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Agricultural Retirement Packages

This NebGuide discusses Simplified Employee Pension plans and Keogh plans as an employee benefit provided by agricultural employers.

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Retirement Plans

Various retirement packages allow pre-tax dollars to be used to save money until retirement age. The most familiar and easy to use retirement account is the Individual Retirement Account (IRA). Other accounts are Simplified Employee Pension (SEP) plans and Keogh plans.

This NebGuide discusses IRA, SEP and Keogh plans in the context of an employee benefit provided by the employer. *Table I* gives a brief summary of each plan. Information here is for educational purposes only and is not a substitute for competent legal or accounting advice.

Individual Retirement Accounts (IRA)

IRAs allow individuals to save a certain number of dollars that are then deductible from taxable income. The maximum amount which can be contributed to an IRA and considered tax deductible depends on the filing status of the individual (married filing joint or separate returns, or single) and their income. Those covered by an employer retirement plan may be entitled to only a partial deduction, or no deduction at all. IRS Publication 590, *Individual Retirement Arrangements* (IRAs), *Appendix A*, provides detailed information on the deductibility of money placed in IRAs.

Contributions to IRAs can be made anytime prior to April 15 to be considered a taxable deduction on the previous year's tax return. Money put into an IRA cannot be withdrawn before the individual reaches age 591/2, or an early withdrawal penalty will be assessed.

Simplified Employee Pension Plans (SEP)

A Simplified Employee Pension (SEP) plan is one way to compensate employees beyond wages and salary. It allows for greater contributions to an IRA than the typical limit for individuals.

SEPs offer tax savings to both the employer and employee. They are useful in attracting, retaining and compensating valued employees.

A SEP allows employers to contribute toward their own and employees' retirement. The plan must be written. IRS Form 5305-SEP, *Simplified Employee Pension - Individual Retirement Accounts Contribution Agreement*, satisfies the written agreement requirement of the law.

Table I. Retirement Account Alternatives

	IRA	*SEP-IRA*	*Keogh*		
			Defined Contribution		*Defined Benefit*
			Profit Sharing	*Money Purchase*	
Maximum employer contribution which is a deductible business expense[1]:					
percent of employee pay[2]	NA	15%	15%	25%	100%
dollars per employee	NA	$30,000	$30,000	$30,000	$102,582
Must the employer contribute every year to the employee's retirement plan?	NA	no	no	yes	yes
Frequency of contributions	annual	annual	annual	annual	quarterly
Maximum annual employee contribution or elective deferral (1991)[3]	$2,000	$8,475	$8,475	$8,475	$8,475
Is the employee fully vested[4]?	yes	yes	yes	no	no

Notes:
NA = not applicable.
[1]Employer contribution is not considered taxable income to the employee.
[2]Maximum percentage for self employed persons will be slightly less.
[3]The amount is subject to yearly change to account for inflation, this amount is subject to social security tax but not to income tax.
[4]Vested means that the employee owns the account and is fully guaranteed the benefits of the account.

Completed SEP agreements are signed and copies given to each employee. They are not filed with the Internal Revenue Service. A SEP requires that each qualifying employee set up an IRA (called a SEP-IRA). A self-employed person is an employee for this purpose. A qualifying employee is defined by the IRS as one who:

1. is at least 21 years old;
2. has worked for the employer during at least three of the last five years immediately preceding the tax year; and

3. has received from the employer at least $363 in compensation in the tax year (1991). The $363 minimum compensation is subject to change each year. Consult IRS Publication 535, *Business Expenses*, for the minimum in force for each tax year.

IRS rules generally allow agricultural employers to compensate their full-time employees with SEP-IRAs without having to compensate their seasonal employees in this way. Though employers must include qualifying employees in any SEP plan they establish, they may also choose to provide SEP-IRA contributions to "non-qualifying" employees they hire. ***Advantages of SEPs to Employers:***

- The entire amount contributed by the business is tax deductible;
- administrative costs associated with the plan are low;
- there is flexibility - the employer is not locked into an annual contribution;
- it increases compensation to employees without increasing the employer's portion of social security tax;
- it aids in attracting and retaining employees;
- it can be easily used by self-employed individuals.

Advantages of SEPs to Employees:

- The employee owns the IRA and the money in it cannot be forfeited;
- employer contributions are not currently subject to income or social security tax;
- the interest earned on the IRA is tax deferred;
- it provides for the employee's retirement.

Employer Contributions:

The employer is not required to make any contribution to the SEP-IRAs that are set up. If the employer does make a contribution to one SEP-IRA, contributions must be made to the SEP-IRAs of each qualifying employee, whether or not they are still employed at the time contributions are made.

The contributions must be based on a written allocation formula and must not discriminate in favor of officers, shareholders or highly compensated employees. If Form 5305-SEP is used to set up the plan, the contributions must be made in an amount that is the same percentage of total compensation for every employee.

Highly compensated employees are those who own more than 5 percent of the capital or profits interest in the sole-proprietorship or partnership, or more than 5 percent of the outstanding stock or more than 5 percent of the total voting power of all stock of the employer corporation. Most farm owner/operators usually would be considered highly compensated employees and cannot discriminate in favor of themselves when making a contribution to a SEP-IRA.

Each year an employer can contribute to each employee's SEP-IRA up to 15 percent of the employee's compensation, or $30,000, whichever is less. Self-employed persons can contribute a maximum of 13.04 percent to a maximum of $30,000 to their own SEP-IRA. These contributions are tax deductible expenses of the employer.

Contributions must be made by the due date of the employer's income tax return for the year in which the deduction will be claimed. The employer's contributions to the employees' SEP-IRA are not included in the employee's current income for either income tax or social security tax purposes.

Money put into a SEP-IRA cannot be withdrawn prior to the individual reaching age 591/2 or an early withdrawal penalty will be assessed. Withdrawals from the SEP-IRA upon retirement will be taxed as income.

Employee Contributions - Elective Deferral:

A SEP can include a salary reduction arrangement, called an *elective deferral*. Under this arrangement, employees can choose to have the employer contribute part of their (employee's) income to their SEP-IRA. Only the remaining portion of the employee's pay is taxable. The income tax on the contribution is deferred. IRS Form 5305A-SEP can be used to set up such an elective deferral.

Elective deferrals are available only if:

1. at least 50 percent of the qualifying employees choose elective deferrals;
2. there are no more than 25 eligible employees at any time during the preceding year; and
3. the amount deferred each year by each eligible highly compensated employee as a percentage of pay is no more than 125 percent of the average deferral percentage of all non-highly compensated employees.

The maximum amount an employee could defer under a salary reduction arrangement was $8,475, in 1991. This amount is subject to annual changes (see IRS Publication 535, *Business Expenses*, for the current year's limit). The employee contribution using an elective deferral is excluded from his/her income in the year of the deferral, but is included in wages for social security and unemployment tax purposes.

Employee Contributions - Independent of Employer:

Employees also may contribute to their SEP-IRA independent of employer contributions. These contributions may be deducted from income the same as a regular IRA. The deduction, however, is dependent on the filing status and adjusted gross income of the employee and may be reduced or eliminated because they are covered by an employer retirement plan (see IRS Publication 590, Appendix A).

Employee Withdrawals:

Contributions to a SEP-IRA are fully vested in the employee. The employee, not the employer, owns the IRA account. Employees can withdraw money in their IRA after they reach age 59 1/2, without penalty. They must begin withdrawing money from their IRA by the time they reach age 70 1/2. Penalties exist for early and late withdrawal.

Example SEP-IRA Plan for an Agricultural Employer:

A farmer has one full-time and two summer employees in addition to self-labor. A SEP-IRA can be set up for the farmer/employer and the full-time employee. If either or both of the two summer employees has worked during three of the last five years for this farmer, these employees also must be covered by a SEP-IRA plan.

If the farmer's net income was $40,000 and the full-time employee was paid $20,000, and if the farmer decided to contribute 15 percent of income to the IRA's of qualifying employees, tax deductible IRA contributions of $5,216, or 13.04 percent of $40,000, for the employer (self), and $3,000, or 15 percent of $20,000, for the full-time employee could be made.

In addition, the farmer could, through an elective deferral, make IRA contributions up to 125 percent of average deferral percentage of the employee. If the employee wanted to contribute another 5 percent of income ($1,000) through an elective deferral, the employer could contribute 6.25 percent of income ($2,500) to the employer's IRA through an elective deferral.

The taxable income for the farmer/employer has decreased from $40,000 to $32,000 through contributions to a SEP-IRA. Taxable income for the employee has decreased from $20,000 to $19,000 by electively deferring $1,000. In reality the employee received compensation of $23,000 since the $3,000 employer contribution to the employee's SEP-IRA was additional compensation to the normal $20,000 salary. Both the employer and the employee must pay their respective share of social security taxes on the amount of income placed in their IRAs through elective deferral.

Keogh Plans

A Keogh or HR-10 plan can only be set up by an employer, a sole proprietor or partnership (but not a partner). The plan covers the employer and employees. It is established for the exclusive benefit of the employees and their beneficiaries. A self-employed person is considered both an employer and an employee.

Most Keogh plans follow a standard form of plan approved by the IRS. The employer simply adopts a plan sponsored by a trade or professional association, a bank, an insurance company or a mutual fund. In setting up a Keogh plan, the employer establishes either a trust or a custodial account to invest the funds or to purchase annuity contracts from an insurance company.

There are two basic types of Keogh plans: defined contribution plans and defined benefit plans. Defined contribution plans provide benefits to the employee in relation to the amount contributed to the employee's account. Employers must contribute a specified amount (percentage of profits or of employee compensation) each year to each qualified employee's account.

Defined benefit plans provide set benefit amounts to the employee. The employer must contribute a specified amount each year to insure the defined benefit can be paid when due.

Keogh plans are more complicated and less flexible than SEP plans and differ depending on the business sponsoring the plan. Keogh plans do offer the potential advantage of allowing more money to be put into retirement accounts than can be done under a SEP plan. A maximum of $30,000 or 25 percent (compared to 15 percent under a SEP plan) of net earnings may be put into a Keogh plan depending on the type of plan arranged with the sponsor.

They are less flexible in that the employer is required to contribute to the plan each year according to plan provisions. Employees probably will not be able to withdraw money from their Keogh retirement accounts unless disabled or no longer working for the employer under whom the Keogh plan was begun.

Employers considering retirement plans for themselves and their employees should contact a bank or trust company, an insurance or investment company, or an accountant for specific information pertinent to their circumstances.

Sources of Information

- IRS Publication 535, *Business Expenses*, Chapter 4
- IRS Publication 560, *Retirement Plans for the Self-Employed*
- IRS Publication 334, *Tax Guide for Small Business*, Chapter 10
- IRS Publication 590, *Individual Retirement Arrangements*

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