

Reducing the IR35 pain with a contractor pension

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Contractors caught by **IR35** face a significantly increased tax burden. The additional income tax and National Insurance Contributions (NICs) can increase the amount of tax they pay by as much as 80% and reduce their net pay by up to 25%.

However, contractors can adopt a strategy where they divert a proportion of their gross fees directly into a **pension scheme**. Pensions are outside of the 5% of expenses that IR35 allows.

As a result, a contractor can divert as much as £40,000 of their gross fee income into a pension, rather than have that income taxed according to IR35's rules. This can lead to tax relief as high as 50%.

How much extra tax is IR35?

Contractors pay significantly higher taxes when they are **caught by IR35** because they cannot use the highly tax efficient **low salary and high dividends** approach. Apart from an allowance of 5% for expenses, under IR35 all other income is taxed as if the contractor were employed.

This means both employers and employee NICs are paid on all of the contractor's income, alongside income tax. The amount of extra tax paid as a result of IR35 depends on the contractor's gross earnings, but ranges between 30% and 80%.

For example, a contractor on £40 an hour inside IR35 has an increased tax burden of 49%. Contractors can use ContractorCalculator's **IR35 Taxes Calculator** to work out exactly how much extra tax IR35 would force them to pay.

How does investing in a pension help?

Pension contributions help reduce a contractor's tax liability because the money can be contributed to a pension before IR35 taxes are applied.

For someone caught by IR35 earning £40 an hour, each £100 drawn as gross salary at the top end of their earnings attracts £50 tax with only £50 ending up in their pocket.

But instead of drawing it as salary the entire £100 could be channelled pre-tax into a pension.

This reduces net income by £50, but almost doubles the pension contribution, leading to tax relief of 50%.

Tax relief for contractors **taking dividends** of between £100,000 and £120,000 can be as high as 50%, as a result of the withdrawing of the personal allowance on earnings between £100,000 and £120,000.

For those contractors earning more than £150,000 per year paying the top rate of tax the tax relief will be 44%. For high earners inside IR35, pensions are now an even more attractive option as a tax saving device for contractors than before.

The amount of tax relief depends on a contractor's rate. Contractors can calculate their own level of tax relief using the **Contractor Pension Calculator**.

How do pensions work?

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

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.

The great advantage of pensions for contractors caught by IR35 is the tax relief. From the outset, the contractor's investment has almost effectively doubled.

How Can I Get A Pension?

“Pension contributions help reduce a contractor's tax liability because the money can be contributed to a pension before IR35 taxes are applied”

You could start by talking to [Contractor Wealth](#), a financial adviser service that focuses on looking after contractors.

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