

Dividing Business Income

any 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.

Page 2 File C4-16

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 party	Second 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	<u>5,000</u>	<u>5,000</u>	<u>10,000</u>	
Total	\$69,000	\$46,000	\$115,000	

First party's net income share	69,000 115,000	= 60%
Second party's net income share	46,000 115,000	= 40%

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			<u>-46,000</u>	
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.

File C4-16 Page 3

				
Table 3. Income and expenses				
Income and expenses	Total			
Gross income	\$166,000			
Direct expenses	<u>- 46,000</u>			
Net return	\$120,000			
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	<u>- 23,000</u>			
Profit	\$5,000			

A Decision Tool for Dividing Business Income is available at: www.extension.iastate.edu/agdm/wholefarm/xls/c4-16dividingincome.xlsx.

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 party	Second 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	<u>2,500</u>	<u>2,500</u>	<u>5,000</u>
Net return	\$71,500	\$48,500	\$120,000

... and justice for all

Iowa State University Extension and Outreach does not discriminate on the basis of age, disability, ethnicity, gender identity, genetic information, marital status, national origin, pregnancy, race, religion, sex, sexual orientation, socioeconomic status, or status as a U.S. veteran. (Not all prohibited bases apply to all programs.) Inquiries regarding non-discrimination policies may be directed to Ross Wilburn, Diversity Officer, 2150 Beardshear Hall, 515 Morrill Road, Ames, Iowa 50011, 515-294-1482, wilburn@iastate.edu.