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Putting a Value on "Sweat Equity"

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Market Report	Yr Ago	4 Wks Ago	10/17/08
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	$92.89	$97.31	$88.82
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb..	119.32	117.70	108.57
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	115.05	111.74	105.70
Choice Boxed Beef, 600-750 lb. Carcass.	145.05	160.67	147.45
Western Corn Belt Base Hog Price Carcass, Negotiated.	56.01	68.48	60.69
Feeder Pigs, National Direct 50 lbs, FOB..	48.57	42.53	41.90
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean.	62.25	76.53	65.99
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct..	94.00	96.62	93.25
National Carcass Lamb Cutout, FOB.	265.45	269.62	265.89
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu..	7.75	6.40	5.00
Corn, No. 2, Yellow Omaha, bu.	3.38	5.27	3.93
Soybeans, No. 1, Yellow Omaha, bu.	9.04	11.41	8.54
Grain Sorghum, No. 2, Yellow Dorchester, cwt..	6.36	7.98	5.32
Oats, No. 2, Heavy Minneapolis, MN , bu.	*	*	*
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton..	135.00	190.00	190.00
Alfalfa, Large Rounds, Good Platte Valley, ton..	87.50	77.50	77.50
Grass Hay, Large Rounds, Premium Nebraska, ton.	*	85.00	85.00
Dried Distillers Grains, 10% Moisture, Nebraska Average.	*	168.50	146.00
Wet Distillers Grains, 65-70% Moisture, Nebraska Average.	38.00	59.75	54.00
***No Market**			

For some farm/ranch families, deciding what to do with the family business can be very troublesome. How can we pass the farming business to the next generation while at the same time not create animosity or envy between the heirs? If we divide it equally between all the children, will it create such small pieces that the successor child cannot make a living operating the family farm? If one child is required to buy out his/her siblings will the business generate enough income to make this a feasible option? Most parents would say "We want to treat our children fairly." Is dividing the farm equally between all the children always a fair solution?

Last week I found myself thinking about a family farming operation struggling with the dilemma of planning their estate. Let's call this family the Smiths. Like many families, Dad and Mom Smith would like to keep the "farm in the family." Fortunately for them son Jimmy, the youngest of three children, decided to return to the business in 1990. But unfortunately, if the farm business were divided into three equal pieces, the resulting slice would not be of adequate size to create a viable operation.

When Jimmy came back into the family business in 1990, the fair market value net worth of the business was $600,000. Dad and Mom discussed the contribution that each child had made over their "growing up" years and decided that each child had contributed more or less about equally to the business during those years. $600,000 divided equally between the three children is $200,000 each. Today's net worth of the business has grown to $1,500,000. If divided equally between the three children $500,000 would be left to each. The contributions from the three children toward the success of the farm business have very definitely not been equal since Jimmy's return, however.

There were no promises made to Jimmy when he returned to the farm, but many decisions were made differently because he was part of the business. When the neighbor's land came up for sale Dad and Mom would not have been interested in purchasing that land if Jimmy had not been involved. It was Jimmy's idea to increase the rented land and add a cow/calf enterprise to the business. It was also the labor and new energy provided by Jimmy that allowed the business to profit, expand and grow. Jimmy has been paid a modest wage and allowed the use of machinery as he has developed his own farming business. But Dad, Mom and Jimmy all know that his contribution to the family farm has resulted in Jimmy developing a sizable investment of "sweat equity" into the farm business.

There are two dilemmas present in this example. The first arises because most of us want to treat our children fairly. Many of us think that the only way to treat each child fairly is to treat them equally. Maybe that's the way it was always done in our family. We certainly don't want to be the cause of any hard feelings. We don't want our non-farm kids to feel that they have been mistreated or slighted, but if you were to divide the farm business into equal pieces would that equal slice be of adequate size to create a viable business? What about the contribution of the farming child to the success and growth of the business? The second dilemma occurs because farm asset values have increased so dramatically. Earning adequate income to pay for the increased value of the assets may be difficult, if not impossible for a successor to accomplish. If the Smiths want their son Jimmy to be successful, they need to consider the income the operation will generate as well as the market value of the farm assets.

Let's look at how the Smith family valued the contribution of their son Jimmy by putting a value on his "sweat equity." They then used this to explain to the non-farming kids how they reached their estate planing decisions.

Today the farm's net worth is $1,500,000. If the Smiths were to divide the assets equally, they would leave $500,000 to each child. But as they considered the contributions made by each child and the impact in the business growth because of Jimmy's return, they thought of it this way. There has been $900,000 of increase since 1990. The business has grown and diversified. Profits have been reinvested into the farm, and farm assets have appreciated in value. Jimmy has contributed a substantial amount of "sweat equity." Both parents feel that they may have actually retired several years ago and sold some of the original land (prior to the recent jump in land values) had Jimmy not decided to return to the farm. After much evaluation and discussion Dad and Mom decided that they would equally divide the 1990 value of the farm between their three children, but they decided that Jimmy was responsible for 50 percent of the business growth since 1990. They therefore decided to allocate their assets as follows:

1990 Jimmy Returns to the Family Business:

1990 Net worth of the family business	$600,000
1990 Net worth divided equally between three heirs	$200,000

Business Growth, Appreciation, Inflation and Diversification:

2009 Net worth has increased to	$1,500,000
1990 Net worth of family business	$600,000
Growth is	**$900,000**

Parents Attribute 50% of Growth in Net Worth to Jimmy:

50% of $900,000 = $450,000 attributed to Jimmy's contribution
50% of $900,000 = $450,000 attributed to parent's contribution
$450,000 parent's portion divided by three equals $150,000 each child

Asset Distribution of Estate Plan:

Jimmy receives $800,000: $200,000 (1/3 of 1990 net worth) + $450,000 (50 percent of growth contribution) + $150,000 (1/3 of parent's contribution).

Siblings receive $350,000 each: $200,000 (1/3 of 1990 net worth) + $150,000 (1/3 of parent's contribution).

Jimmy's contribution of 50 percent is simply an example. Every operation will have different factors and likely arrive at a different percentage for the value of the successor's contribution. In the Smith's case, Jimmy will receive more than twice as much as his brother and sister, however, they all understand the basic process. Contributions equal compensation. The family business looks much different today because Jimmy came back to become part of that business.

Each family situation will be different. The next family may have decided that their successor had contributed to only ten percent or maybe 80 or 90 percent of the growth. The question is how much has the "sweat equity" contributed to the growth of the farm? It is the business owners that are in the best position to evaluate the contribution and adjust the compensation accordingly. The Smith children understand how the estate is to be distributed, and hopefully, they will all be eating Christmas dinner together for years to come.

Treating unequals equally may be the most unfair thing you can do.

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