Foreign qualification: what it means, why to qualify

By André Thiollier and Aaron Bonner

One of the first things a US-based entrepreneur must think about is where to incorporate (see our article on where to incorporate). Related to that initial decision, however, is whether a "foreign qualification" is required. This article explains what it means to qualify as a foreign corporation and what is needed to get properly qualified as a foreign corporation.

What is foreign qualification?

The term "foreign qualification" is slightly misleading. A not uncommon belief is that it refers only to companies with operations reaching outside the US. As it happens, though, for corporations, limited liability companies and limited partnerships, "foreign" essentially means *transacting business outside of the state in which your company is incorporated*.

For instance, suppose you form your company in Delaware (see our article discussing why most investors prefer Delaware as the state of incorporation). Your company is therefore considered to be a domestic company in Delaware but in every other US state it is considered to be a foreign company.

Without the appropriate foreign qualification, your company cannot lawfully transact business outside the state in which your company is incorporated.

What constitutes transacting business?

The rules differ from state to state, but generally your company is transacting business in another state if it is engaged in commercial activity in that state. That could mean having sales in excess of a certain amount deriving from that state, having employees or real property located in that state, or carrying out corporate acts or entering into contracts within the state's boundaries. A useful rule of thumb: if your company is actively engaging in any transaction, maintaining tangible property or generating income in a particular state, chances are that it needs to be qualified as a foreign corporation in that state.

What risks does my company face for doing business without qualification?

The consequences of transacting business without being qualified to do so can be severe, ranging from substantial fines to harsh penalties for your company's officers and board of directors. In California, for example, you must pay a late-qualification penalty, in addition to *per day* penalties when unauthorized business is transacted. The company also remains responsible for paying filing fees and taxes that should have been paid during the period in which the company unlawfully transacted business. Additionally, failure to qualify may inhibit your company from settling legal disputes in some states' courts, which could potentially cost your company significant amounts of money.

A failure to qualify could also potentially impact your company's liability assessment; in the event of a proposed sale, a prospective buyer could use that liability as a means to reduce the offer price or an excuse to withdraw the offer altogether.

How to qualify to do business in another state

To qualify to transact business in another state, you must register to transact business in that state and pay the required qualification fees. As part of the process, you must also submit a written form designated by the state, setting out certain information about the company and its officers and directors, along with a certificate of good standing from the state where your company was formed. You must also designate a registered agent who resides in the state to receive legal documents on your company's behalf while you conduct business in that state. Once your company is registered in a state, you must report and pay state income and sales taxes, as well as comply with state employment tax filings.

Key takeaway

This description makes the process seem daunting, but in practice, the states have made it simple and straightforward, and there are a number of vendors who can help as you scale. The key is to think proactively from the start about qualifying to do business in the states where you operate. Many companies routinely qualify to do business as part of their formation process and then continue to apply for qualifications throughout the business life cycle, often with the help of vendors.
