

November 1991

A.E. Ext. 91-30

**CONSIDERATIONS IN
ESTABLISHING RETIREMENT
PLANS FOR FARM EMPLOYEES**

George L. Casler

Thomas R. Maloney

**Department of Agricultural Economics
New York State College of Agriculture and Life Sciences
A Statutory College of the State University
Cornell University, Ithaca, New York 14853**

It is the Policy of Cornell University actively to support equality of educational and employment opportunity. No person shall be denied admission to any educational program or activity or be denied employment on the basis of any legally prohibited discrimination involving, but not limited to, such factors as race, color, creed, religion, national or ethnic origin, sex, age or handicap. The University is committed to the maintenance of affirmative action programs which will assure the continuation of such equality of opportunity.

Corrections For

A.E. Ext. 91-30

CONSIDERATIONS IN ESTABLISHING RETIREMENT PLANS FOR FARM EMPLOYEES

Page 3

Second paragraph under **Individual Retirement Accounts** should be:

Any taxpayer with at least \$2,000 of earned income (such as salaries and wages) may contribute up to \$2,000 to an IRA. The earnings on the account accumulate on a tax-deferred basis until the money is withdrawn after age 59 1/2, and are taxed in the year of withdrawal. Taxpayers who are not active participants in a qualified retirement plan (either spouse), regardless of level of income, may also claim the IRA contribution as a deduction, which will reduce taxable income and federal and state income taxes. Married taxpayers with adjusted gross income (AGI) above \$40,000 and single taxpayers with AGI above \$25,000 who are active participants in a qualified retirement plan (either spouse) will have a phaseout of the IRA deduction, with complete phaseout at \$50,000 for married and \$35,000 for single taxpayers. Adjusted gross income is total income before subtracting the standard or itemized deductions and exemptions. Most farm employees could claim the IRA deduction even if the spouse is covered by a retirement program.

CONSIDERATIONS IN ESTABLISHING RETIREMENT PLANS FOR FARM EMPLOYEES

George L. Casler
Thomas R. Maloney*

The purpose of this bulletin is to assist farm operators and their employees in developing retirement plans for farm employees. The bulletin begins with a discussion of reasons for establishing retirement plans and moves on to Social Security, Individual Retirement Accounts and formal retirement plans in approximate order of complexity. This bulletin is not intended to be a complete description of retirement plans as they apply to farms. It is intended to cover some of the main issues related to the establishment of retirement plans for employees of farm businesses. It is written as a reference for farm employers who are considering a retirement plan for their employees. Anyone seriously contemplating the establishment of such a plan should seek advice from income tax and pension plan specialists after considering the options presented here.

Reasons for Establishing a Retirement Plan for Employees

Recent studies show that a retirement plan is one of the employee benefits provided least by farm employers. Two 1989 studies -- a Cornell University study (Maloney and Woodruff) of dairy farm employee compensation and a University of Guelph study (Howard, et al.) of hog farm employee compensation -- indicated that less than 10 percent of the employees studied received pension benefits. In contrast, a Ball State University study of small Midwest businesses revealed the use of pension plans by size of business. Nineteen percent of businesses with 1-50 employees provided pension benefits, compared with 53 percent for those with 51-100 employees. This study suggests that more small business employers may provide pension benefits than farm employers. In addition, as small businesses grow in size, there tends to be an increased use of pension programs (Hornsby and Kuratko).

Why would a farm operator be interested in establishing a retirement plan for employees? There are three reasons to add a pension program to the package of benefits offered to employees. First, pensions make employment in the business more attractive and more competitive with employment in other businesses. Employment in many businesses or other organizations, particularly ones with larger numbers of employees, offers the opportunity to participate in a retirement plan funded entirely or partially by the employer. To make employment more attractive, a farmer may want to consider establishing a retirement plan. Second, a retirement plan may encourage employees to stay with the business for longer periods of time. Third, whether employees are aware of it or not, a pension program may be critical to their long-term financial well-being in their retirement years.

*Professor and Extension Associate, respectively.

If a retirement plan is to be an effective competitive tool in attracting and holding employees, it will almost necessarily require a fairly substantial amount of money from the farm operator. In general, almost all employees will have to be covered by the retirement plan. According to federal regulations, it will be difficult or impossible to cover only one or a few highly valued employees and not cover the remainder of the employees who have been with the business more than a year or two. Therefore, the establishment of a retirement plan is a major commitment on the part of the employer.

The decision to provide employee retirement benefits should be made in the context of the overall employee compensation plan. For example, if wages are low or health insurance is not provided, perhaps those issues should be addressed before the retirement issue. Likewise, an excellent compensation package including retirement is not a substitute for good human relations. Wages and benefits alone are not likely to motivate people if they are not provided with good working conditions and positive working relationships. However, as a part of a total human resource strategy, a retirement plan can be a very important employee benefit.

Social Security

Social Security coverage is mandatory for almost all farm employees. As of 1991, the employer and employee each pay 6.2 percent into the Social Security fund on the first \$53,400 (indexed for inflation in future years) of salary or wages. Each is also subject to a 1.45 percent Medicare tax on salaries or wages up to \$125,000.

Social Security retirement benefits depend on the years the employee has been covered under the program and the wage levels during those years. At the time of retirement, the Social Security Administration (SSA) computes an Average Indexed Monthly Earnings (AIME) from which the Social Security retirement benefits are computed. There are also disability and survivors' benefits.

Social Security alone will not provide adequate retirement income for most retirees. As of 1991, the maximum benefit for a retiree at age 65 is about \$1,000 per month, with the nonworking spouse who is also 65 eligible for half this amount for a total of about \$1,500 per month. This maximum is available only for those who had earned at the maximum Social Security (SS) base all during their working career. An employee who had worked at half or less of the maximum SS base will receive a much smaller benefit. This would include most farm employees. Social Security benefits are indexed to inflation, which will be important during retirement.

Contrary to popular belief, SS is not like an annuity where benefits are totally dependent on the deposits into the annuity and the earnings on those deposits. SS benefits to current retirees are paid largely from the SS taxes on those who are paying into the system.

The SS formula is constructed so that benefits are a larger percentage of AIME at lower levels than at higher levels. That makes SS a "better buy" for employees at lower salary levels than those at higher levels. In 1991, SS benefits are 90 percent of the first

\$370 of AIME, 32 percent of the next \$1,860, and 15 percent of AIME exceeding \$2,230. These so-called "bend points" are indexed and change with inflation.

An employee who was earning \$1,750 per month, or \$21,000 per year, in 1991 and planned to retire soon likely would have an AIME of less than \$1,750. Suppose the AIME were \$1,500. SS benefits at age 65 would be:

$$\begin{array}{rcl} \$370 \times .90 & = & \$333 \\ \$1,130 \times .32 & = & \underline{362} \\ \text{Total} & & \underline{\$695} \end{array}$$

The spouse would receive half this amount, or \$347. So the total SS benefit would be \$1,042 per month, or \$12,504 per year, for the couple in this example. Retirement at age 62 would provide benefits of 80 percent of this amount, or \$834 per month or \$10,008 per year. Many farm employees would receive SS benefits substantially smaller than this because of lower wages and AIME.

While Social Security will provide important retirement benefits to most farm employees, in most cases SS alone will not provide adequate retirement benefits. The couple in the example above would have only a modest standard of living if SS were their only retirement plan. This fact should be an incentive for farm operators and their employees to be interested in retirement programs in addition to Social Security.

Individual Retirement Accounts

Participating in an Individual Retirement Account (IRA) is entirely up to the farm, or other, employee and requires no action on the part of the employer. We are interested here primarily in actions of an employer to create a retirement plan for employees, so the IRA information is provided only as background and because of its relation to Simplified Employee Pensions described later.

Any taxpayer with at least \$2,000 of earned income (such as salaries and wages) may contribute up to \$2,000 to an IRA. The earnings on the account accumulate on a tax-deferred basis until the money is withdrawn after age 59 1/2, and are taxed in the year of withdrawal. If a married taxpayer's adjusted gross income is below \$40,000 and neither the taxpayer nor the spouse is covered by a "qualified" retirement plan, the taxpayer may also claim the IRA contribution as a deduction, which will reduce taxable income and federal and state income taxes. Single taxpayers not covered by a retirement plan may take the IRA deduction if adjusted gross income is below \$25,000. There are phaseouts of the IRA deduction for incomes above these levels. Adjusted gross income is total income before subtracting the standard or itemized deductions and exemptions. Most farm employees have adjusted gross incomes below these limitations and, therefore, could claim the IRA deduction unless the spouse is covered by a retirement program.

If an employer could take some type of action to encourage an employee to contribute to an IRA, perhaps by sharing the cost of the contribution, there could be a benefit to both the employer and the employee in terms of retirement benefits to the employee

and making the employer's business a more attractive place to work. However, there may be legal complications that prevent the employer from doing this, particularly if the intent is to do it for only some employees.

Formal Retirement Programs

All retirement programs maintained by employers must operate within the rules laid down by the federal government. Many of the rules that govern retirement plans have their roots in the Employee Retirement Income Security Act (ERISA) of 1974. ERISA is largely concerned with ensuring that employees will actually receive promised benefits when they retire and that retirement programs are fairly administered. ERISA does not require employers to create and maintain pension plans. It only requires that if an employer does have a pension plan it must meet a set of standards.

Tax legislation in the Internal Revenue Code also plays an important part in governing retirement plans. The Internal Revenue Code is concerned with the income tax aspects of retirement programs. This concern primarily is related to the fact that most retirement plans include a deferral of taxation of the money that goes into employees' retirement accounts as described more fully below. Money deposited in the employee's retirement account is not taxed as part of the employee's current income. Instead, the money is taxed as it comes out of the account after the employee retires. If money is withdrawn from the account early (usually before the employee is 59 1/2 years old), it is included in taxable income as withdrawn and the employee is also liable for a penalty on the amount withdrawn.

Simplified Employee Pensions

Simplified Employee Pensions (SEPs) are actually a form of an IRA but are created by the employer. Under a SEP, the employer makes a contribution to the employee's IRA. The contribution is an expense to the employer (similar to wage expense) and is not included in the employee's taxable income. Therefore, in effect, the employee does not pay income taxes on the amount deposited in his/her SEP-IRA, and the earnings accumulate on a tax-deferred basis. Withdrawals from the SEP-IRA are taxed in the year of withdrawal. Like IRAs, withdrawals before age 59 1/2 are subject to a penalty in addition to being taxed as income.

There are several rules which the employer must obey in order to make the SEP-IRA deposits deductible as an expense and tax-deferred to the employee. The plan must cover *all* employees who are at least 21 years old, have worked for the employer during three of the last five years, and have earned \$363 or more during the year. (This is the 1991 value and is indexed to inflation each year.) The plan must not treat some employees substantially better than other employees.

The maximum amount that the employer can contribute for each employee is limited to 15 percent of compensation or \$30,000, whichever is smaller. For virtually all farm employees, the 15 percent is the relevant limit.

In addition to the SEP funded by employer contributions, the employer may create a plan under which employees may contribute additional money (subject to the 15 percent limit including employer contribution) to their SEP-IRAs through a salary reduction plan. This may be done only if (1) there were not more than 25 employees in the previous year, (2) at least 50 percent of eligible employees elect to participate in the salary reduction plan, and (3) highly compensated employees do not contribute far more to their accounts than do the lower paid employees. These restrictions, particularly (2), may make it difficult for most farmers to operate a salary reduction program along with a regular SEP-IRA program. However, an employee could contribute to an IRA subject to the deductibility limits previously stated.

SEPs have the advantage of being relatively simple and inexpensive to establish and maintain. However, the money deposited for each employee belongs to that employee. For all practical purposes, this means that each employee is vested (that is, has a right to retain the money placed in the IRA) immediately when he or she becomes eligible to be included in the SEP. There is no waiting period for the employee to become vested, so SEPs provide little encouragement for the employee to stay with the employer for a period of time to become vested. A SEP may be the "vehicle of choice" for many farmers interested in establishing a retirement plan for employees. The first step could be to call 1-800-TAX-FORM and request a copy of form 5305-SEP. This form allows a SEP to be established without a lot of red tape (see the 1991 version at the end of this bulletin).

Some employers would be interested in providing retirement benefits for long-time and rather permanent employees but not for those who stay only a year or two. This could be possible under a SEP because only those who have worked for three of the last five years need to be covered. Therefore, an employee who did not work three or more years could be excluded from the plan.

Keogh and Corporate Retirement Plans

Keogh plans refer to retirement plans set up by self-employed (noncorporate) business people, while corporate plans are those established and maintained by corporations. At one time, the rules governing the two types of plans were quite different; but in recent years, the rules have been revised so that Keogh and corporate plans operate under close to the same set of rules. Most farms do not operate as corporations. Therefore, the emphasis here is on Keogh plans.

Keogh plans are divided into two general groups: (1) defined benefit, and (2) defined contribution. A defined benefit plan is one in which the employee is promised a given level of retirement benefit beginning at a given age, such as 65. The employer then is required to deposit money into the retirement account so that there is enough money available to pay the promised benefit at the given age. Such plans require the services of an actuary to determine how much money is to be deposited in order to provide the promised benefit. In practice, the benefits may begin before or after 65 with the benefits reduced or increased accordingly. Many farm operators with only a few employees may not want to set up this kind of plan, partly because of the actuarial costs (probably at least

\$500 per year plus an added cost for each employee), and also partly because it may be difficult for both the owner and employees to understand the plan.

A defined contribution plan is one in which the employer deposits an amount of money in each employee's account each year. The retirement benefit depends on how much money is deposited each year, the interest or dividends earned, the number of years the deposits are made, and the age at which retirement benefits begin. The employee will know how much money is deposited each year, which may make the plan easier to understand than a defined benefit plan. However, the employee will not know how much the retirement benefit will be because of the variables listed above.

Defined contribution plans may be funded in one of two ways or a combination of the two. First, a "profit sharing" plan is one in which a percentage of the profit of the business is put into the plan each year. The maximum contribution to a profit sharing plan is the lesser of 15 percent of compensation or \$30,000 for each employee, the same as for a SEP-IRA. Second, a "money purchase" plan is one in which a given amount of money is deposited in the plan each year regardless of the level of profit in the business. A profit sharing plan may result in little or no money going into the plan in years of low or no profit. This may make employees unhappy. On the other hand, the requirement to deposit a given amount of money in a money purchase plan may make the employees happy but could create a hardship on the farm operator in years of low profitability. It is possible to use a combination of the two types of defined contribution plans to alleviate some of the problems with each.

An age-based profit sharing plan is designed to allocate employer contributions on the basis of both age and pay. This type of plan could be attractive to an employer who is much closer to retirement than the employees are because the age factor would allow more money to be set aside for the employer than for the younger employees. Age-based plans do not require an actuary.

It is also possible to establish a "target benefit" plan which is really a combination of a defined benefit and money purchase plan but does not require an actuary.

Keogh (and corporate) retirement plans have a stringent set of rules about which employees must be covered. There are also rules that prevent covering some employees, such as the owner and supervisory employees, much more generously than other employees. Self-employed farmers, including partners, are considered to be employees for purposes of complying with the Keogh plan rules. Another set of rules defines when an employee becomes "vested," that is, has a right to the money which has been contributed on his or her behalf.

In general, an employee is vested in the retirement plan according to the following schedule (but there are exceptions). The employer may choose between:

- (1) Five-year vesting. An employee who has completed five years of service has a nonforfeitable right to 100 percent of the benefit derived from employer contributions.

- (2) Three- to seven-year vesting. An employee has a nonforfeitable right to the benefits derived from employer contributions according to the following schedule:

<u>Years of service</u>	<u>Nonforfeitable percentage</u>
3	20
4	40
5	60
6	80
7	100

The employer should be aware that the employee has rights to the money that has been placed in the retirement plan for him or her. If the employee has worked for the employer long enough to become "vested," he or she has the right to withdraw the retirement money upon leaving employment with this employer. Unless the money is "rolled over" into an IRA or another employer's retirement plan, the former employee will be liable for income tax and early withdrawal penalties. A roll-over is accomplished by withdrawing the money from the retirement plan and depositing it in the employee's IRA or the new employer's retirement plan within 60 days of the date of withdrawal.

The employer cannot prevent access to the money by the former employee who is "vested." Some employees may be tempted to withdraw the money for personal use. However, they should be encouraged to roll over the retirement money to ensure their future financial security.

Any farm operator who is considering the establishment of a Keogh (or corporate) plan should acquire the services of a professional who understands such plans. Many tax preparers do not have sufficient understanding of the rules to be adequate advisors, but may be able to refer farmers to an appropriate pension specialist.

IRC Section 401(k) Plans

Section 401(k) of the Internal Revenue Code provides an opportunity for employees to contribute part of their salaries to a retirement fund on a tax-deferred basis. The employer may also contribute to the fund on a matching basis. This type of plan requires that the employee make a commitment to build a retirement fund. While this type of retirement fund is quite common in nonfarm businesses, it has not been popular in farm businesses. A 401(k) plan must be administered such that it follows a set of rules similar to those for a Keogh or corporate plan. This means that a few valued employees may not be treated more favorably than other employees. These plans require that employees make contributions. Perhaps if employees could see the benefits and understand the retirement program, they would be more willing to participate.

General Considerations in Establishing a Retirement Plan for Employees

Retirement plans should be considered within the context of the total compensation and benefits package being offered by the farm operator to employees of the

business. It is possible that other benefits, such as health insurance, are more crucial to recruiting and retaining employees than is a retirement plan. However, an appropriate retirement savings plan may be a way to retain valued employees.

It is not clear that all farm operators with employees should establish a retirement plan. However, it is clear that most farm employees will not enjoy a comfortable retirement on Social Security benefits alone.

Almost everyone becomes more concerned about retirement income when they approach retirement than they were when in their 20s or 30s. Unfortunately, it takes a much larger deposit each year if one waits until 55 or so to begin to build a fund for retirement at age 62 or 65 rather than if the process had begun 20 or 30 years earlier. Employers who offer retirement benefits should encourage all employees to participate in the retirement program even though some may prefer the cash today. The employer may play a critical role in encouraging employees to plan for their financial future.

References

- Hornsby, J.S. and D.F. Kuratko. "Human Resource Management in Small Business: Critical Issues for the 1990s." *Journal of Small Business Management*. July 1990.
- Howard, W.H., K.A. McEwan, G.L. Brinkman, and J.M. Christensen. "Human Resource Management on the Farm: Attracting, Keeping, and Motivating Labour on Ontario Swine Farms." Working Paper W.P. 89/21, Department of Agricultural Economics and Business, University of Guelph, Guelph, Ontario, Canada. 1989.
- Maloney, T.R. and S.A. Woodruff. "Wages and Benefits of Full-Time, Non-Family Employees on Larger-than-Average New York State Dairy Farms." A.E. Ext. 89-20, Department of Agricultural Economics, Cornell University, Ithaca, NY. 1989.

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under Section 408(k) of the Internal Revenue Code)

Do NOT File with Internal Revenue Service

_____ makes the following agreement under the terms of section 408(k) of the Internal Revenue Code and the instructions to this form.
(Business name—employer)

The employer agrees to provide for discretionary contributions in each calendar year to the Individual Retirement Accounts or Individual Annuities (IRA's) of all eligible employees who are at least _____ years old (not over 21 years old) (see instruction "Who May Participate") and worked in at least _____ years (enter 1, 2, or 3 years) of the immediately preceding 5 years (see instruction "Who May Participate"). This includes does not include employees covered under a collective bargaining agreement and includes does not include employees whose total compensation during the year is less than \$363*.

The employer agrees that contributions made on behalf of each eligible employee will:

- Be made only on the first \$222,220* of compensation.
- Be made in an amount that is the same percentage of total compensation for every employee.
- Be limited to the smaller of \$30,000 or 15% of compensation.
- Be paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

Signature of employer

Date

By _____

Instructions for the Employer

(Section references are to the Internal Revenue Code, unless otherwise noted.)

Paperwork Reduction Act Notice.— We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to determine if you are entitled to a deduction for contributions made to a Simplified Employee Pension (SEP). Complete this form only if you want to establish a Model SEP.

The time needed to complete this form will vary depending on individual circumstances. The estimated average time is:

- Recordkeeping** 7 min.
- Learning about the law or the form** 24 min.
- Preparing the form** 18 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the **Internal Revenue Service**, Washington, DC 20224, Attention: IRS Reports Clearance Officer, T:FP; and the **Office of Management and Budget**, Paperwork Reduction Project (1545-0499), Washington, DC 20503. This form is NOT to be sent to either of these offices. The Form 5305-SEP is only to be kept for your records.

Purpose of Form.—Form 5305-SEP (Model SEP) is used by an employer to make an agreement to provide benefits to all employees under a SEP described in section 408(k). This form is NOT to be filed with IRS.

What is a SEP Plan?—A SEP provides an employer with a simplified way to make contributions toward an employee's retirement income. Under a SEP, the employer is permitted to contribute a certain amount (see below) to an employee's Individual Retirement Account or Individual Retirement Annuity (IRAs). The employer makes contributions directly to an IRA set up

by an employee with a bank, insurance company, or other qualified financial institution. When using this form to establish a SEP, the IRA must be a model IRA established on an IRS form or a master or prototype IRA for which IRS has issued a favorable opinion letter. Making the agreement on Form 5305-SEP does not establish an employer IRA as described under section 408(c).

This form may not be used by an employer who:

- Currently maintains any other qualified retirement plan.
- Has maintained in the past a defined benefit plan, even if now terminated.
- Has any eligible employees for whom IRAs have not been established.
- Uses the services of leased employees (as described in section 414(n)).
- Is a member of an affiliated service group (as described in section 414(m)), a controlled group of corporations (as described in section 414(b)), or trades or businesses under common control (as described in section 414(c)), UNLESS all eligible employees of all the members of such groups, trades, or businesses, participate under the SEP.
- This form should only be used if the employer will pay the cost of the SEP contributions. This form is not suitable for a SEP that provides for contributions at the election of the employee whether or not made pursuant to a salary reduction agreement.

Who May Participate.—Any employee who is at least 21 years old and has performed "service" for you in at least 3 years of the immediately preceding 5 years must be permitted to participate in the SEP. However, you may establish less restrictive eligibility requirements if you choose. "Service" is any work performed for you for any period of time, however short. If you are a member of an affiliated service group, a controlled group of corporations, or trades or businesses under common control, "service" includes

any work performed for any period of time for any other member of such group, trades, or businesses. Generally, to make the agreement, all eligible employees (including all eligible employees, if any, of other members of an affiliated service group, a controlled group of corporations, or trades or businesses under common control) must participate in the plan. However, employees covered under a collective bargaining agreement and certain nonresident aliens may be excluded if section 410(b)(3)(A) or 410(b)(3)(C) applies to them. Employees whose total compensation for the year is less than \$363* may be excluded.

Amount of Contributions.—You are not required to make any contributions to an employee's SEP-IRA in a given year. However, if you do make contributions, you must make them to the IRAs of all eligible employees, whether or not they are still employed at the time contributions are made. The contributions made must be the same percentage of each employee's total compensation (up to a maximum compensation base of \$222,220*). The contributions you make in a year for any one employee may not be more than the smaller of \$30,000 or 15% of that employee's total compensation (figured without considering the SEP-IRA contributions).

For this purpose, compensation includes:

- Amounts received for personal services actually performed (see Regulations section 1.219-1(c)); and
- Earned income as defined under section 401(c)(2).

You may not discriminate in favor of any employee who is highly compensated if you use Form 5305-SEP.

Under this form you may not integrate your SEP contributions with, or offset them by, contributions made under the Federal Insurance Contributions Act (FICA).

Currently, employers who have established a SEP using this agreement and have provided each participant with a copy

*This amount reflects the cost-of-living increase under section 408(k)(8) effective 1-1-91. This amount is adjusted annually. Each January, IRS announces the increase, if any, in the Internal Revenue Bulletin.

of this form, including the questions and answers below, are not required to file the annual information returns, Forms 5500, 5500-C/R, or 5500EZ for the SEP.

Deducting Contributions.—You may deduct all contributions to a SEP subject to the limitations of section 404(h). This SEP is maintained on a calendar year basis and contributions to the SEP are deductible for your taxable year with or within which the calendar year ends.

Contributions made for a particular taxable year and contributed by the due date of your income tax return (including extensions) shall be deemed made in that taxable year.

Making the Agreement.—This agreement is considered made when (1) IRAs have been established for all of your eligible employees, (2) you have completed all blanks on the agreement form without modification, and (3) you have given all of your eligible employees copies of the agreement form, instructions, and questions and answers.

Keep the agreement form with your records; do not file it with IRS.

Information for the Employee

The information provided below explains what a SEP is, how contributions are made, and how to treat your employer's contributions for tax purposes.

Please read the questions and answers carefully. For more specific information, also see the agreement form and instructions on page 1 of this form.

Questions and Answers

1. Q. What is a Simplified Employee Pension, or SEP?

A. A SEP is a retirement income arrangement under which your employer may contribute any amount each year up to the smaller of \$30,000 or 15% of your compensation into your own Individual Retirement Account/Annuity (IRA).

Your employer will provide you with a copy of the agreement containing participation requirements and a description of the basis upon which employer contributions may be made to your IRA.

All amounts contributed to your IRA by your employer belong to you, even after you separate from service with that employer.

2. Q. Must my employer contribute to my IRA under the SEP?

A. Whether or not your employer makes a contribution to the SEP is entirely within the employer's discretion. If a contribution is made under the SEP, it must be allocated to all the eligible employees according to the SEP agreement. The Model SEP specifies that the contribution on behalf of each eligible employee will be the same percentage of compensation (excluding compensation higher than \$222,220*) for all employees.

3. Q. How much may my employer contribute to my SEP-IRA in any year?

A. Under the Model SEP (Form 5305-SEP) that your employer has adopted, your employer will determine the amount of contribution to be made to your IRA each year. However, the contribution for any year is limited to the smaller of \$30,000 or 15% of your compensation for that year. The compensation used to determine this limit does not include any amount which is contributed by your employer to your IRA under the SEP. The agreement does not require an

employer to maintain a particular level of contributions. It is possible that for a given year no employer contribution will be made on an employee's behalf.

Also see Question 5.

4. Q. How do I treat my employer's SEP contributions for my taxes?

A. The amount your employer contributes for years beginning after 1986 is excludable from your gross income subject to certain limitations including the lesser of \$30,000 or 15% of compensation mentioned in 1.A. above and is not includable as taxable wages on your Form W-2.

5. Q. May I also contribute to my IRA if I am a participant in a SEP?

A. Yes. You may still contribute the lesser of \$2,000 or 100% of your compensation to an IRA. However, the amount which is deductible is subject to various limitations.

Also see Question 11.

6. Q. Are there any restrictions on the IRA I select to deposit my SEP contributions in?

A. Under the Model SEP that is approved by IRS, contributions must be made to either a Model IRA which is executed on an IRS form or a master or prototype IRA for which IRS has issued a favorable opinion letter.

7. Q. What if I don't want a SEP-IRA?

A. Your employer may require that you become a participant in such an arrangement as a condition of employment. However, if the employer does not require all eligible employees to become participants and an eligible employee elects not to participate, all other employees of the same employer may be prohibited from entering into a SEP-IRA arrangement with that employer. If one or more eligible employees do not participate and the employer attempts to establish a SEP-IRA agreement with the remaining employees, the resulting arrangement may result in adverse tax consequences to the participating employees.

8. Q. Can I move funds from my SEP-IRA to another tax-sheltered IRA?

A. Yes, it is permissible for you to withdraw, or receive, funds from your SEP-IRA, and no more than 60 days later, place such funds in another IRA, or SEP-IRA. This is called a "rollover" and may not be done without penalty more frequently than at one-year intervals. However, there are no restrictions on the number of times you may make "transfers" if you arrange to have such funds transferred between the trustees, so that you never have possession.

9. Q. What happens if I withdraw my employer's contribution from my IRA?

A. If you don't want to leave the employer's contribution in your IRA, you may withdraw it at any time, but any amount withdrawn is includable in your income. Also, if withdrawals occur before attainment of age 59½, and not on account of death or disability, you may be subject to a penalty tax.

10. Q. May I participate in a SEP even though I'm covered by another plan?

A. An employer may not adopt this IRS Model SEP (Form 5305-SEP) if the employer maintains another qualified retirement plan or has ever maintained a qualified defined benefit plan. However, if you work for several employers you may be covered by a SEP of one employer and a different SEP or pension or profit-sharing plan of another employer.

Also see Questions 11 and 12.

11. Q. What happens if too much is contributed to my SEP-IRA in one year?

A. Any contribution that is more than the yearly limitations may be withdrawn without penalty by the due date (plus extensions) for filing your tax return (normally April 15th), but is includable in your gross income. Excess contributions left in your SEP-IRA account after that time may have adverse tax consequences. Withdrawals of those contributions may be taxed as premature withdrawals.

Also see Question 10.

12. Q. Do I need to file any additional forms with IRS because I participate in a SEP?

A. No.

13. Q. Is my employer required to provide me with information about SEP-IRAs and the SEP agreement?

A. Yes, your employer must provide you with a copy of the executed SEP agreement (Form 5305-SEP), these Questions and Answers, and provide a statement each year showing any contribution to your IRA.

Also see Question 4.

14. Q. Is the financial institution where I establish my IRA also required to provide me with information?

A. Yes, it must provide you with a disclosure statement which contains the following items of information in plain, nontechnical language:

- (1) the statutory requirements which relate to your IRA;
- (2) the tax consequences which follow the exercise of various options and what those options are;
- (3) participation eligibility rules, and rules on the deductibility and nondeductibility of retirement savings;
- (4) the circumstances and procedures under which you may revoke your IRA, including the name, address, and telephone number of the person designated to receive notice of revocation (**this explanation must be prominently displayed at the beginning of the disclosure statement**);
- (5) explanations of when penalties may be assessed against you because of specified prohibited or penalized activities concerning your IRA; and
- (6) financial disclosure information which:
 - (a) either projects value growth rates of your IRA under various contribution and retirement schedules, or describes the method of computing and allocating annual earnings and charges which may be assessed;
 - (b) describes whether, and for what period, the growth projections for the plan are guaranteed, or a statement of the earnings rate and terms on which the projection is based;
 - (c) states the sales commission to be charged in each year expressed as a percentage of \$1,000; and
 - (d) states the proportional amount of any nondeductible life insurance which may be a feature of your IRA.

In addition to this disclosure statement, the financial institution is required to provide you with a financial statement each year. It may be necessary to retain and refer to statements for more than one year in order to evaluate the investment performance of the IRA and for information on how to report IRA distributions for tax purposes.

*This amount reflects the cost-of-living increase under section 408(k)(8) effective 1-1-91. This amount is adjusted annually. Each January, IRS announces the increase, if any, in the Internal Revenue Bulletin.

Other Agricultural Economics Extension Publications

- | | | |
|-----------|--|---|
| No. 91-19 | Dairy Farm Business Summary
Eastern New York Renter Summary
1990 | Linda D. Putnam
Stuart F. Smith |
| No. 91-20 | National and State Trends in
Milk Production, 1991 | Andrew Novakovic
Kevin Jack
Maura Keniston |
| No. 91-21 | New York Milk Production from
1979 to 1989: A County and
Regional Analysis | Kevin E. Jack
Andrew M. Novakovic |
| No. 91-22 | Fruit Farm Business Summary
Lake Ontario Region New York
1990 | Darwin P. Snyder
Alison M. DeMarree |
| No. 91-23 | Time-of-Use Pricing for Electric
Power: Implications for
New York Dairy Farmers | Mark C. Middagh
Nelson L. Bills
Richard N. Boisvert |
| No. 91-24 | Custom Raising Dairy Replacements:
Practices and Costs, 1990 | Jason A. Karszes
B. F. Stanton |
| No. 91-25 | The Year 2000: A Food Industry
Forecast | David M. Russo
Edward W. McLaughlin |
| No. 91-26 | List of Available Agricultural
Economics Publications
July 1, 1990 - June 30, 1991 | Dolores Walker |
| No. 91-27 | Pro-Dairy Financial Data Collection
Workbook | Jonas B. Kaufman
Stuart F. Smith
Linda D. Putnam |
| No. 91-28 | Income Tax Myths, Truths, and
Examples Concerning Farm Property
Dispositions | Stuart F. Smith |
| No. 91-29 | Farm Income Tax Management and
Reporting Reference Manual | George L. Casler
Stuart F. Smith |