# Dividing Business Income 

Many business ventures involve two or more individuals working together. These ventures may focus on marketing products to local consumers, the processing of farm products or other types of ventures. Although these are often not complex arrangements, creating a method of equitably dividing income among the parties is important.

Below are methods to help you divide business income between the parties in an equitable manner. The two most common income sharing models are:

- 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 among the parties.

We will discuss these models as if only two parties are involved. However, they can be used with three or more parties.

A sharing arrangement should be reviewed periodically. If the ownership pattern or the labor and management contributions change, the arrangement should be updated to reflect these changes. A common mistake and source of conflict in these arrangements is the failure to keep them current and accurate. These approaches may be interpreted from a legal perspective as a partnership because there is a sharing of profits and losses.

## Contributions Model

The first step in developing the contributions model is to calculate the annual value or cost of each party's contribution of resources to the venture. These resources can be divided into five types:

- Real estate (land and buildings)
- Personal property (machinery, equipment, livestock, etc)
- Working capital
- Labor
- Management

One way of thinking about the annual value or cost of a resource is the income given up or foregone by using the resource in the business venture rather than in an alternative use. For example, the annual value of ten acres of farmland that will be used by the business venture is the amount of rent that could have been received if rented to a neighbor. If the current rental rate is $\$ 200$ per acre, then the value of the contribution is $\$ 2,000$. This is the annual cost of contributing the land to the business venture. The value computed with this method is commonly referred to as opportunity cost. The same method can be used for determining an annual value or cost of buildings and facilities, although rental rates are less well established.

The annual value (cost) of machinery and equipment can be estimated by using a rental rate or by calculating the cost of ownership. The cost of ownership includes repairs, taxes, insurance, depreciation, and a return on the money invested in the assets.

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Working capital contributed by the parties to cover the cash flow needs of the business can be valued by using the rate of return that would have been received from an alternative investment. For example, the annual value (cost) of the contribution of $\$ 20,000$ used as working capital versus using it in an alternative investment with a rate of return of 6 percent is $\$ 1,200$. Direct expenses such as fuel, utilities, supplies, advertising, and hired labor can be paid from a business account containing the working capital.

Labor can be valued by using a typical wage rate for performing comparable work. A reasonable estimate for management is more difficult to estimate, but a rule of thumb frequently used is to take ten percent of all other costs.

Net income (net of direct expenses) is then shared in the same proportion as each party's respective contribution of resources.

## Example

In the example below, the annual value (cost) of the first party's contribution is $\$ 69,000$, or 60 percent of the total. The second party contributes $\$ 46,000$, or 40 percent of the total.

Table 1. Annual value of contributions

|  | First <br> party | Second <br> party | Total |
| :--- | ---: | ---: | ---: |
| Real estate | $\$ 35,000$ | $\$ 15,000$ | $\$ 50,000$ |
| Equipment | 16,000 | 7,000 | 23,000 |
| Working capital | 1,000 | 1,000 | 2,000 |
| Labor | 12,000 | 18,000 | 30,000 |
| Management | $\underline{5,000}$ | $\underline{5,000}$ | $\underline{10,000}$ |
| Total | $\mathbf{\$ 6 9 , 0 0 0}$ | $\mathbf{\$ 4 6 , 0 0 0}$ | $\mathbf{\$ 1 1 5 , 0 0 0}$ |


| First party's net income |  |
| :--- | ---: |
| share | $\frac{69,000}{115,000}=\mathbf{6 0 \%}$ |
|  |  |
| Second party's net income <br> share | 46,000 <br> 115,000$=\mathbf{4 0 \%}$ |

As shown below, the gross return from the year's activities is $\$ 166,000$ with $\$ 46,000$ of direct expenses. Of the $\$ 120,000$ of net returns, the first party receives a net return of $\$ 72,000$ and the second party receives $\$ 48,000$.

Table 2. Net return

|  | First party | Second party | Total |
| :---: | :---: | :---: | :---: |
| Gross income |  |  | \$166,000 |
| Direct expenses |  |  | -46,000 |
| Total net return |  |  | \$120,000 |
| Percent distribution | 60\% | 40\% |  |
| Individual net return | \$72,000 | \$48,000 | \$120,000 |

## 50/50 Model

In the 50/50 model, the contributions of real estate, machinery and equipment, working capital, labor, and management are paid a return similar to a rental payment or a wage. The amounts can be computed in the same way as they are with the contributions model. The remaining return (profit or loss) is shared equally among the parties.

## Example

In the following example, net business income of $\$ 120,000$ is computed by subtracting the direct business expenses from the gross income. Next a return equal to a rental fee or cost of ownership is paid to each party for the use of land, machinery, labor and management. The remaining $\$ 5,000$ of profit is divided equally between the two parties.

| Table 3. Income and expenses |  |
| :--- | ---: |
| Income and expenses | Total |
| Gross income | $\$ 166,000$ |
| Direct expenses | $\underline{-46,000}$ |
| Net return | $\mathbf{1 2 0 , 0 0 0}$ |
| First party's real estate | $\$-35,000$ |
| Second party's real estate | $-15,000$ |
| First party's equipment | $-16,000$ |
| Second party's equipment | $-7,000$ |
| First party's working capital | $-1,000$ |
| Second party's working capital | $-1,000$ |
| First party's labor \& management | $-17,000$ |
| Second party's labor \& management | $-\mathbf{2 3 , 0 0 0}$ |
| Profit | $\$ 5,000$ |

Each party's total return consists of the rental or wage return from his/her respective resources plus $50 \%$ of the profits. As shown below, the first party receives $\$ 71,500$ and the second party \$48,500.

|  | First <br> party | Second <br> party | Total |
| :--- | ---: | ---: | ---: |
| Real Estate | $\$ 35,000$ | $\$ 15,000$ | $\$ 50,000$ |
| Machinery \& equip. | 16,000 | 7,000 | 23,000 |
| Working capital | 1,000 | 1,000 | 2,000 |
| Labor \& mgmt. | 17,000 | 23,000 | 40,000 |
| Profit | $\underline{2,500}$ | $\underline{2,500}$ | $\underline{5,000}$ |
| Net return | $\mathbf{\$ 7 1 , 5 0 0}$ | $\mathbf{\$ 4 8 , 5 0 0}$ | $\mathbf{\$ 1 2 0 , 0 0 0}$ |

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