Pensions for contractors: an overview

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Contractors should start investing in a pension at the start of their contracting career, even if they feel themselves to be 'too young'.

This is because pensions can not only save contractors money right now as they offer real and substantial tax breaks, but also contractors can retire at age 55 with a lot more money available if they start a pension early.

Why should a contractor pay extra tax now on their savings when they can redirect them to a pension fund?

Some quick 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.

Pensions save on tax

The principle is simple. Normally contractors pay tax on their income. When they invest an element of their income into a pension, they save most of the tax they would normally pay on it.

So, contractors who have not already set up a pension or don't currently make full use of the allowances available could be paying substantial amounts of tax unnecessarily. And this is true whether or not they are caught by IR35.

Contractors can invest money personally from their own funds, or direct from their company bank account. The latter is much more tax efficient.

If caught by IR35, contractors save not only the income tax (PAYE) that would ordinarily be payable but also the employers and employees National Insurance Contributions.

"The amount of tax relief can be as much as 50%, meaning that for each £100 invested you pay £50 and the tax man pays the rest," explains Angela James of Contractor Wealth, a financial advisor who specialises in contractor financial advice.

Calculate pension savings using ContractorCalculator's online tool

Contractors can use ContractorCalculator's pensions calculator to see just how much tax relief pensions can offer them. For example, if a contractor earns gross fees of £100, they can invest £100 into their pension fund without paying any tax on it.

Tax relief - how it works

Take a contractor with a limited company, outside IR35, and who is higher rate tax payer. They are applying the classic strategy of taking a low salary, and drawing the rest of their income in dividends.

For each £100 of company gross profit, corporation tax of 20% (£20) is paid, leaving a potential dividend of £80. Then a higher rate tax contractor pays further tax on the net dividend of 25% (£20), leaving them you with a net figure of £60. The contractor has just paid HMRC £40 in tax and is left with a net income of £60.

However, if the contractor contributes to a pension, instead of taking £60 now, the company makes a £100 contribution directly into the pension fund. In reality £25 of the contribution represents the part of the pension fund which that can be drawn down tax free when the contractor is to retire and it also has the opportunity to grow and be worth considerably more than this initial investment.

£35 pounds also goes into the pension fund together with the £40 that would have gone to the tax man. This £75 can also grow and be used to skim off an income at a later date, be drawn down according to the pension rules introduced in 2014 or can be used to buy an annuity.

This is what it means then it is said that the contractor receives 40% tax relief. It's the percentage of tax saving they get - the amount they channel to their pension rather than be given to the taxman.

All of the money invested starts growing in value immediately. For contractors paying higher rate tax and caught by IR35, the tax relief is 50%.

Funding a contractor’s retirement

Contractors can access their pensions as early as age 55. They then have a flexible fund on which they can draw to invest in property, other investments that generate an income or annuity.

Contractor’s relying on state retirement benefits will suffer a massive drop in their income and standard of living. Contactors planning on not working forever will need to live off an income and pensions offer a great way of saving for the future.

Choosing a provider

One of the key decisions in setting up a pension is choosing a provider. Any pension also needs to be flexible enough to reflect the fact that as a contractor employment status is inherently changeable.

“You must have complete freedom to increase, decrease, suspend, restart and cease contributions completely-literally on month by month basis,” James points out.

“Any pension must be versatile enough to allow contributions regardless of whether you continue to work through a one-man limited company/umbrella company, are between contracts or a permanent employee,” James adds.

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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Further, contractors want to choose a provider that isn't going to disappear and a provider that has the financial strength and backing to remain the steward of their fund for the long term. Newer entrants to the pensions field come and go, so it is vital that any provider have a good track record and have made the long term commitment required.

Contractors should seek advice from a financial advisor before making pension decisions. But they should not neglect the important financial and fiscal advantages that pensions offer.

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