TIPS FOR PARTNERSHIPS

Partnerships Offer Distinct Advantages

There are many advantages to going into partnership. A principal one is that it allows the purchaser to buy a management rights business that is significantly larger than by acquiring one alone with limited funds.

It It makes economic sense for purchasers to buy as big as possible. The bigger the management rights business the greater the return/profit and ability for faster equity build up.

Working partner

A working partner or hands-on business partner has money invested in the business but also puts their time, effort and soul into running the business. They are paid a management fee and receive a full investment return on their portion of the business.

For the working manager there are huge advantages in forming a partnership with an investor, one is being able to buy bigger and better, frequently skipping the entry-level building stage. This enables a stable income, more turnover and profit growth is more assured; greater potential for capital gain, an increase in choice of business and location and more likelihood of being able to employ staff thereby freeing up the manager's time for true management duties.

From the figures in the table, you will notice that the working partner (manager) can be substantially better off by going into a partnership arrangement then by buying a smaller business by themselves.

A manager can double their expected income and triple their capital growth.

Silent partner

Many silent partners are, in fact, past and current owners of management rights. From their experience and involvement, they are very comfortable with retaining their investment within the industry. The current managers often prefer to remain in their present management rights, while reinvesting the extra equity they have built up into another building.

Other investors are people who aren't yet ready to quit their salary paid jobs but still wish to venture into the business world. There are also people involved in the industry that are keen on investing and of course there are some extremely wealthy investors whom have never been in the industry but want a good solid investment (while they play golf).

It is not unusual for an investor to own two, three or more 'part' buildings. As the equity builds up in one business, there is the opportunity to reinvest the capital growth into another.

Steve Burton
PCS Finanace

The fact that management rights are virtually a 'no cash-no debtor' business and their trust accounts are independently audited gives the investors great comfort with knowledge that there is minimal risk. And the returns for the silent partner can range from 15% to 20%.

Partnerships and how they work

Experience has shown that partnerships with two working partners are more likely to fall apart than a silent and working partnership team. There are advantages with two working partners, not the least being able to share the workload and time commitments. However, the risks of falling out are quite a lot higher. But please note there are some examples where a two working partner team works perfectly.

The financial benefits are greater in a partnership consisting of both silent and working partners.

Be mindful a passive investor need not be just one individual, a silent partner can be a group of investors. Also, a joint venture does not require a 50% investment by both parties. A manager may put in as little as 10%. It is essential, however, that the manager does put most of their money into the partnership.

There is an old saying that one should make sure they can get out of a partnership before they get into one. Most partnership agreements have a stability clause for two or three years so

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tips for partnerships

the non-working partners have a reasonable term for their investment. When one partner wants to leave the business generally the others have first right of refusal to purchase all or part of the share.

All parties are also protected by the manager's operating contract.

Experience also shows that a partner that creates the most difficult scenarios in partnerships is when a non-working partner is a friend or part of the family. This firm has often been called on to advise the best structure for family partnership arrangements. It is still advisable to put a full legal agreement in place.

Essentially partnerships allow the mum and dad managers to purchase the bigger businesses instead of having these properties fall into the hands of corporations.

To maximise the return from the business it is still important to maximise the bank loan to take advantage of the gearing. Finance brokers have been able to deliver some very beneficial financial loan packages for these arrangements.

One example is securing a non-crossed collateralisation agreement (stand alone) for investors with multiple buildings and limited guarantee arrangements.

For best results the manager puts in as much money as they can, obtaining the maximum loan, and the investor is sought for the difference.

For example, my company keeps a database of both silent and working partners. Partnership consultants are able to match clients to a range of conditions/credentials and buildings. This allows for a quick resolution, something that can be crucial when a good building comes on the market these days.

My company has arranged scores of partnerships between people who previously didn't know each other and have entered into contracts on large management rights with-in a day or two.

Assistance for partnership buildings

It is also common to involve a marketing company to provide management support as well as marketing support to the new venture to help ensure its success.

Often a new manager going into a partnership arrangement will be new to the industry or new to a large holiday management rights and will need some marketing support. This will assist the business to build value and assist the managers to have more time to manage the day-to-day operation of the building.. rn

WHAT CAN YOU AFFORD?

The purchaser with $250,000 cash looking for a management rights business… what can they afford?

EXAMPLE 1

Own building

Unit	$300, 000	
M/R	$300, 000	(4.6X)
Costs	$30, 000	
Total	$630,000	
Cash	$250,000	
Loan	$380,000	
Total	$630,000	100% Ownership
Income	$65,000	
Loan repays	$35,000	
	$30,000	Net income to manager (before tax)

EXAMPLE 2

Partnership

Unit	$500,000	
M/R	$2,500,000 (5.5x)	
Costs	$180,000	
Total	$3,180,000	
Managing partner	$250,000	
Loan	$480,000	
Total	$730,000	22% Share
Income	$ 450,000	
Manager's salary	$60,000	
	$390,000	
	22%	
	$86,000	Manager's share
	$60,000	Salary
	$146,000	
	$40,000	Loan repays
	$106,000	Net income to manager (before tax)

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Till Death Do Us Part

The concept of pooling resources and forming a partnership to buy management rights is a great idea. When a blend of skills, energy and financial resources come together in the right mix, a profitable business is usually the result.

In management rights, two couples or two companies often form a partnership. One couple may provide financial input only (silent partner) while the other usually contributes their money, skill and the necessary energy to run the business (managing partner).

Most businesses insure their buildings and other property against fire or storm damage but what about the loss of one of the partners? How would a management rights business survive if one of the managing partners became seriously ill and/or died?

There are two main issues from an insurance viewpoint:

Insurance for the business debt

Both couples should arrange life and disability insurance in their own name equal to the amount of their loan. This ensures that in the event of the loss of a partner who has guaranteed the debt, it can be repaid, leaving the survivor with a debt-free business to produce an income into the future. It really has nothing to do with being in partnership but provides essential security for each partner. In some circumstances, the cover may be arranged under superannuation, making premiums tax deductible.

Insuring the key people in the business

The death or permanent disability of the silent partners may have no financial downside to the partnership, as the business will continue to operate unchanged. However, if the managing partner was disabled or died prematurely, then the financial loss to the business could be disastrous. Managing partners are

really the key people as far as the business is concerned and the silent partner may insure them against death or disability to protect their investment. This means an injection of capital into the business at a time of financial stress.

Alternatively, the partnership agreement may state that it is the managing partner's responsibility to perform the management duties. This means that if they can't do the job for a lengthy period, then they have to pay for a replacement manager. The managing partner may insure the cost of providing for this replacement manager. This could be in the form of income replacement or critical illness insurance, depending on the way the business operates and what cover is available.

Structuring the insurance correctly

For death and disability insurance, it may be possible to arrange the insurance tax effectively under superannuation but this depends on individual circumstances and the entity that forms the partnership. Premiums vary according to policy benefits, sum insured, age and health and in most cases an affordable package can be tailored to suit the business needs.

In a business where the investment required often represents a lifetime of savings and extensive borrowing, it would be unwise to ignore the basic human risks of death and disability. The cost of insuring these events is just another business cost, the same as public liability and fire insurance.

In any business where a partnership is formed or where there are a number of directors of a company, it makes good sense for each partner or director to insure the other. This allows for the efficient buyout of a share of the business in the event of death and is often cemented with a 'buy/sell' agreement or 'business will' included in the partnership agreement. The benefit is that those who are in the business retain control rather than allowing the heirs of any deceased person's to step in.

Ian World
Australian Financial Services Ltd

Many of the risks associated with the venture can be managed by the partners discussing the 'what ifs' and agreeing on a planned approach. The partnership agreement may even be extended to document these issues.

Some people have the belief 'it will never happen to me and, if it does, I'll worry about it when the time comes'.

Unfortunately, insurance doesn't work that way! The time you most need it is usually the time when you can't do anything about it. m

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tips for partnerships

FAQs – Income Tax and GST

Q Am I in a business partnership?

A For income tax purposes, persons (or entities) will be deemed to be in partnership where they are carrying on a business with a view to profit.

The definition for income tax purposes is wider than that at common law but the essential element being of 'mutual assent' and the intention of the parties to 'act as partners' such as joint ownership of business assets, entitlement and evidence to share in profits, operation of joint bank accounts, written partnership agreements and so on.

Q Who can be a partner in a partnership?

A Partnerships can have a number or types of partners. For example, a partnership can be a 'Mum and Dad' 50/50 type; a 'Tom, Dick and Harry' in uneven equity shares and even a partnership of companies, trusts or other partnerships. Partners themselves can be active in running the business or silent (contributing equity only). It is highly recommended that more complex partnerships should ensure that a partnership agreement is prepared by a solicitor at the outset, tabling such issues a profit distributions, admission of new partners, retirement/death of a partner, return of capital, presentation of profit reports payment of salaries and so on.

Q Does a partnership need a tax file number?

A Yes, a partnership must obtain a tax file number. While no direct tax is paid by the partnership itself, it must lodge an annual income tax return to evidence the source and basis of the partners' profits. An application for a tax file number can be obtained via the Internet or by your tax agent/accountant quoting the actual tax file numbers of the partners' themselves. It is necessary therefore that the partners (individuals or entities) must obtain a TFN in the first place before the partnership TFN is obtained. Where the partners are family trusts, this can take some time to do, so it is essential that new business partnerships get started on applications as soon as practicable.

Q Does the partnership need to have an ABN?

A Yes, where the partnership is carrying on an enterprise, it must obtain an Australian business number. This is usually done at the same time as making the application for a tax file number. The date of the formation of the partnership is important because this is the date from which the partnership can register for GST and therefore claim input tax credits. The date may be contained in the partnership agreement or in reference to the date of registration of the business name, signing of a contract or opening of a bank account for example.

Q If the partnership has an ABN does that mean it is automatically registered for GST?

A No. A business does not have to register for GST unless the turnover (gross income) is in excess of $50,000 in any 12 month period. Where the income is under $50,000 it is optional to register. Registration for GST means that the entity must lodge a business activity statement and remit GST on a regular basis to the ATO.

Q What other registrations are required for a new partnership business?

A Sometimes the partnership may be required to pay salaries to employees (or company directors who may be employed). If this is the case, the partnership must also register for PAYG withholding tax. The payment of salaries to owners/company directors should be discussed with your accountant before the registration is done. If salaries are paid a minimum of 9% superannuation must be remitted on a quarterly basis.

Kay Terry
BAMR

Q Can a partnership of individuals pay a salary to one partner before distributing profits?

A This issue is a contentious one with the Australian Taxation Office, especially in the absence of a formalised statement in the partnership agreement. A partner cannot be an employee of a partnership, nor is the salary a withholding event subject to PAYG. The distribution of partnership profits and the payment of an intended salary must therefore be discussed with your accountant at the formation of the structure.

Q Can partners decide each year how much will be distributed to each partner?

A No, this is not recommended. While income splitting may be an advantage with partnerships, it should not be altered from the original agreement.

Care must be taken in the determination of profits and the chosen structure at the outset as problems will arise where one partner receives additional income in one year together with the partnership distribution.

Q Can a partnership take advantage of the special capital gains tax concessions?

A Yes, a capital gain made in a partnership actually belongs to the partners and not the partnership structure. Therefore, there is some degree of flexibility in that each partner can independently choose the CGT concessions they want. Failure by one partner to satisfy the conditions will not affect the other partner.

For example, one partner may take advantage of the CGT retirement concession and the other partner may choose to utilise the CGT rollover concession to continue with a new business. m

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Just Like a Marriage

Partnerships are like a marriage. They require compatibility to be effective. They need each partner to understand and respect the other. They produce great benefits when they work. Disputes, when they occur, can be traumatic and expensive, just like divorces.

There is no doubt that management rights partnerships are a very effective way of achieving substantially greater benefits for the individuals than they would be able to achieve separately the old one plus one equals three equation. However, it is essential that careful thought and planning go into any proposed partnership arrangement to ensure that the interests of all partners are protected and the potential benefit for partners is realised.

The following are what I consider to be the essential considerations for entering into a management rights partnership.

Structure: get thorough and professional accounting advice about the best structure from a taxation perspective. That applies to each individual party as well as to the overall entity. Generally, a partnership between the two parties (or their companies or trusts) is the best vehicle but there may be accounting or taxation reasons that lead to a company or a unit trust in which each partner has shares or units to be a more suitable vehicle.

Documentation: view this as a type of 'prenuptial' agreement. It should be designed not just to address how the partnership will operate in the good times but what is to happen in the bad times. It is essential to ensure that whatever structure is utilised, the terms and conditions of the partnership arrangements are properly documented. That might take the form of a partnership agreement, a shareholder's agreement, or some form of joint-venture agreement. Whatever the case, have the arrangements properly embodied in a document by a lawyer with expertise in this area.

Fundamental terms: in the documentation there are some fundamental or basic elements that must be considered and documented. These include but are not limited to the following: The working arrangements and remuneration for that. Will both or only one partner work in the business? What remuneration is paid for that? It is common for the working partner to receive the caretaking salary in small to medium complexes. What are the living arrangements? Will the partner living onsite pay rent, body corporate levies, rates etc? Who will be required to hold the licence and is that permissible under the licensing laws and the letting agreement with the body corporate?

Duration: is a partnership going to be for a fixed period after which either partner can require the business to be sold?

Retirement or sale arrangements: what is to happen if one partner wants to retire? Does the other partner have the option to buy the retiring partner's share? If so, is that based on a valuation or on the original purchase price? Can a partner sell to a third party without the other partner's approval?

We have developed a partnership checklist that sets out all of the important issues that potential partners in a management rights venture need to consider and agree upon. It is an invaluable tool that we, and our clients, utilise to ensure that all relevant issues are addressed and properly documented in partnership agreements or other documentation.

Pitfalls

Just as many marriages end in divorce, a number of partnerships fail. Often the fallout is severe. I see the following reasons as to why partnerships fail.

Incompetence or inexperience of working partners: it can be difficult to assess the abilities of someone without specific experience in the area of management rights. It is essential to fully investigate a potential working partner's abilities and experience to ensure that they can properly carry on the business.

Incompatibility: this might be financial, social, work ethic related or similar. One partner might have visions of substantial expansion of the business, which may necessitate considerable upfront expense, but the other partner might be satisfied to simply let the business run as it has been. One partner might want to take out all the profit without reinvesting it in promotion of the business or debt repayment, contrary to the wishes of the other. One partner might feel intimidated by the ability of the other. These issues need to be considered and investigated as best as they possibly can be, and discussed in an open and frank way before committing to a partnership.

Arrangements not documented: if the partnership arrangements have not been agreed to and documented, there can be dispute as to what the exact arrangements are. It is quite amazing how different partners can have totally opposing views as to what their undocumented arrangements are.

Poor, or no retirement or sale, provisions: it is often the case that disputes arise when one partner wants to retire or sell the business. In the absence of provisions in the partnership agreement dealing with these specific items, disputes can and usually do arise. Again, this highlights the importance of documenting these and other essential conditions.

John Mahoney
Mahoney Lawyers

I have regularly used the expression 'do your homework thoroughly' when talking to potential purchasers of management rights. The same applies to anyone considering a management rights partnership arrangement. Partnerships can and do work well in management rights if they are properly investigated, thoroughly considered from all angles and professionally documented.

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