese companies choose to set up wholly-owned subsidiaries to operate their new or acquired businesses in the U.S.

Steps for Establishing a US Subsidiary

The below section focuses on the establishment of subsidiaries, and their subsequent management, governance, and maintenance, etc.

I. Choosing State

Incorporation in the US is state based whereby the process of forming a corporation, including its legal and regulatory framework, is governed by individual state laws rather than a single, unified federal law.

When deciding which state to incorporate a corporation in the U.S., the following considerations are typically important:

- **Corporate Laws and Legal Environment:** Each state has its own set of corporate laws, which can affect everything from formation to operation and dissolution of the corporation.
- **Tax Implications:** States vary in their corporate tax rates and policies. Some states, like Delaware and Nevada, are known for their tax-friendly environments.
- **Filing and Maintenance Fees:** The costs associated with incorporating and maintaining a corporation can vary significantly from state to state.
- **Privacy Concerns:** Some states offer more privacy for corporate owners and officers than others.
- **Market Accessibility and Presence:** Proximity to key markets and the presence of a particular industry ecosystem can be crucial, especially for businesses relying on local supply chains and customer bases.
- **Court Systems:** The reputation and predictability of a state's legal system, particularly in handling business disputes, can be a significant factor.

Selecting the right state depends on the specific needs and strategy of the business. Many businesses choose states like Delaware due to its business-friendly environment, but the optimal choice can vary greatly depending on the specific circumstances of the business.

II. Choosing Entity Type

Corporation and Limited Liability Company are the two most common types of business entity chosen by the Chinese investors. When choosing between a corporation and an LLC for a business entity in the U.S., consider the following differences:

- **Taxation:** Corporations are subject to double taxation (corporate level and then shareholder dividends), whereas LLCs typically offer pass-through taxation (profits taxed only at the individual level).
- **Ownership and Investment:** Corporations can issue stocks, making them more suitable for raising capital. LLCs have more flexible ownership structures but cannot issue stocks.
- **Management Structure:** Corporations require a board of directors and have a more rigid structure. LLCs offer more flexibility in management and operations.
- **Regulatory Compliance and Formality:** Corporations face more stringent regulatory compliance and are required to hold regular board meetings, keep minutes, and maintain detailed records. LLCs have fewer formal requirements.

- **Future Goals and Expansion:** Consider long-term business goals. Corporations may be better for larger businesses planning to go public or seeking significant investment.
- **Liability Protection:** Both offer liability protection, but the extent and nature can vary based on state law and specific circumstances.

The choice depends on the specific needs and objectives of the business.

III. Incorporation and Formation Process

The incorporation process for a corporation and the formation process for an LLC in the U.S. are as follows:

- **Choose a Business Name:** Select a unique name that complies with state regulations.
- **Select a State for Incorporation/Forming an LLC:** Decide the state where you will incorporate or form the LLC.
- **Prepare and File Articles of Incorporation (for a corporation) or Articles of Organization (for an LLC):** These documents are filed with the state's business filing office, including details like business name, purpose, and initial directors/members.
- **Appoint a Registered Agent:** Designate a representative to receive official documents on behalf of the company or LLC.
- **Create and Adopt Bylaws (for a corporation) or an Operating Agreement (for an LLC):** These internal documents outline governance and operating procedures of the company or LLC.
- **Obtain Necessary Licenses and Permits:** Depending on the type of business and location, various licenses and permits may be required.
- **Register for Taxes and Obtain an EIN:** Register for state and federal taxes and obtain an Employer Identification Number (EIN) from the IRS.

Each step involves specific legal requirements that can vary by state.

IV. Management and Governance Structures of U.S. Subsidiary

1. For corporation

The management and governance structure of a corporation is typically composed of three primary tiers: shareholders, directors, and officers. Each tier has distinct roles and responsibilities in the corporation's governance:

- **Shareholders:** Shareholders are the owners of the corporation. They invest capital in the business in exchange for ownership shares, granting them certain rights, including the right to vote on major corporate decisions and elect the board of directors. However, shareholders do not directly manage the day-to-day operations of the corporation. Their influence is typically exercised during annual meetings or special meetings where they vote on significant matters like mergers, acquisitions, and changes to the corporate charter.

- **Board of Directors:** The board of directors is elected by the shareholders and holds the primary responsibility for overseeing and setting the overall strategic direction of the corporation. The board's key functions include appointing and supervising the officers who manage the daily operations, approving major business decisions, setting corporate policies, and ensuring the company's accountability to its shareholders. Directors have a fiduciary duty to act in the best interests of the corporation and its shareholders.
- **Officers:** Officers, including positions like the Chief Executive Officer (CEO), Chief Financial Officer (CFO), and Chief Operating Officer (COO), are responsible for the day-to-day management and administration of the corporation. They are appointed by the board of directors and are charged with implementing the board's policies and decisions. Officers manage the company's operational aspects, make executive decisions, oversee employees, and report regularly to the board on the company's performance.

2. For LLCs

The management and control structure of an LLC is more flexible compared to a corporation and can be customized to suit the specific needs of its members (owners). The two primary structures for an LLC are member-managed and manager-managed:

A. For Member-Managed LLCs

- In a member-managed LLC, all members (owners) participate directly in the management of the company.
- Members make decisions and run the day-to-day operations.
- This structure is more common in smaller LLCs where the owners are actively involved in the business.
- The rights, duties, and proportion of control of each member are usually outlined in the LLC's operating agreement.

B. For Manager-Managed LLC

- In a manager-managed LLC, the members appoint one or more managers to handle the LLC's daily operations.
- The managers can be members of the LLC or outside parties.
- Members not serving as managers typically have a less active role in the day-to-day management but retain control over major business decisions.
- The operating agreement specifies the managers' powers, duties, and the extent of their authority.

Regardless of the management structure, the LLC's operating agreement is a crucial document. It outlines the governance structure, including how decisions are made, the distribution of profits and losses, and the procedures for adding or removing members or managers. This agreement provides the flexibility that allows an LLC to tailor its management structure to its specific needs.

In both types of management structures, members of an LLC enjoy limited liability protection, meaning their personal assets are generally protected from the LLC's debts and legal liabilities. The choice between member-managed and manager-managed structures depends on factors like the size of the LLC, the number of members, the level of involvement desired by the members in the business, and the complexity of the business operations.

V. Capitalization Requirements and Strategies for U.S. Subsidiary

The capital structure of a U.S. corporation and an LLC differs significantly.

1. Corporation Capital Structure

The capital structure of a U.S. corporation typically comprises two main components: equity and debt. Here's a brief overview of each:

- **Shares of Stock:** The most fundamental aspect of a corporation's equity is its stock, which represents ownership in the company. This can be divided into different types, commonly as common stock and preferred stock. Holders of common stock generally have voting rights and receive dividends. They are last in line when it comes to claims on the company's assets. Preferred shareholders usually have a higher claim on assets and earnings than common shareholders, such as receiving dividends before common shareholders.
- **Debt:** Corporations can also raise capital through debt, which involves borrowing money that must be paid back with interest. This can be in the form of bonds, loans, or other debt instruments. When a corporation issues bonds, it is borrowing money from investors to whom it will pay back the principal amount at a future date (maturity date), along with interest payments at specified intervals.

One question that Chinese investors often asked about the capital structure is "what are the authorized shares of a U.S. corporation?"

The authorized shares are the total number of shares that a corporation is legally permitted to issue as outlined in its articles of incorporation or corporate charter. This number sets the upper limit on the number of shares the company can issue to shareholders. The number of authorized shares can be increased through a formal amendment of the corporate charter, typically requiring shareholder approval. Not all authorized shares are issued to shareholders. They represent the potential for future financing or other corporate actions like stock options or convertible bonds.

Differently from authorized shares, issued shares of a U.S. corporation refer to the portion of authorized shares that have been sold and distributed to shareholders. Once shares are issued, they represent ownership and equity in the company. Payment for the issued shares can be in the form of cash, property, services, or other forms of assets or a combination of them.

2. LLC Capital Structure

The capital structure of a U.S. LLC is somewhat different from that of corporations. Unlike corporations, which have a structured share system, LLCs offer more flexibility in terms of how they

are funded and how ownership is distributed. Here are the key elements:

- **Member Contributions:** The primary component of an LLC's capital structure comes from its members (the LLC equivalent of shareholders) who contribute capital to the LLC. These contributions can also be in the form of cash, property, services, or other forms of assets or a combination of them. The value of each member's contribution typically determines their percentage of ownership in the LLC.
- **Operating Agreement:** LLCs are governed by an operating agreement, a key document that outlines the capital contributions of each member, their ownership percentages, rights, responsibilities, and the distribution of profits and losses. The operating agreement can be very flexible and tailored to the specific needs and agreements of the members.
- **No Stock Issuance:** Unlike corporations, LLCs do not issue stock. Ownership is based on the percentage interest that each member holds in the LLC, as defined in the operating agreement.
- **Profit and Loss Distribution:** Profits and losses can be distributed among members according to their percentage of ownership, or the operating agreement can specify a different distribution method.
- **Additional Capital Contributions:** The operating agreement may include provisions for additional capital contributions by members or the admission of new members.
- **Debt Financing:** LLCs can also raise capital through debt, just like corporations. They can take out loans, issue bonds, or engage in other forms of borrowing. However, the liability for this debt may depend on the terms of the debt instrument and the structure of the LLC.
- **Flexibility in Capital Structure:** One of the advantages of an LLC is the flexibility in structuring capital contributions and distributions. LLCs can negotiate almost any arrangement that suits the members, within the bounds of the law.

It is important to note that while LLCs offer flexibility, they also require clear agreements to prevent disputes and ensure smooth operation.

VI. Tax Registration and Filing Requirements

The tax registration process in the U.S., including obtaining an Employer Identification Number (EIN) and filing tax returns, generally involves the following steps:

- **Obtaining an EIN: Businesses must obtain an EIN from the IRS.** This can be done online, by fax, or by mail. The EIN is a unique number that identifies the business for tax purposes.
- **Registering for State Taxes:** Depending on the state and the nature of the business, you may need to register for state-specific taxes, such as sales tax or employment taxes.
- **Filing Federal Tax Returns:** Corporations file a corporate tax return (Form 1120), while LLCs with multiple members file a partnership return (Form 1065), and single-member LLCs report their business income on the owner's personal tax return (Form 1040, Schedule C).

- **Filing State Tax Returns:** If operating in a state with corporate income tax, businesses must file state tax returns. The requirements vary by state.
- **Paying Estimated Taxes:** Businesses may be required to pay estimated taxes quarterly if they expect to owe tax above certain specific amounts when their return is filed.

Each business's tax responsibilities may vary based on its structure and location, so it's advisable to consult with a tax professional for specific guidance.

VII. Tax Treatments for corporations and LLCs

The tax treatments for corporations and LLCs owned by Chinese shareholder(s) or member(s) vary.

1. For Corporations

- Regardless of the nationality of its shareholders, is subject to U.S. corporate income tax on its worldwide income. This means it pays taxes on all its income, both from U.S. sources and international sources, at the applicable corporate tax rate.
- Generally subject to corporate income tax at both the state and federal levels.
- Face the possibility of double taxation, where the corporation's income is taxed, and dividends paid to shareholders are taxed again on the individual's tax return. Chinese shareholder may be entitled to 10% withholding tax rate on dividends paid to them under the U.S.-China tax treaty versus standard 30% rate imposed under U.S. domestic law.
- A corporation elects to be taxed as an S corporation passes its income, losses, deductions, and credits directly to shareholders who then report these on their personal tax returns. The corporation itself does not pay federal income taxes, thus avoiding double taxation. However, a U.S. corporation that is owned by Chinese shareholders generally cannot elect to be taxed as an S corporation. One of the key eligibility requirements for S corporation status is that all shareholders must be U.S. citizens or residents.

2. For LLCs

An LLC owned by Chinese members is typically taxed in one of two ways, depending on its tax election and the nature of its income:

- **Default Taxation as a Partnership or Disregarded Entity**
 - If the LLC has more than one member and has not elected to be treated differently, it is by default classified as a partnership for tax purposes. The LLC itself does not pay tax, but its income is passed through to the members. Chinese members must file U.S. tax returns (Form 1040-NR) to report this income and pay any taxes due.
 - If the LLC has only one member and has not elected to be treated as a corporation, it is considered a disregarded entity. The single member reports and pays tax on the LLC's income on their personal tax return. If the member is a Chinese individual or entity, they must file a U.S. tax

return (Form 1040-NR for individuals or Form 1120-F for corporations) and pay tax on income effectively connected with a U.S. trade or business.

■ **Elected Taxation as a Corporation**

- An LLC can elect to be treated as a corporation. Once this election is made, the LLC is taxed as a C corporation, which means it pays corporate income tax on its profits. Chinese members of LLC are taxed only on dividends paid to them, which may be subject to 10% withholding tax under U.S.-China tax treaty.

Each state may have different rates and rules for corporate and LLC taxation, making it important to consult local regulations for specific details.

VIII. Ongoing Maintenance and Compliance

Ongoing maintenance and compliance obligations for a corporation or an LLC are crucial to ensure that the business remains in good standing with the state and federal regulatory authorities. These obligations can vary based on the state in which the business is registered, as well as on the type of business. However, some common requirements include:

- **Annual Reports:** Most states require corporations and LLCs to file annual reports. These reports typically include information about the business entity's current address, its directors or managers, and sometimes its financial status.
- **Renewal of Business Permits and Licenses:** Depending on the nature of the business, certain permits and licenses may need to be renewed regularly.
- **Record Keeping:** Corporations and LLCs are required to keep detailed records of business transactions, financial statements, meeting minutes, shareholder or member information, and other significant documents.
- **Holding Annual Meetings:** Corporations are generally required to hold annual meetings of shareholders and directors. While LLCs are not always required to hold annual meetings, it's often recommended.
- **Updating Information with the State:** If there are significant changes in the business, such as a change in address, management, or business structure, this information must be updated with the state.
- **Tax Filings and Compliance:** Both corporations and LLCs must file federal and state taxes.
- **Compliance with Securities Laws:** If the corporation or LLC has issued shares or membership interests, it must comply with federal and state securities laws.
- **Employment Law Compliance:** If the business has employees, it must comply with various employment laws, including wage and hour laws, anti-discrimination laws, and workers' compensation requirements.

- **Maintaining Corporate Veil:** Especially for corporations, maintaining the corporate veil (separation between the business and its owners) is important to protect the owners' personal assets from business liabilities. This involves following formalities like keeping personal and business finances separate.
- **Foreign Qualification:** If operating in states other than the one where the business is registered, the corporation or LLC may need to make a simple registration as a foreign entity in those states.
- **Environmental Compliance:** Depending on the type of business, there may be specific environmental regulations to comply with.
- **Industry-Specific Compliance:** Depending on the industry, there could be additional regulatory requirements.

The legal responsibilities of directors, officers, and managers in the ongoing management and compliance of a corporation or LLC are substantial, as they play key roles in ensuring that the business adheres to legal, ethical, and operational standards. These responsibilities can vary depending on the specific laws of the state where the business is incorporated or formed, as well as the type of business entity (corporation vs. LLC). However, there are several general duties and responsibilities that are commonly applicable:

1. For Corporations

- **Duty of Care:** Directors and officers must perform their duties with the care that a reasonably prudent person in a similar position would use under similar circumstances. This includes making informed decisions and exercising due diligence in overseeing the company's operations.
- **Duty of Loyalty:** This duty requires directors and officers to act in the best interest of the corporation, rather than in their personal interest. Conflicts of interest must be avoided, or if they arise, they must be disclosed and appropriately managed.
- **Duty of Good Faith:** They must act with honesty and integrity in all dealings on behalf of the corporation.
- **Duty of Obedience:** Directors and officers must ensure that the corporation complies with all applicable laws, regulations, and its own bylaws and charter.
- **Record-Keeping:** They are responsible for ensuring that the corporation maintains accurate and complete records, including minutes of board meetings, financial reports, and other important documents.
- **Financial Oversight:** Directors and officers are responsible for overseeing the financial health of the corporation, including budgeting, financial planning, and safeguarding assets.
- **Policy Implementation and Compliance:** They must ensure that the corporation has effective policies in place for legal and regulatory compliance and that these policies are being followed.

2. For LLCs

- **Duty of Care and Loyalty:** Like corporations, managers (or managing members in member-managed LLCs) have duties of care and loyalty to the LLC and its members.
- **Operating Agreement Adherence:** Managers are responsible for conducting affairs in accordance with the LLC's operating agreement.
- **Record-Keeping:** Keeping accurate records of all LLC transactions and decisions is crucial.
- **Financial Management:** Managers must manage the LLC's finances responsibly, which includes proper accounting and tax filings.
- **Legal and Regulatory Compliance:** Ensuring compliance with all relevant laws and regulations applicable to the LLC's business.
- **Conflict of Interest:** Managers must avoid conflicts of interest, and where they exist, they must be handled transparently.

Directors, officers, and managers should be aware that failure to fulfill these responsibilities can lead to legal consequences, including personal liability in some cases. Therefore, they often rely on legal counsel, financial advisors, and other professionals to help navigate these duties effectively.

This article aims to help Chinese investors understand the process and considerations for Chinese companies looking to establish subsidiaries in the U.S. market.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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