Partnership SECURITY

What would happen if your business partners had to exit suddenly? Here, **Pat Mannix** from Physio Accountant advises on the best way to protect the ownership of your practice.

Physiotherapy practices are invariably run with multiple partners. In addition, those entering as a partner in private practice are getting younger, so after a few years in practice they have usually developed a substantial amount of their personal wealth in the business. Realising the value locked inside the goodwill of the physiotherapy practice in the event of an untimely death or serious illness or injury should be an essential component of a partner's security and, in turn, the partnership practice security.

The untimely death or serious illness or injury of a partner may result in significant financial hardship for that person's family and the remaining partners. In a worst case scenario, it may result in the outgoing partner selling their partnership interest for a substantial undervalue or may even result in the selling or liquidation of the whole practice.

The implementation of an effective practice succession plan that includes an insurance-funded buy/sell agreement can ameliorate such hardship. In this article, we will zero in on partnership security and what the options are for minimising the financial plight when a partner meets with serious illness or death.

A buy/sell agreement is a document entered into by the partners which sets out the funding methodology and terms for the disposal of a partner's interest in the practice where that person unexpectedly dies or suffers serious injury or illness.

The disposal of that person's practice interest will usually be to the remaining partners, but given the unexpected timing of that person's death or incapacity, those remaining are unlikely to have sufficient capital or cashflow available to acquire the outgoing owner's partnership interest.

As such, the succession arrangements set up in the buy/sell agreement ensure that:

- the remaining partners are able to acquire the outgoing partner's practice interest
- the outgoing partner or her/his family receive necessary funds from the disposal of that interest.

To facilitate this succession arrangement, the central feature of a funded buy/sell agreement is the availability of insurance proceeds as the purchase price of the relevant partnership interest. The insurance proceeds are paid, tax-free, to the outgoing partner or her/his family and the relevant business interest is transferred to the remaining partners—providing significant tax and cashflow advantages to both the outgoing partner or her/his family and to the ongoing practice and the remaining partners.

A customised insurance-funded buy/sell agreement is required for each partnership's specific requirements to result in 100 per cent financial security for all concerned. If you are in partnership and have some sort of security and succession arrangement in place, it should be reviewed at least every two to three years to ensure the adequacy of the current arrangements. Often the growth of a practice can quickly make redundant the current arrangements, as well as changes to legal and tax laws, so it is prudent to revisit and review regularly for the utmost security of your key financial asset.

Various methods for funding a buy/sell agreement have been developed over many years. I won't review all of these methods but rather concentrate on the favoured model of partnership security for physiotherapists, and that is the self-insurance model for funding a buy/sell agreement.

Insurance-funded buy/sell agreements can be used for all business structures that physiotherapists maybe operating under. As such, in this article when we refer to a 'business/partnership interest' this term may include a shareholding, a unit holding or a partnership interest.

A partner leaves unexpectedly from a physiotherapy practice

The impact of an untimely death or serious disability of a partner not only results in the practice losing the benefit of that person's skill, services, experience and patient relationships, but requires the remaining partners to fund, on short notice, sufficient funds to purchase the outgoing partner's business interest.

If the remaining partners are unable to find sufficient funds then:

- the outgoing partner or her/his family will continue to own an interest in a practice that they have no real involvement or minimal involvement in the operation of
- the remaining partners will be subject to the input and opinions of the outgoing partner or her/his family as ongoing owners in the business
- the outgoing partner or her/his family may receive little income or other financial return from their ownership in the practice because of a reduction in business turnover—particularly if the practice is small, the cost of employing and retaining a skilled physiotherapist to replace the outgoing partner will limit funds available to the remaining partners, especially if the outgoing partner was instrumental to the patient revenue and product sales of the business
- neither the outgoing partner nor her/his family nor the remaining partners will be able to effectively move forward until the matter has been resolved.

Plan for the worst case scenario

Ideally, on the death or serious disability of a partner resulting in them being unable to continue to participate in the business for a period of time, funding and legal arrangements should be in place to facilitate the purchase of their business interest by the remaining partners at market value from:

- the legal personal representative of the outgoing partner on their unexpected death or
- the outgoing partner herself/himself if she/he suffers a serious injury or illness. This results in the outgoing partner or their family receiving well-needed funds and the business continuing to be effectively operated by the remaining partners.

Options for financing the practice and outgoing partner

There are various ways in which the finance can be obtained to achieve the funding solution of a partner who is exiting. For example, the remaining partners may obtain bank funding to fund the purchase of the outgoing partner's business interest, or alternatively, may introduce into the practice another partner who is willing to acquire such business interest.

Both of these alternatives are uncertain and often provide an unreliable solution when required.

Obtaining new funding to acquire the outgoing partner's business interest adds considerable and unexpected costs into the existing business and changes the business dynamics for the remaining partners. That is,

the ongoing financial resources of the practice will come under pressure as a result of the remaining partners having to generate sufficient cashflow to fund these additional financing costs. This often results in the remaining practice partners having to get access to funds secured by their other private assets, which puts stress on their personal partner relationships and brings in assets that were not intended for the business risk.

Of course, the introduction of a new practice partner into the business introduces a whole new set of dynamics and if it is not 'a successful business marriage' then the practice may become locked by conflict and confrontation—all of which would have disastrous financial consequences for the ongoing partners.

So using insurance under a buy/sell agreement is usually the best option.

Self-insurance model: the preferred option

Under the self-insurance model for funding a buy/sell agreement for physiotherapy partners, the insurance proceeds are not paid to the remaining partners, who then pay them to the outgoing business owner or his family; instead, those proceeds are paid directly to the outgoing partner or her/his estate as the purchase price for her/his business interest which is then transferred to the remaining partners.

This allows the outgoing partner or her/his estate to directly control the payout because they are paid directly by the insurer without the proceeds passing through the hands of the remaining partners.

This model is simple: the outgoing partner is both the insured and the beneficiary under the policy. As such, on their unexpected death, the policy proceeds are paid directly to their estate. On their unexpected total and permanent disability (TPD), they are paid directly to the outgoing partner. The insurance proceeds on both death and TPD are received tax free under this structure.

Because the insurance proceeds, whether paid in respect of death/terminal illness or trauma/TPD, are usually received by the outgoing partner or her/his family, the self-insurance model is not burdened with tax issues that may arise under alternative insurance structures where a non-relative receives trauma/TPD insurance proceeds. The family is left with money from the business, buying their share out directly from the insurance company, and the existing partner/s are able to buy the exiting partners' share of the business with this policy. Taking the financial stress out of an already stressful situation and creating peace of mind.

So make sure that if you are in partnership you have a buy/sell agreement funded by insurance. This will be the rock of your business succession plan.

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