

Talking points – Salary sacrifice explained

Bulletin 17 | February 2008

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Salary sacrifice is something that comes in and out of vogue.

With National Insurance (NI) contribution thresholds set to increase over the next few years, salary sacrifice is likely to gain popularity. Indeed it is becoming a valuable benefit forward looking employers can offer to their key staff. This Talking Points looks in broad terms at what is required to set up a salary sacrifice arrangement and the benefits to the employee.

The basics

Put simply, salary sacrifice is where an individual gives up the right to some cash remuneration or bonus in exchange for a non-cash benefit. This can cover a variety of benefits, child care vouchers or nursery places. However, we are interested in pension contributions.

There are some simple rules that must be followed in order for a salary sacrifice arrangement to be successful.

- » The arrangement must be in place and the right to the cash must be given up **before** the employee would have become entitled to the benefit.
- » The result of the arrangement must be such that the employee is entitled to a non-cash benefit plus reduced cash remuneration.
- » Once the arrangement has commenced there must not be an option to revert to the original cash remuneration and give up the benefit, if this is the case then the benefit may be taxable as earnings.

Benefits of this arrangement

Taking an example, an employee is entitled to a bonus, which is declared on the 1 June 2008 as £10,000 but will not be paid until the 1 August 2008.

At the point the bonus is declared the employee is given the option to receive the bonus in their July pay or have the bonus paid plus the employer NI savings paid as an employer pension contribution to a registered pension scheme.

The employee chooses the pension contribution and completes the forms required by the employer to remove their contractual right to the cash sum, giving up their right to change their mind.

Based on an original salary of £40,000, the following results could be achieved.

| | Cash Bonus Option | Pension Contribution option |
|-------------------------------|-------------------|-----------------------------|
| Gross pay | £50,000.00 | £40,000.00 |
| Net Pay (after tax & NI) | £35,430.60 | £29,287.60 |
| Employer Pension contribution | £ - | £11,280.00 |
| Cost to Employer | £55,701.12 | £55,701.12 |
| Overall result | | |
| Gross Pension contribution | £0 | £11,280.00 |
| Total net benefit | £35,430.60 | £40,567.60 |

This example shows that for the same cost to the employer the employee's benefits can be enhanced by over £5,000. Although the uplift is significant, this example uses an optimum salary range for the 2008/09 tax year. If an employee is either a very high earner or a basic rate tax payer then the results will differ. This said, there is always a benefit, provided the employer passes on all or at least some of their NI savings to their employee.

Changes to National Insurance (NI)

For some the benefits of salary sacrifice will increase further when the NI bandings change in April 2008 and 2009. The actual rates are not changing, but the increase in the bands results in almost £5,000 per annum more being exposed to the 11% rate rather than the nil or 1% employee rates. Put another way anyone earning in excess of £40,000 per annum could be paying nearly £500 extra per year in NI contributions, making the argument for salary sacrifice even more compelling

Other things to consider

- » Future salary increases and other salary linked benefits may be affected if based on the lower pay. Of course, the salary cannot be reduced below the minimum wage.
- » The ability to borrow personally may be reduced due to the lower salary
- » State benefits both present and future may be affected by a lower salary and lower NI contributions.
- » Not every employer will be flexible enough to offer the option of salary sacrifice.

Our view

Salary sacrifice, if set up correctly, should be a benefit to both employers and employees alike. Employers can use the option to increase staff benefits without increasing the overall cost. Employees can reduce their immediate tax bill whilst increasing their overall benefits. It should always be remembered that other salary related benefits (e.g. death in service) may be correspondingly affected.