Salary sacrifice for pensions: still the smart option?

Employment Tax Tax voice

05 March 2020

Rob Woodward looks at why salary sacrifice for pension contributions remains attractive to employees and employers

Please note this article was written before the Budget on 11 March 2020.

Employees reducing their salary in exchange for increased employer pension contributions has been for many years the most popular form of salary sacrifice offered by employers. There have been a number of tax and regulatory changes in the past few years that have affected both salary sacrifices and workplace pensions which has led to questions on the viability of salary sacrifice for pensions.

By way of background, employee pension contributions will attract tax relief but there is no corresponding NIC relief, whereas employer contributions to the pension plan attract relief for both tax and NIC. Salary sacrifice for pensions is essentially an NIC efficient ‘wrapper’ around the existing pension arrangement which does not impact the amount paid into the pension but does save both employer and employee NIC costs. Broadly it operates by an employee agreeing to reduce their salary liable to PAYE and NIC and ceasing to make pension contributions from their net pay. In exchange for this, their employer makes an additional employer pension contribution equal to the amount of the salary sacrificed.

By reducing the amount of salary payable in exchange for an additional employer pension contribution which is not liable to NIC, the employee maintains their pension contribution levels but due to the reduction in employee NIC payable, they will see a modest increase in their net pay. The employer NIC savings remain with the employer to be used in whatever way they see fit, although many do choose to share or pass the savings to their employees by way of an increased employer pension contribution.

Clearly, salary sacrifice may not be beneficial for part time employees where a reduction in their taxable salary takes them below the income tax and soon to be increased NIC starting thresholds and the impact on the earnings levels of lower paid staff must also be considered (see below). Due to the success of salary sacrifice for pensions in reducing employer costs while increasing an employee’s total pay and benefits package, salary sacrifice schemes became increasingly popular and were rolled out more widely to incorporate other benefits, particularly where those benefits had a lower tax and/or NIC charge than the cash equivalent.

Extra HMRC scrutiny

Due to the proliferation of salary sacrifice arrangements, the rules governing both the salary sacrifice itself and the benefit provided were confirmed and greater scrutiny applied by HMRC. It has been, and remains the case, that the employee’s salary after taking into account the sacrifice must be above the National Minimum Wage (NMW). Given the greater attention paid to NMW compliance by HMRC and the above-inflation increases in the NMW, the number of employees for whom salary sacrifice is not an option has risen.

Tax changes also impacted on the viability of salary sacrifice. To be a valid salary sacrifice, the employee must sacrifice the pay in advance of entitlement to receive it and that sacrifice must be irrevocable. These conditions flow from the key case of Heaton v Bell [1970] AC 728. The term ‘irrevocable’ was not defined in the case and there has been some debate over what length of time would satisfy the condition. Eventually, for certain benefits (pensions included), HMRC confirmed via the Employment Income Manual at EIM42755 that a minimum time period to agree to the salary sacrifice was not necessary and all that is needed is for the employee to sacrifice the pay in advance of entitlement to receive it.

While the position regarding the salary sacrifice was clarified by HMRC guidance, the tax and NIC treatment of the benefit provided under that mechanism changed with effect from 6 April 2017.

Concerned with the impact of such salary sacrifice arrangements on the overall receipts of income tax and NIC (as well as the consequences for employee’s NIC contribution history), the Government introduced the Optional Remuneration Arrangements (OpRA) rules with effect from 6 April 2017. These rules apply where an employee gives up salary or the right to future salary in exchange for an employer provided benefit. That benefit provided in lieu of salary will be subject to tax and Class 1A NIC at the greater of the taxable value of the benefit in kind (the cost to the employer unless the benefit has a specific cash equivalent calculation such as employer provided vehicles) or the amount of salary foregone.

One of the consequences of OpRA was that many employers shied away from implementing salary sacrifice arrangements. However, it should be noted that within the OpRA legislation were specific exemptions for certain benefits. One of the exempted benefits was employer pension contributions and another was employer funded pensions advice (up to £500 per employee per year).

The Government’s action of legislating against salary sacrifice generally through the OpRA legislation but specifically carving out employer pension contributions, provides more certainty to employers that the Government does not consider salary sacrifice pensions in the same light as other benefits e.g. car parking or mobile phones. Essentially it is the closest they have come to ‘approving’ salary sacrifice for pensions and uptake has again started to increase as employers recognise that the costs of implementation are offset against the employer NIC saving made. It should also be remembered here that if an employer pays the Apprenticeship Levy, any reduction resulting in lower Class 1 NICs will also result in a reduction of Apprenticeship Levy payable.

Potential savings

Having addressed concerns about longevity, the remaining barrier for employers to implement salary sacrifice pensions is the level of savings available.

Those employer NIC savings directly result from the number of participating employees and the amounts the employees sacrifice in favour of pension contributions. For larger employers, the number of participating employees alone drove the savings even in cases where the amounts sacrificed per employee was low. However, for smaller employers with fewer employees with low levels of amounts sacrificed per employee that was not the case. Recent developments have led employers to reappraise salary sacrifice for pensions when previously the savings were low.

Similarly, the potential increase in employee numbers due to the proposed IR35 off-payroll labour legislation due from 6 April 2020 has encouraged some employers to implement salary sacrifice for pensions and so tap into the potential savings available to mitigate their increased costs.

Overall while salary sacrifice generally is not the same proposition as it was in the past, due to the protection of pension contributions from the impact of OpRA and a number of recent developments impacting employee engagement and taxation, salary sacrifice pensions remains attractive for both employees and employers.