

Why have a Partnership Agreement?

A Partnership is, apart from being a sole trader, one of the easiest forms of business structure. However, unless you have a Partnership Agreement in place, then the business is subject to an archaic set of Victorian rules that, if not otherwise varied, could lead to the business being wound up.

In more detail, if there is no Partnership Agreement then the partnership is defined as 'A Partnership at will' and is governed by the Partnership Act 1890. Under this Act, the only way a partner can be expelled is to bring about the dissolution of the partnership. In addition, a Partnership at will automatically ends upon the death, retirement or bankruptcy of a partner. Any partner can choose to end a Partnership at will either without giving notice or reason to the other partners.

What should you include in the Agreement?

Whilst there's no hard and fast rule as to what should or should not be included, the following headings cover the most common areas, although other issues may need to be considered to deal with specific problems such as expense-sharing, incorporation, property ownership and succession issues.

Definitions

So as to avoid misunderstandings or ambiguous clauses, the Partnership Deed should begin with a list of the definitions of the matters to be covered.

Business name

Many Partnerships tend to operate using the surnames of the principals; whilst easy, it does present a problem in that the stationery, website etc will need amending every time there is an addition or subtraction. Thus it is usually better to pick an abstract or iterative trade name. Whatever the name, it is important that it is included in the Agreement whilst at the same time covering the duration of the 'partnership' and its location.

Practice capital

The practice assets, i.e. property and working capital, need to be defined as does each principals' contribution to those assets, along with a minimum capital requirement and procedures to ensure that the minimum requirement is maintained. In addition, this section usually includes details as to the method of valuation of goodwill, property and fixtures and fittings etc.

Profit sharing and drawings

This section lays down the rules regarding profit or expense-sharing, the level of drawings that can be taken against those profits and the provisions for the repayment of excess amounts drawn, along with the basis of any expense-sharing arrangements, including those expenses that would be funded by the practice and those by the principals. It is also possible to have a catch-all phrase such as 'or as the partners agree from time to time', thus giving the day-to-day flexibility to change the ratios outside the scope of the Partnership Deed and as circumstances dictate.

Annual accounts

This clause deals with drafting of the practice accounts on an annual basis and how they become binding on the principals, as well as the provision of accounts following the retirement, death or expulsion of a principal.

Extent of Principals' authority

Without an agreement to the contrary, any principal can bind the 'partnership' without the consent of the others. The Agreement should make it clear when this will be restricted, which is usually done by including a monetary limit above which the principals would need to collectively agree upon.

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Decision making

This typically covers those aspects of the 'partnership' need a unanimous or majority decision before action can be taken. Most proposals can be approved by a majority decision, but there are some issues that require a unanimous decision, such as the appointment of a new principal or partner. A word of warning though, if unanimity is required to expel a principal then it's a bit like asking turkeys to vote for Christmas.

Principals' duties

Where possible, the Agreement should set out which, in any, of the principals are responsible for certain duties within the practice and have a mechanism for dealing with breaches of them. This clause will set out that the principals will be just and faithful to each other in all transactions relating to the practice, and may include restrictions on what the principals are able to do without the prior consent of the others either whilst in office or thereafter. In addition, it may provide for the rules regarding the principals' duty to keep up to date and to comply with any professional CPD obligations and the like.

Absence

This clause will cover such items as the number of days of holiday leave, sabbaticals, compassionate, maternity, paternity or adoption leave and the arrangements covering jury service etc. There may also be provisions that deal with non-authorised absences, suspension by their professional body etc., and the procedures with which to deal with them.

As a point of interest, dental practices have particular requirements relating to their tendency to operate on an expense-sharing basis; thus provision needs to be made when one of the principals is unable to pay their share, or when they are absent from the practice and unable to cover their share of the overheads; the most common of which being sickness or maternity leave. It is important that the Agreement dictates the action to be taken lest the remaining principals find their profit shares reduced by their absent principal's inability to pay their debts as these will subsequently have to be paid by the remaining principals.

In particular, the Agreement should ensure that each partner either has, if available, a locum insurance policy to provide the funds to pay a locum dentist, or a practice expenses policy providing an amount to cover that principal's share of the practice expenses during illness or leave, or other covers such as permanent health insurance, the levels of which should, say, be annually reviewed.

Principals joining

This deals with the procedures and financial terms, if any, for new principals joining the practice and the amounts that they would need to pay and on what terms such as becoming a signatory to the existing agreement.

Principals leaving

Dealing with the retirement, expulsion, disqualification, bankruptcy, incapacity and death of principals and the rules regarding the payout of their capital and / or goodwill are amongst the most troublesome, and a lack of an Agreement here often leads to the partnership being dissolved and banks calling in their guarantees. Moreover, how will your families crystallise the value the business represents? And the more successful the business is, the bigger the problem gets.

The key provision is usually a cross-option agreement to both provide a simple mechanism to prevent the loss of Inheritance Tax (IHT) Business Property Relief (BPR) on a principal's death and the means (typically via life insurance) to crystallise the equity value into cash. Although the value of partnership equity is usually protected from IHT if death occurs whilst still working as a partner in a trading business, if the partnership agreement contains a binding contract to buy the share from the deceased partner's executors, IHT will be payable at 40%, thus significantly eroding the value.

If it is not covered above, the rules regarding the valuation of assets upon principals leaving are often included in this clause.

Resolution of disputes

It is essential to have arbitration or mediation clause in the agreement that provide for a resolution in the event of a deadlock without resorting to law.

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