

A Tax Free Benefit for Employees

Surprisingly enough, it is possible to receive some remuneration from your employer without paying tax or national insurance (NI). Such arrangements go under the general name of Salary Sacrifice.

What is Salary Sacrifice?

A salary sacrifice involves the employee agreeing with the employer to receive reduced cash remuneration in return for an alternative non-cash remuneration, such as a contribution (or increased contribution) to the employee's pension.

For example, an employee earning £24,000 pa agrees with their employer to receive £21,140 salary, and a pension contribution of £100 per month. The reduced salary will be subject to tax and NI in the normal way, but the pension contribution will be free of tax and NI.

	Without sacrifice	salary	With salary sacrifice £100 pm
Paid as salary	24,000		22,800
Personal allowance	6,475		6,475
Tax at 20%	3,505		3,265
National Insurance	2,011		1,879
Employee receives	18,484		17,656
Pension contribution	0		1,200
Total net remuneration	18,484		18,856

It is true that if the employee makes pension contributions out of take home pay, the contribution will be grossed up by the relevant amount of income tax; however, this does not apply to National Insurance.

The employer also benefits as no employer's NI is due on the pension contribution. The employer therefore saves £366 in the example. Perhaps your employer will be generous enough to share this with you!

There are two vital conditions for salary sacrifice arrangements to be effective:

- ◆ There must be a genuine change to the employment contract. In particular the employee must not retain the right to revert to cash remuneration. (However, it is normal for remuneration packages to be reviewed annually).

- ◆ The revised contract must be in place before the employee is paid under the new remuneration arrangements – it cannot be backdated.

Some points for employers to consider:

- ◆ There is no requirement to inform HMRC of the new arrangements. For reassurance however you may wish to advise them after you have implemented the arrangements, to ensure that they approve. (HMRC will not give approval in advance).
- ◆ The arrangements should be available to all employees.

Some points for employees to consider:

- ◆ The employee must be comfortable in the medium to long term with the new level of cash remuneration for ongoing living expenses, because there can be no possibility of reverting to the previous level of cash remuneration. (There is a possible escape however; the contract itself can be changed again in accordance with the normal salary review timetable. It would be inadvisable to do this within 12 months of the original change).
- ◆ Reduced salary may affect entitlement to benefits such as tax credits, sick or maternity pay, or second state pension (see below).
- ◆ The salary cannot reduce below the level of the minimum wage, £5.83 from Oct 1st 2009.
- ◆ In the case of payments to pension schemes, there is no liability to tax or NI on the amount paid by the employer. For other benefits arranged via salary sacrifice, such as medical insurance, the main financial benefit is the non-liability to national insurance, as tax generally remains payable. As the rate of national insurance falls to 1% on earnings over £43,875, (2009-10) there is only a marginal benefit for those earning more than that.

Effect on state benefits

There are various earning thresholds for qualification for benefits such as Statutory Maternity Pay, Statutory Sick Pay, and so on. Generally, if earnings remain above the Lower Earnings Limit of £95 per week there will be no effect on benefit entitlement.

How do we implement a salary sacrifice?

The terms and conditions of the employment contract are varied in accordance with the agreement reached with the employer. This can be done by letter, signed by both parties.

Where can I get further information?

HMRC has provided guidance on its website:

www.hmrc.gov.uk/specialist/salary_sacrifice.pdf

Details regarding state benefits are available at the website of the Department of Work and Pensions

<http://www.dwp.gov.uk/lifeevent/benefits/>