



Case Study:
Admission of a New Partner into Dr. Smith's
Dental Practice

Background

Dr. Smith is the sole owner of a successful dental practice generating \$1,500,000 in annual revenues with \$450,000 in annual expenses, resulting in \$1,050,000 in net income before taxes. Dr. Smith is considering admitting Dr. Jones as a new partner. Dr. Jones plans to buy into the practice by contributing capital and sharing in profits, losses, and management responsibilities.

Both doctors seek to agree on a fair valuation of the practice and determine the optimal legal and tax structure for the new partnership.

Objectives

1. Determine a fair valuation for Dr. Jones's buy-in based on the practice's current financials.
2. Explore entity structuring options that balance tax efficiency, liability protection, and operational flexibility.
3. Define profit-sharing and responsibility allocation aligned with capital contributions and involvement.

Step 1: Valuation of the Practice

Financial Overview

Description	Amount
Annual Revenue	\$1,500,000
Annual Expenses	\$450,000
Net Income Before Tax	\$1,050,000

Valuation Approaches

1. Income-Based Valuation (Capitalization of Earnings Method):

- Using net income and applying a capitalization rate based on industry standards (typically 20-30% for dental practices, depending on growth, risk, and goodwill).
- Example: Capitalization rate = 25% (i.e., multiplier of 4)
- Estimated Practice Value = Net Income × Multiplier = \$1,050,000 × 4 = \$4,200,000

2. Asset-Based Valuation:

- Consider tangible assets like equipment, leasehold improvements, and receivables.
- Typically, less relevant for profitable service businesses where goodwill and income generation drive value.

3. Market-Based Valuation:

- Compare with recent sales of similar dental practices in the region.

Recommended Valuation for Negotiation

- Based on income capitalization, the practice is valued at approximately \$4.2 million.
- Dr. Jones's buy-in percentage will determine capital contribution. For example, for a 25% partnership stake:
 - $\text{Capital contribution} = 25\% \times \$4,200,000 = \$1,050,000$

Step 2: Entity Structure Options

Option 1: Partnership (General Partnership or Limited Liability Partnership - LLP)

- Pros:
 - Simple formation.
 - Income flows through to partners' personal tax returns.
 - Partners share profits, losses, and management.
- Cons:
 - General partners have unlimited liability (unless LLP).
 - Self-employment tax applies on all distributive shares.

Option 2: Professional Limited Liability Company (PLLC) with Partnership Taxation

- Pros:
 - Limited liability protection.
 - Pass-through taxation.
 - Flexibility in profit and loss allocation.
- Cons:
 - More administrative formalities.
 - Self-employment tax applies similarly to partnerships.

Option 3: Professional Corporation (PC) or S-Corporation

- Pros:
 - Limited liability protection.
 - Potential payroll tax savings if structured as S-Corp.
 - Formalized management structure.
- Cons:
 - More regulatory requirements.
 - Restrictions on ownership (must be licensed professionals).
 - Potential double taxation if C-Corp.

Step 3: Tax Implications and Profit Sharing

- Self-Employment Tax:
 - Both partners will pay self-employment tax (15.6%) on their share of business income unless structured as an S-Corp with reasonable salaries.
- Income Tax:
 - Income is taxed at the individual rate (22%).

- Profit Sharing:
 - Typically aligned with capital contributions, but can be adjusted based on agreed roles and responsibilities.
- Recommended:
 - Draft a partnership agreement detailing profit distribution, capital accounts, decision-making authority, and buy-sell provisions.

Step 4: Drafting the Partnership Agreement

Key provisions to include:

- Capital Contributions: Amount and timing of Dr. Jones's buy-in payment.
- Profit and Loss Allocation: Based on percentage ownership or other agreed formula.
- Management and Voting Rights: Define roles and decision-making processes.
- Buy-Sell Clauses: Procedures if a partner wants to exit or in case of death/disability.
- Dispute Resolution: Methods for resolving disagreements.
- Non-Compete and Confidentiality: Protect practice goodwill.

Financial Models: Ownership Percentages & Entity Structures

Model Assumptions

- **Ownership splits:** 100% Dr. Smith (baseline), then 75/25, 60/40, and 50/50 splits.
- **Entity structures:**
 - **Partnership/PLLC:** Income taxed as pass-through, partners pay income tax + SE tax on their share.
 - **S-Corp:** Both partners pay themselves reasonable salaries (modeled as 40% of their share of net income), remaining income distributed as dividends (no SE tax on dividends). Payroll tax rate assumed same as SE tax (15.6%).
- For simplicity, salary is set at 40% of partner's share of net income in S-Corp models.

1. 100% Ownership (Dr. Smith alone) - Baseline

Description	Amount
Net Income Before Tax	\$1,050,000
Income Tax (22%)	\$231,000
Self-Employment Tax (15.6%)	\$163,800
Total Taxes	\$394,800
Net Income After Taxes	\$655,200

2. 75% Dr. Smith / 25% Dr. Jones — Partnership

Description	Total Practice	Dr. Smith (75%)	Dr. Jones (25%)
Net Income Before Tax	\$1,050,000	\$787,500	\$262,500
Income Tax (22%)	\$231,000	\$173,250	\$57,750
Self-Employment Tax (15.6%)	\$163,800	\$122,700	\$41,100
Total Taxes	\$394,800	\$295,950	\$98,850
Net Income After Taxes	\$655,200	\$491,550	\$163,650

3. 75% Dr. Smith / 25% Dr. Jones — S-Corp

Description	Dr. Smith (75%)	Dr. Jones (25%)	Total
Share of Net Income	\$787,500	\$262,500	\$1,050,000
Reasonable Salary (40%)	\$315,000	\$105,000	\$420,000
Remaining Income (Distribution)	\$472,500	\$157,500	\$630,000
Payroll Taxes (15.6% on salary)	\$49,140	\$16,380	\$65,520
Income Tax (22% on total income)	\$173,250	\$57,750	\$231,000
Total Taxes	\$222,390	\$74,130	\$296,520
Net Income After Taxes	\$565,110	\$188,370	\$753,480

4. 60% Dr. Smith / 40% Dr. Jones — Partnership

Description	Total Practice	Dr. Smith (60%)	Dr. Jones (40%)
Net Income Before Tax	\$1,050,000	\$630,000	\$420,000
Income Tax (22%)	\$231,000	\$138,600	\$92,400
Self-Employment Tax (15.6%)	\$163,800	\$98,280	\$65,520
Total Taxes	\$394,800	\$236,880	\$157,920
Net Income After Taxes	\$655,200	\$393,120	\$262,080

5. 60% Dr. Smith / 40% Dr. Jones — S-Corp

Description	Dr. Smith (60%)	Dr. Jones (40%)	Total
Share of Net Income	\$630,000	\$420,000	\$1,050,000
Reasonable Salary (40%)	\$252,000	\$168,000	\$420,000
Remaining Income (Distribution)	\$378,000	\$252,000	\$630,000
Payroll Taxes (15.6% on salary)	\$39,312	\$26,208	\$65,520
Income Tax (22% on total income)	\$138,600	\$92,400	\$231,000
Total Taxes	\$177,912	\$118,608	\$296,520
Net Income After Taxes	\$452,088	\$301,392	\$753,480

6. 50% Dr. Smith / 50% Dr. Jones — Partnership

Description	Total Practice	Dr. Smith (50%)	Dr. Jones (50%)
Net Income Before Tax	\$1,050,000	\$525,000	\$525,000
Income Tax (22%)	\$231,000	\$115,500	\$115,500
Self-Employment Tax (15.6%)	\$163,800	\$81,900	\$81,900
Total Taxes	\$394,800	\$197,400	\$197,400
Net Income After Taxes	\$655,200	\$327,600	\$327,600

7. 50% Dr. Smith / 50% Dr. Jones — S-Corp

Description	Dr. Smith (50%)	Dr. Jones (50%)	Total
Share of Net Income	\$525,000	\$525,000	\$1,050,000
Reasonable Salary (40%)	\$210,000	\$210,000	\$420,000
Remaining Income (Distribution)	\$315,000	\$315,000	\$630,000
Payroll Taxes (15.6% on salary)	\$32,760	\$32,760	\$65,520
Income Tax (22% on total income)	\$115,500	\$115,500	\$231,000
Total Taxes	\$148,260	\$148,260	\$296,520
Net Income After Taxes	\$376,740	\$376,740	\$753,480

Summary Table: Net Income After Taxes (by Ownership & Structure)

Ownership Split	Partnership Net Income After Taxes	S-Corp Net Income After Taxes	Tax Savings (S-Corp vs Partnership)
100% Dr. Smith	\$655,200	N/A	N/A
75/25	Dr. Smith: \$491,550 Dr. Jones: \$163,650 Total: \$655,200	Dr. Smith: \$565,110 Dr. Jones: \$188,370 Total: \$753,480	\$98,280
60/40	Dr. Smith: \$393,120 Dr. Jones: \$262,080 Total: \$655,200	Dr. Smith: \$452,088 Dr. Jones: \$301,392 Total: \$753,480	\$98,280
50/50	Dr. Smith: \$327,600 Dr. Jones: \$327,600 Total: \$655,200	Dr. Smith: \$376,740 Dr. Jones: \$376,740 Total: \$753,480	\$98,280

Key Observations

- S-Corp structure yields approximately \$98,280 more net income for the practice overall due to payroll tax savings by splitting income into salary and distributions.
- Tax savings are roughly the same regardless of ownership split because the total practice income and expenses remain constant.
- Each partner's after-tax income scales with their ownership percentage.
- Partnership structure is simpler but results in higher self-employment taxes on the full distributive share.
- S-Corp requires payroll setup and reasonable salary determination but offers significant tax savings.

Recommendations

- Consider electing **S-Corp status** for the new entity to maximize tax efficiency.
- Agree on a **reasonable salary** for each partner to comply with IRS rules.
- Draft a **partnership/shareholder agreement** detailing ownership, profit sharing, salary, and distributions.
- Consult tax and legal professionals to optimize entity choice and structure based on state laws and professional licensing requirements.

Frequently Asked Questions (FAQs)

Q1: How is the buy-in price determined?

A: Typically, through valuation methods such as capitalization of earnings, market comparisons, or asset-based approaches.

Q2: Can profit sharing differ from capital contributions?

A: Yes, partners can agree to different profit-sharing ratios based on roles, responsibilities, or other factors.

Q3: What liability protection does each structure offer?

A: Partnerships generally expose partners to liability unless structured as LLP or PLLC; corporations offer limited liability.

Q4: How are taxes handled in partnerships vs. corporations?

A: Partnerships have pass-through taxation with self-employment tax on income; S-Corps can reduce self-employment tax by paying reasonable salaries.

Q5: What happens if one partner wants to leave?

A: Buy-sell provisions in the partnership agreement govern exit terms, valuation, and transfer of ownership.

Conclusion

Admitting Dr. Jones as a partner offers growth and shared management opportunities for Dr. Smith's dental practice. A fair valuation and clear agreement on entity structure, profit sharing, and responsibilities are essential for a successful partnership. Professional advice and thorough documentation will help ensure the partnership's long-term success and tax efficiency.