Pension drawdown explained for contractors

Contractors aged 55 and over may find that a pension income drawdown arrangement offers a flexible and tax efficient mechanism for accessing their pension savings, potentially at the same time as securing a pension income and continuing to grow their pension pot.

"Rules changes announced in 2014 and coming into force from April 2015 mean that contractors qualify for flexible drawdown, which means they can access the cash in their pension savings spot whenever they like," explains Angela James of Contractor Wealth, a financial advisor who specialises in contractor financial advice.

"The choices afforded by flexible drawdown suits the flexible contracting lifestyle, particularly for those contractors seeking a 'phased retirement'. It is a useful tool for those who wish to downshift their contracting career at the same time as maintaining their income through a combination of fewer contracts and the income from the drawdown."

Income security: annuities versus a drawdown

According to James, before the 2014 rule changes, most contractors on reaching retirement age would buy an annuity to secure their income and 'crystallise' their pension assets: "An annuity provides a secure income for the rest of the contractor's life, regardless of how long they live.

"However, once bought it can't be changed, and the fixed return depends on many factors, such as gilt yields and mortality rates, that are beyond a contractor's control. So the potential income can vary widely according to when the contractor chooses to purchase the annuity. Annuities may also cease to pay out, or only pay a smaller share to a surviving spouse or partner when the contractor dies."

In contrast, James says a flexible drawdown allows a contractor to extract multiple lump sums from their pension pot of which 25% is tax free and the remainder taxed as income. The 'uncrystallised' pension asset – in other words the cash left in the pot – can continue to grow. Any remaining assets will hopefully continue to grow, with any 'uncrystallised' benefits, new contributions, offering a further lump sum at a later date.

> **The choices afforded by flexible drawdown suits the flexible contracting lifestyle, particularly for those contractors seeking a 'phased retirement'**
>
> Angela James, Contractor Wealth

A pension drawdown offers flexibility

"The advantage of a flexible drawdown is that it offers contractors a huge degree of flexibility, which works entirely in favour of the equally flexible contracting business model and lifestyle."

For example, a contractor turning 55 could adopt a phased retirement and potentially draw down some their pension fund and use a lump sum from the fund to purchase a smaller annuity to provide a fixed income for life, and continue to invest company profits into the reminder of the fund so the pension pot continues to grow.

"After the first pension drawdown, a contractor might over several years generate greater profits than originally anticipated. These they can invest directly into the company pension fund, and then perform another pension drawdown perhaps five years later," adds James.

And, unlike an annuity, if a contractor dies then the remainder of the fund is paid to the contractor's beneficiaries tax free. However, any benefits which have not been 'crystallised' can be paid out either as a tax free lump sum or as income through drawdown to their beneficiaries on death before the age of 75. If an annuity is taken, it will be taxed as income. Previously they only had the option to take the capital as a lump sum tax free but they can now have a drawdown income tax free before age 75.

The benefits of pension investments for limited company contractors

"Pensions remain a hugely tax efficient mechanism for dispersing contracting profits," explains James. "Contractors who run a company pension scheme transfer income directly from their limited company into the scheme. The payments are a legitimate business expense."

In fact, as James highlights, company pensions reduce the company's profits and resulting corporation tax: "A company pension scheme also circumvents private pension rules that restrict contributions to the level of a worker's salary. That means contractors who only draw a small salary and would be restricted in what they could pay into a personal pension can divert profits of up to the tax-free cap of £40,000 a year into a company scheme."

And if a contractor has not used up the previous three year's pension allowance, they could invest as a much as £160,000 in a single year, because the rules allow contractor's to utilise unused pension allowance in a single year.

Angela James

Pension Specialist

Contractor Wealth

Angela is a qualified Senior Financial Planner at Contractor Wealth and specialises in pension advice and financial planning for contractors.

Contractor Wealth are a specialist in offering tailored financial solutions for contractors, together with the building of excellent client relationships. **Read Full Profile...**

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“A flexible drawdown won’t suit every investor’s personal risk profile, but it does add a level of flexibility that is particularly suitable for contractors,” says James. “Because contractors have flexible working practices, those considering a drawdown should consult a financial advisor with specific experience in the contracting sector.”

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