How pensions work for contractors

One thing is sure: when you earn income as a contractor, you have to pay tax on it. Unless of course you use your contractor income to make payments into a pension fund.

Tax or pension?

If you are a Pay As You Earn (PAYE) contractor you pay full National Insurance (NI) and PAYE Income tax on that income before you see any cash for yourself. If you work through a limited company and are outside IR35 you first pay Corporation Tax on the company profits, and then take a dividend – which is subject to personal income tax when you complete you annual self-assessment.

These taxes can take away a considerable portion of your income. For higher rate tax payers you could be looking at marginal rates of tax of up to 48% - or even 58% for those earning over £150,000 per year. And for those earning just over £100,000 per year the effective tax rate is 60% due to the reduction in personal allowances introduced in the April 2010 Budget.

But suppose you don't put the money in your pocket now. Suppose that, by making pension fund payments now and waiting until you are of retirement age, which moved to 55 in April 2010, you don't pay any taxes on it at all now - you can invest the entire amount.

Pension investments enjoy significant tax breaks because the government wishes to offer us incentives to save for our retirement. In recent years thousands of contractors have been able to receive millions in tax relief.

At retirement

When you retire, if you wish, you can take 25% of the money as a lump sum – completely tax free. With the rest of the money there are various options:

- Skimming: you can take income from your fund based on specific limits each year relative to the size of the fund, leaving the remaining fund invested for future growth
- Annuities: You must purchase these at age 75, but you need not before that age
- Inheritance: You can leave your pension to your heirs--it is not subject to inheritance tax if you die before you retire

(If you die after retirement age, but before you take an annuity, you can still leave the funds to your heirs but there are taxes to pay.)

Tax relief for both higher and lower rate brackets

'''Since Pensions simplification in 2006 and further clarification in 2007, pensions are a lot easier to work with,'' says Tony Harris, chief executive of the Richmond, Surrey-based ContractorFinancials, which specialises in contractor affairs. There is now just one set of tax rules for all types of pension, with an individual Lifetime Allowance (£1.8 million).''

> **“Since 2007, pensions are a lot easier to work with”**
>
> Tony Harris- ContractorFinancials

The marginal tax rate is the percentage of tax you pay on the last bit of income you earn. For example, if you are a higher rate tax payer using an umbrella company you pay £48 tax on every £100 you earn (or only £58 tax if you earn over £150,000 per year). This is because you pay employers NI, employees NI, and Income Tax.

If instead you put the £100 in a pension, you may consider that you are getting 48% tax relief. ''Tax relief'' is the percentage of tax you have not paid because you have decided to invest in a pension.

For contractors using limited companies, also in the higher rate tax bracket but not caught by IR35, the tax relief is approximately 40%. So, instead of paying £40 tax and taking £60 as net income, you can invest the full £100 in a pension, thus obtaining 40% tax relief. For those earning over £150,000 per year the additional rate of tax @ 50% this means your investment is doubled due to the tax relief available. And for earnings just over £100,000 per year the effective rate of tax is 60% due to the personal allowance reductions introduced in the April 2010 Budget.

For contractors who are not higher rate tax payers there are still large tax benefits to be achieved, because you avoid tax at the lower corporation tax bracket of 21%.

How much can you invest?

The rules governing pensions investment no longer fix a percentage of salary for investment. Now contractors can place up to 100% of their contract income into a pension. In addition the rules regarding funding a pension scheme direct from your limited company (or contractor umbrella provider) allow an investment of up to £50,000 per annum without regard to the amount of your earnings. Company investment is the most lucrative method from a tax perspective.

So, you can put as much tax-free money as you want to into your pension fund. You just have to pick the one that's right for you. You'll take 25% tax-free and then may pay some tax on the rest of it when you access it at age 55, but the tax will be probably be much lower than what you would have paid on it as income when you were younger. What you leave in the fund to grow remains tax free.

What can you invest In?

You can invest in a variety of funds, and divide up your portfolio into investments with varying degrees of risk. Or if you aren't a fan of the stock market, you can hold it all in cash and simply earn interest as you would with an ISA

You can even add commercial property investments to your pension. Buy an office or a shop, and put the revenue from it into your pension. We'd hoped residential property would be included but at least we've come this far.

Your options at age 55

You may, if you choose, start enjoying pension benefits from the age of 55. Nonetheless, you will have access to your money at a relatively young age and lots of time to enjoy it. You can take 25% of your money in a tax-free lump at this age (or later if you wish). It doesn't matter whether or not you have actually retired or are still working.

After age 55 there are a few options:

- Leave the money in the fund where it continues to enjoy the potential to grow tax efficiently
- Take a lump sum of 25% tax-free
- Skim some money out of the fund each year as an income
- Buy an anuity to provide income

At age 75

At age 75, you must use your pension funds to buy an annuity, or enter something called an alternatively secured pension.

An annuity is a policy that provides a regular income in exchange for a lump sum. It's not a high rate-paying investment and usually returns around 5%.

But it does ensure you a regular income as you mature. You should explore other tax and inheritance options at that point with an accountant or tax lawyer, but you will have many more lower-tax possibilities thanks to your pension investment.

Given that nothing is certain but death and taxes, contractors should consider pensions as a way of taking the sting out of the latter.

Updated: Monday, May 16, 2011

Tweet

Expert Contributor

Tony Harris
Managing Director
Contractor Financials

Tony Harris is MD of ContractorFinancials, recognised as the specialist independent financial adviser for Contractors.

ContractorFinancials offer jargon free and timely mortgage, pension, insurance and investment solutions tailored to the unique needs of Contractors. **Read Full Profile...**

View all our experts

Readers Comments...

1 Be the first to comment on this article

Also of interest...

Related Guides:

- Pensions for contractors: an overview
- Reducing the IR35 pain with a contractor pension

Related Calculators:

- Contractor Mortgage Calculator
- Contractor Pension Calculator

Related Internet Links:

- Contractorfinancials