Why contractors need pensions

Contractors need pensions so that they can maintain their lifestyle during retirement, particularly as any state pension provision is likely to fall well below a contractor's retirement income requirements.

"Contractors earn a very good living and are used to having plenty of disposable income to fund their lifestyle," explains Angela James, pensions and investments expert at specialist contractor financial adviser Contractor Wealth.

"Being higher earners, contractors are also liable to higher rates of tax. The added bonus of a pension is that contractors can significantly reduce their corporation tax and income tax liability by funding a pension through their limited company."

Retirement lifestyle could suffer with no pension provision

When working out how much to save towards retirement, James would normally look at a contractor's outgoings and calculate how that might change when the contractor stops working.

"In my experience, apart from possibly the mortgage and children related outgoings ending or reducing, most contractors' outgoings won't change much when they retire," continues James. "In fact, with more leisure time on their hands, some contractor's normal outgoings actually increase post-retirement!"

This is why contractors need to invest in a pension as early as possible in their employment or contracting career, so that they have the widest range of options available to maintain their lifestyle when they stop working.

How pensions can flexibly fund retirement

Contractors have traditionally used flexible access draw down at age 55 and bought an annuity on retirement to provide a regular income. Following the pension reforms introduced in April 2015, contractors have many more options but James believes that annuities will continue to feature.

"April 2015 pension reforms mean contractors are not required to invest most of their pension pot tax efficiently in an annuity. These reforms were announced in December 2014, as a result, financial services providers have responded with more sophisticated and attractive annuity products and the range and attractiveness of options are likely to increase."

James draws contractors' attention to investment linked annuities and shorter term annuities, which offer contractors increased flexibility. Contractors can also opt to take a tax-free lump sum at 55 and not retire, acquiring other assets and retiring later.

The alternatives to pensions often don't add up

"Some workers choose to invest in alternatives to pensions such as ISAs. If a contractor saved £15,000 a year into an ISA each year over 20 years, they would have a formidable savings pot that superficially looks the same as a pension," notes James.

"The advantages of ISAs are that they are more flexible and contractors can access their investment at any time, rather than having to wait until they are aged 55. The income generated by an ISA is also tax free, and contractors can choose ISAs based on a basket of shares."

However, pensions offer significant benefits compared to tax-free cash savings. James explains: "For a start, an ISA is a personal savings account and the contractor must pay corporation tax and income tax on their cash before it can be extracted from their limited company. Pensions can be paid by the contractor's limited company from gross fees and are corporation tax deductible.

Pensions are investments that typically grow in value faster than cash savings

"A pension also does not require the same level of saving as an ISA. For example, if one contractor had £100,000 invested in a pension and another contractor had £100,000 in an ISA and they each drew down £5,000 per year, the contractor with ISA savings can take the cash tax-free whereas the pension income is taxable.

"However, the contractor with the ISA had to save £100,000 of post-tax income into their savings account. The contractor with the £100,000 pension pot would only have had to invest £60,000-£80,000, depending on timescales and the pension scheme's performance."

James tends to recommend ISAs as an option for umbrella company contractors who, because their salary may be lower as a result of their expenses claims, are not able to put as much cash into a pension as limited company contractors.

Other pension planning options can be expensive or high risk

According to James, the other investments that contractors make to fund their retirement are typically property and businesses. Both can be viable alternatives, but have disadvantages.

“Property is more tangible and contractors may have greater control over their property portfolio compared to a pension investment. However, property is rarely tax efficient in any shape or form. Investing in a business can generate significant returns, but can be highly risky.”

Pensions also do not fall into a contractor’s estate for inheritance tax (IHT) purposes, unlike property, cash savings and other assets. And if a contractor dies before retirement, their beneficiaries will receive a refund from the pension scheme, which is also outside of IHT.

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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James concludes: “Contractors seeking the optimal pension fund, savings and other asset portfolio to fund their retirement should seek professional financial advice to ensure that their retirement planning strategy is suitably diversified against risk and will fund their lifestyle when they retire.”

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