Retirement planning for contractors: 10 key areas to focus on

Contractors can maximise their income and minimise their tax liability to ensure their retirement is well funded. **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore**, has identified ten key areas that contractors should focus on both before and once they are retired.

"Contractors don't have to stop being tax efficient just because they've stopped or reduced their contracting business," notes Abbott. "Simple measures, such as ensuring HMRC has the right information, can ensure that contractors only pay the tax that they should."

Abbott's ten key areas to focus on are as follows:

1. Pensions

Contractors can **contribute to their pension fund highly tax efficiently**. Contributions of up to £40,000 a year can be made without paying tax, and a contractor's **limited company** will benefit from a corporation tax deduction for the contributions. Contractors can also use under payments going back three years if they want to make a lump sum contribution when extracting cash surpluses tax efficiently from their business.

"Make sure you make any pension contributions when your company is still trading," advises Abbott, "so you won't experience difficulties with the corporation tax relief."

2. Optimising basic rate bands

When contractors retire, their income usually falls. A contractor and their spouse should ensure they maximise their basic rate tax bands. Pensioners over 65 benefit from a personal allowance of £10,500 before having to pay 20% tax [correct at the time of writing]. But if retirement income is greater than £26,100, the age related personal allowance is reduced by one pound for every two pounds over the £26,100 limit, although it is never reduced below £9,440 unless your income exceeds £100,000.

"There is a point when income over £26,100 is taxed at 30%," warns Abbott, "so contractors should adjust their retirement income so they and their spouse are both earning either at least two thousand pounds above the £26,100 limit, or keep their earnings below the limit. This will ensure that the contractor and their spouse will only pay 20% tax on their income."

3. Claiming a full state pension

The state pension is still quite valuable, with a full pension paying £110.15 per week [correct at the time of writing]. It is one of the reasons why contractors should **pay themselves a salary**, so they qualify for the state pension and other benefits. To qualify for a full state pension, contractors must have made 30 years worth of contributions (at the time of writing).

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>
> James Abbott, Abbott Moore

However, it is quite common for contractors to have missed out years because of their freelance status, or simply because of paperwork errors, such as the P60 not being sent to HMRC. Abbott recommends that contractors apply for a **state pension statement** to check whether they have made a sufficient amount of contributions.

"Contractors with missing years can top-up their state pension pot by paying class 3 National Insurance Contributions (NICs), which costs £13.55 per week," notes Abbott.

4. Splitting assets

A fundamental step that all contractors should take when planning for retirement is to ensure that their assets are split between themselves and their spouse to maximise the use of tax allowances. This may necessitate transferring assets between the contractor and their spouse so that any income uses up both spouses' allowances.

"Income such as bank interest on savings or investments can be transferred to a spouse to use their tax allowance if a contractor is being paid a large pension," suggests Abbott.

5. Talk to an IFA about annuities and sheltering income from tax

Abbott urges all contractors to engage with a financial adviser when planning their retirement, and then having an update meeting when about to retire. Since the retail distribution review (RDR) of the financial services industry means that many advisers now charge for their services, a retirement review will cost a contractor some cash.

But Abbott believes this is money well spent because it can add a lot of value: “Annuities, which are what will ultimately dictate a contractor’s retirement income, can vary considerably in performance. If they engage with a financial adviser, contractors may well end up buying a much better value annuity and can shelter income in tax efficient vehicles such as individual savings accounts (ISAs).”

6. Pension fund drawdown

Contractors aged 55 and over can access some of their pension funds early through a pension drawdown. This can release up to 25% of a contractors pension pot, which for many contractors will be substantial if they have made regular tax efficient contributions via their limited company.

“Contractors can take money out without paying tax, and if the pension pot is worth £12,000 or less, a contractor can withdraw the entire sum,” explains Abbott. “This is another conversation to have with a financial adviser who can advise what to do with the remaining pension pot after drawdown.”

7. Delay drawing pensions if earning fees

Pensions attract income tax. So, contractors should think about all of their income streams when retiring. The rules allow contractors to retire at 55, but most choose to continue to work.

“Contractors thinking of retiring early might wish to delay drawing down their pension at the same time as continuing to earn fees because the two incomes could combine to drive them into the basic rate or higher rate tax bands,” highlights Abbott.

8. Limited company costs outweigh benefits during retirement

Many contractors don’t really retire. They are tempted out of retirement by interesting and exciting projects that might last a month or two each year, and non-executive directorships which may take up a couple of days each month.

Even though these projects tend to pay quite well for experienced contractors, unless they are earning over around £30,000 a year, it is not worth running a contractor limited company.

“Contractors only working a few days per month, or a few months per year, should consider working on a fixed-term contract basis with their client, trading as a sole trader or using an **umbrella company**,” says Abbott.

9. The state pension is taxable

Even though the state pension only pays £110.15 per week, or £5,727.80 a year, it is still taxable, although there are no NICs on pensions received. Contractors should ensure they factor the state pension into their tax planning.

Abbott explains: “Failing to allow for the state pension in tax planning can result in contractors running up unexpected tax bills.”

10. Getting HMRC’s form P161 correct

On retirement, all workers submit a form P161 to HMRC. This form includes all of a contractor’s income and is what HMRC uses to set a contractor’s tax rate, which the pension company will use to deduct the correct amount of tax. Get it wrong, and it can cause endless problems with under- or overpaid tax.

Pension providers deduct income tax at source from pension payments, and they will deduct what HMRC tells them to. This is why getting the P161 right first time is so important, particularly for contractors with multiple income streams.

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James Abbott is the owner of Abbott Moore LLP and often speaks on freelancer / contractor tax matters. He has his own growing portfolio of contractor clients.

Abbott Moore LLP are PCG Accredited Accountants and specialise in providing tax advice to freelancers as well as dealing with their year end accounts and tax returns. **Read Full Profile...**

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Abbott concludes: “Ideally, when contractors retire they should structure their pension and other income arrangements so that they are taken out of selfassessment and no longer have to complete a tax return. Contractors should ask their accountant to complete their P161 so that it includes all the information that HMRC requires.

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