Contracting mindset tips: flexible contracting income allows a choice when paying tax

When you were a permanent employee, you paid a fixed amount of tax via Pay As You Earn (PAYE) each month, and probably focused on your take-home pay without giving too much attention to payslip deductions like 'employee NI' and 'employer NI'. Contracting income is much more flexible, allowing you greater choice over when and how you pay tax.

Would you rather pay up to 60% tax now, or save for early retirement?

Out of each £1,000 you earn, what would you rather do? Pay the taxman £400 and put £600 in your pocket or pay no tax now and **invest in a pension** you can draw down when you retire?

Let's say you earned £100,000 in contracting fees but have been offered a dream permanent job. Do you bung the taxman £40,000 and walk away with £60,000, or would you prefer to pay just £10,000 in tax and keep £90,000?

Or let's assume you have built up a cash pile of £100,000 in your contracting company. Would you rather **declare a single dividend** and pay 40% tax of that in tax, or drip feed yourself an income over several years, varying your dividend according to how much personal allowance is left after other earnings?

Employees have much less control over their tax affairs

As an employee, you probably paid the same amount each month into your pension and may not have had the excess income to choose to add additional voluntary contributions; or if you did, you may have found the associated admin and pension plan inflexibility off-putting.

When you were employed and changed jobs, perhaps with a lump-sum severance package or 'golden handcuff' sign-up bonus, you could not choose to defer payment of the cash until your tax situation was more beneficial or hold it in reserve for a rainy day. Your former or new employer would pay you via PAYE and tax your accordingly.

If you had a good year and were paid a bonus, then chances are you were not given the option of stashing that cash away tax-free until you had a lower-earning year, or fancied a long break, and so couldn't eke out the bonus to use when it suited you.

Contractors have choices that employees don't

Employees can't choose when to pay tax, but contractors can. In fact, as a contractor you can choose to sacrifice a substantial proportion of your annual earnings into a pension scheme tax-free, thus allowing you to retire early with a potentially substantial retirement income.

If you decide to take a break from contracting and take a permanent job then, rather than **keeping your limited company dormant**, you can exercise a special concession from HMRC, **Section 1030A**, which allows you to remove excess cash as 'capital', rather than income, paying tax at 10% and not 40% or even 50%.

Contractors can choose when and how to disburse the money they've generated in their **contractor limited companies**. So you could take a year off and pay yourself a dividend up to your personal allowance, or drip feed dividends as your other income varies: the choice is yours.

Contractor mindset tip:

Contractors control their tax affairs and can choose when and how to pay themselves according to their income and tax situation.

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