# How pensions work for contractors



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

## Tax or pension?

If you are a Pay As You Earn (PAYE) contractor, you will pay National Insurance Contributions (NIC) and PAYE income tax on your fee income before you see any cash for yourself.

If you work through a **limited company** and are outside **IR35** first the company pays corporation tax on the company profits. Then you take a **dividend** – which if you earn over the higher rate tax threshold is subject to personal income tax when you complete your annual self-assessment tax return.

These taxes can take away a considerable portion of your income. For higher and top rate taxpayers, you could be looking at high marginal rates of tax. And for those earning between £100,000 and £120,000 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

Following the pensions reforms introduced in 2014, from age 55 you can withdraw multiple lump sums direct from your pension to invest in property or other investments. Here are some facts about pensions:

Contractors can invest up to £40,000 each year without any additional tax implications, up to a lifetime allowance of £1m

Pensions are no longer about saving money to buy an annuity. Contractors can draw down on their pension funds from age 55 following new rules announced in 2014 that enable contractors to take multiple lump sums direct from their pension fund.

A contractor's pension savings can be passed onto their family if they die before age 75 - provided you've not bought an annuity.

A contractor's pension savings are perfectly safe as pensions funds cannot become insolvent. A private pension fund is carefully protected by law.

If a contractor is risk adverse and concerned about funds invested in the stock market, they can choose to keep their pension pot in cash - just like an ISA.

## Tax relief for both higher and lower rate brackets

"Since Pensions simplification in 2006, in 2007 and the reforms of 2014 introduced in 2015, pensions are a lot easier to work with," says **Angela James** of **Contractor Wealth**, a financial advisor who specialises in contractor financial advice. "There is now just one set of tax rules for all types of pension, with an individual Lifetime Allowance (£1 million)."

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 £50 tax on every £100 you earn. 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 50% 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.

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> Angela James, Contractor Wealth

For those earning over £150,000 per year the additional rate of tax of 45% this means your investment is doubled due to the tax relief available. And for earnings between £100,000 and £120,00 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 20%.

### 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 £40,000 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 up to a lifetime allowance of £1m. You just have to pick the one that's right for you. You can access the funds at age 55, but the resulting tax you will pay will 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 a cash 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.

### 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 sum at this age, or later if you wish, or take multiple amounts for investing in other assets. 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

Withdraw multiple amounts to invest in other assets

Draw some money out of the fund each year as an income

Buy an annuity to provide income.

### Annuities

You can 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 a financial adviser and accountant, 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.

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