USA

Legal overview

Introduction

Except where there is a special legislative act, all U.S. companies are formed pursuant to the statutory laws of one of the fifty states of the United States, the District of Columbia, or one of the several U.S. territories and possessions. The territories include the U.S. Virgin Islands, Puerto Rico, Guam, American Samoa, and the Northern Mariana Islands. This chapter will primarily focus on the law of corporate formation and maintenance in just two states: New York and Delaware.

While there are special, and very favorable, federal income tax and privacy advantages available to U.S. citizens and foreign persons who form entities in certain U.S. territories, most notably the U.S. Virgin Islands and Puerto Rico, by far the U.S. jurisdiction with the highest number of corporate formations is the State of Delaware. Delaware typically is home to almost half of the U.S. entities formed each year. There are several reasons for this. The most important is simply that Delaware established itself by the early 20th century as a friendly and inexpensive place to form corporations and, later, other entities. And Delaware has been the leader ever since. In addition, and also very important to its popularity, Delaware does not impose a state level corporate income tax on corporations that do not conduct business in that state. In addition, Delaware is popular because it is not necessary to reveal to the government or on the public record the identity of the beneficial owner of a corporation or other entity when it is formed in Delaware, although this is true of nearly every other U.S. state and territory as well. Finally, Delaware is considered to have one of the most sophisticated corporate laws in the United States and a state court, the Delaware Court of Chancery, which specializes in corporate legal issues and has a long history of well-respected corporate jurisprudence.

In addition to Delaware, this chapter will also discuss the law of the State of New York. New York is included because it is the legal home jurisdiction of numerous large domestic and international companies, many of which are listed on stock exchanges. This factor alone makes the New York corporate law more important than that of many other jurisdictions. Also, primarily for this reason,

New York courts have decided more than their share of corporate law issues. This has resulted in New York having a very sophisticated and extensive common law with regard to corporations, making it similar to Delaware in that regard.

It is worthy of note, however, that the laws of most states and territories have substantially more similarities to the laws of New York and Delaware than they have differences. In determining where a U.S. company should be established, a businessperson needs to consider where, if anywhere, the company needs to establish a physical presence in the United States, as well as other factors such as taxation. While there may be particular provisions of the laws of other states that will impact on this determination, many of the details presented in this chapter will also apply to corporations or limited liability companies established in U.S. states and territories other than New York and Delaware.

Entity Selection

There are numerous types of entities that may be formed in Delaware or New York including, most importantly, the following: corporation; limited liability company ("LLC"); limited partnership ("LP"); limited liability partnership ("LLP"); and limited liability limited partnership ("LLLP") (not available in New York). Forming or registering any of these five types of entities, each of which features limited liability for some or all of the owners, requires an administrative and filing process which involves the corporate office of the Secretary of State of the jurisdiction of formation.

Business can also be done by sole proprietorship and general partnership but it should be noted that these forms of business do not provide limited liability to owners. Therefore they have been effectively replaced by LLC, LLP and LLLPs.

It is also possible for an entity formed in, or under the law of, another jurisdiction, whether a foreign country or another U.S. state or territory, to register or qualify to conduct business in Delaware, New York, or other states or territories. Upon registration, such a foreign entity is treated for purposes of Delaware or New York law in the same manner, and in many cases with the same or similar tax result, as that of a domestic entity, i.e., an entity formed under the law of, and operating in, one of those two states.

Corporation

A corporation is the traditional form of incorporated entity and the law regarding this type of entity is well developed in all of the U.S. states and territories, and, in particular, in New York and

Delaware. Typically a corporation will have at least a president or a chief executive officer and a secretary, and many will also have a treasurer or chief financial officer and one or more vice-presidents. All of the individuals associated with a corporation, including shareholders, directors, and officers, are protected from liabilities incurred by or on behalf of the entity.

Limited Liability Company

Unlike a corporation, the owners of an LLC are called members. The members may, but need not, appoint one or more managers to operate the company. If managers are not appointed, then the members themselves operate the company directly. When comparing an LLC and a corporation, it is best to think of LLC managers as including the roles of both directors and officers of a corporation. Members and managers of an LLC generally are protected from the liabilities of the company, although it is possible (but extremely rare) for the formation documents of an LLC to provide otherwise with respect to members. The most important difference between a corporation and an LLC is that, for federal tax purposes (and for the purposes of taxation in most states, including Delaware and New York), a corporation is a separately taxable entity while an LLC is not taxed at all; rather, the tax on the profits of an LLC "passes through" the entity and is charged directly to its members in a manner similar to that of a sole proprietorship or partnership. It should also be noted that a single member LLC (i.e., an LLC owned by only one person or entity) is completely disregarded for federal tax purposes.

General Partnership

A general partnership consists of two or more individuals or entities that conduct a business together and share in its profits. The partners of a general partnership are liable for the debts of the entity. A general partnership may be formed by an agreement among all of the partners, which may or may not be in writing. If it is in writing (which is typical), then it must be agreed to by all of the partners and it is usually called a partnership agreement or a joint venture agreement. State law governs the relationships among partners, how profits and losses are shared, and other matters, but a partnership agreement may, and usually does, alter the default rules that are contained in the statute.

Limited Partnership

An LP is identical to a general partnership except that it has two types of partners: at least one general partner and at least one limited partner. The general partners have unlimited liability and

they are charged with managing the partnership and conducting the LP's business. The limited partners' liability is limited to the amount of their capital contributions and they are not allowed to participate in the operation or management of the LP. The affairs of a limited partnership are governed by a limited partnership agreement.

Limited Liability Limited Partnership

This type of entity only exists in a few states and territories, including Delaware and the U.S. Virgin Islands. It does not exist in the state of New York. An LLLP is identical to an LP except that the general partner of an LLLP has limited liability, the same as a limited partner in an LP.

Limited Liability Partnership

This type of entity is similar to a general partnership except that all of the partners have limited liability, i.e., the partners are not generally liable for the debts and obligations of the entity. As with general partnerships and LPs, and LLLPs, an LLP will usually have a written partnership agreement that governs its affairs.

Sole proprietorship

A sole proprietorship is simply another name for an individual doing business on his own. No agreements or filings are required of a sole proprietorship (except for a trade name registration filing, if applicable) and the proprietor has unlimited liability.

The balance of this chapter will focus on the two most widely used forms of entity created and used in New York and Delaware: the corporation and the LLC.

Entity Formation; Organizational Documents

New York

A corporation is formed in New York by filing a certificate of incorporation with the Secretary of State of the State of New York. This basic document is required to contain the following information:

- Name of the corporation
- Purpose or the purposes for which it is formed
- County within the state where corporation's office is to be located
- Description of the shares of the corporation, including number, class, and par value

- Designation of the secretary of the state as agent of the corporation for the receipt of service of process
- Duration of the corporation if other than perpetual
- Optionally, other matters relating to its business, affairs, rights, and powers that are not inconsistent with law

A New York corporation must also adopt by-laws to govern various aspects of its management, the conduct of its affairs, and the rights and powers of shareholders, directors or officers not inconsistent with the certificate of incorporation or with law. By-laws typically contain descriptions and rules with regard to at least the following:

- Offices and officers
- Meetings of shareholders
- Duties of directors
- Election and power of officers
- Stock
- Indemnification of officers and directors
- A New York LLC is formed by filing articles of organization with the Secretary of State. This document must contain the following:

- Name of the LLC
- County within the state in which the LLC's office is to be located
- Designation of the secretary of state as agent of the LLC for the receipt of service of process
- Optionally, any other provision, not inconsistent with law, that regulates the internal affairs of the LLC

A New York LLC may, but is not required to, adopt an "operating agreement." The operating agreement is a statutory agreement between the company and its members which generally governs the management and operation of the company. In the absence of an operating agreement, New York State statutes provide the default rules.

Delaware

A corporation is formed in Delaware by filing a certificate of incorporation with the Secretary of State of the State of Delaware. This basic document is required to contain the following information:

- Name of the corporation
- Address the corporation's registered office in Delaware and the name of its registered agent for service of process at that address

- The nature of the business of the corporation or its purposes to be conducted or promoted, or a statement that it may engage in any lawful act or activity
- A statement of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof
- Name and mailing address of the incorporator or incorporators
- Optionally, other matters relating to its business, affairs, rights, and powers, and those of its directors or stockholders that are not inconsistent with law
- As in New York, a Delaware corporation may, and usually does, also adopt by-laws to govern various aspects of its management. By-laws typically contain rules with regard to the same matters as listed above for New York corporations.

- A Delaware LLC is formed by filing a certificate of formation with the Secretary of State. This document must contain the following:

- Name of the LLC
- Address the corporation's registered office in Delaware and the name and of its registered agent for service of process at that address.
- Optionally, any other provision, not inconsistent with law, that the members desire to include.

A Delaware LLC may, but is not required to, adopt an "operating agreement." The operating agreement is a statutory agreement between the company and its members which generally governs the management and operation of the company. In the absence of an operating agreement, Delaware statutes provide the default rules.

Share Capital

The shareholders of both New York and Delaware corporations must contribute capital to the corporation, in return for which they receive "shares" of the corporation's stock. The capital contributions are accounted for as "share capital".

If shares are only of one class, they are called "common" shares, but it is possible to have multiple classes of shares, with each class having differing rights both in terms of voting and for distribution upon liquidation. Also, one or more classes of shares may be of a "preferred" class, with the preference usually relating to a first preference over common shares when dividends are paid or in the case of liquidation. All shareholders within the same class must be treated identically in terms of capital contributions for

their shares, distributions, and liquidation rights.

Shareholders are not liable to contribute to a corporation's capital beyond their initial payment for shares, thus providing the shareholders with "limited liability."

In the case of a limited liability company in either New York or Delaware, the owners (known as "members"), like shareholders of a corporation, contribute capital to the company and are not liable to contribute to an LLC's capital beyond their initial contribution, unless the LLC's operating agreement provides otherwise. In contrast to a corporation, however, the LLC operating agreement may be drafted in a completely flexible manner in terms of addressing the rights of various members to distributions of profits or upon liquidation, as well as in respect of all manner of management rights, voting rights, etc. Therefore, different members may have different rights and obligations in this regard.

Public Offer of Shares

Public offers of shares and other securities are primarily subject to regulation at the federal level in the United States, but state level securities law that do not conflict with federal law, or for transactions that are wholly conducted within a state, will often apply as well. In the State of Delaware this known as the Delaware Securities Act and in the State of New York it is commonly known as the Martin Act.

Both federal and state securities laws are intended to provide safeguards to prevent securities fraud in the issuance and sale of securities. The U.S. Securities and Exchange Commission (the "SEC") is responsible for the administration and enforcement of the U.S. securities laws. Rules and regulations promulgated by the SEC affect all aspects of the U.S. capital markets, including the issuance and after-market trading of public and private securities, the registration of brokers and dealers, investment companies and investment advisers. Issuance and trading of securities on exchanges and markets are subject to the requirements that each one promulgates.

Generally, securities may not be sold by an issuer unless the securities are registered (in the case of a public offer) or an exemption for registration is available (in the case of a private offer).

Initial public offers conducted in the United States are registered with and subject to review by the SEC. The issuer prepares a registration statement including many details that are vetted by the SEC. Only after the SEC declares the registration statement effec-

tive can sales then occur. The SEC does not approve or disapprove any securities and the responsibility for disclosure is that of the entity and its management, counsel, accountants and advisors.

Private offers are also subject to extensive regulation designed to protect investors. Generally, issuers prepare private placement or offering memoranda that contain similar disclosure information as that required for public offers but, depending on the size of the transaction and the nature of the investors, some offers are exempt from registration. SEC rules generally prohibit general solicitation and public advertising, except with respect to certain "accredited investors" (generally defined as a persons or entities with sufficient income, net worth, and investment experience to be able to appreciate and withstand the risks associated with investing). Transactions within only one state are subject to state law and each state has its own disclosure and review procedures.

General Meetings

The law of both Delaware and New York requires that shareholders shall meet annually in what is called an "annual meeting of stockholders" in the case of Delaware, or an "annual meeting of shareholders" in the case of New York. The items of business in such a meeting will usually at least include the election of company directors and a review of the company's financial situation. Additional shareholders meetings may occur for other purposes and the law in both states require that such matters as a corporate dissolution or merger, the sale of a substantial amount of assets, or other major decisions, must be approved by the shareholders. In some cases, a shareholders or stockholders meeting may be dispensed with if a sufficient number of members agree in writing.

The statutes of neither Delaware nor New York require meetings of LLC members to be held. The operating agreement of an LLC formed in either state may require such meetings, however, and may also prescribe a manner of member decision making that does not necessarily include the holding of a formal meeting.

Directors, Managers, and Officers

The management of a corporation in both Delaware or New York is vested in a board of directors elected by the shareholders, usually on an annual basis. At least one director is required and directors must be individuals, not other companies. The directors generally set policy and usually will meet on a regular basis, although no particular schedule of meetings is required. The directors elect officers who are responsible for the everyday business of the corporation. Directors may, but need not, also serve as officers. There

is substantial flexibility in the number of officers and their titles, although the most typical are president, vice-president, secretary, and treasurer. The duties of officers are typically spelled out in a company's by-laws. There are no citizenship or residency requirements for directors and officers.

An LLC, whether formed in the state of New York or Delaware, may be managed by either its members or by managers, as specified in its formation document. A member may serve as a manager. There may be any number of managers and there are no residency or citizenship requirements. If there are managers, they are elected by the members. Managers may be individuals or other companies. Optionally, the operating agreement of an LLC may also provide for officers who may act for the company and who are responsible to the managers or members.

The operating agreement of an LLC spells out which decisions may be taken by managers and which are reserved to the members; however, state law in both Delaware and New York requires that certain major decisions, such as the following, must be taken by members only:

- Admission of a member;
- Approval of the incurrence of indebtedness;
- Actions to adopt, amend, restate or revoke the articles or certificate of organization, or an operating agreement;
- Approval of the dissolution of the LLC or the sale, exchange, lease, mortgage, pledge or other transfer of all or substantially all of the assets of the LLC; and
- Approval of a merger or consolidation of the LLC.

Financing of a Company

In the case of an LLC or a corporation, and in both New York or Delaware, companies may be financed in several ways. These include initial and subsequent capital contributions of shareholders (in the case of corporations) or members (in the case of LLCs), loans from shareholders or members, and loans from banks, other financial institutions, or other unrelated third parties. In the case of a corporation, a shareholder who agrees to a particular capital contribution may be required to actually make that contribution, but absent a guarantee, the shareholder will not be liable for any debts of the company. In the case of an LLC, however, the certificate or articles of organization may provide that members may be liable for all or some of the debts of the company, although this type of provision is rare.

Commencement of Business

Corporations and LLCs formed in either New York or Delaware will usually apply for a taxpayer identification number known as a "TIN" and sometimes referred to as an Employer Identification Number or "EIN" even if the company has no employees. The TIN application is filed with the Internal Revenue Service. A TIN is needed if the company is required to file a federal income tax return, and for other purposes such as the opening of a U.S. bank account. In the case of New York, the state requires that the federal TIN be reported to the state tax authorities; in Delaware, however, corporations and LLCs are not subject to state tax at the entity level if they are not doing business in that state. An accountant or lawyer can usually obtain the TIN on behalf of its clients by online registration which takes less than one hour.

If a company is doing business in New York, the state or a locality may also require the company to obtain a business license, but this is only for certain types of businesses such as banks and other financial institutions, real estate brokers and appraisers, and certain other professional occupations or specialized vendors. If a company is doing business in Delaware, it must obtain a business license from the appropriate state agency.

If a company has employees it will need to establish a payroll. This requires registration with state agencies with regard to unemployment taxes and workers compensation schemes, as well as with the state and federal tax authorities. These registrations can be accomplished within a matter of a few days after company formation, especially if a payroll service is used.

Mergers and Acquisitions

Generally, mergers and acquisitions are negotiated and conducted by the management of the Company, often advised by investment managers or intermediaries and represented by counsel. Transactions must be approved by the governing body of the entity and may also require the approval of the shareholders or members. Where shareholder approval is required, state law in both New York and Delaware generally provides for dissenting shareholder rights. State law also imposes the fiduciary duties of care and loyalty on management officials and these responsibilities are often heightened in the context of a proposed merger or acquisition.

In a merger, where two or more companies combine to form one entity, the parties will negotiate a merger agreement that details how the merger will be accomplished and the roles and ownership rights of the respective parties after merger.

Acquisitions may include acquisition of all or substantially all of the assets of a company as well as a stock purchase where one entity buys all the stock from the holders of another entity. In the latter case, often the stock purchase will be followed by a merger to combine the two legal entities into one. The determination of whether to purchase the assets or stock of another entity is often based on tax and liability considerations.

Transfer of stock or other securities of the acquiring party as part of the consideration for the merger or acquisition subjects the transaction to applicable federal and state securities law as such issuance is considered a securities offering for regulatory purposes. As a result, the securities must be registered to be publicly offered under the Securities Act, which is a time consuming and expensive process or, in most instances for private companies, an exemption from registration may be available.

For certain large merger or acquisition transactions, federal law requires reporting to the U.S. Federal Trade Commission and the U.S. Department of Justice. There also is a waiting period so that the federal regulators can evaluate the anti-trust implications of the planned transaction. The regulators have authority to block a planned transaction where they perceive anti-trust problems.

Corporate Insolvency

In the United States, only the federal courts have jurisdiction to attend to bankruptcy matters. Thus, a bankruptcy of a corporation or LLC will be accomplished in a similar manner regardless of the state of the entity's formation or where it is operating. The fundamental goal of the federal bankruptcy laws is to give debtors a financial «fresh start» from burdensome debts. This goal is accomplished through the bankruptcy discharge, which releases debtor companies from liability for specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts.

The different types of bankruptcy proceeding are typically referred to by reference to the chapter of the U.S. Bankruptcy Code that authorizes them. For entities seeking bankruptcy protection, by far the two most popular forms of bankruptcy are a chapter 7 liquidation and a chapter 11 reorganization.

A chapter 7 liquidation, contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors subject to the rights of secured creditors. A creditor holding an unsecured claim will get a distribution from the bankruptcy

estate only if the debtor has assets and the creditor files a proof of claim with the bankruptcy court. By the conclusion of a chapter 7 proceeding, the debtor will have ceased operations, if it has not done so previously.

In contrast, a chapter 11 reorganization is typically used by a commercial enterprise that desires to continue operating a business and repay creditors concurrently through a court-approved plan of reorganization. The chapter 11 debtor usually has the exclusive right to file a plan of reorganization with the court for a period of time after it files the case and it must provide creditors with a disclosure statement containing information adequate to enable creditors to evaluate the plan. The court ultimately approves (confirms) or disapproves the plan of reorganization. Under the confirmed plan, the debtor can reduce its debts by repaying a portion of its obligations and discharging others. The debtor can also terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability. Under chapter 11, the debtor normally goes through a period of consolidation and emerges with a reduced debt load and a reorganized business.

Dissolution of Companies

Dissolution is the process of terminating the legal existence of an entity and disposing of its assets and liabilities. It may occur on a voluntary basis, or (more rarely) by action of a state government or court, or as a result of insolvency. The legal act of dissolution is followed by the so-called “winding-up” of the business, which may include prosecuting and defending lawsuits or administrative actions, settling and closing the company’s business, and resolving the relations among the various parties affected, including shareholders (or members) and creditors. During this process, liabilities must be paid and any remaining assets must be distributed among the shareholders or members.

New York

A voluntary dissolution must be approved by the directors and shareholders (in the case of a corporation), or by the members (in the case of an LLC). The entity must obtain clearance from the New York Department of Taxation confirming that all tax obligations have been met. The dissolution is commenced by filing this clearance along with a Certificate of Dissolution in the case of a corporation with the New York Department of State. In the case of an LLC, no tax clearance is required and only Articles of Dissolution must be filed with the Department of State. Nevertheless, both types of entities must fulfill their tax obligations (except in the case of an insolvency).

A non-voluntary dissolution may occur due to failure to file tax returns or pay taxes for two or more years. This would occur by action of the New York Secretary of State who will issue a proclamation in this regard.

In both scenarios the dissolved corporation might still have liabilities to, or claims against, business partners that must be resolved during the winding-up stage. By giving notice about the dissolution to the creditors, the corporation protects itself from potential future law suits. A corporation's assets may be distributed among the shareholders at the end of the winding up process, if they were not previously sold to fulfill liabilities to creditors.

Delaware

The voluntary dissolution process in Delaware is somewhat more streamlined than that of New York. It does require management approval and a majority stockholder vote for a corporation. For an LLC, the operating agreement may provide for different procedures for dissolution and for the required majority, but absent that, a written consent of members who own more than two-thirds of the interest in the profits of the company is required under Delaware law.

The dissolution is commenced in the case of a corporation by filing a Certificate of Dissolution with the Delaware Department of State. In the case of an LLC, the document is called a Certificate of Cancellation. Since the Delaware Department of State collects all corporate franchise taxes in the State of Delaware, no separate tax clearance is required. Nevertheless, as in New York, both types of entities must fulfil their tax obligations before a dissolution may be finalized (except in the case of an insolvency).

Similar to New York, following the filing of the dissolution, the winding-up commences in order to prosecute and defend lawsuits, dispose of company property, discharge the company's liabilities, and distribute any remaining assets to stockholders. A company should give notice to creditors in order to protect the rights of shareholders or members to the assets that are distributed to them. To do so, a written document must be sent directly to known claimants and a notice of dissolution must also be published in a newspaper.

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Tax overview

Company registration

Every new business, whatever its legal form, must register with the Department of State / Division of Corporations (or equivalent agency) in the state where business will be conducted. After the registration in the State, the company has to obtain a federal Employer Identification Number (EIN) with the Internal Revenue Service (IRS). Additionally, each state has its own rules and regulations for obtaining a state tax ID number if it is different from the federal EIN. Further, each state has its own tax collection agency.

Setting-up taxation

There are no setting-up costs in terms of taxation in the US except for a fee for registering the company in the Department of State / Division of Corporations of the State where business will be conducted. Different types of entities may be established which have different features in terms of taxation, liabilities, etc. Each state has different registration fees for each kind of entity.

National current benefit taxation

Corporate income tax

Federal corporate tax is applicable in the US to entities treated for tax purposes as a corporations. Beginning in the 2018 tax year, a flat rate of 21% is imposed on taxable income for those corporations, due to the approval of a major change in the tax law enacted in late 2017 popularly known as the “Tax Cuts and Jobs Act”. As mentioned before, each state and local authority has its own rules and regulations regarding how to tax business activities in their tax environment. Many of those state and local regulations are based on federal tax concepts.

Trade tax (local profits tax)

Each state and local authority has its own rules and regulations regarding how to tax business activities in their tax environment. Many of those state and local regulations are based on federal tax concepts.

Other taxes (VAT, property taxes)

In the United States, currently, there is no federal value-added **tax (VAT)** on goods or services. Instead, a sales and use tax applies in

most, but not all, US states.

Sales and use tax is charged on the transaction value. The tax collected by the business from its customers is paid to the state tax authorities by the business on the basis of a tax return, which is filed monthly, quarterly or annually.

Also, property taxes are assessed and managed by a state and local authorities. For example, in the State of Florida, property taxes are managed by the counties where the property is located. Such tax is based on different premises and are calculated depending of the value of the property. The tax revenues are distributed by the local authority (county) to different agencies, such as the fire department, school district, police department, etc.

Treaties for the avoidance of double taxation

General rules

The US has a wide range of double tax treaties that generally reduce or eliminate the withholding tax on interest, dividends and royalties that would generally apply under domestic legislation.

The wide double-taxation treaty networks cover almost all the industrialized countries and a number of others. Apart from the number of treaties, the rates negotiated for withholding tax rates are often lower than other countries manage to obtain.

Benefit distribution (national withholding taxes, international tax exemption options)

There are types of withholding tax that are imposed at various levels in the United States:

- Withholding taxes on wages;
- Withholding tax on payments to foreign persons; and
- Backup withholding on dividends and interest.

The amount of tax withheld is based on the amount of the payment subject to tax. Withholding of tax on wages includes income tax, Social Security and Medicare, and certain local or state level taxes. Certain minimum amounts of wage income are not subject to income tax withholding. Wage withholding is based on wages actually paid and employee declarations at the state and federal levels. Social Security tax withholding terminates when payments from one employer exceed the maximum wage base during the year.

Amounts withheld by payers (employers or others) must be remitted to the relevant government agency promptly. Amounts subject to withholding and taxes withheld are reported to payees and to the government annually.

Withholding on wages

In the US, withholding by employers of tax on wages is required by the federal, most state, and some local governments. Taxes withheld include federal income tax, Social Security and Medicare taxes, state income taxes, and certain other levies in a few states.

Income tax withheld on wages is based on the amount of wages less an amount for declared withholding allowances (often called exemptions). Amounts of tax withheld are determined by the employer. Tax rates and withholding tables apply separately at the federal, most state, and some local levels. The amount to be withheld is based on both the amount wages paid on any paycheck and the period covered by the paycheck. Federal and some state withholding amounts are at graduated rates, so higher wages have higher withholding percentages. Withheld income taxes are treated by employees as a payment on account of tax due for the year, which is determined on the annual income tax return filed after the end of the year. Withholdings in excess of tax so determined are refunded.

Withholding on payments to foreign persons

Companies and individuals who make certain types of payments to foreign persons must withhold federal income tax on those payments. Foreign persons include non-resident aliens, foreign corporations, and foreign partnerships. Payments subject to withholding include compensation for services, interest, dividends, rents, royalties, annuities, and certain other payments. Tax is generally withheld at 30% of the gross amount of the payment but this withholding rate may be reduced under a tax treaty. The tax withheld is usually considered a final determination and payment of tax requiring no further action or tax return by the foreign person, but the foreign entity always has the choice to file a tax return if the actual tax owing is less than the withholding made by the payer. In that case, the IRS will issue a refund check to the foreign entity.

In addition, partnerships are required to make tax payments (referred to as withholding) on behalf of foreign partners. These payments are required regardless of whether income is actually distributed to the partner. Payments are also required quarterly or at year end for business income or other undistributed income. Partnership payments on business income are treated like esti-

mated tax payments, and the foreign person must still file a U.S. tax return reporting the business income.

Tax treatment of losses

When businesses suffer losses in a calendar year, well-structured corporate tax codes allow them to deduct those losses against previous or future tax returns. These provisions are called net operating loss (NOL) carrybacks and carryforwards. While the federal tax code allows 20 years of NOL carryforwards and 2 years of NOL carrybacks, states vary widely on their net operating loss policies. Net operating loss deductions are important because many businesses operate in industries that fluctuate greatly with the business cycle. They might have very large profits one year, but then suffer losses the next year. NOL carryforwards and carrybacks help those businesses to "smooth" their income, so that tax obligations are more neutral with respect to time.

Employer obligations (salary taxes, social security)

Social Security tax is withheld from wages at a flat rate of 6.2%. Wages paid above a fixed amount each year by any one employee are not subject to Social Security tax. For 2018, this wage maximum is $128,400. Medicare tax of 1.45% is withheld from wages, with no maximum. In addition to remitting the tax withheld against employees' wages, employers are also required to pay an additional equal matching amount of Social Security taxes at the 6.2% rate and Medicare taxes at the 1.45% rate.

A few states also impose additional taxes that are withheld from wages. Wages are defined somewhat differently for different withholding tax purposes. Thus, federal income tax wages may differ from Social Security wages which may differ from state wages.

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