

Ready Set Retire



Farming: Investment Planning

If there is one lesson to be learned from the unstable farm land values and stock markets in recent decades, it is that having all of a family's investments in one venture is risky. The purpose of this pamphlet is to present issues in investment considerations before retirement and at retirement.

Investments Before Retirement

In spite of the recommendations of experts who suggest that retirement planning should begin early, many couples postpone planning for retirement until they are in their 40s and 50s. The children are on their own, the initial outlays for land, equipment, and machinery have been completed, and it is time to think about putting money aside for retirement.

One investment option for farm couples is a traditional IRA. Up to \$3,000 may be contributed to an IRA each year. If you are not covered by an employer-sponsored pension plan, your contributions to a traditional IRA are tax deductible, i.e., the amount you deposit is not counted as part of your taxable income for that year. If you are covered under an employer's pension plan, whether your IRA contribution is deductible depends on your income. Earnings grow tax-deferred until withdrawal.

A Roth IRA is another possibility. Contributions to a Roth IRA (up to \$3,000 annually) are not tax-deductible, but distributions at retirement are tax-free. Eligibility to contribute to a Roth is dependent on income (less than \$160,000 for married filing jointly). For more information on IRAs, see *Retirement Investment Options* (PM 1822), cost publication.

Keogh plans, established by Congress under the 1962 Keogh Act, are designed to provide retirement monies for self-employed individuals and have advantages similar to the retirement plans of corporations. Basically, a Keogh plan allows up to \$40,000 (in 2002) of compensation to be set aside in various types of approved investment funds. Amounts contributed to the plan are tax deductible (maximum deduction is 25 percent of aggregate pay of eligible employees), as is income earned by the investments. Income taxes on both the contributions and the earnings from the investment are payable when money is withdrawn from the fund. Because withdrawals are usually after retirement, the tax liability is likely to be lower because the individual will be in a lower tax bracket. As with an IRA, an individual may begin to withdraw money from a Keogh plan after age 59½; withdrawals must start at age 70½.

A Simplified Employee Pension (SEP) allows employers to make contributions toward their own and their employees' retirement without the administrative complexities of a Keogh plan. A self-employed person is considered both an employer and an employee. With a SEP, the employer contributes to a traditional IRA (called a SEP-IRA) for each eligible employee. In 2002, the maximum contribution to a SEP-IRA is 15 percent of compensation (up to \$200,000) or \$30,000, whichever is less.

SIMPLE plans (Savings Incentive Match Plan for Employees) are the newest retirement investment option for self-employed individuals and small businesses having 100 or fewer employees who earned compensation of \$5,000 or more during the year. These plans can be set up as either a SIMPLE IRA or a SIMPLE 404(k) account and involve both employee and employer contributions. The maximum employee contribution for 2002 is \$7,000. The annual employer match is generally required to be a dollar-for-dollar match up to 3 percent of the employee's contribution. Instead of using a match formula, the employer can choose to make flat contributions of 2 percent of compensation for every eligible employee up to a maximum contribution of \$4,000.

For more information on retirement investment options for self-employed individuals and small businesses, see *Retirement Investment Options* (PM 1822), cost publication. *Retirement Plans for Small Businesses* (publication 560) is an Internal Revenue Service publication that provides further details on the retirement plans. It is available free at 800-829-3676 or at <http://www.irs.ustreas.gov>.

The retirement plans presented here are **individual** retirement plans, owned by an individual, not by a couple. In general, the owner of the plan will designate the spouse as the beneficiary upon the owner's death. If eligible to do so, it is generally advantageous for each spouse to contribute to a retirement plan. It is beneficial for the spouse who works in the farm business but does not receive pay to become an employee of the business, receive a salary, and have a SEP or SIMPLE plan established in his or her name. For example, a husband's taxable earned income would be reduced by the amount of his wife's salary. In addition, there would be the deduction of her retirement plan contribution.

Cash value life insurance, particularly universal life, can ensure savings for retirement. The cash value of the life insurance can be used as security for a loan for special needs during retirement. Or the cash value can be converted to an annuity to provide retirement income.

Probably the most important principle in investing prior to retirement is diversification. The above plans should be considered first because of their preferential tax treatment. Then consider investment in stocks and bonds and real estate. The past 20 years have shown how risky land investment can be, when it is the only investment. Purchasing additional land to "provide for retirement" is probably not as good an investment as establishing a Keogh plan and an IRA for each member of the couple.

A financial plan can be thought of as a pyramid, with the base solid, conservative investments. Once that base is built, the pyramid can be topped off with riskier investments that may give higher returns. Contributions and the accumulated interest on IRAs and Keogh plans, plus cash and equity in the dwelling should be the major components of the pyramid base at retirement. Next should be investment in land and other real estate, along with stocks and bonds. Finally, investments in business assets and commodities can top off the pyramid.

Investments Upon Retirement

In addition to preretirement investing, many farm couples are faced with decisions about investments at retirement. Such decisions are especially important if the couple has sold all or part of the farm and has received a lump sum as partial or total payment. The investment decisions made should be geared toward using the money to provide housing and current income for both spouses until their deaths. If the sale of the farm business involved the sale of the couple's residence, one of the obvious investments could be a different dwelling. A couple choosing to rent would, of course, not make this investment. The estimated monthly housing expenses (See *Ready, Set, Retire—Farming: Special Considerations*, Pm-1167e) would need to be adjusted accordingly. After the living arrangements have been secured, at least a portion of the remainder should be invested in such a way that adequate monthly income is ensured.

Types of Investment Available

There are two basic classes of investments. The first involves lending to others through savings accounts, bonds, mortgages and installment contracts, and annuities. The second is equity ownership, in which all or a

portion of something is owned through outright purchase (as in the purchase of real estate), or the purchase of stock directly or through mutual funds.

Savings Accounts

These are probably the most familiar of the investment instruments, and can be savings deposits like passbook savings and NOW accounts (in which there is ready access to the funds) or time deposits (in which there is a penalty if the funds are withdrawn prior to the maturity of the deposit). In general, time deposits earn a higher rate of return than passbook savings accounts.

Bonds

Bonds are instruments issued by governmental units or by corporations for the purpose of raising funds, usually for capital improvements. Bonds can be issued by governmental units, including the federal government, state governments, and local governments. Bonds are available from the issuing body, through stock brokers, or through a mutual fund. A mutual fund is so named because the funds of an investor group, both large and small investors, are pooled to purchase bonds from a variety of issuers for a diversified portfolio. Some mutual funds specialize in municipal bonds, others in corporate bonds.

Mortgages and Installment Contracts

Selling the farm on a land contract with the sellers receiving interest and principal payments amounts to lending money to the farm purchasers.

Life Insurance and Annuities

Purchasing life insurance or an annuity can take alternate forms. Essentially, the purchaser deposits a sum of money and is returned the principal plus interest in a single payment at a later date or in a series of periodic payments, depending on the terms of the annuity or the life insurance policy.

Common or Preferred Stock

Owning a share of stock in a corporation essentially means owning a part of the corporation. Stock can be purchased directly, through a stock broker, or through a mutual fund that specializes in stock purchases.

Real Estate

Real estate can be purchased in an exchange between private individuals, as in the purchase of rental property, or it can be purchased through investment in a real estate trust or syndicate. In general, if the latter course is chosen, there will be management fees. If the former

alternative is selected, the investor will be the manager, responsible for property upkeep, rental, and the like. Investment in farm land is a particular type of investment in real estate, with many of the same limitations.

Business

An investment could be made in a business venture, including but not

Table 1. Investment alternatives compared by evaluation criteria.

| Investment | Risk | Annual return | Liquidity | Management required | Protection against inflation | Protection against deflation | Income tax |
|-------------------------------------|--|------------------|-------------|-------------------------|------------------------------|-------------------------------|--|
| Savings accounts | None, if insured | Low | High | None | None | Good | Interest taxed as ordinary income |
| Bonds | Low to moderate. Can be substantial with traded bonds. | Low to moderate | Variable | Very little | None | Good | Interest taxed as ordinary income, some exempt or deferred |
| Mortgages and installment contracts | Variable | Low to moderate | Low | Low to moderate | None | Variable; may risk forfeiture | Interest taxed as ordinary income |
| Life insurance and annuities | None, if company is financially sound | Low | High | None | Almost none | Good | Interest income deferred to maturity unless paid |
| Common and preferred stock | Moderate to substantial | Moderate to high | Variable | Moderate to substantial | Variable but generally good | Poor | Dividends and capital gains taxed as ordinary income |
| Mutual funds | Moderate to substantial | Moderate to high | High | Very little | Variable but generally good | Variable | Same as above |
| Real estate | Variable | Variable | Moderate | Moderate to substantial | Generally good | Moderate | Same as above |
| Real estate trust or syndicate | Moderate | Variable | Very little | Generally | Moderate good | | Same as above |
| Limited partnerships | Moderate to substantial | Variable | Variable | Low to moderate | Depends on investment | Depends on investment | Same as above |
| Business | Moderate to substantial | Variable | Moderate | Moderate to substantial | Variable | Variable | Same as above |

Adapted from NCR 49, Retirement Planning for Farm Families, 1981, Ralph Hepp, Michigan State University, and Michael Boehje, Iowa State University.

limited to, the farm business. The investor puts up capital and receives both the gains and the losses. Investment could be through a general partnership or a limited partnership. Investing in business assets, as in machinery, livestock, and the like is another way to invest in a business.

Investment Criteria

When considering either equity investments or investments in loans, there are several criteria that should be considered. They include: degree of risk, annual return, liquidity, marketability, personal management required, protection against inflation, and the tax treatment of the investment. Table 1 compares investment alternatives according to these criteria.

Risk

The major risk is the loss of the capital invested. At retirement, most couples want to minimize this risk by selecting low-risk investments. This does not necessarily mean the couple is limited to insured deposits and U.S. government savings bonds. There are excellent low-risk investments available in municipal bonds, mutual funds, and annuities offered by life insurance companies.

Annual Return

A general principle is that the higher the rate of return, the greater the risk. The goal in investing is to maximize the annual return while minimizing the risk. The highest returns in the past few years have been in stocks, available directly or through participation in one of a number of mutual funds. To measure the returns accurately, income

from both the principal and growth of the principal must be combined.

Liquidity and Marketability

Liquidity refers to the degree to which the purchase or selling price approximates the cost or value that is assigned to the investment. The marketability of an asset refers to the ease with which an investment can be bought and sold. The ideal is good marketability and good liquidity. Savings accounts generally have this combination; bonds have good marketability and average liquidity; common stocks have good marketability and poor liquidity. Depending on the economic climate, real estate often has high marketability and low liquidity. In general, the greater the risk associated with the investment, the lower its liquidity.

Management Required

Investing in a certificate of deposit requires no management, once the decision has been made to invest. The certificate is purchased, and, at maturity, redeemed. Not so with an investment in a four-plex that is rented. The real estate investment requires constant attention in terms of maintenance, tenant relationships, and the like. True, such services can be purchased, but there is a fee that can substantially reduce the rate of return.

Protection Against Inflation-Deflation

Lending to others traditionally has provided steady but fixed returns with no opportunity for the growth of the capital invested. In times of inflation,

the returns on this type of investment have fallen behind the returns on equity ownership. Equity ownership, on the other hand, has traditionally provided greater returns during times of inflation and greater losses during times of deflation. If inflation and deflation could be predicted accurately, shifts would be made from lending instruments to equity ownership when inflation is on the rise, and back during times of deflation. Since even the best financial analysts are not able to forecast economic cycles with that level of accuracy, the key to sound investing is diversification.

Taxation

The final consideration is the tax treatment on returns from investments. In general, returns such as rent or interest are taxed as ordinary income in the tax year during which those returns are realized. Taxes on the appreciation will be deferred until the investment is sold. The capital gain will be taxed at a lower rate than ordinary income. Careful planning needs to occur to minimize the impact of capital gains tax liability when equity in anything is sold.

For Further Reading

Growing Your Nest Egg: Risk and Return (Pm 1821)

Retirement Investment Options (Pm 1822) cost publication

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