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A CEO's Guide to Retirement Planning

By S.L. MINTZ

Low interest rates and looming tax hikes are reshaping the way top executives think about their nest eggs. How to get the most out of a king-size savings plan.

When astute corporate chieftains look at today's rock-bottom interest rates and looming tax hikes, they aren't just thinking about their businesses. They're sizing up their retirement accounts.

CEOs of America's biggest corporations sock away retirement funds in a complex array of tax-advantaged accounts and other programs set up by their companies, often totaling in the tens of millions. And at one time or another, each CEO must make a decision: receive the money as annuity-like payments for some period of time, or take it up front in a lump sum.

Lately, interest rates and taxes are tilting the decisions toward lump-sum payments. Low interest rates mean a low discount rate for calculating the lump-sum value of a stream of future payments. (Put differently, if rates and investment returns were higher, a smaller pot of money today could fund those future payments). And with Washington poised to raise taxes on big earners, any future payments may well be subject to higher federal rates. Result: Many CEOs see a once-in-a-lifetime chance to maximize after-tax, lump-sum payments, says P. Scott Duesterdick of the Ayco Co., a Goldman Sachs subsidiary that provides financial counseling to senior executives.

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Scott Pollack for Barron's

Corporate chieftains often have tens of millions stashed in an array of retirement accounts.

Taxes and interest rates aren't the only issues, of course. CEOs must consider an assortment of factors when making the now-versus-later decision. To hear their advisors tell it, many CEOs could use a refresher course on retirement; they're preoccupied with business issues and assume, falsely, that retirement accounts will take care of themselves. Aspiring executives, meanwhile, should also take a peek into this rarefied realm of savings, just to know what may lie ahead.

As with all retirement planning, guessing what's ahead is the name of the game. The outcomes all depend on facts nobody knows in advance. "If you live to 110, you'll be happy you took an annuity," says wealth adviser Stephen Baxley of Bessemer Trust. "If you live to 68, your family might wish for a lump sum." Nevertheless, says Baxley, there is room for judgment. Poor decisions burden retirement with excessive taxes and market risk. Conversely, informed decisions sustain lifestyles and preserve legacies.

"The first question to ask is how quickly do you want to receive payments as a general creditor of your former company," says Bill Fleming, managing director in PwC's Private Company Services Practice. "How does that make you feel? Would you rather receive the income over a shorter period of time, knowing management is changing because you are leaving?"

The sums at stake call for some serious thinking. The table below lays out the retirement money held for the CEOs of America's 20 largest corporations. James Mulva of **ConocoPhillips** has the biggest stash of the bunch; the present value of his accumulated retirement benefits comes to more than $70 million, and he has another $44 million in deferred compensation. But big paydays don't all cluster near the top. At **McDonald's**, ranked 107 by revenue, CEO James Skinner steps down from the fast-food giant this month with $10 million in company retirement benefits and $38 million in deferred compensation. Like most companies, McDonald's won't say how its retiring chief is taking the money -- as a lump sum or over time. Either way, it's a lot of burgers.

King-Size Nest Eggs

Here is the present value of retirement money awaiting the chiefs of America's 20 largest companies (by revenue).

Company/Ticker	Rev (bil)	CEO	Qualified	Non-Qualified	Total	Deferred Comp Plan Balance
1. Wal-Mart Stores/WMT	$445	Michael Duke	0	0	0	$85,379,524
2. ExxonMobil/XOM	434	Rex Tillerson	$2,062,945	$52,971,978	$55,034,923	1,144,429
3. Chevron/CVX	236	John Watson	1,182,903	14,422,549	15,605,452	6,090,971
4. ConocoPhillips/COP	231	James Mulva	1,959,838	68,527,688	70,487,526	44,380,703
5. Berkshire Hathaway/BRKA	144	Warren Buffett	0	0	0	0
6. General Electric/GE	142	Jeffrey Immelt	1,331,814	46,639,393	47,971,207	5,330,180
7. Ford Motor/F	136	Alan Mulally	0	0	0	667,479
8. Bank of America/BAC	130	Brian Moynihan	224,914	6,582,962	6,807,876	2,116,059
9. Hewlett-Packard/HPQ	127	Margaret Whitman	0	0	0	0
10. AT&T/T	127	Randall Stephenson	978,127	40,542,567	41,520,694	5,480,871
11. Valero Energy/VLO	125	William Klesse	3,823	7,808,787	7,812,610	5,911,690
12. McKesson/MCK	123	John Hammergren	0	83,380,246	83,380,246	23,202,556
13. Verizon Comm/VZ	111	Lowell McAdam	1,112,334	1,678,509	2,790,843	5,934,602
14. JPMorgan Chase/JPM	111	James Dimon	103,103	316,900	420,003	138,512
15. Apple/AAPL	108	Timothy Cook	0	0	0	0
16. CVS Caremark/CVS	107	Larry Merlo	0	19,582,269	19,582,269	26,854,983
17. IBM/IBM	107	Samuel Palmisano	1,016,710	34,024,886	35,041,596	68,637,022
18. Cardinal Health/CAH	103	George Barrett	0	0	0	510,769
19. Citigroup/C	103	Vikram Pandit	0	0	0	0
[illegible]	[illegible]	Stephen Hemsley	0	10,703,229	10,703,229	7,766,319

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...Os where there is no accrued pension benefit and /or non-qualified deferred ... the proxy.

Source: Frederic W. Cook & Co., company reports

EXECUTIVES AMASS RETIREMENT MONEY under a thicket of tax laws and company policies. From CEOs on down, most salaried workers accumulate retirement benefits under so-called qualified, or tax-advantaged, plans, up to ceilings set by the Internal Revenue Service. In 2012, the contribution limit to traditional 401(k) plans is $17,000, with additional allowances for workers over 50. Ceilings next year and after may include cost-of-living increases.

The rest -- the huge majority -- of executive retirement money resides in supplemental nonqualified accounts without ceilings. Supplemental executive retirement benefits include employer-funded executive-retirement savings and deferred compensation that executives postpone until retirement.

Post-retirement, companies distribute the vast majority of qualified and nonqualified retirement assets either as lump sums or as annuities. Well-paid executives who see income fall sharply after they retire often enter lower tax brackets with smaller tax bites, which makes annuities look good. But CEOs who remain in top brackets have more to think about.

CEOs must also consider the taxes in the states where they will live, the prospects for inflation, estate planning, charitable giving, and, not least, the company's creditworthiness. Will the company be good for the dough 10 or 20 years down the line? Financial models can crunch all these variables but, alas, cannot guarantee that a lump sum or annuity is the right choice.

IRS codes used to let CEOs decide retirement questions near the end of their tenures. In 2004, Congress curtailed flexibility, moving annual elections to the year before income is deferred or company-funded pension benefits accrue. For a shrinking number of CEOs, pre-2004 rules still govern ample retirement assets accumulated before the change. In either case, retired CEOs collect deferred compensation in lump sums or in annuities subject to company plans.

Pension savings that companies set aside for top executives usually feature optional lifetime benefits. And those almost always allow continued survivor benefits, says compensation consultant George Paulin of Frederic W. Cook. Conversion terms for a surviving spouse reflect assumptions about interest rates and lifespans. Normally, when the CEO and spouse are gone, lifetime annuities pay no further benefits.

Faced with choosing a lump sum or annuity as his retirement vehicle for $1.3 million in deferred 2011 compensation, John P. Bilbrey, CEO of **Hershey**, opted for a lump sum when he eventually retires -- he turns 56 this year -- according to a source at the company. Had he gone with an annuity, instead of facing a single tax day he would pay taxes on every distribution for the term of the annuity. Until tax bills come due, his untaxed deferred income balance would fluctuate with the market. Hopefully, gains would more than offset increased tax rates over the life of the annuity.

The Bottom Line

Today's conditions may present CEOs with a once-in-a-lifetime opportunity to take after-tax, lump-sum retirement payments, rather than a lifetime stream of income.

Bilbrey declined to speak with *Barron's,* but his case illustrates some of the tricky issues faced by his peers. Retiring to a state without income tax, such as Florida or New Hampshire, could help Bilbrey shed the Pennsylvania tax liability for annuities.

But if an annuity has fewer than 10 installments, Pennsylvania may not surrender its tax claim, and the new state of residence, if it collects income tax, may claim a share also, says William P. O'Malley, a director in the Washington national tax office of McGladrey LLP, an accounting, tax, and business-consulting firm.

In other words, moving to another state may not be as appealing as it looks, and states are demanding more and more proof that you really live in the new locale. When bidding goodbye to tax authorities in one state, taxpayers should have in hand a new driver's license, voter registration, formal evidence of membership in community organizations, and proof of residence outside the high-tax state for at least six months.

A VOLATILE TAX HORIZON can scupper best-laid plans. If U.S. tax rates climb by an amount greater than Pennsylvania's tax rate, Bilbrey, even if he's basking in Florida with no state income tax, would face higher taxes on annuitized deferred income than state and federal taxes combined would levy on a lump sum at his retirement. Once a Florida resident, he would owe nothing to Pennsylvania. If fiscally strained Florida introduces an income tax in the next decade, it would change the picture for the worse.

No one can predict state or federal tax rates -- much less inflation, Bilbrey's health, or Hershey's financial condition when he's slated to collect the last hypothetical payout of deferred income. In the remote event consumers lose their appetite for chocolate, and Hershey's files for bankruptcy, Bilbrey might never see the last of his deferred income. He or his heirs would have to stand in line with other creditors.

Given the swift reversals at companies with household names like Kodak, **General Motors**, and AIG, CEOs have reason to be concerned that under duress, future boards might challenge deferred compensation. The legal costs of mustering a defense of a legitimate payout are reason enough for alarm, never mind the outcome.

Rather than leave fate up to a former employer's creditworthiness and stable tax rates, lump sums sound like logical retirement solutions for CEOs accustomed to managing uncertainty at the helm of multi-billion dollar corporations. Who knows better than a CEO how to squeeze sufficient returns from financial stakes? And who, more than a CEO, likes to control all the dials and the outcomes with an eye to diversification and inflation?

Decisions aren't so simple, however. CEOs near retirement become conservative from a personal-investment perspective, Duesterdick finds. They scour the landscape for investments suited to conservative risk appetites. And unless they step out of the comfort zone, all they see today are puny returns. If portfolios can't keep up with inflation, even comparatively modest lifestyles can force a retired CEO or surviving spouse to spend capital.

IN CLOSE CALLS, emotions sway decisions. Decades of regular paychecks endow steady annuity checks with friendly regularity. They assure income for surviving spouses who reach their 80s and 90s. Choosing annuities also shows faith that the companies won't buckle after CEOs depart.

Principal Financial Group CEO Larry Zimpleman hasn't signaled plans to retire, but he has announced his intention to take his retirement assets as an annuity. The decision reflects his "complete confidence in the company's strategy and its long-term future," says a Principal spokeswoman.

There is, however, a big catch to annuities: Lifelong annuities seldom adjust for inflation. Keeping up with prices in later years may depend on cautious management of fixed income in early years. Inflation steadily shrinks buying power. Despite tame inflation since 2000, what $1 million bought in 1990 would have cost $1.7 million in 2010.

Similarly, if a CEO elects in advance to take a lump sum and interest rates rise before the money is paid out, he will have lost some value. That risk can be hedged, says Robert Barbetti, an executive-compensation specialist at JPMorgan Private Bank. Barbetti proposes interest-rate swaps.

If interest rates drop by the time the swap is eventually settled, the CEO pays a fee to the financial institution but receives a larger lump sum. If interest rates rise, the hedge makes up the loss to the lump sum. Boards of directors can use this kind of approach to forestall a CEO's early departure.

At Lockheed Martin, CEO Robert Stevens plans to retire this December. Assets in his qualified retirement plan approach $1 million, payable only as an annuity, or roughly $90,000 a year starting at age 65.

Like most counterparts at large companies, Stevens's non-qualified assets dwarf qualified retirement assets. At year-end 2011, the company's obligation to him approached $22 million. Exchanged today for a lifetime annuity starting at age 60, that sum is worth around $1.7 million a year, subject to prevailing discount rates.

Just where is the break point after which an annuity surpasses a lump sum? It depends. Ignoring the time value of money -- the notion that a dollar today is worth more than a dollar tomorrow -- Stevens would collect after-tax annuity proceeds equal to his forgone after-tax lump sum in a bit more than 12 years, if current U.S. and Maryland tax rates hold steady. After that, every payment might resemble a hefty return on the initial investment.

However, lump sums are moving targets. Suppose Stevens can double his lump sum over 12 years, expanding it at 5% a year compounded. In that scenario, fixed annuity payments will lag far behind the lump-sum portfolio after 12 years.

If the lump sum doubles again, it would effectively outpace an annuity forever -- barring dramatic reversals. Then again, a lump sum received in 2008 might have lost 40% right off the bat.

Ultimately, the final verdict on lump sums versus annuities will always depend on risk appetites, market climates, tax rates, portfolio management, and, grim as they are to contemplate, funeral dates.

It's a tough call, but by this point in their careers, most CEOs know how to make those. Or at least they should.

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