Should I be considering salary sacrifice?

In our first A-Day Survival Guide, we raised the possibility of using salary sacrifice as a way of maximising pension contributions before taking primary or enhanced protection at A-Day. Our second Survival Guide looks at salary sacrifice in more detail.

What is a salary sacrifice?

A salary sacrifice is an arrangement whereby an employee gives up in advance the right to a specified amount of cash salary or bonus in return for additional pension (or other) benefits. The main benefit of this arrangement is that National Insurance (NI) can be considerably reduced for both employer and employee. Salary sacrifices can be introduced on both an individual and a scheme-wide basis.

Individuals can enter into an agreement with their employer to receive reduced salary on the understanding that the pay they have sacrificed will be paid into their pension scheme as an additional employer contribution instead. This means that salary sacrifices may be very attractive as a way of employees maximising their pension entitlements in advance of A-Day without cost to the employer.

It is also becoming increasingly common for employers to replace contributory occupational pension schemes with salary sacrifice arrangements in order to take advantage of their NI-efficient characteristics. This Survival Guide focuses primarily on the opportunities salary sacrifice provides for individuals. Please contact us if you would like a copy of our briefing note on salary sacrifice for employers.

What are the potential advantages of salary sacrifice for individuals?

For individuals in an occupational pension scheme, one of the main advantages of salary sacrifice is that it increases the scope for making contributions, since contributions made by salary sacrifice do not count towards the current Inland Revenue limit on employee contributions of 15% of earnings (for personal pension schemes, a limit is set on employee and employer contributions taken together and so this point would not apply). This can make salary sacrifice a more attractive way of maximising benefits before A-Day than paying additional voluntary contributions (AVCs) or free-standing additional voluntary contributions (FSAVCs), though individual advice should be sought on the relative merits of the terms on offer.

Important note

It should be noted that this guide is provided for general information only and should not be relied upon to take action, nor should it be seen as attempting to provide you with any advice. The issues covered are most likely to be of interest to high earners, although other individuals may also be interested in salary sacrifice. A-Day will present a large number of complicated opportunities and you will need to seek advice specific to your individual circumstances, needs and objectives.

It is important to note that the provisions of the Finance Act have not yet come into force, and may be amended before A-Day. The Chancellor's pre-Budget report indicated that: "The Government is responding to representations made on the Finance Act 2004 legislation, and will introduce a package of supplementary measures in Finance Bill 2005".

The views and opinions expressed here are those of the author, Richard Meek, given his understanding of the issues at the time of publication.

There is also a particular advantage to salary sacrifice if the employer agrees to pay the NI saved on the amount sacrificed as an additional contribution to the pension scheme. This can apply to payments to personal pension schemes as well as to occupational schemes. This is because employers have to pay 12.8% NI on an employee's pay, but not on employer contributions to a pension scheme. The following example gives an idea of the possible savings:

Fred wants to sacrifice 10% of his salary in order to maximise his pension contributions before A-Day.
His employer agrees that he will receive the full benefit of the NI saving made. Fred's salary is £100,000.

After the sacrifice, Fred's salary is now £90,000. In return for the reduction in salary, Fred's employer makes a pension contribution of £11,280 (the £10,000 of salary sacrificed by Fred plus the £1,280 of NI saved by the employer). The net cost of the arrangement to the employer is nil. If Fred had chosen to pay £10,000 to an AVC scheme, then he would not have been able to receive the additional NI saving as a pension contribution.

In addition, as Fred's gross salary will be lower, he will also benefit from lower employee NI. As Fred's earnings are above the Upper Earnings Limit, the saving will equate to 1% of the salary being sacrificed, i.e. £100.

What are the potential disadvantages of salary sacrifice for individuals?

Probably the most significant disadvantage is that the individual's gross salary is reduced by salary sacrifice. This means that benefits that are calculated by reference to gross salary such as life cover or defined benefit pensions could also be reduced. If the individual is only interested in making salary sacrifice arrangements in order to maximise benefits before A-Day, then the effect of these reductions may not be significant in the long term. However, individuals may want to consider taking out additional life cover in the event that they die while their salary is temporarily reduced (assuming that this is possible within current Inland Revenue limits). Some companies may be prepared to continue to link such benefits to the higher salary.

Individuals who are looking to take out a mortgage during the period when their salary is reduced will need to be aware that the amount that mortgage lenders are prepared to lend may also be reduced. There may also be possible implications if gross salary is reduced to a level that may affect entitlements to state benefits. Salary sacrifice cannot reduce a member's pension below the minimum wage.

It is also important to note that an individual's pension benefits before A-Day will be subject to a maximum benefits check on current Inland Revenue limits at A-Day and therefore any contributions made will need to take account of current Inland Revenue maximum limits for benefits. This may be a particular issue given that gross salary will be reduced by salary sacrifice, and therefore the individual's current Inland Revenue maximum benefits will also be reduced.

How can I make a salary sacrifice?

The Inland Revenue requires that:

- The potential future remuneration must be given up before it is received.
- The true construction of the revised contractual arrangement between employer and employee must be that the employee is entitled to lower cash remuneration and a benefit.

A salary sacrifice is ineffective if, in practice, the arrangement enables the employee to continue to be entitled to the higher level of cash remuneration. If the Inland Revenue decides that a salary sacrifice is not effective, then the amount sacrificed will be treated as an employee contribution to the pension scheme and will therefore be subject to NI. It is therefore very important that individuals take proper advice before they enter into a salary sacrifice.

The agreement to sacrifice any element of salary must be made before the amount has started to accrue. In practice this means that salary must be sacrificed before the period of employment for which the salary is paid. For example, if salary is paid monthly in arrears, then the sacrifice must take place before the start of the month.

A genuinely discretionary bonus can be sacrificed at any point before the bonus is paid; however, there may be issues with contractual bonuses where it could be argued that they accrue over a certain period and therefore start to be earned before the bonus is paid. Individuals may need to seek advice if they intend to sacrifice contractual bonuses.

An opportunity to maximise pension contributions by salary sacrifice also arises for individuals who are made redundant between now and A-Day. Redundancy payments are generally taken to be earned at the point where the employment is terminated. Individuals could therefore agree with the employer to sacrifice all or part of their redundancy payment in return for an additional payment to their pension scheme.

Where an amount of £5,000 or more is sacrificed in return for a contribution to an occupational pension scheme, the sacrifice must be notified by the employer to the appropriate Tax District.

If there is no occupational pension scheme already available for the employer to make the contribution to, then a stand-alone Executive Pension Plan can be set up by the employer to receive the amount sacrificed (and the NI saving, if the employer agrees to pay this to the pension scheme).

The Treasury has recently made it clear that it has no intention of interfering in salary sacrifice arrangements. A spokeswoman said "Salary sacrifice is a matter of employment law and is a contract between the employer and the employee. It is not a matter for the Treasury."

Where can I get further information?

For independent financial advice, please contact Richard Meek on 0121 213 1800 or your usual PSFM Consultant. For an overview of the new pensions tax regime, please get in touch with your usual Punter Southall contact.