How much salary should a contractor pay themselves as director?

Limited company contractors seeking the most tax efficient method of extracting remuneration from their contracting business typically pay themselves a low salary and the balance as dividends from profits.

“There is no definitive right answer, because every contractor’s tax position is unique,” explains James Abbott, owner and head of tax at contractor accountant Abbott Moore.

“The objective is generally to strike a balance between paying sufficient salary to qualify for state pension and other benefits and generating the most tax efficient income for the contractor.”

High dividend, low salary, but not to the full personal allowance limit

“The most tax efficient strategy for most limited company contractors has been to adopt the classic approach of paying themselves a salary up to the level of their personal allowance, and the balance in dividends,” continues Abbott.

“That’s because there have traditionally been no income tax or National Insurance Contributions (NICs) liabilities on the salary. Furthermore, dividends do not attract NICs, and income tax only applies to contractors taking dividend earnings over the higher rate threshold.”

However, as Abbott explains, the threshold for being liable for NICs has not risen at the same pace as the personal allowance for income tax: “The personal allowance for 2013/14 has risen to £9,440 per year, or £181.53 per week. However, the threshold for employer’s NICs is £148 per week, or £7,696 per year. For employee’s its slightly higher at £149 per week or £7,748.”

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>
> James Abbott, Abbott Moore

The implications are that if a contractor draws a salary to the full amount of their personal allowance, they will pay employer’s NICs of 13.8%% on £9,440 - £7,748 = £1,692, which equals an NIC bill of £233.50, even though there is no income tax to pay. Furthermore, employee’s NIC’s are due at 12% on earnings above £7,696 per annum so that’s a further £209.28.

Abbott recommends that for most contractors, drawing a salary of £640 a month, or £7,680 per year, which until the new Employment Allowance comes into force from 5th April 2014, is a sufficient salary to provide contractors with access to the state pension and other benefits without incurring an NIC charge. This is because NIC is payable, albeit at nil percent on earnings above £109 per week or £5,668 per year.

After the NIC Employment Allowance takes effect in April 2014

“After 5th April 2014, the situation could change for most contractors,” says Abbott. “Although we don’t yet know the full details of how the new Employment Allowance will work, the idea is to provide all businesses with a £2,000 credit on their employer’s NIC bill.”

That, believes Abbott, might mean that it is more tax efficient for limited company contractors to pay a salary up to the full level of their personal allowance: “The coalition’s objective is to raise the personal allowance to £10,000, so contractors may be able to pay themselves a monthly salary of up to £833.33 without incurring income tax.

“However, they will still incur around £200 in employee’s NIC and £230 employer’s NIC. However, as the £230 is below £2,000 they will get the employers NIC back making the additional salary more tax efficient compared to dividends.”

Salaries and IR35

“In practice, contractors inside IR35 are forced to take the majority of their income as salary, subject to the 5% expenses allowance,” notes Abbott.

“This means they either pay income tax and NICs at the end of the year via the deemed payment calculation, or they can simply pay themselves a monthly salary and make income tax and NIC payments directly to HMRC via a Pay As You Earn (PAYE) payroll.”

Why a contractor may pay themselves a higher salary

Abbott highlights that there are some circumstances when a limited company contractor who is a director of their contracting business may wish, or be required, to pay themselves more than just a minimum tax and NIC-free salary. These include:

The contractor actually has an employment contract with their company, in which case they are subject to national minimum wage (NMW) legislation. For a contractor working a typical 8 hour day over 22 working days in a month they would have to pay themselves £1,089.44, taking them above the NIC lower earnings limit and the personal allowance

The contractor’s business is showing a loss, perhaps because it is in its early days or the contractor is growing the business and made substantial investments in equipment or employees. If there are no profits, the contractor cannot pay a dividend, so has to take remuneration as salary

A contractor wishes to maximise personal pension contributions. Unlike a pension funded by a contractor’s limited company, the maximum personal pension contribution must be matched by at least the same amount in salary received unless the contribution does not exceed £3,600..So, if a contractor wishes to make additional payments and enjoy the tax benefits, they will need to pay themselves a higher salary, or more usually pay the contributions directly from their company.

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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There is also a contracting myth that paying a higher salary of a few thousand can reduce the chances of an **HMRC IR35 investigation**. “If a contractor is inside IR35, they should pay the tax they owe,” warns Abbott. “And if they are not, then they should only pay the salary they need to.”

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