

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.

	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	$\frac{69,000}{115,000} = 60\%$
Second party's net income share	$\frac{46,000}{115,000} = 40\%$

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.

	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.

Table 3. Income and expenses

Income and expenses	Total
Gross income	\$166,000
Direct expenses	- 46,000
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	- 23,000
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

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