

Deciding on a salary to pay to a director

Options

One of the main reasons for setting up a limited company is to be able to take advantage of the benefits of paying a mixture of a salary and dividends. Deciding on the split between salary and dividend is very important.

The options (assuming you do not fall under the provisions of IR35) are:

- A salary set at the level of the tax and National Insurance ('NI') free allowance (£5,715 per annum for 2010/11) - commonly referred to as the **Lower Earnings Limit** ('LEL') or
- A salary at or above the level of the **National Minimum Wage** ('NMW'). The NMW is currently £5.80 per hour (age 22 or over), so for a typical 37.5 hour week paying the NMW would equate to a salary of £11,310 per annum.

Advantages and Disadvantages of Each Option

The main advantages and disadvantages of each option are summarized as follows:

	Salary Basis	Advantages	Disadvantages
1.	Lower Earnings Limit - £5,715 per annum for 2010/11	Saving of £973* per annum compared to NMW (savings are greater the higher the salary is above NMW) National insurance credits towards basic state pension Simplified payroll	No National Insurance credits towards state second pension
2.	National Minimum Wage or higher	National insurance credits towards state basic and second pension	£973* per annum more tax and NI than LEL (additional cost higher the higher salary above NMW) Full payroll required

* Employer NI - £716, employee NI - £615, PAYE - £967, less corporation tax reduction - £1,325

National Minimum Wage

As things currently stand, a director of a limited company does not have to be paid the NMW provided that he or she does not have a formal contract of employment with the limited company

The following link to the Direct.gov website contains relevant information.

<http://www.direct.gov.uk/en/Employment/Employees/TheNationalMinimumWage>

Tax Investigations

It is a common contention that a company director being paid below the NMW is risking unnecessary attention from HM Revenue & Customs which could provoke a tax investigation. It is not really practical to comment on the accuracy or otherwise of this contention: what can be said, however, is that many factors (including straight random selection) can trigger a tax investigation. But if a company's affairs are in order, then there is little to fear from such an investigation. And, as an additional comfort, the annual tax and National Insurance savings by paying a salary based on the Lower Earnings Limit would more than cover a good tax investigation insurance policy.

State Pension

There can be more complex issues relating to the second tier earnings related state pension. The following link provides useful information:

http://www.moneymadeclear.fsa.gov.uk/pdfs/contracting_out.pdf

If this is of concern, advice should be taken from a competent Independent Financial Adviser ('IFA'). Additionally, a forecast pension entitlement can be obtained from the State Pension Forecasting Team at the following link:

<http://www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/StatePensionforecast>