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**Keogh Investment Funding Choices by
Farmers and Other Self-employed Persons**

by

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I. INTRODUCTION

This article compares and analyzes Keogh¹ self-employed retirement plan investment choices of farmers with those of taxpayers from other industries.² The legal requirements for Keogh participation will be set out briefly, but the emphasis of this article will be on the economic components and implications of self-employment retirement plans. Limitations of the data used in the study will be exposed and the results of the study will then be analyzed in some detail.

II. HISTORICAL PERSPECTIVE

Economists often talk of two distinct kinds of income earning resources—human and nonhuman capital.³ For each individual, the size and relative proportion which he holds of these two kinds of capital may influence his ability to retire and standard of living during retirement.

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† Technical Article No. TA11367 of the Texas Agricultural Experiment Station.

1. Retirement plans for the self-employed are popularly referred to as "Keogh" (or sometimes HR-10) plans in recognition of the fact that Representative Eugene J. Keogh was the primary legislative sponsor.
2. A previous article reported on a different aspect of this study—retirement plan participation rates and levels by industry. The interested reader is referred to Levi & Rogers, *A Legal-Economic Analysis of Keogh Retirement Plan Participation by Farmers and Other Self-Employed Persons*, 50 N.D.L. REV. 255 (1974).
3. The term "nonhuman capital" refers to land and all other physical but nonhuman resources which may be utilized in a given production process or enterprise.

Employees generally do not have substantial stocks of non-human capital on which to rely during retirement. Rather they must rely on private savings and retirement programs, social security, medicare, etc., to meet retirement expenses. This is one reason why employee retirement plans have been given special treatment in the Internal Revenue Code.

Self-employed persons whose income is derived principally from personal services (*e.g.*, attorneys, physicians) comprise another group whose capital stock is mostly human, so theoretically at least they face essentially similar retirement income problems as employees (though perhaps to a lesser degree). This basic rationale led to the Keogh self-employed retirement plan legislation passed in 1962.⁴

The equity argument of equal treatment led to 1966⁵ and 1967⁶ amendments which made Keogh more attractive to participants and extended similar treatment to other self-employed individuals for whom nonhuman capital is a material income-producing factor (*e.g.*, farmers). These amendments, along with social security, have substantially broadened retirement alternatives for these persons. By definition they have a higher proportion of nonhuman to human capital than employees and other self-employed persons. Therefore, they logically have one additional retirement alternative—that of selling business assets and using the proceeds to cover retirement expenses.

Before 1968 Keogh was unattractive to persons for whom non-human capital was a material income-producing factor because they could only (1) treat 30 per cent of their net profit as earned income, and (2) deduct one-half their Keogh contributions from taxable income. Therefore, in order to avoid these limitations and establish an attractive retirement plan before 1968, many incorporated their business, established a corporate retirement plan, and covered themselves as a corporate employee. Thus, one effect of the 1966⁷ and 1967⁸ amendments was to neutralize the form of business organization with respect to retirement plans.

III. KEOGH RULES

The basic 1968 Keogh scheme was as follows: First, self-em-

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4. Self-employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, 76 Stat. 809.
 5. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, tit. II, § 204, 80 Stat. 1577.
 6. Act of October 21, 1967, Pub. L. No. 90-607, 82 Stat. 1189.
 7. Note 5 *supra*.
 8. Note 7 *supra*.

ployed individuals could invest up to 10 per cent of "earned income," or \$2,500, whichever is the lesser⁹ in a retirement "fund" (current rules are the lesser of 15 per cent of earned income or \$7,500).¹⁰ "Earned income" refers to that portion of net trade or business profits constituting a reasonable allowance for personal services rendered¹¹ (essentially all net income for most farmers).

Second, neither the money invested in this "fund" nor the income generated therefrom is taxed in the year earned. Rather, such monies are not taxed until received, usually after retirement. Distributions cannot *begin* before disability¹² or age 59½,¹³ or after age 70½.¹⁴

Participating self-employed individuals must also make retirement fund contributions on behalf of full-time employees¹⁵ who have been employed for three years or more or, if employed less than three years, for as long as the sole proprietor. Employees have a vested right to contributions made by their employer.¹⁶ Rules prohibit the percentage contribution (of earned income) made by and for the self-employed person from exceeding the percentage contribution (of wages) made on behalf of an employee.¹⁷

Keogh contributions may be invested in: (1) a trust, with a bank as trustee; (2) a custodial account, with a bank as custodian; (3) United States retirement plan bonds; (4) insurance contracts, or (5) other investments approved by the Internal Revenue Service ("Service"). If more than one of these investment alternatives is used, the total 1968 Keogh contributions are limited to the lesser of 10 per cent or \$2,500.

Under the trust arrangement, investments may be made in essentially any kind of property including stocks and bonds, mutual funds and real estate. Also, it is significant that the participating

9. Treas. Reg. § 1.404(e)-1(a)(2) (1963).

10. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829.

11. Treas. Reg. § 1.401-10(c)(3) (1963).

12. Treas. Reg. § 1.401-12(m)(1) (1968). See Treas. Reg. § 1.72-17(f) (1971) for the definition of "disabled".

13. Treas. Reg. § 1.401-12(m)(1) (1968); see also Rev. Rul. 65-21, 1965-1 CUM. BULL. 174.

14. Treas. Reg. § 1.401-11(e)(2) (1968). This limitation does not apply to United States Retirement Bonds.

15. Those who work more than 20 hours per week for more than five months out of the year. Treas. Reg. § 1.401-12(e) (1968).

16. Treas. Reg. § 1.401-12(g) (1968).

17. Treas. Reg. § 1.401-12(f) (1968). The magnitude of employer contributions on behalf of employees may be lessened by "integrating" the Keogh plan with social security. See Levi & Rogers, *supra* note 2, at 265.

taxpayer may be able to retain control over trust fund investment decisions by naming himself as a co-trustee with a bank. Investment options for custodial accounts include mutual funds, both fixed and variable annuity insurance contracts, and United States retirement plan bonds.

IV. GENERAL ECONOMIC CONCEPT UNDERLYING SELF-EMPLOYED RETIREMENT PROGRAMS

A. Subsidy Aspects of Keogh

Conceptually, the tax savings accruing to Keogh participants is a subsidy paid taxpayers purchasing units of retirement income. As with any subsidy, it is purposefully designed to cause changes in production or consumption patterns to conform more closely to the congressionally perceived social optima. The Keogh subsidy payment (reduction in current and/or long-run income tax liability) changes the effective price of units of retirement income.

Since participation postpones income tax liability until income is distributed from the retirement fund, Keogh is the equivalent of an interest-free loan and may be characterized as a credit subsidy. The principal benefit of a credit subsidy is simple deferral. However, depending on the timing and magnitude of retirement fund distributions, and to the extent that other income will likely be lower and exemptions and deductions higher when Keogh funds are distributed, the total taxes paid over time may be less than with nonparticipation. To the extent long-run tax liability is lessened, Keogh may be thought of as a tax subsidy. Conceptually then, the Keogh subsidy is the algebraic sum of two distinctly different types of subsidies—credit and tax.

B. Earned Income

In the specific context of the treatment authorized by Keogh, income earned solely by capital, such as interest and capital gains, is not eligible for classification as "earned income." A self-employed businessman, such as a farmer or hardware dealer, however, can treat *all* income generated by his business as being earned income. Thus, the practical effect of the Keogh provisions is to make a distinction between "active" business income (which qualifies as earned income) and "passive" or "investment" income (which is not eligible for earned income treatment). This distinction is important, of course, since it delineates the maximum deductible upper limit on the retirement contribution where annual earned income is less than \$25,000.

Therefore, it is perhaps worthwhile to note that the term "earned income" has a different interpretation under Keogh than under the Code in general. In the latter, only wages are considered to be "earned income," and thus earned income is taxed at preferential rates in some circumstances. This is based on the ability to pay principal, recognizing that income from nonhuman capital is a return to wealth which represents an ability to pay over and above that indicated by current income from wages. It is emphasized that this argument has no application to Keogh simply because the Code generally employs a broader definition of "earned income" than do the Keogh-related provisions.

V. NATURE AND LIMITATIONS OF THE DATA

The data used in this article, sample estimates of population totals, were tabulated under special contract with the Service from 1968 sole proprietor income tax return records. It does not cover partnership or corporation retirement plans. Because the Service does not record this data each year and changes have been made in the form on which Keogh participation is reported, no similar data is available for later years.

To facilitate taxpayer group comparisons the data were obtained by industry, using 1968 Office of Management and Budget standard industrial classifications.¹⁸ Special tabulations were run for the farming subsector of the agriculture, forestry and fisheries industry. Where a tax return contained activities in more than one industry, the entire return was classified in the industry showing the largest percentage of total receipts.¹⁹ Information about specific combinations of industries was not recorded. Only "pension or annuity" (no profit-sharing) type plans were covered.

VI. ANALYSIS

Table 1 indicates bankers benefit substantially from the Keogh subsidy. Custodial accounts (34 per cent) and trusts (28 per cent) together constituted more than 60 per cent of all 1968 Keogh investments and each requires a bank to oversee the Keogh fund. In addition, only the general investments option under the trust investment would appear to have the potential of substantial bank administrative costs and problems, because investments in life insurance and mutual funds will be substantially administered by the sellers.

18. DEP'T OF TREASURY, INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1968—BUSINESS INCOME TAX RETURNS, Pub. No. 438 (1-72), 253 (1969).

19. *Id.*

Table 1

Percentage Usage of Primary Keogh Investments Reported on 1968 Taxable Returns by Industry

| Industry | Trusts % | Custodial accounts % | Life insurance % | U.S. re- tirement bonds % | Other % | Total % |
|---|-------------|----------------------------|------------------------|------------------------------------|------------|------------|
| Farms | 24.8 | 29.0 | 19.4 | 1.4 | 25.4 | 100.0 |
| Other agriculture, forestry and fisheries | 17.8 | 23.9 | 18.3 | 0.0 | 40.0 | 100.0 |
| Mining | 13.6 | 23.7 | 3.9 | 0.0 | 58.8 | 100.0 |
| General construction | 13.9 | 18.7 | 26.1 | 0.4 | 40.9 | 100.0 |
| Manufacturing | 12.2 | 26.5 | 19.1 | 0.0 | 42.2 | 100.0 |
| Transportation | 17.9 | 47.1 | 0.0 | 0.0 | 35.0 | 100.0 |
| Wholesale and retail trade | 22.9 | 31.2 | 16.2 | 2.7 | 27.0 | 100.0 |
| Finance, insurance and real estate | 26.1 | 41.5 | 10.7 | 0.4 | 21.3 | 100.0 |
| Services | 30.7 | 34.8 | 12.4 | 1.3 | 20.8 | 100.0 |
| All industries | 27.7 | 33.6 | 13.9 | 1.4 | 23.4 | 100.0 |

The research did not disclose precisely why banks have been so successful in the Keogh funding business. Some hypotheses are that they (1) were more aggressive in seeking Keogh customers than life insurance companies, (2) had available a ready list of taxpayers likely to be interested in Keogh participation in the form of customers for other bank services, and/or perhaps (3) had more credibility with their customers than did life insurance agents. Life insurance participation rates tended to be highest among the lower income Keogh participants—notably farmers—who may well have been less aware of investment alternatives.

It is not surprising that custodial accounts and trusts were the two funding mediums used most often. Since banks must serve as either custodian or trustee, these type investments readily lend themselves to the development of prototype plans which all of a bank's Keogh customers consent to use. Given that a participant can make his own investment decisions under a trust while he has no control over custodial account investments, some participants who have a choice logically might prefer trusts over custodial accounts. The fact that the data revealed the opposite preference (34 per cent v. 28 per cent) may indicate that participating bank customers often had no real choice between trusts and custodial accounts. That is, many banks may have only one prototype plan, and it may often provide for all Keogh funds to be invested through custodial accounts.

Since Service approval must be obtained before an "other investment" Keogh plan is put into operation, the fact that other investments constituted nearly one-quarter of all 1968 Keogh funding appears to be surprisingly high. It should be kept in mind, however, that 2950SE returns, not reporting their method of funding, were classified by the Service under this investment alternative.

One might have expected the proportion making primary investments in life insurance to be somewhat larger since insurance agents may have performed an important educational function in informing clients of Keogh availability, especially in 1968.²⁰ However, they directly sold policies to only 14 per cent of all Keogh participants.²¹

Those choosing to invest in United States retirement bonds constituted less than two per cent of all Keogh participants. A previous study²² found the after-tax rates of return to be almost precisely equal for bonds and fixed annuity life insurance. Since the proportion of total life insurance composed of variable annuity contracts is not known, the explanation for the different rates of utilization of bonds and life insurance is subject to conjecture. Investors may prefer the higher returns historically associated with variable annuity insurance contracts or may simply be unaware that retirement bonds are an investment alternative. An alternative explanation is that some Keogh insurance purchases may be a part of an overall insurance program or package "pushed" by insurance agents.

While farmers followed the general investment preference pattern for all industries with respect to ordered rank of investment alternatives, they did invest in life insurance more often than all other industries except general construction. This adds credence to the previously posited hypothesis regarding farmers' lack of knowledge about Keogh alternatives and the educational function of life insurance agents. The latter assertion has particular appeal since 1968, the year the data was gathered, was the first year in which farmers were likely to view Keogh as a rational alternative.²³

The finance, insurance, and real estate industry utilized Keogh life insurance investments at a relatively low rate. To the extent

20. This may have occurred because of the previously set out legislative changes in 1966 and 1967.

21. However, indirect or secondary life insurance investments purchased under either trusts or custodial accounts pushed the total Keogh investments share of life insurance to 25%.

22. Stubblefield, *The Keogh Act: A Farmer's Retirement Plan, 1969* (unpublished M.S. thesis at University of Missouri).

23. Note 20 *supra*.

that this industry is composed of self-employed insurance people, logically a relatively high state of knowledge about the insurance alternative should have existed. This may suggest that insurance agents themselves do not see insurance as a particularly attractive Keogh investment. Or, perhaps participants in that industry already had substantial insurance investments and sought to diversify their investment portfolios.

Table 2 illustrates that with respect to custodial accounts, every industry had a distinct preference for mutual funds over life insurance with more than 90 per cent of custodial accounts being invested in mutual funds.

Table 2
Percentage Usage of Secondary Keogh Investments Under Trusts and Custodial Accounts Reported on 1968 Taxable Returns by Industry

| Industry | Trusts | | | Custodial accounts | | |
|---|----------------|---------------------|-------|--------------------|----------------|-------|
| | Life insurance | General investments | Total | Mutual funds | Life insurance | Total |
| Farms | 53.8 | 46.2 | 100.0 | 97.4 | 2.6 | 100.0 |
| Other agriculture, forestry and fisheries | 72.7 | 27.3 | 100.0 | 76.6 | 23.4 | 100.0 |
| Mining | 17.9 | 82.1 | 100.0 | 100.0 | 0.0 | 100.0 |
| General construction | 50.3 | 49.7 | 100.0 | 97.7 | 2.3 | 100.0 |
| Manufacturing | 24.0 | 76.0 | 100.0 | 100.0 | 0.0 | 100.0 |
| Transportation | 90.0 | 10.0 | 100.0 | 100.0 | 0.0 | 100.0 |
| Wholesale and retail trade | 37.5 | 62.5 | 100.0 | 93.8 | 6.2 | 100.0 |
| Finance, insurance and real estate | 24.6 | 75.4 | 100.0 | 88.3 | 11.7 | 100.0 |
| Services | 28.9 | 71.1 | 100.0 | 94.5 | 5.5 | 100.0 |
| All industries | 32.8 | 67.2 | 100.0 | 94.0 | 6.0 | 100.0 |

It is not known whether this preference is the result of a conscious choice by participants or whether it suggests that most custodial account prototype plans provide for all self-employment deductions to be invested in mutual funds.

Under trusts, all industry taxpayers tended to prefer general investments over life insurance by roughly a two to one margin. More farmers, however, invested in life insurance than in general investments. Once again it is not known whether this is the result of a conscious choice on their part or rather is a function of the types of prototype plans generally available at the banks where farmers do business.

As indicated by Table 3, under trusts, the all-industries mean level of participation in general investments was greater than for life insurance. This is logical because a primary attraction of trusts is the opportunity to make one's own investment decisions.

Table 3

Average† Secondary Keogh Investments Under Trusts and Custodial Accounts Reported on 1968 Taxable Returns by Industry

| Industry | Trusts | | Custodial accounts | |
|---|----------------|---------------------|--------------------|----------------|
| | Life insurance | General investments | Mutual funds | Life insurance |
| Farms | \$ 560 | \$1,200 | \$1,010 | \$2,150 |
| Other agriculture, forestry and fisheries | 1,390 | 2,430 | 2,020 | 1,370 |
| Mining | 1,000 | 2,330 | 1,710 | — |
| General construction | 950 | 1,510 | 1,010 | 2,090 |
| Manufacturing | 1,980 | 1,620 | 1,680 | — |
| Transportation | 1,090 | 2,420 | 870 | — |
| Wholesale and retail trade | 980 | 1,460 | 1,460 | 900 |
| Finance, insurance and real estate | 1,400 | 1,510 | 1,480 | 620 |
| Services | 1,860 | 2,020 | 1,880 | 1,760 |
| All industries | 1,490 | 1,860 | 1,690 | 1,440 |

† Arithmetic mean rounded to nearest ten dollars.

On the other hand, investments in life insurance can be made directly without using the trust arrangement. The trust alternative would, of course, clearly preserve investor flexibility for shifting from life insurance to general investments in the future. Since lower risks may be attached to life insurance than to general investments under the trust alternative, it may be that some secondary life insurance investment is being made in pursuit of portfolio diversification.

For farmers within the trusts option, general investment means were more than twice the size of life insurance means.²⁴ This suggests that, to the extent that their prototype plans offered them a real choice, higher level Keogh participating farmers investing in trusts preferred a voice in investments decisions and were willing to take some investment risks with their retirement funds.

Under custodial accounts, however, the average level of life insurance investment by farmers was more than twice that of mutual

24. See Table III.

funds. Again to the extent that plans offered farmers a choice between these two alternatives, this would suggest that farmers participating in Keogh at higher levels and utilizing custodial accounts preferred the less risky investments. The relatively low life insurance investment under custodial accounts may also be important in attempting to rationalize the magnitude of these differences.

The inconsistency between the apparent willingness of farmers to take risks, as indicated by trust and custodial account secondary investment levels, may be more apparent than real. One possible explanation is that farmer investment performances were somewhat mixed and indecisive since 1968 logically may have been their first year of Keogh participation that is, Keogh participation was not attractive to farmers before the passage of previously cited 1966 and 1967 amendments). The real secondary investment choices available under bank prototype plans could also be important here.

VII. CONCLUSION

Because of the practices of the Service in recording taxpayer data on tape, and because of the time lag between filing of returns and the compilation of estimates of taxpayer income characteristics, detailed industry data needed to get a current picture of Keogh participation and investment patterns is not presently available. While the situation may have changed substantially since 1968, data for that year indicate that those in agricultural businesses generally participate in Keogh plans at lower percentage rates and absolute dollar levels than do their counterparts in other areas.²⁵ One reason for the lower dollar level of participation may be, of course, that they also generally had lower earned incomes on which to base their participation.

It is not known whether farmers generally participate in Keogh plans at the same (often rural) banks which they patronize for other bank services. If so, differences in prototype plans adopted by banks in different geographical areas (and with different population bases) may help explain observed differences in industry percentage rates and dollar levels in various investment alternatives.

25. D. Levi, *An Economic Analysis of Farmer Participation in Keogh Retirement Plans*, 1974 (unpublished Ph.D. dissertation at Washington State University).