Pensions for contractors with an umbrella company

If you are using a contractor umbrella company to manage your contracting income, you can get very significant tax advantages through pensions while at the same time building up a fund which you can start withdrawing from starting at age 50 (or 55 for younger investors from April 2010).

Pensions Are liberalised

Everything has changed for pensions funding since the so-called 'A Day' in April 2006 when the regime was vastly liberalised.

No limits

''For all but a few very high earners, in effect there is now virtually unlimited scope to contribute funds from your gross contract, into a pension fund. If Freelancers have the scope to cover bills etc by other means, they could avoid paying tax and NI on almost all of their contract income, '' explains Tony Harris, director of the Richmond, Surrey-based ContractorFinancials, which offers independent financial advice and specialises in contractor affairs.

'Pre-taxed' income

Provided your umbrella company has a pension scheme in place you can use 'salary sacrifice' to contribute 'pre-taxed' income to a pension. Most do have a scheme in place, and if they don't they can get one set up fairly quickly. So, instead of paying employers NI, employees NI and Income Tax you can put the whole sum straight into your pension.

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>
> Tony Harris - ContractorFinancials

Salary versus pensions

Here's an example:

You have £100 worth of income, and you are a higher rate tax payer @ 40% (we'll assume the additional rate @ 50% doesn't come into play for this example). You can either put the £100 into a pension, or you can take it as salary via your umbrella company.

But if you choose the latter option and take a salary, you pay:

1. £12 employers and employees NI, leaving £88.
2. A further £36 is paid as higher rate PAYE tax (Income Tax).
3. Your total take home is £52.

Choosing the pensions option means that the whole £100 goes into a pension fund and then has the opportunity to grow in a tax efficient environment. In reality £25 of your contribution represents the part of the pension fund which you can then draw out tax free when you are retire. £27 of your own money also go into the pension fund, together with the £48 that would have gone to the taxman (quite a decent initial 'return' on your £27). This £75 can also grow and be used to skim off an income at a later date, or buy an annuity.

In April 2010 the new additional rate of tax @ 50% for those earning over £150,000 was introduced. For those contractors earning more than £150,00 per year the tax relief will be 58%. 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. For high earners pensions are now an even more attractive option as a tax saving device for contractors than before.

Annuities, skimming, inheritance

You don't have to buy an annuity until you reach the age of 75. Before that time you can skim a certain amount from your pension as income. Most annuities only pay around a 5% return, but remember you've only invested £36 yourself, but with the £39 from the taxman it is paying off as £75. So even with the choice of an annuity your overall return is much higher because of the initial tax savings.

In the event that you die before you retire, if you've not taken an annuity, the whole of your fund can be passed on as an inheritance completely tax free.

Contractors should not fear that they are 'making a rigid commitment' to pension funding. ''Any contractor pension should be flexible: as a contractor your employment status is inherently changeable and you must have complete freedom to increase, decrease, suspend, restart and cease contributions completely - literally on month by month basis,'' Harris points out.

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So whether you choose a pension with an eye to an annuity, or just to taking some tax-efficient income for yourself as you reach a more advanced age, you should not neglect this possibility for an entirely legal and risk-free tax-savings strategy.

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

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