National Minimum Wage and family companies

The National Minimum Wage (NMW) has been with us for over four years but there is still confusion about how it applies to directors of owner-managed companies.

When the National Minimum Wage Act 1998 was published it provided that NMW must apply to all workers who work under a contract of employment. A contract for these circumstances includes an oral or written contract either expressed or implied. So there seemed no escape for the owner/ director, he (or she) was obliged to pay himself the NMW or risk a maximum fine of £5,000 and a criminal record.

The National Minimum Wage Regulations (SI 1999/548) gave an exemption for family businesses who employ family members that live at home and who help with the family business just as they share the tasks and activities of the family. The DTi made it clear that a family business in this context could only mean an unincorporated business. Directors and other employees of family companies remained within the NMW net.

This is a slightly ridiculous situation as an owner-director may have several good reasons why he does not want to pay himself the NMW for every hour he devotes to the business. For instance:

- the business may be making losses, and does have not spare funds to pay the director;
- the retained profits may be needed for investment; or
- the director wishes to extract his rewards in the most tax efficient form, usually as a dividend.

The last of these reasons is particularly pertinent now every sole-trader in the land has been advised, either by his accountant or his mate down the pub, to trade as a limited company. This advice is normally based on the assumption that the owner will pay himself just £4,615 per year, which is tax free being covered by the personal allowance and NI free as it is just under the NI earnings threshold. The balance of the owner's cash needs are extracted from the company as a dividend that carries no further tax liability for a lower or basic rate taxpayer. Coupled with the zero rate corporation tax band covering the first £10,000 of the company's profits, many very small businesses can theoretically escape the tax net altogether.

The requirement to pay wages at the NMW rate would completely muck-up this beautiful tax-free scenario. An owner-director working an average 40 hour week would need to pay himself £9,360 per year (at the new rate of £4.50 per hour), which would give rise to a total tax and NI liability of £1,938. Add this to the increased accountant's fees for dealing with a limited company and its payroll, plus the Companies House filing fees, and the owner may be no better off as a company than he was as sole-trader business.

The Tax Faculty met with the Dti in the summer of 2000 to discuss the NMW position of small company directors. It was quickly agreed that the NMW does not apply to a director who does not have an explicit employment contract. The Tax Faculty

released advice along these lines in September 2000 as Tax Guide 7/00 which is still available on the ICAEW website at:
http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_42233,MNXI_42233

The Dti official guidance on this matter is contained in para 22 of 'A detailed guide to the National Minimum Wage', which states:

> 'The national minimum wage does not apply to company directors unless they have contracts which make them 'workers'. Company directors are classed as 'office holders' in common law and can do work and be paid for it in that capacity. This is true no matter what sort of work is done or how it is rewarded. So, it is unlikely that a director will have an implied contract which makes him a worker. However, company directors who have employment contracts will need to be paid the national minimum wage. If a company director is unsure whether he has entered into an employment contract with his company he may wish to take legal advice.'

This guidance can be found at on the Dti website at:
http://www.dti.gov.uk/er/nmw/gtmw.pdf

The Inland Revenue support this view and refer to both the Tax Faculty document and the Dti guidance in the Working Together Bulletin issue no. 3, quoting the following passage from the Tax Faculty document that was agreed with the Dti:

> 'The DTI have confirmed that if there is no written employment contract or other evidence of an intention to create an employer/worker relationship they will not seek to contend that there is an unwritten or implied employment relationship between a director and his company. As the Inland Revenue administers NMW as agents for the DTI they will adopt this policy also.'

So both the Dti and the Inland Revenue have agreed not to impose a hypothetical employment contract where no written contract exists between a shareholder/ director and his company, for the purposes of the NMW. It is also clear that there is no need to have a letter in place to say there is no employment contract.

As we know the UK tax system is stranger to logic, so where the IR35 rules are in point the opposite is true. The personal services tax legislation requires the hypothetical contract between the worker and the final customer to be considered. This does not mean that if IR35 applies the director must pay himself at least the NMW, because it is the contract between the director and his own personal service company that is important for the NMW, not the contract between the worker and the client. However if IR35 does apply it would be sensible for the director to pay himself at least a living wage, as this will reduce the amount of deemed salary that must subject to PAYE at the tax year end.