Sharing the Wealth: Six Methods of Partner Income Distribution

Understanding methods of income distribution can minimize conflict and help partners plan their futures.

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It's not fair. I founded this practice almost 30 years ago. I've brought all four of my partners into the practice. And now I find that I want to cut back to two days a week, but if I do that, I won't make any income and will actually owe the practice money each month."

You can imagine how this founding physician must feel as he finds that his hopes to slow down during the last years of his career have been crushed by his practice's compensation system. The method a practice uses to divide owner compensation is one of the most common sources of conflict between partners. However, the more the co-owners understand the six basic methods of partner income distribution, the higher the probability that they will be able to agree on an appropriate approach.

Even Division

The basic formula for determining income in a practice can be shown as:

Revenues
- Expenses
Net Income

A practice could simply subtract all its expenses from its revenues and then divide up the remaining net income among the owners as a model for paying the partners. Or a practice could instead apply the formula above to each owner separately by allocating expenses to each partner based on one of the methods detailed below. In this case, each owner becomes, in a sense, a profit center, with collected revenues and allocated expenses individually assigned. The net income for each partner then becomes that person's compensation.

Essentially, all methods of partnership income distribution fall into two basic categories:

Dividing up income or
Allocating expenses.

Within these two major categories, there are only six specific methods that we have found for doctors to distribute the proceeds from their practices.

Dividing Income

If a practice chooses to divide income, it can advocate one of three methods:

1. Equal Pay. Equal pay results in each doctor receiving the same income, regardless of his or her production. This method gives a high incentive to refer patients to the most qualified doctor in the practice, since there is no financial incentive to do a procedure if someone else in the practice has more experience in that area. Competition among the group's doctors is also minimized in an Equal Pay approach, and teamwork is fostered. This is probably the easiest compensation method for attracting new doctors to a practice if the practice is financially successful.

On the other hand, equal pay eliminates the individual incentive to be productive. Practices using this method often find that they must police their physicians by implementing rules about how many patients must be seen per

day, how many days must be worked per month, etc. High producers often become disenchanted with Equal Pay and sometimes leave the practice because they feel like they are subsidizing lower producers.

2. Production Percentage. This method is probably the most commonly used system for dividing income among practice owners. In practices that use this approach, a partner who generates 60 percent of the total collected revenues receives 60 percent of the practice net income. This method produces a strong incentive for each partner to be productive, since income is directly tied to her/his ability to generate revenues for the practice. Under this system, if one doctor increases her production, all partners benefit. However, the reverse is also true: if an owner decreases his work time, all partners see a reduction in income.

3. Ownership Percentage. In this method, physician compensation is divided by percentage of ownership. When this approach is used, the practice typically only divides a portion of its income by ownership percentage. For example, 10 percent of the practice net income might be divided by Ownership Percentage and the remaining 90 percent by Production Percentage. In offices where ownership percentages are unequal between partners, this method may be used to increase the reward for those with a greater stake in the practice.

In an S-corporation, a partnership entity or a limited liability company, this method becomes the default income distribution system at the end of the practice's tax year, since any income not already paid out is allocated to the owners in proportion to their ownership percentages. C-corporations typically distribute all income to the owners before the end of their tax year to avoid double taxation on dividends and so would rarely use this allocation method.

Allocating Expenses

If a practice's owners choose to distribute income by allocating expenses to individual partners, there are also three ways to do that:

1. Equal Overhead. In this method, overhead expenses are split equally among the partners. If the overhead is $500,000 per year, and there are two partners, each partner is responsible for paying half the overhead ($250,000); any revenues a partner generates above that amount are hers to keep.

> The objective of any method of partnership income distribution should be to provide the incentives to owners that will lead to the accomplishment of their mutual goals and will reward each partner's relative contribution.

Splitting overhead equally provides a high incentive to produce and favors the higher producers. For example, a doctor producing $350,000 per year in revenues and paying $250,000 in overhead would make $100,000; another doctor paying the same overhead but producing $450,000 would make $200,000, so the high producer would have 100 percent more income than the low producer, while only generating 28.6 percent more in revenues.

Using the Equal Overhead method can make it difficult to attract new doctors to a practice, since the thought of paying an equal share of the overhead load can be overwhelming to a young physician who is still building revenues. Also, as in the case of the founding physician mentioned above, the Equal Overhead approach makes it difficult for a partner to reduce his workload at the end of his career.

2. Equal Overhead Percentage. In this method, the same overhead percentage is applied to all of the physicians. For example, if the practice's overhead is 60 percent of revenues, then each doctor would pay 60 percent of his/her revenues to cover expenses and the other 40 percent of his/her revenues would be his income. In other words, if a doctor produces $700,000 in revenues, he would be charged 60 percent of that in overhead ($420,000) and would have income of $280,000 ($700,000 - $420,000 = $280,000). Another physician who produces $300,000 in collections would be charged $180,000 in overhead, leaving $120,000 in income. There are two other ways to state this method, but the calculations yield the same result:

Overhead is split among physicians based on their percent of the total production of the practice, i.e. if one doctor produces 60 percent of the revenue, he pays 60 percent of the overhead; the other partner producing 40 percent of the revenues would pay that portion of the overhead.

The Equal Overhead Percentage method is also the same as splitting income based on the doctor's Production Percentage as noted above. In our example, with revenues of $1 million and overhead of $600,000, the

practice income would be $400,000. The first doctor would receive 70 percent of that income, since his/her production is 70 percent of the total, and would make $280,000. The second doctor would receive 30 percent of the income, or $120,000, so the net result is the same for the Equal Overhead Percentage method of allocating expenses as for the Production Percentage approach to dividing income.

The underlying assumption of this method is that a partner who produces more revenue is using more resources of the practice, and so should pay more of the overhead. This method makes it relatively easy to add a new doctor, since a physician building a practice will pay less overhead in the early years when production is lower. It also allows for an easier transition out of practice; as a doctor cuts back his schedule, his overhead charges decline in relative proportion to his decreasing production. However, any reduction in revenues by one partner increases the overhead load for the remaining partners, so some practices limit how much a physician can reduce his work schedule.

3. Specific Overhead Expense Allocation. In this method, measurements are made of actual resources used by each owner, and the expenses attendant to those resources are individually assigned to the partners. Some expense allocations under this method are easy to determine. For example, if a doctor is the exclusive user of a particular assistant, she would be charged for the cost of that assistant, including salary and benefits. Likewise, any CME expenses, association memberships, insurances, or equipment exclusively used by a provider would be charged directly to the appropriate doctor.

However, some expenses are harder to allocate between doctors. For example, receptionists typically work for all doctors, so the partners have to decide whether the receptionists' pay and benefits will be allocated based on the number of patients seen by each doctor or on the percentage of revenues generated by the individual doctors or by some other method. Rent and utilities can be divided based on the percentage of the exam rooms used by each physician, or on an equal basis, depending on the partners' preference. Other expenses must likewise be directly allocated to the actual user or split up equally or by another measure that approximates usage.

This method of splitting overhead provides an incentive for doctors to be very careful in their use of resources and rewards the most efficient providers. The weakness of this system is that it is very difficult for the majority of practices to implement, it requires sophisticated accounting processes, and it can lead to squabbles among the partners regarding who pays for which resources.

Even Distribution

Most practices use a combination of two or more of these six methods in their income distribution plan. For example, a practice might split income by Production Percentage, but then use the Specific Overhead Expense Allocation method to deduct from each doctor's individual income "physician discretionary" expenses such as CME costs, dues and subscriptions, personal insurances, and pension plan contributions. Another practice might use the Equal Overhead Percentage system to charge the partners for general practice expenses but then divide income generated by retail product sales or by employed providers based on the Equal Pay method.

The objective of any method of partnership income distribution should be to provide the incentives to owners that will lead to the accomplishment of their mutual goals and that will reward each partner's relative contribution to the practice. If practice owners spend the time to understand the basic methods of income distribution, they will be ready to devise a compensation system that is as fair as possible to all parties.

New In Your Practice

Winterize the Skin. When the cold, bitter air of winter leaves the skin dry, patients can try mesoestetic USA's Winter Pack, a collection of clinical skin care products the company says is formulated to protect, nourish, and moisturize skin. Included in the Winter Pack is a cleansing milk that contains botanically-sourced AHAs, a facial tonic, an anti-aging flash ampoule containing vitamin F, vitamin C, collagen, elastin, and vegetal tensors, and an eye lift.

Handy Foam. Because dermatologists recognize the importance of good skin hygiene in the clinic, you may be pleased to note the launch of Avagard Foam Instant Hand Antiseptic with Moisturizers (62 percent w/w ethyl alcohol, 3M). Containing a blend of five different emollients designed to moisturize and condition the hands as it disinfects, Avagard Foam is a non-aerosol product that provides fast, effective bacterial kill (including MRSA), according to the company.