



August 2011
Volume 49 Number 4
Article Number 4TOT7

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Simple Retirement Plan Options for Small Agricultural and Forestry Operations

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Abstract: Many family farm and forests are small operations with just a few employees. Retaining these employees can be difficult, and a retirement package can make a big difference in employee job satisfaction. Extension professionals ought to be aware of several simple individual retirement account options available that minimize administrative costs and paperwork. The advantages of tax deferral in retirement planning are explained. The simplified employee pension (SEP) individual retirement arrangement (IRA) and the SIMPLE IRA are described. Examples are provided of typical savings from these programs and sources for additional information are identified.

Introduction

Many family farms and forestry operations are relatively small and have just a few employees (Muhammad, Megegne, & Ekanem, 2004). Retaining these employees is important, and the typical benefit package offered by smaller operations leaves some employees dissatisfied (Gorham, DeVaney, & Bechman, 1998; Mishra, El-Osta, Morehart, Johnson, & Hopkins, 2002; O'Neill, Komar, Brumfield, & Mickel, 2010). A retirement plan is a benefit that can make a big difference, and it does not have to be a major cost or administrative burden (Becker, Trail, Lamberts, & Jimmerson, 1983; O'Neill, & Xiao, 2006).

There are some simple options (Bailey, & Turner, 2004; Breazeale & Behal, n.d.), and they can play a huge role in retirement planning for the self-employed (Goudy, 1982; Jones, 2003). There are plans, like 401(k)'s, that require considerable paperwork and often require significant company matching, but there are others that require hardly any paperwork and don't even require any matching (unless the employer chooses to match). These simple plans are discussed later in the article (Internal Revenue Service, 2010a). Extension professionals should be aware of the simpler options that small farm and timber producers might use in retirement planning. This article explains how these plans work and the basic options available. Extension professionals are not accountants, but they ought to be able to explain fundamentals to the level that a client knows the importance of retirement planning and where to seek more information.

Tax Deferral

Tax deferral is the engine that drives retirement plans. The money a farmer, timber producer, or other Extension client invests in a retirement plan and the interest it earns are not taxed until it is withdrawn. The client might say, "So what, it'll be taxed later." And, of course, he or she would be correct. Taxes will

eventually be due. But does the client expect to be in the same tax bracket after retirement? Many retirees expect lower tax brackets after retirement. So tax payments are deferred until some future date when the client expects to be subject to lower tax rates. Plus, the client may time the withdrawals to remove more money from the account in years with lower than normal income (and lower tax brackets). Without tax deferral, the client pays today's tax rates with no timing flexibility.

Contributing to a retirement plan affects the client's paycheck. Take-home pay is reduced. But a contribution of, say, \$2,400 to a retirement plan through payroll deduction reduces take-home pay by much less than \$2,600. Assume a federal tax rate of 25% and a state tax rate of 5%. By putting the \$2,400 into the retirement plan, this year's taxes are deferred. The client's taxes on that amount would have been \$720, or 30% of \$2,400. So it only cost \$1,680 to contribute the \$2,400. Or, if the client contributed \$200 monthly, his or her paycheck would only be reduced by \$140, not the full \$200.

Plus, the interest on the invested money is also tax deferred. No tax is due on interest until the money is withdrawn. Because both the principal and the interest escape taxes until withdrawal, the account balance can increase very rapidly. Consider an example of investing \$200 per month over 35 years at 6% interest and a 30% tax rate. Table 1 shows three situations and corresponding account values at 5-year intervals: an account with no tax deferral and an account with tax deferral (with corresponding amounts before taxes are paid and after taxes are paid). Notice at the end of 35 years, if taxes were paid, the tax deferred account would net an additional \$33,911, and that does not include the likely reduction in tax rate due to the ability to time withdrawals.

Table 1

Account Balance for Investment of \$200 Monthly at 6% Interest and 30% Marginal Tax Rate

Years	No Tax-Deferral No Retirement Plan After-Tax	Tax-Deferred Retirement Plan Pre-Tax	Tax-Deferred Retirement Plan After-Tax
5	\$13,327	\$13,954	\$13,368
10	\$29,763	\$32,776	\$30,143
15	\$50,031	\$58,164	\$51,515
20	\$75,027	\$92,408	\$79,086
25	\$105,852	\$138,599	\$115,019
30	\$143,867	\$200,903	\$162,232
35	\$190,748	\$284,942	\$224,659

IRA Options

The least complex retirement plan option is simplified employee pension (SEP) IRA (Internal Revenue Service, 2010b). The employer makes the contributions, not the employees. Paperwork, or the lack of it, is the big advantage. The employer completes Form 5305-SEP, and the employee completes an IRA investment application. Nothing has to be filed with the IRS, either at the beginning or over time. There need be no third party administrator.

Annual employer contributions are discretionary and can range from 0% to 25% of compensation, up to \$49,000 for 2011. All contributions are immediately vested. The employer has flexibility to change contribution levels from year to year, or to make no contribution in any year. The employer deducts contributions for himself and employees from the company's taxable income.

An example of how a SEP IRA works would be an employer who maintains a SEP IRA and declares a company contribution of 5% for 2011. One employee had compensation of \$30,000. The employer makes a contribution of \$1,500 to that employee's SEP IRA. The money immediately vests. The employer contribution is not taxable income to the employee, but is a deductible expense to the employer.

A second option is a salary reduction plan for the employer and the employees called a SIMPLE IRA. This IRA allows employees to make a salary reduction contribution, and the employer makes a matching or nonelective contribution. This plan is limited to firms with 100 or fewer employees. The employee contribution can be up to 100% of compensation, with a maximum contribution of \$11,500. A catch-up provision allows participants over age 50 to contribute an additional \$2,500.

The employer match can be by two different methods. The matching option requires the employer to match each participant's contributions dollar-for-dollar, up to 3% of compensation (but not more than \$11,500, or \$14,000 for workers over age 50, for 2011). The employer is allowed to reduce his or her match to as little as 1% for any 2 years in a 5-year time period. The second method, the non-elective contribution option, requires the employer to contribute 2% of each employee's compensation, up to a maximum of \$4,900 for 2011. This contribution is required even if the employee does not contribute.

Paperwork is minimal for this plan also. No annual forms must be filed with the IRS. Form 5305-SIMPLE is filled out, information is supplied to employees, and a form is sent to the bank, mutual fund, or financial institution that will administer the plan. Fees are usually very modest. Contributions vest immediately.

An example of a SIMPLE IRA matching contribution would be a consulting forestry firm with 20 employees that chooses a 3% dollar-for-dollar match. Only employees who make contribution to the plan are entitled to a match. One employee earns \$30,000 and decides to put 6% into the plan. He contributes \$1,800 during the year. The employer match would be 3% of \$30,000, or \$900. The plan receives total contributions of \$2,700 for the year.

A second example of a SIMPLE IRA would be the 2% nonelective contribution. All employees receive the contribution, regardless of their own contribution. One employee earns \$30,000. He does not contribute to the plan. The employer makes a contribution for him of 2% of \$30,000, or \$600. The plan receives total contributions of \$600 for the year.

Access to Their Assets

These are retirement plans, and access to the retiree's money is limited. Retirees are encouraged to save for the long term. But, like any IRA, money can be withdrawn at any time. Except for certain circumstances, withdrawals before age 59½ are subject to a 10% penalty. Of course, taxes are owed at the time of withdrawal. The SIMPLE IRA has harsh penalties for withdrawals in the first 2 years. These plans can be set up with large financial institutions that offer a wide variety of stocks, mutual funds, bonds, CD's, and other investment options.

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