Family companies – optimal salary for 2019/20

For personal and family companies it can be beneficial to extract some profits in the form of a salary. Where the individual does not have the 35 qualifying years necessary to qualify for the full single-tier state pension, paying a salary which is equal to or above the lower earnings limit for National Insurance purposes will ensure that the year is a qualifying year.

New tax rates and allowances came into effect from 6 April 2019, applying for the 2019/20 tax year. These have an impact on the optimal salary calculation for family and personal companies. As in previous years, the optimal salary level will depend on whether or not the National Insurance employment allowance is available.

It should be remembered that directors have an annual earnings period for National Insurance purposes.

Employment allowance unavailable

Companies in which the sole employee is also a director are not able to benefit from the employment allowance. This means that most personal companies are not eligible for the allowance. Where the allowance is not available or has been utilised elsewhere, the optimal salary for 2019/20 is equal to the primary and secondary threshold set at £8,632 (equivalent to £719 per month and £166 per week).

At this level, assuming that the director's personal allowance (set at £12,500) is available, there is no tax or employer's or employee's National Insurance to pay. However, as the salary is above the lower earnings limit of £6,136 (£512 per month, £118 per week), it will provide a qualifying year for state pension and contributory benefit purposes.

The salary is deductible in computing the company's taxable profits for corporation tax purposes, saving corporation tax of 19%.

Employment allowance is available

It is beneficial to pay a salary equal to the personal allowance (assuming that this is not used elsewhere) where the employment allowance (set at £3,000 for 2019/20) is available to shelter the employer's National Insurance that would otherwise arise to the extent that the salary exceeds £8,632.

Although employee's National Insurance is payable to the extent that the salary exceeds the primary threshold of £8,632, this is more than offset by the corporation tax deduction on the higher salary.

For 2019/20, a salary equal to the personal allowance of £12,500 exceeds the primary threshold by £3,868. Therefore, employee's National Insurance of £464.16 (£3,868 @ 12%) is payable on a salary of £12,500. However, as salary payments are deductible for corporation tax purposes, the additional salary of £3,868 saves corporation tax of £734.92 (£3,868 @ 19%). This exceeds the employee's National Insurance payable by £270.46.

So, if the employment allowance is available, paying a salary equal to the personal allowance of £12,500 allows more profits to be retained (to the tune of £270.46) than paying a salary equal to the primary threshold of £8,632.

If the director has a higher personal allowance, for example, where he or she receives the marriage allowance, the optimal salary is one equal to that higher personal allowance.

Director is under 21

Where the director is under the age of 21, the optimal salary is one equal to the personal allowance of £12,500 (assuming that this is not used elsewhere) regardless of whether the employment allowance is available. No employer National Insurance is payable on the earnings of employees or directors under the age of 21 until their earnings exceeds the upper secondary threshold for under 21's set at £50,000 for 2019/20. Employee contributions are, however, payable as normal

Any benefit in paying a salary above the personal allowance?

Once the personal allowance is reached it is not worthwhile paying a higher salary as further salary payments will be taxed and the combined tax and National Insurance hit will outweigh the corporation tax savings.