Key points

- Under a pensions salary sacrifice arrangement an employee gives up part of their cash salary in return for pension benefits
- Typically the employee's salary is reduced by the amount that they were previously paying as employee contributions to a pension scheme and the employer pays an equal amount to the pension scheme as an employer contribution
- Salary sacrifice results in cost savings on National Insurance contributions
- To introduce a salary sacrifice arrangement an employer needs to vary the terms of the employee's contract of employment
- As salary sacrifice involves a reduction to the employee's salary, it could have some disadvantages (though most of these can be avoided if the arrangement is set up carefully)

Main sources

- www.hmrc.gov.uk/specialist/salary_sacrifice.htm

What is it?

A salary sacrifice arrangement is a contractual agreement between an employer and an employee, under which the employee agrees to give up part of their cash salary in return for a non-cash benefit.

In a pensions context, a salary sacrifice normally involves employees agreeing to accept a reduced salary in exchange for pension benefits. Typically, the employee's salary is reduced by the amount that they were previously paying as employee contributions to a pension scheme. Instead, the employer will agree to pay an equal amount to the pension scheme as an employer contribution.

Why do it?

The reason for doing this is that it saves money. If the employer pays salary to the employee, which is then paid over to the pension scheme, both the employer and the employee will pay National Insurance contributions (NICs) on that salary. However, no NICs are payable on employer contributions to a pension scheme. So if the employer pays the pension contributions instead of the employee, both the employer and the employee pay reduced NICs.

In addition, a pensions salary sacrifice arrangement has the effect of deferring income tax for the employee as the amount sacrificed will not be subject to tax until it is taken as pension income.

How does it work?

To introduce a salary sacrifice arrangement, an employer will need to vary the terms of the employee's contract of employment. In some circumstances this will involve a consultation exercise, and the employee's agreement will also be required. Employee consent can either be express or implied (if employees are offered the option to opt-out, and do not choose to do so).

A good communications exercise accompanying the introduction of salary sacrifice is essential so that employees can make an informed choice, not least because salary sacrifice can be complex to explain to employees.

The sacrifice will only work if the employee has agreed to give up the salary in advance. Normally, it is also put in place for a

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minimum period (e.g. a year), as it will be ineffective if the employee has the right to revert back to the higher salary at any time. The exception is where an employee is automatically enrolled into a pension arrangement which uses salary sacrifice. HMRC has confirmed that, in this situation, if the employee opts out of the pension arrangement, they can also simultaneously end the salary sacrifice.

An employer can ask HMRC to review a salary sacrifice arrangement, and confirm that it is effective. However, HMRC will not comment on a proposal, only on an arrangement that has already been put in place.

Are there any disadvantages?

Salary sacrifice involves a reduction in the employee's salary, which could have some disadvantages. However, most of these can be avoided if the arrangement is set up carefully:

- A salary sacrifice arrangement should not be offered to employees if it would reduce their earnings below the National Minimum Wage. Also, if entering into the arrangement would cause an employee's earnings to fall below the Lower Earnings Limit, they could lose entitlement to certain State benefits, e.g. statutory sick pay. Employers would usually exclude all such employees from the arrangement.

- If the employee is in a defined benefit pension scheme which calculates benefits by reference to salary, a reduced salary could mean reduced pension benefits. It could also mean a reduction to contractual benefits which are based on salary, such as sick pay. However, employers will normally avoid this problem by agreeing to base these benefits on a notional salary which includes the sacrificed salary.

- Where an employee leaves an occupational pension scheme within the time period specified by law, they may be entitled to a refund of employee contributions. However, employer contributions (as there are no employee contributions under salary sacrifice) cannot be refunded in these circumstances without tax penalties, so an occupational pension scheme would not normally refund contributions paid under a salary sacrifice arrangement. However, some employers may be willing to offer an equivalent contractual payment instead.

- Finally, a reduced salary could impact on borrowing, e.g. the maximum mortgage available to the employee. Again, this can be overcome by use of a notional salary for mortgage purposes.

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