Advising Chinese Clients On Establishing And Operating Successful Businesses In The United States

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Here's how to go from The Great Wall to Wall Street.

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IT IS ONLY a matter of when, not if, Chinese businesses expand their direct investment and business operations from the mainland of China to the United States. The continuing strength of the Yuan will make U.S. assets appear relatively inexpensive to a Chinese buyer. Chinese businesspeople will also realize that greater profit margins reside not in producing labor intensive cheap goods but rather in value added brand or technologically differentiated products. The wealth and sophistication of the U.S. market provides great receptivity to these types of goods. Finally, the Chinese have already recycled a considerable amount of their free cash into U.S. sovereign debt and indirect equity investments in vehicles like private equity funds such as the recently announced $3 billion investment in a Blackstone fund. The next logical progression is direct Chinese investments in U.S. assets like real estate or operating businesses.

Chinese businesses continue to expand their direct investment in the United States. In 2006, Chinese businesses directly invested $973 million in the United States. In 2007, that figure actually swelled to $1.091 billion. (All figures from the United States Bureau of Economic Analysis.) In contrast, the United States made direct investments in China of over $23 billion (over 24 times as much) in 2006 and $28 billion in 2006.

Lawyers counseling Chinese clients setting up business operations or buying assets in the United States have a vast panoply of issues to discuss with these clients to guide them through what for an Asian businessman is vast uncharted territory—different legal system, different customs, different morals, cultures, and values. The outline attached as Appendix 1 to this article gives you a sense of the vastness of the topic of legal items on which to counsel a Chinese businessperson in investing in the United States to maximize his or her chances of doing business successfully in the United States.

The overall list of items comprising legal factors to consider in choosing to do business in the United States is like food at a buffet: they are many and varied and constitute a full meal. This article is limited to a few key components critical for any lawyer to master to guide his or her client past the Chinese Wall and to Wall Street and Main Street.

BACKGROUND •. Compared to many countries, the United States is a very welcoming place to do business. While we have many laws, and lawyers feverishly negotiate many lengthy contracts, and litigation clogs the court system, these are small frictional costs to provide larger benefits to our overall economy. The core bedrock principle of our capitalist system is efficiency and absence of unnecessary intrusion on the smooth flow of commerce. Therefore, comparatively very few rules or delays inhibit the efficient flow of completing a deal. Laws are rarely changed and evolve gradually to provide guidance to investors. Very little systematic ongoing corruption is tolerated. Rules and regulatory bodies strive for transparency to foster efficiency.

Foreign Investment Laws

Many federal, state, and local laws impact foreign investment neutrally. These laws do not discriminate in favor or against, or impose unreasonable burdens on, foreign investors or businesses. The outline lists many significant federal statutes impacting foreign investors and businesses. Most laws targeting foreign investors merely regulate the time, place and manner of such investment. For example, Congress recently enacted a pervasive and prominent law impacting foreign investors in partial response to the 9-11 terrorist attacks, and is called the Patriot Act. The Act emboldens law enforcement agencies to counter terrorism both in and outside the United States and strengthens anti-terrorist criminal laws. To address the threats of money laundering and terrorist financing, the Act requires financial institutions to conduct due diligence on all accounts belonging to non-U.S. persons. Before any foreign person making an investment in the United States, the foreign investor must disclose:

- The identity of persons who control its assets;
- The origins of funds coming into the Western financial system and the destinations of these funds; and
- Any undisclosed purpose for transactions, particularly when the transaction seems suspicious.

U.S. financial institutions must not only collect this information but also establish expanded anti-money laundering programs, including strengthening "know your customer" procedures, and conduct enhanced due diligence on all accounts belonging to non-U.S. persons. Consequently, when foreign investors in the United States engage in various financial transactions in the United States, they, as well as their families and associates, should expect to have to disclose certain information regarding matters such as ownership status and non-affiliation with certain individuals and organizations deemed to be adverse to the national security of the United States Compliance with this law is cumbersome but it does not prohibit conduct or ownership. Very few industries restrict foreign ownership. Like many countries, the United States restricts ownership of technology deemed necessary for the national defense, and specifically restricts foreign ownership of broadcasting and other federally licensed communications businesses to 25 percent foreign investment. Clever businessmen, like Rupert Murdoch, have not let these rules impede purchases of broadcast and communications businesses. Moreover, unlike many countries, no federal laws restrict foreign ownership of real estate, except some states like Wisconsin do impose limitations.

CONTRACT ENFORCEMENT • Enforcement of a contract is a central pillar of underpinning the integrity of any commercial agreement. Differing customs between Chinese and U.S. businessmen increase the chances of uncertainty, tension, and added costs, complicating the relationships between the parties and possibly frustrating the fulfillment of each party's expectations. At the risk of vastly oversimplifying, Chinese and U.S. philosophical differences can create the potential for conflict in contract interpretation and enforcement. In the United States, a contract is typically enforced like a snapshot. All facts and circumstances to be enforced, absent force majeure events, bad drafting or fraud, will be set forth in the four corners of the document. In contrast, Chinese contracts are interpreted like movies. The contract changes with each scene, and as the time, needs, and relationships of the parties evolve. Therefore, U.S. parties tend to view the contract as sacrosanct whereas to the Chinese businessperson, the contract may have represented the parties' state of mind at one point in time, but their positions may have shifted since then. Contract drafters should carefully consider the merits of resolving disputes by judicial, arbitral, or alternative means.

Judicial Enforcement

United States courts typically uphold contractual provisions that set forth non-judicial means of resolving disputes. Many parties have a deep aversion to judicial resolution. They argue that this process consumes more time and expense than arbitration and also exposes the litigating parties to public scrutiny of the dispute, sensitive information, and the result. I take a contrary view and often prefer judicial to arbitral resolution, but recommend that parties evaluate the appropriateness of alternative relief provisions on a case-by-case basis. In some jurisdictions, judicial relief is surprisingly efficient. If you represent a party that is far wealthier than the other party, a costlier and more time consuming process may have advantages. Likewise, if you question the candor and integrity of the other party, the judicial process compels full and honest disclosure of evidence, whereas an arbitrator cannot compel full and honest disclosure of all evidence and truthful testimony. Further, a judicial result may be appealed and therefore a prejudiced or simply wrong decision can be overturned, whereas arbitrations are very difficult to reverse. Finally, if you are an entrepreneur doing business with a more established company, that more established company may be more willing to settle if the dispute is in a judicial forum, due to fear that a loss might negatively effect the company in the marketplace or have a precedential effect. Due to enforcement issues (see below), unless the Chinese-owned business has substantial assets in the United States from which to collect on a judgment, the U.S. counterparty to a contract will insist that disputes be resolved by arbitration.

Arbitration

United States courts will enforce arbitration provisions. We generally recommend a three arbitrator process to reduce the risk of arbitrariness and increase the chance of a fair hearing. Many qualified professional arbitrators, many of whom are former judges, are available; and many distinguished companies provide these services. Absent contractual provisions to the contrary, or an equitable finding by the arbitration panel, each side normally pays for its own arbitrator and then splits the costs and fees of the third arbitrator. These fees can be quite significant. If your contract specifies arbitration as an exclusive dispute resolution mechanism, try to set forth specific rules covering timing, witness lists, depositions, documents, interrogatories, and the typical procedure for information discovery. You should also specify that all testimony is under oath with penalties of perjury for untruthful testimony. Although the judicial forum has well-defined rules and consequences, too many arbitration clauses neglect to consider these crucial concepts. The less scrupled party therefore many times has an undue advantage. So while arbitration is often viewed as cheaper and faster than judicial resolution, and in some cases that is true, there are pitfalls as discussed above.

Mediation Process

We often suggest that the parties negotiate to resolve disputes in good faith for some period of time before instituting the judicial or arbitral process. The discussions to resolve the matter could then escalate to the top executives of the two companies. Bringing in a trained mediator who will evaluate the merits of the parties' respective positions, on a non-binding basis, is often a viable option.

Contractual Dispute Resolution Mechanisms

The parties should also consider non-judicial resolution ideas. For example, in the event of a dispute between the parties to a joint venture, some agreements designate the appointment of a provisional director who will break the tie. Other agreements set forth many mechanisms to sell the business in the event of a hopeless conflict.

Regardless of the process selected for dispute resolution, contractual clauses should cover the following items. In my opinion, the most important clauses are the choice of language, procedure, and location of the forum. Governing law, too, is critical:

- *Language.* English is the sole language of the resolution process;
- *Jurisdiction and venue.* Regardless of whether the contract requires an arbitration resolution, contract provisions specifying the state law and the forum for resolving the dispute will typically be enforced as long as there is a reasonable basis for selecting these items and they do not contradict public policy. These clauses are particularly crucial when at least one party is from overseas or its home country has a judicial system and set of laws that are not widely known or understood in the United States. Parties may consider compromises such as choosing an exclusive jurisdiction or agreeing that the jurisdiction and venue will be in the site of the party that is not bringing the action. This approach tempers aggressive initiation of litigation.

Enforcement Of Awards

A dispute resolved in a U.S. court may not necessarily be enforced by a Chinese court since neither country has ratified the Hague Convention on the Choice of Court Agreements. The enforcement of foreign judgments in China is set forth in Articles 267 and 268 of the Civil Procedure Law. Under Article 267 of the Civil Procedure Law of the People's Republic of China, a party can request acknowledgment of a foreign court judgment or ruling through two methods: a party's direct request to an intermediate court, or the by the foreign court's request. Absent a treaty between the United States and China, the Chinese court bases the enforcement on the existence of reciprocity between the two countries. The Chinese Court will only recognize a "legally effective judgment." The Chinese Court will not enforce a foreign judgment which "contravenes the basic principles of Chinese law, China's sovereignty, or its national and social interest." The most reliable method of having a judgment enforced by either the United States or China is to go through arbitration. Both countries are currently parties to the 1958 New York Convention on Recognition and Enforcement of Arbitration Awards. Therefore, unless the Chinese entity doing business in the United States has substantial assets in the United States, arbitration will be the necessary mechanism to assure that the successful U.S. litigant can collect its U.S.-pronounced award in China without facing the risks of re-litigating the matter in China.

FORM OF ENTITY • What form of organization should a Chinese business choose to own and operate a business in the United States? Three main goals dictate the proper choice of entity:

- Limitation of owner liability;
- Ease of administration; and
- Efficient taxation.

Although the states in the United States offer many forms from which to choose to structure Chinese business operations in the United States, four main choices are particularly relevant. The nuances and complexities of this subject far exceed the space devoted to this simple article. Appendix 2 provides much greater depth on the benefits, detriments, and comparisons of many different U.S. entities.

Branch

A branch is an unincorporated division of a foreign entity. A branch mirrors the U.S. concept of a division or sole proprietorship, which is summarized as follows:

- No legal entity separate from owner;
- Owner bears all profits and losses;
- Owner is sole managing authority;
- Owner bears personal liability for all obligations and liabilities;
- No registration requirements to form or maintain (except for qualifying to do business).

A branch may satisfy the ease of administration goal, but it fails to satisfy the other two goals. The branch's activities impose personal liability on the Chinese owner in both the United States and China. Further, as discussed below on taxation, a branch of a non-U.S. based corporation may not be tax efficient and can draw a greater portion of the home country operations into the complexities of the U.S. taxation system. A branch may be appropriate if a Chinese company's activities are preliminary and exploratory, such as evaluating sales or other initial business opportunities in the United States. Also, devices exist to accomplish goals of limited liability for a branch (for example, setting up a subsidiary of the owner in China and having that subsidiary own the branch), and reduce taxes (subject to rules on transfer pricing, paying management fees instead of dividends). However, the cost of circumvention of these pitfalls does not typically outweigh the benefits derived from other entities described below.

Corporation

Chinese businesses operating as U.S. subsidiary corporations serve the purposes of limited liability and ease of administration. A corporation, unlike a branch, is a separate legal entity, owned by its shareholders. Shareholders may be foreign or U.S. residents. Liabilities of a corporation lie trapped in the entity and its shareholders are not liable for the debts of the corporation, absent special egregious acts. Note that a specific type of tax advantage available to corporations comprised of a limited number of U.S. individual residents or legal aliens (known as an "S" corporation) is not available to Chinese non-resident shareholders.

Formation of a corporation merely requires registration with the state of incorporation. The incorporator must file articles of incorporation specifying basic information about the incorporators, the corporation's directors, the number of authorized shares of stock, and similar matters. The franchise frequently takes only a day or so to establish and the cost to set up the entity is very modest. Corporations have the following characteristics:

- A legal entity distinct from its shareholders;
- Limited liability to shareholders, i.e., sharehold-

ers not responsible for corporate debts;

- Ownership is denoted by shares of stock;
- Managed by a board of directors, appointed by the shareholders, and the board, in turn, appoints the officers. The directors, officers, and employees are fiduciaries to the corporation and shareholders;
- Formation requirements—
  __ Registration with the state of incorporation;
  __ Articles of Incorporation specifying founder and other information;
  __ By-laws;
  __ Stock certificates.

Corporations with a lesser number of shareholders, common in family businesses, may be considered as closely held. In closely held corporations, the formalities are less stringent, and, in lieu of shareholder meetings, often the shareholders will sign a written consent. It is still critically important to document corporate actions to preserve the corporate form. Disregard of corporate formalities can be a basis to "pierce the corporate veil" for extinguishing the limited liability aspect of the corporate form.

Chinese entities might consider corporate form in the United States if they operate in corporate form in China and desire to consolidate profits and losses from operations. Moreover, Chinese entities might consider conducting business operations in corporate form in the United States if they desire to set up foreign entities and consolidate early stage losses from those operations with profits derived internationally in other jurisdictions. My personal view is that due to tax inefficiency as described below, Chinese investors' use of limited partnerships or limited liability companies better accomplishes all three goals.

Limited Partnerships

Limited partnerships ("LPs") potentially achieve all three goals. An LP is also a separate legal entity, comprised of at least one general partner, responsible for management and control, and at least one limited partner (which may not be the same entity as the other partner or else the entity will be disregarded and treated as a corporation). Limited partners receive a shield from individual liability and only the general partner is liable for the debts of the LP (provided that the general partner possessed some level of capital). Most LPs are structured so the general partner has few assets, so as a practical matter, very little personal liability is at risk. An LP, like a corporation, also accomplishes the goal of ease of administration. Limited partnerships are formed through formal filing and registration in the state where they are doing business. Major LP characteristics include:

- Formal filing and registration required;
- Must have at least two partners—general and limited;
- General partners—managing person or entity;
- Limited partners—no personal liability for partnership debts;
- The general partner is a fiduciary to the LP and limited partners.

The LP has less of a limited liability benefit than the corporation due to the need to find and utilize a general partner, notwithstanding how that general partner may be capitalized. The LP potentially has greater tax benefits than a corporation, unless the Chinese parent does not desire to receive these benefits. While the LP is therefore a useful vehicle, and is still very common for private equity and hedge funds, the potential exposure of the general partner, together with the advent of the limited liability company possessing all of the benefits and none of the drawbacks of an LP, have reduced the use of LPs in recent years.

Limited Liability Company

The entity that combines the superior limited liability benefit of the corporation, administrative ease of both a corporation and LP and tax benefit of LPs is the limited liability company ("LLC"). LLCs have become accepted in virtually every state in the past decade. A small handful of states, however, notably Texas and California, do not bestow certain tax benefits to these entities and thereby diminish their appeal in those jurisdictions. LLCs share characteristics of a corporation and an LP. An LLC is owned by members, analogous to partners in an LP and shareholders in a corporation, and is managed by either the members or a manager like the board of a corporation or general partner of an LP. Their respective participation rights are typically designated in an operating agreement, which would address matters such as allocation of profits and losses. Maintaining an LLC includes certain record keeping and registration requirements. Important LLC characteristics include:

- Members and managers;
- Limited liability for members and managers;
- Fiduciary duties among members and between members and managers;
- Interests freely transferable;
- Registration required.

Membership interests can be freely transferable, unlike LPs, when attempted transfer of a partnership interest might terminate the partnership. LLCs, like corporations, and unlike LPs, may have only one member. In this situation, while the LLC will retain its limited liability status, it will be disregarded for income tax purposes and be taxed as a corporation or branch. (We will discuss the implications of this treatment below.) The law is unsettled regarding whether adding a "dummy" or shell entity controlled by the other member will receive the necessary respect as a second member.

Which Entity To Choose?

The facts, circumstances, goals, and objectives of each situation determine the proper entity. For example, a Chinese company investigating business opportunities in the United States or procuring sales in the United States without fear of imposing any liability to the parent entity in China might consider a branch office as a starting point. As the activities of the branch ripen into a more sophisticated business, with multiple employees, manufacturing, potential product liability infringement, environmental liability, or working with one or more investors or joint venture partners, the Chinese entrepreneur would almost certainly convert the branch to a legal entity such as a corporation, LLC, or LP. My personal bias is in favor of an LLC. LLCs offer similar liability protection and relative administrative ease as a corporation or LP but will often offer more favorable present tax benefits as described below. In the final analysis, the Chinese business owner can accomplish his other goals of liability insulation and reduced administration by choosing any of the three entities discussed above. Therefore, tax goals and considerations often drive the ultimate decision.

INCOME TAXATION • International income tax rules have rapidly evolved as nations have vigorously competed to attract foreign business and diversify local economies. This competition for tax revenues has generated international tax fairness initiatives and driven governments to dedicate vast resources to the negotiation of advance pricing arrangements, and the policing of existing transfer pricing relationships.

As a result of the rapid evolution of the rules of international taxation, the optimal choice of business structure for the Chinese business owner desiring to operate in the United States defies generalization. An understanding of basic U.S. tax principles and then answers to the questions posed below will enable the Chinese business owner to judge which business form satisfies its objectives for operating in the United States.

What Are The Basic Federal Income Tax Rates?

Federal income tax rates on corporations range from 15 percent on the first $50,000 of net income to 39 percent in the $100,000 to $335,000 range. For corporations with much larger annual net income levels, the graduated income tax rates are phased out and a flat 35 percent rate is applied. These rates apply to branch profits as well. Similarly, if an LLC has a single corporation member, it will be taxed at these corporate rates. A dividend from the corporation to its Chinese parent owner will generally then be taxed at a 15 percent rate. State taxes are often a major factor as well but will not be considered in this article. When the U.S. business operations cease, and the corporation's assets are ultimately sold and the proceeds distributed to the Chinese owners, a "double tax" will be incurred, once at the corporate level and then once again at the shareholder level.

In contrast, an LP or multi-member LLC pays no federal income tax and this obligation flows through to the individual member to pay at its own rate. If the LLC's member is a Chinese corporation or U.S. corporation owned by a Chinese person, the LLC's income would not be taxed at the LLC level but only once, as it flows through to the corporate member. If the member is an individual, the rate would be the individual rate which ranges from 10 percent for income up to $7,550 and 35 percent for income over $336,550. For example, assume a corporation has net income of $1 million from normal operations and chooses to make a dividend of $100,000 to its Chinese stockholder. Assuming there is sufficient earnings and profits, the $1 million would result in a tax of approximately $350,000 and then the dividend would result in a tax of $15,000 for a total federal income tax of $365,000. The federal income tax relating to the same income of and dividend from an LLC owned by an individual is approximately $300,000, since the income and dividend are effectively not taxed twice, and the tax rates for individuals are generally somewhat lower than for corporations. This significant savings is magnified in the context of a sale of the assets of the business. That same $1 million sale, assuming zero basis in the corporation's assets or stock, would result in an aggregate federal income tax to the corporation and selling Chinese shareholders of approximately $550,000. In contrast, the same $1 million sale of the business assets of an LLC would result in $200,000 less in federal income tax.

What Income Will Be Taxed?

Nations tax income earned in their countries by their residents and non-residents in one of two ways: either on the source of the income, whether it is earned within its borders or not, or only on income earned within the nation's borders. The United States imposes income taxes on its residents on the source of the income, regardless of whether it is earned in the United States or abroad. Thus, a U.S. entity, even one owned by a Chinese owner, that earns income both in the United States and in other countries, will be taxed on all of that worldwide income. Income that a non-resident Chinese business owner earns in the United States (whether or not the source is from the United States or another country) will, in turn, depend on whether the income is derived from an active trade or business or from a passive source like a real estate investment or dividends and interest. If the income which a Chinese business earns in the United States is from an active trade or business, it is deemed to be "effectively connected" to the United States and is taxed at the rates discussed in the preceding paragraph. In contrast, if the income the Chinese investor earns in the United States is from passive sources such as dividends, royalties, interest and the like, the income will be subject to a flat withholding rate of 30 percent.

Is There A Tax Treaty Providing Credit Relief?

If income which a Chinese citizen earns from and is taxed on its business operations in the United States were again subject to tax in China, the Chinese investor would face confiscatory taxation and suffer a real disincentive to invest. Consequently, China and the United States have enacted an income tax treaty. While the treaty is very complex and deals with many specific situations, the salient point is that tax paid by the Chinese entity or its branch in the United States will be applied as a tax credit for that entity in China as it is attributable to the same income. If a U.S. entity which is owned by Chinese citizens incurs $500,000 in U.S. federal income tax attributable to the net income of that entity on "U.S. source income" and that income generates a tax in China equal to $450,000, then the entire $500,000 of income tax would be paid in the United States and China would not receive any tax payment. Conversely, if that U.S. entity generates the same $500,000 in federal income tax in the United States attributable to the net income of that entity for U.S. source income and the tax in China would be $600,000 on such income, then the entire $500,000 of income tax would be paid in the United States and China would receive a $100,000 tax payment resulting from that U.S. source income. Since the maximum corporate rate in the United States is 39 percent and in China is 33 percent, the chances are great that income earned attributable to U.S. sources will be largely credited against taxes otherwise payable in China.

What Type Of Entity To Select?

Assuming the liability limitation questions and administrative ease questions answered above are the same, then the decisive question revolves around the taxation of the potential form of business in the United States that the Chinese investor chooses to establish. In sum, my preferred form for a Chinese business operating in the United States is an LLC, absent the business' significant cash constraints, or its high likelihood of ultimate exit by a sale of ownership interests or initial public offering. An LLC is simply easier to administer than an LP and its ultimate income tax rate will be lower than operating in corporate form. Every circumstance is unique, so a Chinese business person should consider the following distinct but somewhat related eight questions to analyze properly the form of business entity in which to operate in the United States.

1. Is Income Tax Minimization Important?

Due to the significant impact of double-taxation in certain structures described above, a Chinese owner desiring to minimize U.S. based federal income tax should choose an LLC or LP.

2. Do The Business Operations In The United States Represent A New Business Venture Or Are They Simply An Expansion Of Existing Business Operations?

If the U.S.-based operations of a Chinese parent represent an expansion of its existing business, and it is desired to integrate the two businesses from an accounting standpoint, a corporate subsidiary, branch, or single member LLC is the desired form. However, the ability of the Chinese entity to consolidate its income from a U.S. branch, LLC, or LP will depend largely on Chinese consolidation rules. If such accounting or tax consolidation is not desired, then the converse may be preferable. If such consolidation is not important, then this factor is not relevant.

3. Does The U.S. Business Expect To Have Foreign Operations?

As stated above, the United States taxes its residents (including an entity formed in the United States by a Chinese owner or which a Chinese businessman has any form of ownership interest) on their world-wide income. As a result, once a Chinese parent chooses a form of entity for its U.S.-

based operations, it must consider where the entity will be organized. For instance, if the U.S.-based operations will generate profits in other countries, the organization of the entity as a U.S. domestic entity will subject the earnings generated in other countries to income tax in the United States. In contrast, if that entity is organized offshore in the U.S. Virgin Islands, and has multiple operations around the world including the United States, only the U.S. operations will be subject to income tax in the United States. If the foreign operations are likely to have losses, at least in the foreseeable future, and tax treaties exist among all countries in the group, then a U.S. corporation owning the foreign entities might be advisable. Conversely, if all enterprises are expected to be profitable relatively quickly, and treaties do not exist between the United States and some or all of the other nations in the group, then considerable double tax may result in the United States as a result of selecting corporate form in the United States. Additionally, we would want to know under what circumstances will the domestic revenue laws permit the consolidation of U.S. operations with the existing business. This might be important if, for example, the U.S. operations may generate losses that would be beneficial if available in China or consolidated with the United States from abroad and then ultimately in China.

4. What Are The Projections For Business Profitability Arising Out Of The U.S. Operations?

As mentioned, this may be important. For example, if the business will produce start-up losses in the United States, it would be helpful for those U.S.-based losses to be available to offset income in the business owner's home jurisdiction. Naturally, this benefit would only be available when a pass-through form (LLC or LP) or a branch of the Chinese corporate entity is used as the investment vehicle, or if Chinese tax law permits consolidation.

5. What Are The Ongoing Capital Needs For The U.S.-Based Operations And Does The Business Owner Anticipate Raising Capital From U.S. Investors?

If the Chinese owned business located in the United States will raise equity capital from U.S. individuals, those individual investors may overwhelmingly favor an LLC predominantly because of the single level of taxation. On the other hand, U.S.-based investors do occasionally favor the corporate form for joint ventures, often for regulatory reasons, which also would more predictably and efficiently dispose of the equity in a corporate takeover or public offering setting.

6. Does The Business Owner Otherwise Have Any Other U.S.-Based Business Interests?

An LLC, LP, or branch may require the Chinese owner to individually file tax returns in the United States and in every individual state in which the business operates. Many individual foreign business owners would prefer not to have to expand their tax compliance burden dramatically, but if they already have operations in the United States, they may be used to the filing requirements. Taking the corporate form obviates this concern.

7. Do Owners Intend To Distribute Or Repatriate Periodic Business Profits?

If the Chinese company is an investor in an LP or LLC that has U.S. partners, then a withholding tax will be required to be paid by the LP or LLC relating to any income attributable to the Chinese owner's share of that business, even if no cash is distributed to pay those taxes. Many LLCs and LPs, however, desire to conserve cash and therefore require their members or partners to pay their share of the tax, thereby allowing the entity to save precious cash resources. Therefore, if the Chinese business owner plans to reinvest periodic earnings of the U.S. operations in the U.S. business, operating in an LP or LLC form can be a drain on the business' cash flow.

Branch profits taxes or taxes on corporate dividends, on the other hand, are not paid to the U.S. federal government until earnings are actually distributed or otherwise repatriated. As a result, if the Chinese business owner's plan is to realize on its investment by way of reinvesting periodic profits with an ultimate disposition of equity interests, the corporate form may be the preferred choice of entity structure for U.S.-based operations.

8. What Are The Likely Exit Strategies?

Federal income taxation of the Chinese business owner's ultimate disposition of the U.S. business operations is also a critical factor in selecting the appropriate business entity. If the Chinese business owner's expected goal for disposition of the business is to cause them to be acquired by a U.S. corporation or by way of the issuance of stock in an initial public offering, operating the business in U.S. domestic corporate form may be desirable to provide tax deferral of any capital gain.

However, where the Chinese business owner's plans may be to operate the U.S. business for the realization of current cash flow from operations, and likely ultimately sell the assets of the business, an LLC or LP structure may be more appropriate.

As can be seen, there is no magic formula for the choice of a foreign owned business entity to conduct operations in the United States. The business owner and business advisors must address many questions related to the business and financial goals of the Company when considering the appropriate structure for U.S.-based operations.

KEYS TO U.S. CONSUMERS • As legal advisors and counselors, we strive to provide our clients with more than just technical, narrow legal advice. In addition to legal considerations just outlined to enhance the chances of success of a Chinese business venture in the United States, please allow me to offer a few non-legal, but very important ways in which doing business in the U.S. market may be considerably different than doing business in the Chinese market. Even the greatest legal structure, which saves the most in taxes, will be dwarfed without these considerations.

Quality

Americans are spoiled by quality goods at reasonable prices. Chinese manufacturers have mastered this art, so the United States can only learn from China. However, the U.S. market insists on a manufacturer standing behind its products. Warranty support and consumer services are expected.

Decision Making

Although every company is structured differently, many U.S. companies act fast and decisively to meet market challenges. Many companies decisions are made at the local level since decentralization and local decision making provides efficient, speedy action.

Branding

United States consumers trust, and will pay more for, the power of a strong, quality brand. We will pay $1-2 more for a box of Kellogg's cereal than a private label store brand.

Market Research

Many U.S. companies trust and rely on extensive market research on consumer tastes and wishes. United States companies attempt to give the consumer what he or she wants as opposed to telling the consumer what he or she *should* want.

Community Involvement

Many successful U.S. companies give back to the community, whether out of pure conviction or savvy necessity. Sponsoring high-profile community events or contributing to worthy causes reduces skepticism of being foreign and helps gain consumer awareness and acceptance. This positive and constructive form of influence is widely accepted and admitted in the United States. Behind-the-scenes bribing, blandishment, and influence-peddling, while they certainly occur, are not considered honorable conduct, and typically fail.

VENTURE CAPITAL/PRIVATE EQUITY INVESTMENT • The terms "private equity" and "venture capital" are often used interchangeably, but they represent completely different investment strategies. Venture capital investments typically represent early stage investments in explosive-growth industries such as biomedical. Given the nature and stage of the targeted portfolio companies, many of which have not yet generated meaningful or any revenue, the size of a venture capital initial investment is relatively small and the use of debt (or "leverage") is rare. However, the size of the venture capital industry in the United States is enormous. In 2007, there were 3,918 venture capital transactions and an estimate of $30.7 billion in volume. Through two quarters of 2008, 1,967 venture capital transactions have taken place worth an estimated $14.9 billion. (All figures from the MoneyTree Report, published by PriceWaterhouseCoopers and the National Venture Capital Association.) Venture capital investments rarely confer actual control on the investor, although many devices exist to provide some degree of control which may increase as circumstances warrant.

Private equity, on the other hand, usually involves the purchase of at least a controlling interest in an operating business. The business might be at all stages, from early stage, growth stage, mature, or turnaround, but the investment typically is less risky than a venture capital investment since the investor will have control and the product or service might have been proven yet more risky since a considerable amount of debt is typically deployed to make the acquisition and in many cases the business is either mature or a turnaround.

Higher rewards have justified the higher risks that venture investors have taken. Over the past 10 years, an early or seed venture fund has enjoyed a 38.3 percent annual return, a balanced fund has received a 16.8 percent annual return, and a later-stage investor only a 9.4 percent return. (These figures are from the National Venture Capital Association and Thomson.) Private equity investors, however, have only earned an 11.2 percent annual return over that 10-year period (during which the NASDAQ has returned 7.1 percent annually and the S&P 500 7.5 percent). Perspective is important. Five-year returns for all venture capital funds continue to be a negative number (less than one percent per year) and one-year returns a positive 10.8 percent, whereas the five-year return for all private equity funds is 5.9 percent and one-year return escalates to 19 percent.

Numerous structural factors underlie a venture capital or private equity investment. Appendix 3 attached hereto outlines many of the key items. (A more detailed article on this subject, which I co-authored with Scott Guan, will appear in the December issue of The Practical Lawyer.) We hope that this thorough deconstruction of the significant structural and motivational underpinnings of this major source of finance will help facilitate cross-border investments, provide fertile ground for critical self-examination and improvement, and offer insights to those seeking venture capital financing to appeal to the needs of their future partners.

Appendix 1
Outline Of A Chinese Perspective Of Doing Business In The United States

• General:
__ Very few rules;
__ Very few delays;
__ Very little corruption;
__ Very much transparency;
__ Very business friendly.

• Overall regulation:
__ Source of laws (constitution, statutes, regulations, common law);
__ Promulgators of laws (federal, state, local, administrative);
__ Mutual respect, comity, preemption.

• Specific foreign investment laws:
__ Antitrust;
__ Franchising;
__ Securities;
__ Consumer product safety;
__ Exon-Florio;
__ Export license requirements;
__ Foreign Trade Zone Act;
__ Anti-boycott laws;
__ Buy America Act;
__ USA PATRIOT Act;
__ Immigration;
__ Very few prohibitions on foreign investment but some critical industries have ownership limitations.

• Contract formation:
__ Simple formalities;
__ No registration or approvals except in limited circumstances.

• Contract enforcement:
__ Language;
__ Jurisdiction and venue;
__ Rules;
__ Mediation or arbitration vs. judicial;
__ Costs;
__ Enforcement of judgments/orders;
__ Alternative deadlock mechanisms.

• Choice of entity:
__ Branch;
__ Corporation (subsidiary or sister);
__ Limited liability company;
__ Limited partnership;
__ Costs, timing, and reporting requirements of each;
__ Responsibilities of directors and officers;
__ See tax matters immediately below for considerations.

• Taxation:
__ General principles of U.S. taxation;
__ Federal, state, and local income, and other taxes and credits;
__ Foreign tax credits;
__ Taxation of foreign entities in United States;
__ Major tax questions to determine choice of business entity.

• Imports to United States:
__ Assessment of duties;
__ Categories of goods;
__ Valuation;
__ Avoiding customs penalties;
__ Role of customs brokers and attorneys.

• Basic U.S. employment law:
__ Fair Labor Standards Act;
__ Equal Pay Act;
__ Immigration Reform and Control Act;
__ Occupational Safety and Health Act;
__ Civil Rights Act;
__ Americans with Disabilities Act;

__ Age Discrimination in Employment Act;
__ Consolidated Omnibus Budget Reconciliation Act;
__ Family and Medical Leave Act;
__ Employee Retirement Income Security Act;
__ Worker Adjustment and Retraining Notification Act;
__ State and local laws;
__ Implied and written contracts;
__ Policies, handbooks, and manuals;
__ Course of conduct;
__ Other compensation (options, bonus plans).

- Immigration laws:

__ Employer liability;
__ Prohibition on discrimination;
__ Non-immigrant working visas;
__ Temporary visitors for business or pleasure;
__ E Visas for treaty traders and treaty investors;
__ H-1B Visas for Specialty Occupation Workers;
__ H-3 for Trainee;
__ L Visas for Intra-Company;
__ Immigrant Working Visas;
__ Skilled, Professional, and Other;
__ Advanced Degrees;
__ Priority Workers (EB-1).

- Intellectual property rights:

__ Source of protection—
__ Registration and common law;
__ Patents;
__ Trademarks, trade dress;
__ Copyrights;
__ Trade secrets;
__ Steps to protect confidential and proprietary information;
__ Damages/penalties.

- Significant differences in doing business in the United States:

__ Corruption;
__ Administration;
__ Decentralization of decision making—lack of hierarchy;
__ Rapt attention to corporate feedback;
__ Importance of brands;
__ Warranty;
__ Damages/penalties.

- Key needs of venture capital/private equity investors:

__ Structure of transaction;
__ Participation feature;
__ Dilution protection;
__ Governance;
__ Blocking rights;
__ Exit strategies.

- Key needs of a VC/PE:

__ Valuation;
__ Management team;
__ Business model;
__ Technology or product;
__ Competition;
__ Size of potential market.

Appendix 2

Comparison Of Business Entities

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
I. Formation					
A. Method	Articles of Incorporation	Articles of Incorporation	None	Partnership Agreement	Articles of Organization
B. Owner Eligibility					
1. Number of Owners	No limit	75 for tax years beginning before 2005; 100 thereafter	One	Two or more partners, at least one of whom is general partner	No limit
2. Type of Owners	No limitation	Only individuals and certain trusts and estates for tax years beginning before 1998; certain tax-exempt organizations as well for tax years beginning after 1997	Individual	No limitation	No limitation
3. Affiliate Limits	No limitation	No subsidiaries (except name holding) for tax years beginning before 1997, may own subsidiaries and qualified Subchapter-S subsidiary is treated as same tax entity as parent	No limitation	No limitation	No limitation

Applicable Factor	C-Corporation	S-Corporation	Sole Proprietor	Partnership	Limited Liability Company
C. Capital Structure					
1. Equity	No limitation (multiple classes permitted)	Only one class of stock	No stock	No limitations (multiple classes)	No limitations
2. Debt	No specific limits on debt/equity ratio	Safe-harbor for debt	No specific limits	No specific limits	No specific limits
D. Status Determination					
1. Election by Entity	No election requirement	Required election	No election requirements	No election requirement, but state law filing	No election requirement
2. Owner Consents	None required	Consent required	None required	None required	None required
E. Liability	Limited to shareholder's capital contributions	Limited to shareholder's capital contributions	Unlimited	General partners jointly and severally liable. Limited partners generally limited to capital contributions	Limited to member's capital contributions
II. Operational Phase					
A. Tax Year	Any year permitted (limit for personal service corporation)	Generally calendar year	Calendar year	Generally calendar year	Generally calendar year
B. Tax on Income	Corporate level	Shareholder level	Individual level	Partner level	Member level

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
C. Elections	Corporate level	Corporate level	Individual level	Partnership level	Corporate level
D. Allocation of Income/Deductions	Not permitted (except through multiple equity structure)	Not permitted (except through debt/equity structure)	N/A	Permitted if substantial economic effect	Permitted if substantial economic effect
E. Character of Income/Deductions	No flow-through to shareholders	Flow-through to share-holders	Flow-through to individual	Flow-through to partners	Flow-through to members
F. Net Operating Losses	No flow-through	Flow-through to share-holders (limited to basis)	Flow-through to individual	Flow-through to partners (limited to basis)	Flow-through to members (limited to basis)
G. Net Capital Losses	No flow-through, but 3-year carryback and 5-year carryforward	Flow-through to share-holders	Flow-through to individual	Flow-through to partners	Flow-through to members
H. Effect of Statutory Limitations	Imposed at corporate level	Imposed at shareholder level	Imposed at individual level	Imposed at partner level	Imposed at member level
III. Compensation Arrangements					
A. Fringe Benefits	Shareholder-officers qualify for benefits	Certain benefits includible in 2 percent of shareholder's income	Generally subject to limits applicable to individuals	Limited participation for partners	Limited participation for partners

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
B. Retirement Benefits	Shareholder-officers included in qualified plans	Certain limits on shareholder-employees; ESOPs available for tax years beginning after 1997 (although certain special tax breaks available to C-corporations will not be available)	Generally subject to limits applicable to individuals	Certain limits applicable to partners	Certain limits applicable to members
C. Reasonable Compensation Limits	Applicable to shareholder-employees	Applicable to shareholder-employees	N/A	May be applicable in a family partnership context where capital is a material factor	May be applicable in a family LLC context where capital is a material factor
IV. Transactions with Owners					
A. Distribution of Cash	Dividends to extent of earnings and profits	No effect until previously taxed income fully recovered	No effect	No effect except in calculation of basis	No effect except in calculation of basis
B. Distribution of Property	Dividend treatment; gain recognition to entity	Gain recognition to entity	No effect	No gain or loss to entity, but partners may recognize gain on certain appreciated property distributions	No gain or loss to entity, but members may recognize gain on certain depreciated property distributions
C. Purchase of Owner's Interest					
1. Partial Interest	Probable dividend treatment	Tax-free; but gain for proceeds in excess of basis	N/A	N/A	N/A

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
2. Entire Interest	Capital gain treatment with exceptions	Capital gain treatment after basis recovered	Cannot sell entity interest; sale of business is viewed as a sale of each asset	Capital gain treatment except ordinary income for ordinary income assets and certain payments to retiring or deceased partners	Capital gain treatment except ordinary income for ordinary income assets and certain payments to retiring or deceased members
D. Property Sales to Entity by Owner	Possible dividend treatment or contributions to capital	Any excess value treated as distribution or contribution	N/A	Any excess value treated as distribution or contribution	Any excess value treated as distribution or contribution
E. Property Sales to Owner by Entity	Possible dividend treatment or contributions to capital	Any excess value treated as distribution or contribution	N/A	Any excess value treated as distribution or contribution	Any excess value treated as distribution or contribution
V. Termination of Entity or Owner Interest					

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
A. Sale of Interest by Owner to Third Person	Capital gain; no effect on basis of corporation's assets	Capital gain; no effect on basis of corporation's assets	Cannot sell entity interest; sale of business is viewed as a sale of each asset	Capital gain, subject to §751 ordinary income categorization and elective basis adjustment for partnership assets	Capital gain, subject to §751 ordinary income categorization and elective basis adjustment for LLC assets
B. Death of Owner	Estate continues as shareholder: FMV at date of death (or alternate valuation date) is a basis for shares; no effect on basis of corporation's assets	Estate continues as shareholder: FMV at date of death (or alternate valuation date) is a basis for shares; no effect on basis of corporation's assets	Estate takes over business	Estate as partner subject to agreement, FMV at date of death is basis for interest	Estate as member subject to agreement, FMV at date of death is basis for interest
C. Liquidation Distributions					
1. Effect to Distributor	Gain recognition if appreciated property distributed; no increase in shareholder basis for gain	Gain recognition if appreciated property distributed; increase in shareholder basis for gain	N/A	No gain recognition on asset distributions	No gain recognition on asset distributions

Applicable Factor	**C-Corporation**	**S-Corporation**	**Sole Proprietor**	**Partnership**	**Limited Liability Company**
2. Effect to Recipient	Capital gain on excess value received over basis	Capital gain on excess value received over basis	N/A	Elective substituted basis in assets equal to basis in partnership interest; gain may be recognized depending on assets distributed	Elective substituted basis in assets equal to basis in LLC interest; gain may be recognized depending on assets distributed
D. Reorganizations	Tax-free to shareholders if qualifying under reorganization provisions (§354 and §368)	Tax-free to shareholders if qualifying under reorganization provisions (§354 and §368)	N/A	No taxability on merger of partnership	No taxability on merger of LLC
E. Carryover of Tax Attributes	Carryover of tax attributes to successor entity if tax-free reorganization	Carryover of tax attributes to successor entity if tax-free reorganization	N/A	N/A	N/A

APPENDIX 3

Outline Of Items To Evaluate For Private Equity Investment In Target Company

These issues are highlighted for discussion purposes only, do not constitute any recommendation, and are intended to elicit discussion so that the goals and objectives, and risks and benefits, of a possible investment may be better evaluated and considered. Please consider the following issues, listed in no particular order.

- Nature of investors:

__ One or multiple;
__ Professional fund or wealthy individuals;
__ Knowledge of industry or general well-rounded expertise;
__ Investor characteristics—"helpful" or hands-off;
__ Follow-on investment capability.

- Timing of investment:

__ After tender;
__ After one or more transactions;
__ Permitted by bank documents;
__ If price is higher than at tender, sufficient time lapse;
__ Milestones;
__ One transaction, if possible, i.e., tender as part of a recap.

- Solicitation of investors:

__ Investment bank strategy;
__ Special board committee.

- Amount of investment:

__ Capitalization issues—bank considerations;
__ Control or non-control;
__ Valuation;
__ Use of Proceeds:
Tender;
Further redemptions;
Dividends;
Working capital;
Debt reduction;
Corporate opportunities.
__ Timing issues—one or multiple drawdowns;
__ Purchase at target parent level or only at selected subsidiaries.

- Type of security:

__ Straight mezzanine debt and warrants;
__ Convertible debt;
__ Participating preferred;

__ Convertible preferred;
__ Common.

• Dividends:
__ Coupon;
__ Cumulative;
__ Forfeit on conversion.

• Dilution protection:
__ Preemptive rights;
__ Exclusions;
__ Weighted average vs. ratchet;
__ Pay to play.

• Board representation:
__ Number of seats;
__ Blocking rights;
__ Special committees (compensation/audit).

• Protective provisions:
__ Depends on total ownership;
__ Specific major items (sale, merger, additional equity issuances, borrowings, senior capital, capital spending, acquisitions, divestitures, IPO, new businesses, auditor);
__ Threshold ownership requirement to maintain.

• Information rights:
__ Regular financial reporting;
__ Key developments regarding sale and acquisition activity;
__ Capital expenditures;
__ Budgets.

• Operational and incentives:
__ Adjustments to key executive compensation;
__ Employment agreements;
__ Non-competes/confidentiality agreements in place;
__ Option pool;

• Exit strategy:
__ Registration rights:
    Demand;
    Piggyback;
    Time;

Threshold.

__ Redemption:

Optional;

Mandatory;

Consequences of default on redemption.

__ Sale rights and restrictions:

Company and existing shareholders with first right of refusal;

Tag-along and drag-along rights.

- Due Diligence:

__ Financial;
__ Operational;
__ Legal;
__ Tax;
__ Regulatory.

- Macro market conditions:

__ Timing considerations;
__ Valuation implications;
__ Investor flexibility on target specific needs.

- Costs of an equity investment/recapitalization:

__ Investor fees;
__ Investment banking;
__ Legal;
__ Other.