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Introduction to partnership succession - problems and solutions

Synopsis: How to ensure that the continuing partners can continue the partnership and the family is compensated.

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The topic of partnership succession is concerned with the provision for smooth succession of partnership interests in the event of a partner's departure from the business, whether on death, critical illness or retirement, planned or otherwise. While in family businesses succession may be secured, in most businesses where succession is not secured, it will be desired that in the event of a partner's departure for whatever reason the partnership can continue in the ownership of the continuing partners, leaving them with control of the business while the family/dependants of the outgoing partner is/are compensated financially.

In most partnerships, the problem will be compounded by the fact that while on the death of a partner their family will inherit the right to the deceased's share of the business, unless there is a suitably qualified heir, they will not be able to join the firm.

The statutory position under the partnership Act 1890 is that the partnership is automatically dissolved. The problem is, therefore, how to ensure that the continuing partners can continue the partnership and the family is compensated without having to dissolve the partnership. For convenience the word "partner" includes a member of a LLP (please see LLPs below).

In principle there are three possible ways to achieve this...

Provision via the Will

In theory at least, the most straightforward route would be for each partner in the business to simply provide in their Will that their interest in their share of the business should pass to their co-partners, while the family or dependants will be directly compensated by personal life cover subject to trust for the benefit of members of the family. Although this sounds very simple and straightforward, the main disadvantage of such a direct route is that a Will can be altered at any time without informing the co-partners. This would mean that such an arrangement is unlikely to provide sufficient certainty. For this reason, it is not common to find this type of arrangement.

It may be thought that the problem could be overcome by ensuring that the parties complete identical Wills in each other's favour in respect of their partnership interests. In such circumstances, potential problems could arise where two partners make such identical provisions in their Wills, whereby such Wills could be considered under English law to be "mutual" Wills. Legal and practical complications might arise which are likely to mean that it may not be possible to change the Will after one of the partners has died.

For the above reasons it will not normally be recommended that Will provisions are used to achieve the desired business succession.

Automatic accrual

Another of the routes for the transfer of a business interest available only to partners, which does not involve sale/purchase of the business interest, and which is particularly popular with professional partnerships, is automatic accrual. Broadly speaking, this means that the assets specified to “automatically accrue” will pass automatically on the specified event to the continuing partners without payment.

Agreement for partnership share purchase

Where no automatic accrual provisions exist or to the extent that assets are not subject to automatic accrual, the preferred route for the smooth transfer of business interests on a partner’s departure would be an agreement for sale/purchase of the departing partner’s business interest along with funding arrangements, for example, via life assurance or critical illness policies. As long as the agreement is structured properly, there should be no adverse tax implications and certainty will be provided that the purchase actually takes place.

Limited liability partnerships (LLPs)

Since the introduction of LLPs as a third choice of business medium (in addition to a conventional partnership or a limited company) the issues surrounding succession planning for business owners running a business through this medium may appear to have become a little more complex. At least this is the general perception.

With a LLP being a corporate entity on the one hand (for legal purposes) and a collection of individuals on the other (for tax purposes), it is no surprise that some confusion exists as to how to treat these business entities and their owners, especially in the area involving life assurance planning and trusts, including succession (share purchase) arrangements and keyperson cover. However, clear understanding of the LLP structure and the issues involved should prevent any confusion.

LLPs and keyperson cover

Since a LLP is a corporate entity, then it can transact in its own name. A question may therefore arise whether, if there is a keyperson cover need, a policy should be effected by the LLP itself rather than individual partners. A situation similar to a keyperson in a limited company or a keyperson in a Scottish partnership (where a partnership has a separate legal persona in a similar way as to a LLP).

Whether a policy should be effected by the LLP or its individual members will depend on the circumstances. If the keyperson is an employee of the LLP (and not one of its members) then a corporate owned policy (effected by the LLP) is likely to be more appropriate. As indicated above, although the legal owner of the policy will be the LLP, for tax and other purposes each member is treated as owning a part of that policy. The tax rules are the same as for any other keyperson policy.

If the keyperson in question is one of the members of the LLP, then how the policy should be effected will depend on the specific purpose of the cover. If the LLP effects the policy, then it must be remembered that the member themself or their estate will be entitled to their proportionate share of the policy proceeds.

This would, mean, for example, that on death, the estate of the keyperson would be entitled to their share of the proceeds as represented by their share of the value of the LLP, i.e. their capital account. In most cases of keyperson cover, the purpose is to put the surviving owners in funds to combat the loss of profits or to hire a replacement or both. In such circumstances it would be more appropriate for the policy to be held not through the LLP structure but outside the business, whether through an individual policy in trust for the co-members or (less attractively in most cases) a life of another policy.

Succession (share purchase) planning

Bearing in mind the transparency of a LLP as far as the members´ ownership of their interests in the partnership is concerned – effectively putting a LLP on the same footing as a conventional partnership - then similar considerations with regard to LLPs members´ business interests and any share purchase arrangements would apply as for conventional partnerships.

This could include, depending on the circumstances, an automatic accrual of goodwill, but in most cases, other than family businesses (where the interest of a deceased partner will be left to a family member with no payment), a buy-out arrangement involving an option agreement and funding via a life assurance policy subject to an appropriate trust would probably be a preferred route.

A solution analogous to corporate share purchase, since no separate "shares" exist, would not be feasible for the LLP, so the question of a LLP effected life assurance for these purposes would not arise.

It is important to remember the different terminology as far as LLPs are concerned. As mentioned above, we refer to members rather than partners and we refer to business interests rather than shares. A LLP would also have an incorporation document and a member´s agreement – a conventional partnership would have a partnership deed or partnership agreement. Terminology is particularly relevant when using the so called "standard" draft option agreements and trusts. It is important to ensure that any documentation contains the relevant terminology.

When reviewing existing arrangements for businesses who have changed their structure (e.g. conventional partnership changing into a LLP) existing arrangements should be reviewed to ensure that they continue to apply to the new structure.

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