

# Earning Capacity Assessment for the Self- Employed

---

**Jeremy Sharpe, MBA**

Senior Managing Consultant

Berkeley Research Group, LLC

**Kourtney Layton**

MRC, CRC, LVRC, ABVE/F, IPEC, CLCP

Kourtney Layton & Associates

# Agenda/Presentation Goals

---

- *Provide an overview for analyzing the lost earning capacity of the self-employed and discuss why this category of work provides unique assessment situations.*
- *Identify and define key terms and concepts.*
- *Outline a document request list.*
- *Identify sources of data for earnings history.*
- *Learn how to evaluate the earnings data for the self-employed worker.*
- *Discuss methodologies for assessing the lost earning capacity of a self-employed person.*
- *Discuss expectations for interactions between vocational expert and economist.*
- *Develop strategies for effectively working with the collaborating economist.*
- *Identify pitfalls in an analysis.*
- *Review case studies to gain a better understanding of how to evaluate loss of earning capacity for self-employed individuals.*



# Key Terms

---

- Earning Capacity
- Worklife Expectancy
- Life Expectancy
- Disability
- Closely Held Business
- Reasonable Compensation
- Business Owner-Employee or “Active Owner”
- Key Person
- Going Concern
- Business Financial Statements
- Dividends and Distributions

# Key Concepts

- A business owner's personal tax return rarely reflects the earning capacity of the owner.
- Business owners have the incentives and the ability to control the amount, timing, and types of compensation they receive. The IRS requires business owners to report “Reasonable Compensation” which represents an approximation of the market rate for the tasks performed by the individual.
- Reasonable Compensation and Earnings Capacity *may* be the same but the conceptual notion of normalizing the owners compensation will support the VE conclusions of pre-injury earning capacity.
- The types of compensation received by the owner can be for the tasks they perform in the business or distributions. It can sometimes be difficult to delineate between the two forms of owner compensation.
- Economic damages related to a loss of earning capacity should only include the compensation the business owner receives as a result of the tasks they perform in the business.

# Iowa Model Jury Instructions

## Lost Earnings Capacity of Business Owners

---

1. Future loss of earning capacity is not measured by future loss of profits from a business, but is measured by the value of a person's own labor.
2. Profits represent the gain from an investment in capital or business and the labor of others, after payment of expenses.
3. You may consider evidence of past profits of the business in determining the plaintiff's earning capacity prior to the injury only if the evidence shows the value of plaintiff's services to the business as distinct from the profits derived from invested capital and the labor of others.

# General Document Request List

---

- Evaluatee name, Date of Birth, Date of Injury;
- Date of Loss (if different than DOI);
- Evaluatee's contact information;
- Employment History (resume or historical employment summary);
- Copies of full medical file plus any medical summaries already completed (electronic records are preferable);
- If a Life Care Plan is requested, we'll also need copies of all medical bills and any physician recommendations regarding future medical care;
- All expert reports (IME's, impairment ratings, FCE's, etc.);
- Fringe Benefit Information;
- Personal tax returns, W-2 statements, 1099 statements.

# Sources of Business Data for Analysis

---

- Business Tax Returns
- Financial Statements
  - Income Statement
  - Balance Sheet
  - Statements of Cash flows
  - Statement of Stockholders' Equity
- Identification and documentation of lost customers, contracts, etc.
- QuickBooks or similar software
- Tax preparer's work papers and contact information
- Plaintiff's contact information, interrogatories or deposition.
- Bookkeeper's contact information or 30b6 deposition.

# Types of Business Structures

- Sole Proprietorships
  - S Corporations
  - Partnerships
  - Limited Liability Company (LLC)
    - State business entity
    - The IRS treats LLC's as a corporation, partnership or as self-employment income.
  - C Corporations
- Sole Proprietorships report their business earnings on schedule C of their personal return.
  - Distributions from LLC's or S Corp. entities are typically reported on schedules C or E of the individuals personal tax return.
  - Partnerships, C corporations and Corporate LLC's will have returns filed for the entity. Distributed income is reported on the personal return schedule E.
  - C Corporations pay shareholders dividends and these are reported on schedule B of the personal return

# A sample of tax court factors used to determine Reasonable compensation

1. Active Owner's role (or roles) in the company
2. Scarcity of qualified replacement employees
3. Comparison of the business owner-employee compensation with the compensation of non-owner employees performing similar tasks in similar companies.
4. Character and condition of the company
5. Possible conflicts of interest
6. Internal inconsistencies of employee pay
7. General economic conditions that influence the business performance.

# Practical Steps to Determine the Earning Capacity of a Business Owner

1. Understand actual tasks performed by the active owner in the business. Many business owners perform various tasks that have differing market values. Be prepared to incorporate the market pay of multiple vocations.
2. Understand the time allocated to these functions, including total typical hours worked each week
3. Apply market rate(s) for expected compensation in the open labor market. What would an investor pay a replacement employee?
4. Analyze the actual compensation to the owner by reviewing wages, distributions, fringe benefits and perquisites. Be prepared to explain any apparent or real inconsistencies between the claims and the accounting evidence.

# Methodologies for Assessing the Lost Earning Capacity of a Self-Employed Person

---

Regardless of the model used, self-employed persons usually work longer than employees.

- The older the person is, the higher the probability that they will continue working past the age of expected retirement.

# Expectations for Interactions Between the Vocational Expert and Economist

---

## Kourtney says:

- Stay in your lane. Don't try to do the economist's job.

## Jeremy says:

- Communicate early and often as each expert reviews the case materials
- Be very specific with the attorney about the data you need to complete your analysis.

# Strategies for Effectively Working with the Collaborating Economist

---

- Have a conversation about the methodologies you have utilized in past case work;
- Discover if there are any concerns regarding different approaches that can be exploited by the opposing counsel;
- Understand the opinions of the vocational expert regarding the pre and post injury earning capacity of the individual;
- Discuss the job title or titles the business owner is performing;
- Identify types/categories of fringe benefits;
- Delineate between opinions of each expert (economist and vocational expert) and discuss how they interrelate, overlap or differ. i.e. economist may rely upon VE's expertise regarding worklife expectancy.

# Possible Pitfalls in an Analysis

---

- The earnings losses that are determined by the economist and the vocational expert differ;
- Tax returns don't match the financial statements;
- Insufficient evidence to show causation that may be explained by the business financial data:
  - Ask for support for specific lost earnings from the owner
  - Delay of when jobs were performed
  - Damages may be identified as temporary replacement employee
- If there is an increase or decrease of revenues, be prepared to explain why:
  - There can be economic factors unrelated to the incident
  - Expenses may have increased due to loss of efficiency or hiring of replacement employees

# Case Studies

---

## Case Study #1

What happens if a "key person" is injured?

## Case Study #2

What happens if the person is injured but can only do part of their former job function and, therefore, replacement labor is required?

## Case Study #3

What happens when the business can no longer function without the key person?

## Case Study #4

What happens if the evaluatee's business acumen doesn't match his or her earning capacity?