Woodbury: Farm Family Business

Make or Break Decisions: The Compensation Message

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Bio

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Over the course of my experience in consulting with family-owned farms and ranches, there are a few critical decisions which, if approached and executed well, contribute to the longevity of the enterprise. This is the second column in a series suggesting several "make or break" decisions and the reasons they are so important. The first column dealt with the issue of gifting or selling the business. For several of the decisions there are no "right or wrong" answers; their success lies in their execution, regardless of the direction chosen.

Some families may regret linking their compensation to the size of a mortgage or the number of children in the family. Need does not equate to performance, Woodbury cautions. (Photo by Atwater Village Newbie, CC BY 2.0)

When it comes to valuing your contribution to the business, what are you worth? Are you worth what someone else running another operation might pay you? Do you assign yourself an hourly rate or a salary? Or do you focus on living off of what's left over, after everyone else is covered?

Now put yourself in the shoes of a family member returning to the business. What message do you want them to hear about compensation? Are they worth what they could get in a similar business? Should you consider what they might make outside of the agriculture industry? Are they to be paid less because someday they may inherit the farm? Or are they paid more because you want to entice them to return or stay?

Family member compensation is an issue that is at best awkward, and at its worst can destroy the business. This column aims to offer some suggestions for how you might think and talk about compensating family members.

DISTINGUISH BETWEEN MANAGEMENT, OWNERSHIP OR GIFTS

Family business consultants often discuss the different roles involved in a family business. One role is that of a family member: a mother, father, in-law, son, daughter, or cousin, someone connected by DNA, marriage or adoption. Another role is that of a manager or employee, someone working daily in the business and who has a spot on the organizational chart. Yet another role is that of an owner, a shareholder who has some amount of capital at risk in the business. Difficult issues often arise because these three roles exist simultaneously, and it can sometimes be confusing as to which hat someone is wearing when they communicate.

When considering compensation, it can be helpful to consider assigning a value to a member's place in those three systems. For example, if someone is working in the management system as an employee or a manager or supervisor, you might consider their market value, that is, what they would be worth hourly or on salary to your business if they were not a family member. There might also be a bonus plan based on the profitability or performance of the business.

If they are also an owner, you might develop a distribution policy around profits. For example, many families, if the business is profitable, might pay the owners a little more than the amount needed to cover state and federal taxes (often in the neighborhood of 40%). If the business is in a growth mode, you might not have a distribution, or if the business is mature you might pay out a higher amount. (Note that it is important here to consider the accrual-based profitability of the enterprise, not the cash left in the checking account, since the deferral of income or prepayment of expenses can create a distorted view of profitability.)

If you pay a family member more than the prevailing market rate, consider calling that additional amount a gift or a bonus. The risk you run by not categorizing compensation in this way is that family members may develop an inflated value of their contribution. Or they may begin feeling entitled to unreasonably high payments, or you may begin to drain the equity in the business -- just at a time when such equity may be necessary to survive tighter financial margins.

DIFFERENTIATE MARKET VALUE FROM FAMILY NEED

Years ago, I heard of a family that based compensation for returning family members in part on their house payments. Well guess what the younger generation did? They began building bigger houses!

Family needs are often an important conversation when a family member is considering coming into the family business. But if you agree to pay beyond market value for their contribution, be cognizant that over the long run, the business has to perform better to sustain those higher than average payments. If it is a short-term strategy, it may be important to acknowledge those funds as a gift, or an early draw on their inheritance. Then make sure you have a clear conversation and understanding about the future of their compensation and your intentions.

RECOGNIZE FAMILY BENEFITS AND SWEAT EQUITY

One of the benefits of family business participation is the level of long-term commitment. There have been significant periods of low farm incomes; part of the sustaining force through those periods can be positive family dynamics. (Such times can also test family dynamics!) Agricultural family businesses often require long hours, face uncertainty in weather and markets, and are located in remote areas. The history, independence, flexibility, vocation and chance to work with your children or parents help offset many such challenges.

My point is that "compensation" is not measured just in terms of cash. And it goes beyond other benefits that can -- and should be -- financially valued, such as vehicles, fuel, housing, food and utility payments. There are reasons to think beyond the paycheck and discuss why you enjoy working together. Those reasons might or might not cause you to think differently about your cash remuneration, but the conversation you have now as a family about compensation and benefits can help prevent future conflict.

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