What’s it Worth if You Stay on the Farm?
The Purdue Farm Succession Team is committed to cultivating strong farm families through the succession planning process by providing educational opportunities and current resources.
Outline of Presentation

• Background
• Important Concepts
  – Succession Planning
  – Compensation and Sweat Equity
• Sweat Equity Example
• Case Study
Background

Recent Survey Results
Definition of Family Fairness

- Percent of Responses

Survey Response

- did not answer
- don't know
- treat according to needs
- treat according to contribution
- treat the same
- do not have definition

Purdue University Cooperative Extension Service is an equal access/equal opportunity institution.
Tension Related to Unequal Farm Ownership

Survey Response

- did not answer
- don't know
- none
- small amount
- moderate amount
- large amount
- extremely large amount

Percent of Responses

0 10 20 30 40 50 60 70 80 90
Tension Related to Confusion Over Authority

Survey Response

- did not answer
- none
- small amount
- moderate amount
- large amount
- extremely large amount

Percent of Responses

Purdue University Cooperative Extension Service is an equal access/equal opportunity institution.
Tension Related to Family Compensation Issues

- None (70%)
- Small Amount
- Moderate Amount
- Large Amount
- Extremely Large Amount

Purdue University Cooperative Extension Service is an equal access/equal opportunity institution.
Interest in Transferring Farm to Children

<table>
<thead>
<tr>
<th>Survey Response</th>
<th>Percent of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>did not answer</td>
<td>0</td>
</tr>
<tr>
<td>don't know</td>
<td>2</td>
</tr>
<tr>
<td>no interest</td>
<td>10</td>
</tr>
<tr>
<td>slight interest</td>
<td>10</td>
</tr>
<tr>
<td>moderate interest</td>
<td>10</td>
</tr>
<tr>
<td>large interest</td>
<td>35</td>
</tr>
<tr>
<td>extremely large interest</td>
<td>20</td>
</tr>
</tbody>
</table>
Heirs Should Share Equally

Survey Response

- don't know
- strongly disagree
- slightly disagree
- neither disagree nor agree
- slightly agree
- strongly agree

Percent of Responses

0 5 10 15 20 25 30

Purdue University Cooperative Extension Service is an equal access/equal opportunity institution.
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

<table>
<thead>
<tr>
<th>Continuation of Farm Family Business</th>
<th>Continuation of Family Ownership of Business Assets (e.g., Land)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Succession Plan</strong></td>
<td><strong>Estate Plan</strong></td>
</tr>
<tr>
<td><strong>Orderly transfer of business ownership</strong></td>
<td><strong>Process of accumulating, conserving, and distributing of one’s assets during lifetime and at death</strong></td>
</tr>
<tr>
<td><em>Avoids financial and managerial disruptive risk</em></td>
<td><em>Avoids surprises and helps mitigate conflict</em></td>
</tr>
</tbody>
</table>
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 Organization Chart?

➢ Succession Planning Is The Planned Change Of The Organization 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.”
Case Study
Adapted using information from John Baker, Iowa State University
Johnson Family

The Johnson family is a typical Indiana family who own and operate a farm family business and they want it to continue for another generation. Only one of their children is interested in farming.
The Johnson’s

- Matthew and Mary farm with Matthew’s father, Richard.
- They have three children: Luke, John, and Elizabeth.
  - Luke has expressed interest in returning to the farm.
- Matthew and Mary love all their children and wonder how to divide assets when they are gone.
The Johnson’s: Stage One

• Luke is 21 and has a cattle herd of 10.
• He is in college and will finish this year.
• Since he hasn’t contributed to the farm, no compensation is needed.
• Equal division would be fair because Luke hasn’t done anything “extra.”
The Johnson’s: Stage Two

- Matthew and Mary are 65.
- Luke is 41 and is married to Jane, and has two children.
- Matthew and Luke have been farming together for 20 years.
- Luke makes some management decisions.
- 2,000 acres are farmed by Matthew and Luke.
- Their herds have grown significantly.
- **How do we value Luke’s contribution to the farm?**
Factors to Consider

1. What value has Luke added to the farm?
2. What value has Matthew added because he knows Luke is going to take over?
3. Has Luke built assets on Matthew’s land?
4. What amount should Luke receive for management decisions?
5. Has Luke made repairs and improvements to the property (machinery, buildings, land)?
The Johnson’s: Stage Three

- Matthew’s dad, Richard, passes away.
- Matthew is having back problems and finds it hard to drive a tractor.
- Luke’s daughter, Jessica, and her husband want to come back and farm.
- Half of the cash leases have been transferred to Luke’s name.
- Luke has taken over the hay operation and all management tasks.
- Matthew is slowly phasing out of the business.
- How do we value Luke’s contribution to the farm?
Factors to Consider

• What value has Luke added to the farm?
• Does Luke have assets on Matthew’s property?
• How much of the physical work does Luke provide on Matthew’s land.
• How much has Luke been compensated for managing the farm?
• How much wealth has been preserved because of Luke’s presence?
• What personal services for Matthew and Mary have been performed by Luke and Jane?
The Johnson’s: Stage Four

- Matthew dies; Mary’s health declines rapidly.
- Luke and Jane help her with almost everything (i.e., chores, doctor visits, cooking meals, laundry, etc.)
- Cows are gone; Luke uses buildings, shop, and grain bins on the farm.
- Luke received all of Matthew’s machinery.
- Mary now owns a portion of the land because Matthew and her held the land in joint tenancy.
The Johnson’s: Stage Four

• How do we value Luke’s contribution to the farm?
• How do we value Luke and Jane’s extra work on the farm and caring for Mary?
Factors to Consider

- Would the farm business still exist without Luke?
- Would Mary be in a nursing home if Luke and Jane didn’t care for her?
- Are Luke and Jane receiving other benefits by staying on the farm?
- How much value has Luke added to the farm?
- Is Luke managing the entire business?
- What are increased profits due to Luke’s management?
Now, how do we value?

- There is no exact formula to do this!
- However, we can place values on services and increase in wealth.
- Once values have been determined, we can multiply this by the number of years worked by Luke.
Key Take Home Messages

• Equal is not always fair.
• An equitable division needs to address on-farm heir compensation and the ability of the on-farm heir to maintain the farm family business.
Questions, Comments