

Salary Sacrifice: Pension Contributions

Where employees contribute to their employer’s pension arrangement, salary sacrifice offers savings to both employees and the employer. It also fits in well with employers who want to be flexible and progressive in the remuneration package they offer.

Salary sacrifice arrangements are more commonly applied to defined contribution (money purchase) pension plans but can also be considered for defined benefit schemes too. Trust based pension schemes would need an appropriate amendment to their trust deed and rules.



What is salary sacrifice?

Firstly, it is known by other names such as ‘salary exchange’ and ‘smart pay’. They mean the same thing but for the purpose of this note we will use the expression ‘salary sacrifice’ as this is the term with which most people are familiar.

Salary sacrifice is a contractual agreement between an employee and the employer to exchange part of the employee’s salary in return for a non-cash benefit, in this context an employer pension contribution. Salary sacrifice can also be used for a range of other employee benefits, e.g. life assurance, income protection and private medical insurance, and in these situations it may form part of a flexible benefit offering from the employer.

Most employers will embark on a full consultation programme with their workforce to explain how the salary sacrifice arrangement will work, the impact on take home pay and any impact on other employee and State benefits.

How does it work?

The employee sacrifices salary equivalent to the level of employee pension contribution, in exchange for which the employer makes an equivalent employer pension contribution. This has the effect of reducing both the employee and the employer’s National Insurance (NI) contributions (as these are levied on pay), whilst having an overall neutral effect on income tax. The employee’s NI saving takes the form of increased take home pay and many employers increase the benefits to employees of the arrangement by sharing a proportion of the NI savings they make, often in the form of enhanced pension contributions.

The following example assumes an employee with pre-sacrifice earnings of £20,000 per annum agrees to sacrifice £1,000 of earnings in return for an equivalent employer pension contribution. The other assumptions are that the employee has a personal allowance of £7,475 for income tax purposes and NI contributions are payable on earnings above £7,225 (£139 per week) at a rate of 12%:

Table 1	Pre-sacrifice position	Post-sacrifice position	Difference
Earnings	£20,000	£19,000	-£1000
National insurance	-£1,533	-£1,413	£120
Income Tax	-£2,505	-£2,305	£200
Employee Pension contribution	-£800	-	£800
Net pay	£15,162	£15,282	£120

Using the same example as shown in Table 1, and assuming the employer agrees to share 50% of its NI savings with the employee (optional), the impact on the pension contribution could be as follows:

Table 2	Pre-sacrifice position	Post-sacrifice position	Difference
Employee pension contribution	£800	-	-£800
Equivalent Company contribution	-	£1,000	£1000
Sharing of Employer's NI saving	-	£69	£69
Tax relief added by HMRC	£200	-	-£200
Total pension contribution	£1,000	£1,069	£69

Employers can decide how much, if any, of their NI savings to share with employees and the figures in Table 2 above are for illustrative purposes only. However, if a salary sacrifice arrangement is not made compulsory, successful take up may be dependent on such an incentive and on a thorough communications exercise.

Different rates of NI contributions apply to different levels of earnings. The Class 1 yearly rates for the tax year commencing 6 April 2011 are set out in the following table:

Table 3	Employee	Employer
Earnings below £7,072 pa	nil	nil
Earnings from £7,072 pa to £7,225 pa	nil	13.8%
Earnings from £7,225 pa to £42,475 pa*	12%	13.8%
Earnings over £42,475 pa	2%	13.8%

*Different NI rates apply for members of trust based pension schemes that are contracted out of the State Second Pension Scheme.

As can be seen from Table 3 above, for employees earning above £7,072 per annum, the potential employer NI saving for each £1,000 of salary sacrificed is £138 per annum. Of course, if the employer shares some of its savings with employees, the potential employer savings will reduce.

The potential savings per employee can therefore be relatively modest, and for small employers such arrangements are unlikely to be attractive if viewed solely on a cost/benefit basis. Salary sacrifice does however deliver ongoing savings and, particularly for larger employers, these can often significantly outweigh the costs of its implementation.

Does salary sacrifice impact on other work place salary related benefits?

Generally no, as most employers will apply a 'reference salary' equivalent to the pre-sacrifice salary. This reference salary would then be used as the basis for workplace salary related benefits, e.g. pay rises, shift and overtime allowances, life assurance and income protection benefits. Non cash benefits (such as an increased employer pension contribution passed on to employees as part of salary sacrifice) are subject to different rules during maternity leave, so it may be appropriate to consider placing a limit on the level of salary that can be sacrificed.

Is there any impact on State benefits?

Some State benefits are based on payment of NI contributions, e.g. State pensions and Employment and Support Allowance. Employees for whom salary may be reduced below the threshold on which NI contributions are payable are therefore usually not included.

Participating in salary sacrifice may result in a reduction for some employees to benefits from the earnings related State Second Pension but for NI payers the reduction should be outweighed by the immediate financial advantages.

What about working tax credits?

Sacrificing salary may reduce relevant pay for tax credit purposes, as the value of an employer's pension contributions is not included in the calculation of income. Salary sacrifice could therefore increase the working tax credit award in some cases.



What about Student Loans?

Repayment of student loans is dependent on pay and is therefore likely to be affected by salary sacrifice. The level of repayments will reduce and in consequence the length of the repayment period will increase.

Is it suitable for everyone?

No. Some employees could be disadvantaged by salary sacrifice, in particular and (as already identified) low earners whose earnings may be reduced below the threshold for payment of NI contributions. Further, salary sacrifice is not permitted to take an employee's pay below the national minimum wage level. Before a salary sacrifice arrangement is launched we recommend that an employer filters out those employees for whom salary sacrifice is not suitable.

What about employees over state pension age who are no longer paying NI contributions?

This sector of the working population is increasing and although an employee's NI contributions will cease on reaching state pension age, the employer's NI contributions continue. Thus if an employer is prepared to share some of its NI savings it could still be an attractive option for such employees.

The future for salary sacrifice and 2012

From time to time speculation on salary sacrifice suggests that it is a tax or NI loophole that is waiting to be closed – this often comes from people who believe salary sacrifice is “too good to be true”.

Recent detailed guidance provided by the Pensions Regulator indicated that salary sacrifice can operate alongside the auto enrolment regulations when they are introduced in 2012, as long as active membership of the pension scheme can be achieved without the jobholder having to consent to the salary sacrifice arrangement before they are made an active member. It is therefore fair to assume that the minimum contribution levels required to comply with the auto enrolment legislation will be based on a percentage of contractual earnings, i.e. the pre sacrifice earnings.

HM Revenue & Customs (HMRC) has developed part of its website to explain how an effective salary sacrifice arrangement should operate, which it would be unlikely to have done if salary sacrifice was on their hit list for withdrawal. Furthermore, in its simplest form and when combined with a pension arrangement, salary sacrifice has the effect of re-basing salaries and turning a contributory pension scheme into a non-contributory pension scheme (which is a perfectly legal and acceptable way for employers to provide benefit packages).

What are the first steps an employer should consider before implementing a salary sacrifice arrangement?

A feasibility report will help to:

- identify if and how such an arrangement could work with an employer's pension arrangements;
- quantify the level of potential employee and employer NI savings;
- identify employees for whom the arrangement would not be suitable;
- identify other matters for consideration, e.g. presentation in payslips;
- illustrate the potential reduction in State Second Pension benefits and compare this with increased take home pay and any enhanced pension benefits; and
- give guidance on the suitability of introducing salary sacrifice and impacts on other parts of the employment remuneration package.

A feasibility report would be followed by employee consultation and communication, with the employer taking appropriate legal and tax advice. Once implemented, employers may approach HMRC for confirmation that their salary sacrifice arrangement is effective.

For further information

For more information about salary sacrifice please contact your usual Barnett Waddingham contact or email: employeebenefits@barnett-waddingham.co.uk

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