Swallow
Financial Planning

SALARY SACRIFICE EXPLAINED

These notes are our current understanding of the rules that govern the use of salary sacrifice to enhance pension savings.

SECTION **PAGE NUMBER**

1. WHAT IS SALARY SACRIFICE

Salary sacrifice is where you give up the right to receive cash remuneration due under your contract of employment, in return for your employer's agreement to provide you with a form of non-cash benefit.

2. ADVANTAGES OF SALARY SACRIFICE

2.1 Saving Tax

This reduces your National Insurance (NI) taxation. Where you are earning less than the upper earnings limit (UEL) of £50,000 pa in 2020/21 this is 12% of your earnings above £8,632. Any earnings over the UEL of £50,000 pa will save 2% on everything above that.

For employers (where there is no ceiling to NI) the saving in 2020/2 will be 13.8% of any amount paid to a pension plan rather than in salary.

2.2 Workplace Pensions

It is acceptable to use salary sacrifice to mitigate some of the costs of the new workplace pensions requirements.

3. DISADVANTAGES IN USING SALARY SACRIFICE

3.1 Occupational Schemes

Some pension schemes (not personal pensions) have a rule stating a member cannot keep the employer's contributions to the scheme until they have been in the pension plan for a minimum of up to 2 years. This means that the employer could retain any salary sacrifice if you leave.

3.2 Maximum Pension Provision

As your salary has reduced, so does your maximum pension allowance. This reduces the amount you can save towards your retirement, as the tax relief allowed on pension contributions is either up to 100% of your earnings or a £40,000 annual allowance for 2020/21, whichever is the lowest.

3.3 Protection Insurances

Most group schemes will have benefits such as life and disability insurance linked to salary. Clearly, if your salary has reduced the benefit from these schemes also reduces. However, it may be possible for the group scheme rules to compensate for this reduction.

4. SACRIFICING REGULAR INCOME

4.1 Example

Fred is an employee on a salary of £40,000 pa. This is paid to him as £3,333 on the 25th day of every month.

Fred wishes to change his existing personal pension contribution of £500 a month so it is paid by his employer with his salary reducing by £6,000. The sacrifice is effective for the monthly salaries subsequent to the date of the salary sacrifice. If Fred makes the salary sacrifice agreement on 27th March 2020 and the sacrifice is to be made in equal monthly instalments from his salary, he will receive a reduced monthly salary of £2,833 from 25th April 2020 onwards.

4.2 Saving To Fred

The saving to Fred is as follows:

	Now	**After SS**	**Difference**
Gross Income	£40,000	£34,000	(£6,000)
-550BR Tax	(£5,500)	(£4,300)	£1,200
NI	(£3,764)	(£3,044)	£720
Net Income	£30,736	£26,656	(£4,080)
Less Net Pension Contribution	(£4,800)	-	£4,800
Net take home pay	£25,936	£26,656	£720

This example assumes normal allowances, no other income or P11D. As this is a basic rate tax payer the pension contribution has tax at source but the salary sacrifice deals with the tax relief through the PAYE system.

4.3 Saving To The Employer

As Fred is taking less salary the employer pays less NI as well:

	Now	After SS	Difference
Employee's Salary	£40,000	£34,000	(£6,000)
Employers NI	£4,328	£3,500	(£828)
Pension Cost	-	£6,000	£6,000
	£44,328		
Total Cost		£43,500	(£828)
Less Tax Relief @ 20%	(£8,871)	(£8,705)	£165
Net Of Tax Relief Cost	£35,457	£34,795	(£662)

In this example the employer saves £662 after tax relief and Fred gets £720 more in his take home pay, so it's a "win win" for all concerned.

Please note! If the employer's NI bill is less than the employer's Annual Allowance Rebate (£4,000 in 2020/21) then these savings will not apply.

You cannot reduce earnings below the current National Minimum Wage rates for the tax year: Current hourly rates for April 19 are as follows:

Year	25 and over	21 to 24	18 to 20	Under 18	Apprentice
Apr-20	£8.72	£8.20	£6.45	£4.55	£4.15

These rates change in April each year.

4.4 Protection Cover

If the protection insurance rules are not changed then Fred's protection insurances could change as follows:

	Now	After SS	Difference
Life Cover (4 x salary)	£160,000	£136,000	(£24,000)
Disability Cover (67% of Salary)	£26,800	£22,780	(£4,020)

It should be a straightforward matter to change the scheme salary definition to pre-salary sacrifice to get over this problem.

5. SACRIFICING CONTRACTUAL BONUS OR COMMISSION

A bonus can be successfully sacrificed as long as the sacrifice is made before the bonus is treated as received for schedule E purposes.

5.1 Example

George is a senior salesman, not a director, who is contractually entitled to a bonus depending on the level of the employer's profits each year. The company's year end is 31st January. The accounts are normally finalised during the July following the year end, enabling the amount of bonus entitlement to be calculated. The bonus is then paid to George in his October salary payable on 25th October. The company had a successful year and on 15th July 2020 they calculated that under the terms of his contract George should receive a bonus of £10,000.

The company sends a letter to George confirming the amount on 15th August 2020 stating that he can choose to receive the bonus or give up his contractual rights to the bonus in return for the company paying an employer's contribution of £11,000 to the company pension scheme on his behalf.

George decides to opt for the employer's pension contribution and completes and returns the documentation to the employer on 20th September 2020.

This is a successful sacrifice as he has given up his contractual right to the bonus before it is treated as received and he does not have the right to change his mind later.

In this example the company has given George most of its NI saving as follows:

5.2 Saving To George

The saving to George is as follows:

	Now	After SS	Difference
Basic Gross Salary	£40,000	£40,000	-
Bonus	£10,000	-	(£10,000)
Income Tax	(£ 7,500)	(£ 5,500)	£ 2,000
NI	(£4,964)	(£ 3,764)	£1,200
Net Income	£37,536	£30,374	(£6,800)
Less Pension Contribution	(£8,000)	-	£8,000
Net take home pay	£29,536	£30,736	£1,200

This example assumes normal allowances, no other income or P11D. Remember he will also end up with £11,000 in his pension pot instead of £10,000 salary.

5.3 Saving To The Employer

	Now	After SS	Difference
Basic Gross Salary	£40,000	£40,000	-
Bonus	£10,000	-	(£10,000)
Employers NI @ 13.8%	£5,708	£4,328	(£1,380)
Pension Cost	-	£11,000	£11,000
Total Cost	£55,708	£55,328	(£380)
Less Tax Relief @ 20%	(£11,141)	(£11,065)	£76
Net Of Tax Relief Cost	£44,567	£44,263	(£304)

Therefore, even after giving George the extra £1,000 pension payment his employer is £304 better off to cover their admin costs.

6. SACRIFICING DISCRETIONARY BONUS

A discretionary bonus is a non contractual payment. As such, it does not come within the ambit of salary sacrifice. A discretionary bonus cannot be given up once it is included with the individual's remuneration and assessed under schedule E. The discretionary bonus can be replaced by an employer's contribution to an approved pension scheme as long as this is done before it is paid.

6.1 Example

Harry's employers have had a very profitable year largely down to Harry's fine salesmanship and hard work. They decide to reward Harry with a large bonus. They can instead pay an appropriate amount as an employer's contribution to an approved pension scheme without the necessity of documenting it as a bonus sacrifice.

In reality Harry's employer would tell him they are going to pay him a bonus and Harry would ask them instead to make an employer's contribution to an approved pension scheme.

7. TIMING

For a salary sacrifice to be effective it must be made before the remuneration being given up is treated as received for schedule E tax purposes. This then begs the question "when is income treated as received". The following are our understanding of this point:

7.1 Employees

As employees would not normally have a great deal of control over how they are paid the dates when schedule E income are treated as received will be the earlier of:

- The date the payment is made, and
- The date the individual becomes entitled to the payment.

We believe this should be interpreted to mean that the sacrifice must be agreed in the "remuneration month" prior to the reduced salary being paid.

7.2 Directors

As directors may have more control over their remuneration and their income is also often documented in the company's accounts, the following additional dates also need to be considered:

- The date when remuneration is credited in the company's accounts or records;

- Where the remuneration is determined during the course of a company's accounting year (or other period in respect of which the remuneration is paid) it is deemed to be paid at the end of that year or period;

- Where the amount of director's remuneration is determined after the end of the period to which they relate, the date when the remuneration amount is determined.

Obviously, where there is any doubt as to the date remuneration becomes assessable to schedule E tax this should be checked with the company's or employee's taxation advisers.

The decision to sacrifice must be made a reasonable period before the sacrifice is concluded.

8. SACRIFICING MUST NOT BE REVOCABLE

The sacrifice must not be seen to be made for valuable consideration, because the employee may well be taxed on that consideration. To satisfy HMRC, the waiver must be seen to be binding (i.e. not revocable by the employee). Strictly the only way to achieve this, is to have the document evidencing the forgoing under seal (i.e. in the form of a deed just as, for example, the HMRC require covenants for annual payments to charities, relatives, etc, to be under seal if they are to be tax effective).

HMRC have, however, accepted letters signed as opposed to being deeds (sealed). It has confirmed that these documents are satisfactory to prevent a charge to tax on the employee for the amount given up.

Do note that HMRC does accept that it may be necessary to change the terms of a salary sacrifice arrangement where an unexpected 'lifestyle change' significantly alters the employee's financial circumstances, e.g. marriage, divorce, or where an employee's spouse or partner becomes redundant or pregnant.

9. THE SACRIFICE SHOULD BE FOR A PERIOD OF 12 MONTHS

Whilst the 12 month rule requirement from HMRC ceased when auto-enrolment came in, many employers have kept the requirement to ensure they meet the requirement for a contract of employment to be certain.

Any contract must be clear on what the employee’s cash and non-cash entitlements are at any given time, as a general rule if an employee can swap between cash earnings and a non-cash benefit whenever they like then any expected tax and NI advantages under a salary sacrifice arrangement won’t apply.

To allow for auto-enrolment and pensions generally the clause usually has the facility for the salary sacrifice agreement to end where it relates to pension contributions and the employee opts out of the pension plan.

10. OTHER USES OF SALARY SACRIFICE

It is worthwhile noting that there can be other very tax efficient ways of paying employees other than salary:

10.1 Car-Parking

For the time being at least (some say due to the HMRC parking facilities in London) the provision of free parking to employees is not a taxable benefit.

10.2 Lunch

You can be pretty generous in terms of staff canteen benefits without taxation benefits.

10.3 Private Medical Insurance (PMI)

Whilst the company has to pay NI on PMI payments, the employees do not, hence saving them up to 12%. Why not convert personal payments to salary sacrifice?

10.4 Nursery Care

Whilst this is still a developing area, the current government seems to be child friendly and hence the provision of childcare for working mothers presents useful tax saving opportunities. These are just some of the myriad of smaller exemptions available to employers. Your taxation advisers should be able to suggest many more and clarify the inevitable small print which applies to each alternative.

11. DOCUMENTATION

The salary sacrifice letter should set out the changes in the contract of employment for the individual concerned. HMRC will neither comment on the proposed letter documenting the change (as this is a matter of employment law), nor will they offer advice however they do have helpful guidance notes at:

https://www.gov.uk/guidance/salary-sacrifice-and-the-effects-on-paye

Great care should be taken in drafting any salary sacrifice letter. If it appears that the employee is not giving up remuneration but simply directing the employer how to apply same, the Local Inspector may deem the proposed salary sacrifice invalid.

If the individual is a director the change in salary should also be recorded in a board resolution or a resolution of the company (shareholders), as appropriate.

E.&.O.E.