Valuing On-Farm Heir's Sweat Equity Is Complicated and Agreements Should Be Developed to Fairly Compensate On-Farm Heirs

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Determining the value of sweat equity

can be both challenging and controversial for farm families. ***Sweat equity*** arises as an issue when an on-farm heir receives payment at below-market rate, and the farm business grows in size due to an on-farm heir's below-market labors. Land in the farm may also appreciate in value due to the work of the on-farm heir. Since farmland is typically the bulk of a farm's

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assets, dividing the assets equally among on-farm and off-farm heirs means on-farm heirs could potentially get a portion of the farmland too small to generate livable farming income. At the same time, off-farm heirs may receive farm assets which have increased in value due to the work of the on-farm heir.

Only 30% of farms transition past the founding generation, 12% transition past the first generation, and only 3% transition past the second generation (Ferrell, Jones, and Hobbs, 2015). Handling sweat equity issues when bringing in the on-farm successor can limit issues down the road where an on-farm heir feels slighted. Properly ensuring the success of a farm for future generations is a challenging task, but steps can be taken ahead of time to avoid problems.

It is important to note that the best solution for handling sweat equity is to agree early on to pay the on-farm heir at a market rate. Handling sweat equity early on may necessitate the on-farm heir also working off the farm for additional income if the farm cannot support an additional person fulltime. It is important to discuss the farm succession plan and limit the possibility of sweat equity claims at an early stage of farm expansion. For more information on farm succession planning tools, see *Estate Planning for Farm Families* (UME FS-972).

One of the first problems arising from sweat equity is the lack of communication between farm owners and the individuals working on the farm. Both parties need to set clear expectations. The farmer should know how much the on-farm heir expects after a certain time, and the on-farm heir should know how much labor he/she is expected to give. Without a clear set of expectations and guidelines, there is a lack of enforceability. The idea of sweat equity, when not properly outlined, can hide the fact that a farm is not as profitable as needed to support that on-farm heir. Thus, setting clear guidelines and expectations for both the on-farm heir and farmer well before the transitioning process occurs is essential.

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Farm owners often find themselves between the future farm success and the "fair" treatment of the farm to heirs and children during transitioning. There is an important distinction in the transitioning process between deeming equitable and equal behaviors. For example, if John owns 100 acres of land and has two sons, giving each 50 acres upon his death is fair. However, if one son has worked on the farm for 30 years while the other son has distanced himself from the farm, each son receiving 50 acres is equal, but not necessarily equitable. A farm owner may compensate the son who worked on the farm for 30 years more than the other son.

So the question becomes: How do owners set themselves up for a smooth transitioning process? Most owners would agree that there are two primary goals of a transitioning: 1) secure the farm's financial viability and 2) transition the farm in such a way to make everyone happy. It is important to remember in the transition process that parents treating all heirs fairly does not necessarily mean equally. As one farm transition specialist has stated, "Treating unequals equally, may be the most unfair thing you can do" (Goeller, 2014).

An example may illustrate how a farm can struggle with determining the value of sweat equity, without having a transitioning plan in place. George and Louise Jefferson own farmland in Maryland and have three adult children. One child, Michael, returned to the farm to work in 1999 and has continued to work on the farm. Since then the other two children have left the farm. Michael's work has increased the value of the farmland. Equally dividing the farmland might be considered unfair due to Michael's contributions.

Looking deeper at the example, the value of the farm has increased from $800,000 to $1,500,000 since Michael's return. George and Louise agree that the $800,000 value of the farm before Michael returned should be equally split among their three children. The $700,000 increase in farm value since Michael's return is a result of his work and not the other two children. The Jeffersons determine it would not be fair to

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simply divide the increase in farm value since Michael's return by 3; they feel he deserves a larger share for the labor he put into the farm. If the Jeffersons had compensated Michael for his labors at the start, this would have made this issue easier to handle.

While Michael was never promised reimbursement for his sweat equity, George, Louise, and Michael acknowledge that decisions which increased the value of the farm such as renting and purchasing more land were possible because of Michael's sweat equity investment. The Jeffersons also realize

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that simply dividing the farm into three may not provide enough land to be viable and that they want to recognize Michael's contribution to the farm's success.

George and Louise decide they will divide the value of the farm before Michael's return equally among children, with each child getting $800,000 divided by 3, or $266,667. The increase in farm value after Michael's return ($1,500,000-$800,000, or $700,000) will be split 50% to Michael and the other 50% deemed the parents' contribution since Michael's return. The parents' contribution will be split amongst all three children, or $516,667 to Michael and $166,667 to the other two children. In the end, Michael would receive $783,334 and the other two children would receive $383,334 each.

Many issues can be worked out if clear expectations are set ahead of time. Engaging lawyers, accountants, families, and business consultants in advance can alleviate many farm transitioning problems. Beginning the transition planning process early, developing agreements on how to compensate on-farm heirs, and how the farm business will be transferred to the next generation will provide a smoother transition than trying to handle a sweat equity issue later on.

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