

Putting a Value on Sweat Equity in Your Farm Business

Michael Langemeier, Professor, Center for Commercial Agriculture

Denise Schroeder, County Extension Director, White County

PURDUE
UNIVERSITY

Center for
Commercial Agriculture

Sweat Equity
August 23, 2016

Outline of Presentation

- Important Concepts
 - Interaction of Family and Business
 - Dividing Business Income
 - Sweat Equity
- Example

Important Concepts

How is “family farm” defined?

- Maintaining family ownership of farm land is not the same as maintaining the family farm.
- The former is an investment in an illiquid, long term, appreciable fixed asset and the latter is a business.
- **If inheriting farm land creates a farmer then inheriting economic books creates an economist.**

The Farm

Continuation of Farm Family Business	Continuation of Family Ownership of Business Assets (e.g., Land)
Succession Plan	Estate Plan
Orderly transfer of business ownership	Process of accumulating, conserving, and distributing of one's assets during lifetime and at death
<i>Avoids financial and managerial disruptive risk</i>	<i>Avoids surprises and helps mitigate conflict</i>

Two Different Systems

- Family is inward looking
- Family avoids risk
- Family focuses on emotions
- Family seeks stability
- Family does not count cost
- Business is outward looking
- Business embraces risk
- Business focuses on work
- Business seeks change
- Business tracks cost

The FAMILY System

- Attributes of a successful family
 - Loving
 - Loyal
 - Affectionate
 - Supportive
 - Empathetic
 - Understanding
 - Enduring
 - Communicative

The BUSINESS System

- Attributes of a successful business
 - Efficient
 - Profitable
 - Goal Directed
 - Effective
 - Aggressive
 - Evaluative
 - Innovative
 - Proficient

Structure

- The Structure Of A Family Does Not Change
 - What Is The Genogram (Family Tree)?
- The Structure Of A Business Must Change
 - What Is The Organizational Chart?

➤ **Succession Planning is the Planned Change of the Organizational Chart**

What is Fair?

- **Your children are not the same.**
 - Different motivations
 - Likes
 - Dislikes
 - Different needs
 - Different causes for problems

Dividing Business Income

- **Common Income Sharing Models**

- **Contributions Model**

- Income is divided in the same proportion as the relative value of each party's contribution of resources to the business venture.

- **50/50 Model**

- A return is paid to each party for his/her contribution of resources to the venture. Any remaining profit or loss is shared equally.

Dividing Business Income

- **Contributions Model**
 - **Compute the annual value of each party's contribution of resources to the venture.**
 - Land and Buildings
 - Machinery, Equipment, and Livestock
 - Working Capital
 - Labor
 - Management
 - **Net income is shared in the same proportion as each party's respective contribution to resources.**

Dividing Business Income

- **50/50 Model**
 - **Each resource is paid a return similar to a rental payment or wage.**
 - Land and Buildings
 - Machinery, Equipment, and Livestock
 - Working Capital
 - Labor
 - Management
 - **The remaining return (or loss) is shared equally among the parties.**

What is Sweat Equity?

- The term “sweat equity” is used frequently in discussions of the contributions of an on-farm heir to the value of the family owned business.
- Sweat equity arises in part when an on-farm heir is paid less than their true opportunity cost to work for the business.
- The term also arises in situations where the business has grown substantially in value due to the managerial ability of the on-farm heir.

Sweat Equity Example

Adapted using information from

David Goeller, University of Nebraska-Lincoln

Putting a Value on Sweat Equity

- Let's use a family situation to illustrate a few key points.
- Mom and Dad want to keep the “farm in the family.”
- The youngest of three children, Michael, came back to the farm in 1990. Unfortunately, if the farm business were divided into three equal pieces, it would not be of adequate size to create a viable enterprise.

Putting a Value on Sweat Equity

- When Michael came back to the family farm in 1990, the fair market value of the business was \$420,000.
- At that time, Mom and Dad agreed that the contribution of each child up to 1990 was equal. Dividing the \$420,000 by three results in a contribution of each child of \$140,000.

Putting a Value on Sweat Equity

- Today's fair market value of the business is \$1,680,000. If we divide by three, \$560,000 would be left to each child. However, the contributions of the three children have not been equal since 1990.
- There were very few promises made to Michael when he returned to the farm. However, decisions were made because he came back (e.g., land was purchased).

Putting a Value on Sweat Equity

- Mom, Dad, and Michael know that his contribution to the family farm has resulted in Michael developing a sizable investment of “sweat equity” into the farm business.
- There are two dilemmas present in this example.
 - Treating each child fairly
 - Farm assets have increased dramatically

Putting a Value on Sweat Equity

- **First Dilemma**

- We don't want the non-farm kids to feel that they have been mistreated or slighted, but if you were divide the farm business into equal pieces would each slice be large enough to create a viable business?
- What about the contribution of the farming child to the growth or success of the business?

Putting a Value on Sweat Equity

- **Second Dilemma**

- Earning adequate income to pay for the increased value of the assets may be difficult, if not impossible, for a successor to accomplish.
- For Michael to be successful, both the income the business generates and the market value of the farm assets has to be considered.

Putting a Value on Sweat Equity

- **Resolution**

- After careful consideration, Mom and Dad decided that they would equally divide the 1990 value of the farm between the three children.
- They also decided that Michael was responsible for 50 percent of the growth since 1990 (value of business grew from \$420,000 to \$1,680,000 or \$1,260,000).

Putting a Value on Sweat Equity

- **Asset Distribution in Estate Plan**

- Michael receives \$980,000:

- \$140,000 (1/3 of 1990 value)
 - \$630,000 (50% of growth)
 - \$210,000 (1/3 of parent's contribution to growth)

- Non-farm siblings receive \$350,000 each:

- \$140,000 (1/3 of 1990 value)
 - \$210,000 (1/3 of parent's contribution to growth)

Putting a Value on Sweat Equity

- **Contributions Equal Compensation**
 - The family business looks different today because Michael came back to the farm.
- **Caveats**
 - It is often difficult to determine how much “sweat equity” contributed to the increase in value of the business.
 - The level of Michael’s annual compensation is an important consideration when valuing “sweat equity.”

**Join Us for our next Webinar on
September 13, 2016; 9:00 am EDT**

Updated Crop Outlook

PURDUE
UNIVERSITY

Center for
Commercial Agriculture

Sweat Equity
August 23, 2016