Executive Share Ownership Guidelines and Stock Retention Requirements Today

Share ownership guidelines for executives continue to be a common feature at an overwhelming majority of U.S. public companies. The basic premise of mandating ownership of company stock is that the interests of senior management will more closely align with those of shareholders. Whether mandated share ownership results in better individual, corporate or stock performance remains to be proven.

We have been tracking the design of share ownership guidelines at Ayco corporate partners for the past 25 years. In the early 1990s, only about a quarter of companies had guidelines, while nearly 93% of public companies now have ownership requirements for senior executives – a percentage that has remained fairly constant over the past 10 years. What has expanded are those companies with share retention requirements related to their ownership guidelines. Most commonly, retention must be maintained for stock received as compensation until targets are attained. The following reflects what we now see among the U.S. companies with ownership guidelines and/or stock retention requirements that we monitor:

- **Ownership Guidelines & Retention Requirements**: 59%
- **Share Ownership Guidelines Only**: 40%
- **Retention Requirements Only**: 1%

Design and Structure of Ownership Guidelines

This is intended to be a brief summary of share ownership guidelines and stock retention requirements in place at the U.S. public companies for which Ayco provides financial counseling or financial education services, a total of 350 organizations. The Securities and Exchange Commission (SEC) requires public companies to disclose details of their stock ownership and retention guidelines in the Compensation Discussion and Analysis (CD&A) section of proxy statements. Companies typically then also describe those executives and directors who are in compliance with the guidelines.

Most companies with stock ownership targets continue to use a “multiple of salary” approach. That is, an executive must own company stock (or stock equivalent) equal in value to a stated multiple of his or her salary as of a specified future date. A less common approach is to require ownership of a fixed number of shares or the lesser of two targets. A small number of companies use customized guidelines, including four companies that target a dollar value for their CEO and senior executives, two companies that base the target on the stock options granted over a defined period, and a few companies that use a multiple of salary plus annual bonus.
One of the inherent problems with a multiple of salary approach is that it may not work as intended when company stock price is volatile, and especially, when there has been a significant drop in share price. To address this concern, we saw some companies modify their guidelines within the past 10 years to be a specified number of shares.

We also see some companies combining both methods; approximately 6% of our survey group have a target that is the lesser of a salary multiple or a specific number of shares. An advantage of this approach is that once the guideline amount is reached, additional acquisitions are not required in the event that the company stock price falls significantly.

A slightly different approach we have seen adopted by a handful of companies is that the guidelines specify that once an executive has met their target, any drop in stock price will not necessitate acquiring additional shares.

The number and position level of executives subject to guidelines varies by company. In almost all cases, guideline amounts are tiered by position level. That is, the CEO and sometimes the Chairman have the highest ownership requirement. Most companies have several additional tiers with lower ownership levels. We saw three companies with no specified targets for the CEO (in each case due to their existing large ownership position), but with guidelines for other senior executives, and two companies with guidelines only for the CEO.

What Counts For Ownership?
In designing ownership guidelines, a company must establish what type of ownership will count. The following are commonly counted toward meeting target guidelines:

- Shares owned outright or beneficially owned by executive (or owned jointly with spouse);
- Company stock held in a 401(k) plan, ESOP, and/or Employee Stock Purchase Plan (ESPP);
- Company stock units under a nonqualified Deferred Compensation Plan or excess 401(k) plan;
- Restricted stock or restricted stock units, including (sometimes) unvested awards.

Beneficial ownership usually means that shares held in trust will be counted, at least where the executive has investment control.

Share Ownership Guidelines by Position Level
In the chart below, we have illustrated how the 350 companies in our survey group have established their targets by position level or tier. What we have called the “2nd Tier” typically are direct reports to the CEO. The “3rd Tier” are executive officers, such as senior vice-presidents. The “4th Tier” are other officers or executives. While the majority of the companies we tracked have three tiers in their guideline structure, nearly 30% have four or more tiers.

Approximately 10% of our survey group reported that they modified their ownership guidelines within the past two years, in most cases increasing the target for one or more groups or adding a retention feature.

<table>
<thead>
<tr>
<th># of Companies</th>
<th>CEO</th>
<th>2nd Tier</th>
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<th>4th Tier</th>
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<td>Multiples of Pay Target</td>
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<td>16%</td>
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<td>1.5X Salary</td>
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<td>2%</td>
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<td>2-2.5X Salary</td>
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<td>8%</td>
<td>34%</td>
<td>23%</td>
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<td>3-3.5X Salary</td>
<td>2%</td>
<td>47%</td>
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<td>4X Salary</td>
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<td>5X Salary</td>
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<td>7-8X Salary</td>
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<td>9-20X Salary</td>
<td>4%</td>
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Other Targets

| Specified Number of Shares | 8% | 8% | 8% | 9% |
| Lower Multiple or Specific # of Shares/or Dollar Amount of Shares | 5% | 6% | 6% | 7% |
| Other Metric (e.g., salary plus bonus, dollar amount, avg. # options granted) | 2% | 2% | 2% | 1% |

Are Stock Options In the Mix?
Stock options and stock appreciation rights (SARs) commonly do not count toward meeting targets. However, we saw 40 companies (about 12% of our survey group) that do count all or a portion of the “in-the-money” value of vested stock options toward meeting ownership targets.
About half of those companies that count stock options will consider only 50% or the after-tax value of the spread. Under the guidelines at two companies, an executive may elect to count the after-tax value of some or all of the vested stock options, but, in that case, the guideline target is doubled. Several of the companies with the highest target for the CEO – up to 20 times salary – generally do consider the value of some or all of vested stock options in the guideline target. The increased use of performance-based long-term incentive awards over the past five years to the detriment of time vested awards has not appeared to have much of an influence on companies’ ownership targets. However, a few companies have based the payout of a performance award – in cash or shares of company stock – depending whether the recipient had already met ownership guidelines. For example, one S&P 100 company has a provision in its performance plan that provides that payout will be in cash only if the recipient has achieved 200% of his/her share ownership target.

**Measuring Ownership**

Exactly when and how ownership levels are measured varies considerably. Most companies attempt to measure stock ownership levels at least annually. But, we also have seen companies provide for a recalculation every two or three years. Because ownership will almost always include shares owned directly and indirectly by the executive (and usually immediate family members and certain trusts), the company must solicit information from the executive confirming total ownership. Thus, the means by which stock price is measured can be important. Here again, we see a wide variety of techniques, which take into account stock price volatility as well as administrative convenience. Here are a few stock price measures we noted:

- Company stock price as of last day of a designated calendar quarter;
- Average stock price for 10 trading days before Board of Directors meeting;
- Average month-end closing price over past 3 years;
- Lower of average stock price over prior 1 year or 5 year period;
- 200-day average closing stock price.

For companies with executives who are not paid in U.S. dollars, we have seen some companies convert the executive’s salary to dollars (as of a defined date or using a 30-day average exchange rate) and then measure compliance with the target.

**Share Retention Requirements**

Totally distinct from share ownership guidelines are share retention requirements. These have mushroomed within the past seven years. We count 60% of our survey group that now have share retention requirements in place. This is more than double the number of companies that had these in place in our survey conducted five years ago. In most cases, these requirements are mandated only until a key executive achieves their target guidelines.

![How much of equity award (net of taxes) to retain until meet target](chart)

We continue to see more companies requiring key executives to retain a portion or all of shares received as compensation for a specified time period even if targets are met. We counted 35 companies (10% of the survey group) requiring key executives to retain the net after-tax gain upon the exercise of stock options or vesting of restricted stock/RSUs, or payment of other compensation in shares, even if ownership goals are achieved, for a period of one to five years. A few companies have a longer retention period, including nine companies that require a portion of shares to be held until or even beyond retirement. This is most common in the financial services industry. The premise is that this gives key executives a longer term focus and limits excessive risk.

Note that a stock retention requirement does not delay the timing of taxation for shares acquired by stock option exercise or upon the vesting of restricted stock or the payout of RSUs.

Almost all companies now have adopted policies that prohibit hedging and even pledging company stock positions, especially by Section 16 insiders and Named Executive Officers (NEOs).

**Monitoring Compliance**

In most cases, executives are required to meet their employer’s ownership targets within a five-year period. The longest timeframe to meet the targets we saw was ten years and the shortest was two years, with a small
percentage of companies using a three-year period to meet the targets. In some cases, executives are expected to show progress toward meeting the guidelines on an annual basis. Most companies now have written guidelines and, in some cases, annual monitoring statements or attestation forms for executives to complete.

While it is expected that executives will meet their targets voluntarily, many companies have expressed possible ramifications if guideline targets are not met, or even if annual progress is not made toward meeting the guidelines. These include the following:

- A portion or all of stock acquired upon option exercise or vesting of restricted stock or RSUs must be retained (35% of our survey group);
- Performance or annual bonus awards may be paid in stock (10% of the group);
- Future long-term incentive plan grants may not be made (5% of the group).

Requirements typically last as long as the key executive remains employed. Several companies (approximately 5% of our survey group) temper or reduce the guideline when the key executive is a specified age (e.g., age 55, 60 or 62) or is within one or two years of retirement. A few other companies allow the executive to request an exception for certain transactions. This may mean that stock may be disposed of, with permission, in the event of a financial hardship, to meet estate planning needs, in the event of a divorce, and sometimes, for gifts to charity or to meet educational requirements for children.

As far as disclosure, virtually all public companies now disclose ownership guideline targets or retention ratios in their annual proxy statements. Those companies where all of the Named Executive Officers (NEOs) already meet ownership guidelines disclose that fact, as well as the actual number of shares owned by each NEO and director.

Guidelines for Directors
Of the companies in our survey group that have stock ownership guidelines for executives, we count just over 75% that have similar requirements for outside directors. Frederic W. Cook & Co. reported in its 2017 Director Compensation Report that around 88% of large and mid-cap companies and a bit over 60% of small-cap companies have stock ownership guidelines for directors. Typically, a director’s ownership target will be a multiple of the annual retainer. We have seen a few companies that allow guidelines for directors to be waived, at the Board’s discretion, for new directors joining the Board from academia or government service.

Why more companies do not require their directors to own or retain company stock may relate to the fact that more of a director’s total remuneration already is tied to stock in the form of outright grants, restricted stock, stock units, or stock options.

Corporate Governance Outlook
The major corporate governance monitors – ISS and Glass Lewis – do not specifically target or recommend a specific ownership requirement. ISS has indicated that a best practice is for key executives to attain “substantive” share ownership by a certain time after appointment. Their “QuickScore” adopted in 2015 did consider the percentage/multiple of salary, at least for the CEO. For U.S. companies, a multiple of less than 3X salary for the CEO could raise the level of governance risk concern. In its latest policy updates, ISS eliminated a partial credit if the holding period for shares acquired as compensation is expressed as less than 12 months (it had been expressed as a 36-month holding period previously). Now, a company will receive full points in this score if an executive is expected to hold shares received, net of taxes, for at least 12 months or until ownership requirements are met.

Glass Lewis encourages ownership guidelines and recommends strict company policies prohibiting the hedging of company stock. Restrictions on pledging stock can depend on the exact circumstances.

Help In Meeting Guidelines
The increased utilization by many companies of restricted stock, RSUs and performance shares in place of stock options is helping executives meet their ownership requirements. This also may explain why we have been seeing a slight adjustment upwards in targets, at least for the CEO. The median ownership target for CEOs has increased from about 5X salary five years ago to about 6X salary today. For other tiered executives, the targets have remained the same or very similar.

Allowing the deferral of equity-based awards, such as restricted stock units (RSUs) or performance shares or units, also can help executives meet ownership targets. Almost all companies with guidelines count deferred share units in meeting the target. In fact, using such units can make sense for an executive attempting to meet a guideline because they are pre-tax (like shares held in a 401(k) plan), so can
“cost” less than acquiring shares by other means. Plus, the increased use of full-value shares or payment of performance awards in stock helps in achieving targets.

**A View Of Ownership Requirements**

Public companies seem to have concluded that share ownership guidelines have positive “optics” and are consistent with good corporate governance. Thus, ownership targets are an expected part of corporate compliance and equity programs. When stock prices are rising, ownership targets are often easier to attain for most senior executives. It is when company stock price plummets - or the market as a whole crashes - that ownership targets and retention requirements can seem unduly restrictive, especially since most executives are prohibited from hedging their company stock position.

It is possible that we could see public companies alter their current mix of equity compensation awards to executive officers due to the recent changes made to IRC §162(m) – the $1 million corporate tax deduction limitation. With the performance-based pay exception now eliminated (save for certain grandfathered contracts that are not materially modified), and with the definition of a “covered employee” expanded, it is possible that companies could increase time-vesting awards and decrease performance-based equity. Whether this impacts ownership targets remains to be seen. We’ll have to keep an eye on this in our future review of the allocation of long-term incentive awards (see March 2017 Digest for our last survey).

Due to the plethora of “stock drop” lawsuits, we are seeing companies limit the exposure that salaried employees have to company stock in their 401(k) plans. Yet, this has not seemed to impact executive ownership guidelines. Younger executives (especially those with college education commitments) might find that acquiring and holding company stock can create a cash flow problem. Therefore, executives must learn how they can be smart in timely meeting ownership guidelines while also reaching personal objectives. With most public companies now prohibiting the hedging and/or pledging of company stock, it makes sense for executives who are subject to guidelines to have and maintain appropriate ownership among the various vehicles that count.

If you would like sample corporate communications concerning share ownership guidelines and/or stock retention requirements, please contact us at Lbertrand@ayco.com.

**Several Fringe Benefit Tax Rules Are Changing**

A fringe benefit is an employment-related benefit that supplements salary. Such a benefit generally is taxable to employees unless it may be excluded from taxation due to Internal Revenue Code rules (i.e., IRC §132), regulations or IRS guidance. The Tax Cuts & Jobs Act (TCJA) has made changes in the tax treatment of certain fringe benefits both for employers and employees. While there likely needs to be clarification as to certain definitions and other provisions of the new law, IRS officials have confirmed that they are in the process of writing guidance on how it will affect a variety of fringe benefits.

Here’s a brief overview of some of the fringe benefits that are impacted:

- **Qualified Transportation Benefits**

  Under IRC §132(a), certain qualified transportation fringe benefits may be excluded from income. This includes transit passes, van pooling, commuting and parking related expenses provided under an employer-sponsored plan. For 2018, the maximum amount that may be excluded from income for such expenses is $260 per month, which includes any employer contributions to an arrangement, as well as employee pre-tax elections for these benefits. While the tax treatment to employees has not been changed by the TCJA, what has been changed is the employer’s deduction for the cost of transportation fringe benefits. Beginning with 2018, an employer will not be allowed to deduct for corporate tax purposes amounts excluded from an employee’s income. There is an exception to this general rule for transportation expenses that are “necessary for insuring the safety of the employee” – although exactly how this will be defined is up to future IRS guidance.

  An employer will be able to take a corporate tax deduction for transportation expenses if the employer reports amounts as taxable income to the employee. It is expected that most employers currently providing qualified transportation benefits will continue to provide them on a pre-tax basis despite the loss of the corporate tax deduction since corporate tax rates have significantly decreased.

  One minor change made by the new law relates to bicycle-related benefits. For a relatively short period of time prior to this year, up to $20 per month of qualified bicycle commuting expenses could be excludable from an employee’s gross income. These include the cost of bicycle
purchases, repairs, improvements, and storage if the bicycle was regularly used for commuting by the employee or for work-related transportation. Effective this year, however, any payment or reimbursement for these expenses will be treated as taxable income. As a result, an employer now will be able to deduct such expenses. However, this change is scheduled to sunset at the end of 2025.

- **Food, Snacks & Meals Provided by the Employer**
  Many, but not all, employers provide meals or snacks to employees, generally on the employer’s business premises. There are two distinct Internal Revenue Code (IRC) sections that exclude from income these fringe benefits. Under IRC §119, the value of meals provided to an employee (as well as a spouse or dependents) provided on the employer’s business premises and for the employer’s convenience is not taxable to the employee. In addition, IRC §132 excludes from the employee’s income the value of any de minimis fringe benefit (e.g., snacks), but which also include the value of a nondiscriminatory eating facility on or near the employer’s business location. The TCJA did not alter these exclusions from income for employees. However, it did alter the employer’s corporate deduction for these fringe benefits. Prior to 2018, an employer could deduct 50% of the expenses associated with an eating facility for the employer’s convenience and 100% of any expenses associated with nondiscriminatory de minimis fringe benefits. However, beginning with taxable year 2018 and through 2025, the employer’s deduction for the expenses of providing meals at an eating facility will be limited to 50%, and then will be entirely nondeductible beginning after 2025. It should be noted that these changes in the employer’s ability to deduct these expenses does not affect meal expenses paid or incurred while an employee is traveling on business.

- **Employee Achievement Awards**
  Most employers provide gifts, awards or recognition for length of service with the employer or for achieving certain defined targets or standards. The value of such an award that constitutes tangible personal property is not taxable to the recipient to the extent that the cost is deductible by the employer. These rules will not be changed under the new law. The maximum value of a “qualified” award which generally is available to all employees is $1,600 per employee. For awards that do not meet this standard (i.e., only provided to certain executives), the maximum exclusion amount is $400.

The law now clarifies what awards would meet the definition of “tangible personal property”. For example, it confirms that cash, cash equivalents or gift cards are not eligible for an employer’s deduction. In addition, the value of vacations, sports tickets, theater tickets, lodging, stocks, bonds or similar awards also are nondeductible if paid after 2017. These provisions are consistent with prior IRS guidance provided with regard to these types of awards. It still is possible that some awards could qualify as a non-taxable de minimis fringe benefit.

- **Entertainment Activities**
  Under existing rules, employees have not been able to take a corporate tax deduction for the costs associated with entertainment, amusement or recreation activities offered to employees. But, there has been an exception, and a deduction has been permitted under IRC §274, for those activities either (a) directly related to the employer’s business or (b) associated with the business and occurring just prior to, or right after, a bona fide business meeting or convention. In these limited situations, employers have been allowed to take a deduction for up to 50% of the expense incurred. However, the TCJA now eliminates this corporate deduction entirely for amounts paid or incurred after 2017.

There still needs to be clarification as to what constitutes an entertainment expense, which now generally will be nondeductible as opposed to a legitimate business-related expense, which may continue to be deductible.

- **Relocation and Moving Expenses**
  Certain relocation and moving expenses paid for by an employer prior to 2018 could be nontaxable to the employee. These include the payment or reimbursement for moving household items and personal effects, as well as travel expense to a new location. However, the payment for the cost of meals, the expenses of buying or selling a home, or the purchase price of a home will not qualify for tax-free treatment, per IRS guidelines (see Pub. 521). Most companies applied similar rules on a relocation program.

Effective as of January 1, 2018 and through 2025, relocation or moving expenses paid or reimbursed by an employer will now be taxable to the recipient employee. However, a tax exclusion is still available for reimbursements to active duty military members required to relocate. Companies might want to review existing relocation policies and any tax reimbursement.
- **New Family and Medical Leave Tax Credit**
  Under the Federal Family and Medical Leave Act, employees at larger companies are guaranteed up to 12 weeks of leave annually. Employers will now be entitled to claim a business tax credit for a portion of wages paid to employees who utilize an employer’s paid family and medical leave program. To qualify, a company must have a written family leave program providing all qualifying full-time employees (and part-time employees on a pro rata basis) at least two weeks of paid leave. Employers who pay at least 50% of an employee’s regular wages can claim a tax credit of 12.5% of wages paid for up to 12 weeks of family and medical leave. This credit is increased up to a maximum of 25% if the payments exceed 50% of pay. This credit is scheduled to sunset at the end of 2019. It also doesn’t apply if paid leave is mandated by state law. (States that currently offer paid family medical leave include CA, NJ, NY, and RI).

- **Proposals Not Enacted**
  There were proposals that would also have eliminated tax exclusions for education assistance, dependent care assistance, adoption assistance, childcare benefits, and housing benefits provided by employers. However, these were not incorporated into the tax law changes.

**Lawsuit over Retirement Benefits after Sale of Business Division**

Many, if not most, large companies either have sold or spun-off a business unit. One of the concerns of employees and retirees of such a business unit may have is what could happen to various earned benefits. Obviously, each situation is different; however, the concern is legitimate and often should be addressed prior to a transaction. Circumstances can also lead to litigation and here is a recent example.

John Krauter worked for Siemens for 27 years and retired as a SVP and chief financial officer. He participated in two pension plans (one qualified and one nonqualified), a 401(k) plan plus an elective nonqualified deferred compensation plan. After his employment ended, Siemens sold one of its business divisions to Sivantos, Inc. As part of the transaction, Siemens transferred to Sivantos the obligation to pay Krauter’s benefits from all four plans. Krauter was unhappy with this action and sued Siemens in a federal court in New Jersey claiming that his former employer breached its fiduciary duty under ERISA and engaged in a prohibited transaction by taking this action. He sought to recover benefits owed since he alleged that Siemens had promised him that it would be responsible for paying his pension and retirement benefits. He also claimed that he had been injured because he would not have invested in the company’s defined contribution plans if he had known they would be transferred to another entity. In addition, certain investment options under the 401(k) plan and deferred comp plan were no longer available after the transaction, and he alleged that some of the new investment options charged considerably higher management fees. However, since he had already begun to receive pension plan payments, he did not allege that Sivantos had failed to pay him any benefits he was owed.

The federal district court dismissed Krauter’s lawsuit finding that he had not asserted appropriate claims and, in addition, had not exhausted all administrative remedies. He appealed this dismissal and judges from the 3rd Circuit Federal Court of Appeals recently released their decision on his appeal (*Krauter vs. Siemens Corp.*).

The court concluded that Krauter had not documented a concrete injury he had suffered because there were no allegations that any of the plans failed to make scheduled payments. With regard to the qualified and nonqualified pension, the court concluded that he had merely hypothesized as to a harm that could occur in the future, but only if Sivantos failed to make scheduled payments. The court ruled that these allegations were merely speculative. This court had previously ruled in other cases that the risk of future negative effects on benefits is too speculative to find an ERISA violation.

With regard to the nonqualified deferred compensation plan, while it is true that certain investment options were no longer available, Krauter failed to illustrate any injury he suffered. In addition, the failure of the company to fund its rabbi trust did not prove any injury in itself. With regard to the 401(k) plan, it may have been true that the plan at Sivantos had higher management fees which may have generated less of a return than his investment in the Siemens plan. However, Krauter had rolled over his 401(k) account into an IRA. In conclusion, the appeals court found that Krauter had not proven any ERISA violation.

Finally, the court agreed that Krauter was not injured by Siemens decision not to provide him copies of the purchase and sale agreement between Siemens and Sivantos which a company is not required to provide under ERISA rules. While this case illustrates the litigation risk that all companies involved in corporate transactions potentially face, it also illustrates that any plaintiff needs to allege and prove actual harm in order to succeed.
Did You Know...

- Since the beginning of the year, U.S. public companies have announced company stock buybacks of more than $178 billion – the largest amount in any quarter, per Birinyi Associates, a market research firm. JP Morgan has predicted that S&P 500 companies will buy back a record $800 billion of their own shares in 2018.

- According to America’s Charities, a nonprofit organization, approximately $4 billion is donated to charities through workplace giving annually. Large companies with the largest charitable gift matching programs include: Apple, Boeing, ExxonMobil, General Electric, Johnson & Johnson, and PepsiCo. The organization with the highest match amount is Soros Fund Management with a 3:1 match ratio up to an annual maximum of $300,000.

- The IRS just announced that the 2018 family health savings account (HSA) maximum has been reduced to $6,850 from the previously reported $6,900 due to a change in indexing adjustments made by the recent tax reform act. The self-only HSA amount of $3,450 will remain in place.

- Mea culpa. An article in last month’s Digest on the new federal tax withholding stated that the default tax withholding for an individual who fails to submit a Form W-4 will be married with 3 allowances, per IRS Notice 2018-14. However, this is the default rule for periodic payments from a qualified retirement plan. It does not apply to other income or non-periodic payments from IRAs or an employee’s 401(k) plan. For this income, the default withholding assumes single with no allowances.

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