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## **Damages of the Self-employed: An Introductory Overview**

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### **Introduction**

Those who are “traditionally employed” typically:

- Earn income that is reported by their employer on a T4 slip
- Work in occupations for which census-based income data is available
- May be subject to collective bargaining agreements that specify income levels for specified time periods and specified job classifications

Of critical relevance from a pecuniary loss perspective, it is the employer and not the “traditionally employed” employee who makes the final decision regarding pay level.

From an earnings loss perspective, self-employed individuals are distinguished from traditionally employed individuals by the source or sources of their work income. For example:

- An unincorporated sole proprietor will have business or professional income and business or professional expenses. The excess of income over expenses is the individual’s taxable income from work.
- If there is a corporation, the self-employed individual may take his or her income entirely as employment income (with an associated T4 slip), entirely as dividend income, or from both sources.

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Decisions about whether or not to incorporate, when and how to extract money from one's corporation, etc. are often made in the context of a desire to minimize one's "income for tax purposes", through all legal means available, and thus to minimize income tax payable.

When a self-employed individual is injured or suffers a wrongful death, the actuary or other economic loss expert must scrutinize and adjust the reported taxable income – which was minimized for strategic tax reasons – in order to evaluate, as accurately as possible, the injured party's true pre-accident annual earning capacity and thus the value of past and future lost earning capacity.

To add further complexity, the company's revenue may fluctuate from year to year due to a variety of internal and external factors (state of the general economy, presence of competitors, weather, equipment breakdowns, etc.). These fluctuations can impact the funds that are available to provide income to the business owner.

Finally, the self-employed individual may choose to leave money in his or her company in order to invest in property or equipment that is expected to generate future revenue growth for the company and increased personal income for the individual.

All of these factors must be considered by the economic loss expert as he or she formulates an expert opinion regarding the past and future annual pre-accident and residual earning capacity of a self-employed individual.

## **Key Assumptions**

When the injured or deceased party is self-employed, the actuarial assumptions that require the most attention are:

- Annual earning capacity (pre-accident and residual)
- Probability of disability
- Retirement age

Once the assumptions are selected, the valuation process does not differ materially from the situation of a traditionally employed individual.

## **Considerations Regarding Annual Earning Capacity**

These examples illustrate the sort of adjustments that may be made to reported income:

- The spouse of the injured party is an employee of the corporation and is paid more than market value for the work performed.
  - If this is an income-splitting (tax minimization) exercise, then it may be appropriate to attribute some or all of the spouse's income to the injured party.

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- The corporation has significant retained earnings.
  - It may be reasonable to assume that if not for the accident the injured party would have eventually removed those retained earnings from the corporation as employment or dividend income.
- The sole proprietorship pays for a mobile phone or a gym membership that the injured party would pay for if the business did not exist.
  - It may be appropriate to remove the cost of such items from the business expenses. This would increase the injured or deceased party's income.
- The business premises are in the home of the injured party and the injured party is claiming a percentage of household utility and maintenance costs as business expenses, as is permitted.
  - If the business did not exist, those costs would continue. Thus, it may be appropriate to reverse some or all of those deductions from income.
- Self-employed individuals are generally not eligible for Employment Insurance benefits.
  - Thus, EI premiums would not be deducted from past lost income (or from future lost income in Newfoundland & Labrador) if the cause of the injury is such that pecuniary losses are to be determined on a net income rather than a gross income basis.

## **Considerations Regarding Disability Incidence**

Some traditionally employed individuals participate in employer-sponsored short-term and long-term disability programs. These provide income support during temporary or permanent periods of disability that are in addition to the disability benefits that may be provided by the Canada Pension Plan and the sickness benefits that may be provided by the Employment Insurance (EI) program.

A self-employed individual, particularly if he or she has a very small business, may not have private disability coverage and is generally not eligible for EI benefits. The patterns of disability incidence may differ between traditionally employed and self-employed individuals because the available "safety nets" are different for these two categories of individuals.

Although there may not be sufficient evidence to justify divergence from standard disability incidence tables, the economic loss expert should consider the available information before formulating an opinion regarding disability incidence rates for a self-employed individual.

## **Considerations Regarding Retirement Age**

Although pre-accident retirement age is a factual issue, the economic loss expert will usually make an assumption and present some evidence to substantiate that assumption.

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There is significant data available from Statistics Canada, the insurance industry, and other sources regarding retirement trends and average retirement ages for various occupations.

In considering data that may support a later-than-average retirement age assumption for self-employed individuals, it should be understood that a self-employed individual has considerable control over his or her conditions of work. A traditionally employed individual will typically work full-time until a specific date and then retire fully. A self-employed individual may be more likely to phase into full retirement by taking longer and longer holidays each year or working shorter weeks over a number of years prior to full retirement.

The expert's assumption should take such factors into account.

## Other Considerations

1. Is there unreported income? Is there evidence to substantiate the existence of the unreported income?
2. Parties other than the injured individual may have suffered pecuniary losses:
  - Partners in the business
  - The corporation itself

Is the injured party the only plaintiff? In this regard, the 1996 Supreme Court of Canada decision in *D'Amato v. Badger* is instructive. It outlines the very limited circumstances under which a corporation might be awarded damages for the pure economic losses experienced due to the injury to or death of a key shareholder or employee. In the *D'Amato* matter, some of the losses suffered by the corporation were awarded to Mr. D'Amato (the injured party and a shareholder of the corporation that employed him) under the *alter ego* principle. However, this aspect of the award (originally made by the BC Court of Appeal) was not appealed to the Supreme Court and thus was not reviewed by the Supreme Court.

The 1981 BC decision in *Everett v. King* provides insight into the courts' approach to considering when and why the *alter ego* principle may or may not apply. The more recent (2011) BC decision in *Zen v. Readhead* is of interest because it outlines the spectrum of issues that the courts may consider when determining whether or not a company's profitability has been affected by an injury to a key shareholder/employee.

## Further Common and Not-so-common Complexities

- The company's revenue increases after the injury or death.
- The company continues to pay the injured party after the accident, but also hires replacement labour to do the work previously performed by the injured party.

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- The injury or death occurred shortly after the company was established.

## Data Requirements

The data collection process is more complicated when the injured or deceased party is self-employed. Your economic loss expert will probably ask for the following:

- If a Chartered Business Valuator (CBV – a specially trained accountant) has imputed annual income to the injured party for another purpose (perhaps a family law matter) in the recent past, then that report may provide helpful information to evaluate the lost earning capacity.
- Full tax returns and expense summaries if the business is a sole proprietorship (instead of the less detailed personal income tax return summaries)
- Corporate financial statements
- Income tax return summaries of the spouse (if “income-splitting” may have occurred)

## Final Word

Evaluating the pecuniary damages of a self-employed individual can be complicated. It is reasonable to ask your expert, before confirming the retainer, whether or not they have the requisite expertise.

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