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Salary sacrifice

"Salary Sacrifice" describes an arrangement whereby an employee foregoes an element of their salary in exchange for alternative benefits. This can lead to savings in National Insurance Contributions and in some circumstances, Income Tax.

For example, instead of a salary increase an employee may agree to their employer making a contribution direct to their pension fund. In this example, this would produce Income Tax and NIC savings for the employee and NIC savings for the employer.

The important issue to note at this point is that the word sacrifice in this context does not mean giving up something and being worse off; in fact, it means the opposite.

The comments that follow regarding HMRC's past changes to the taxation of salary sacrifice arrangements only apply where an employer has contracted with an employee to replace salary with Benefits in Kind. In most cases the motivation for these arrangements has been to reduce tax and NIC for the employee and NIC payments for the employer.

Other salary adjustment schemes, for example taking extra holiday instead of an increase in salary, are not affected by these changes.

HMRC have tightened the restrictions on salary sacrifice schemes

The following statement by HMRC explains their motive for making the tax changes covered in the remainder of this section:

Salary sacrifice allows some employers and employees to pay less Income Tax and NICs by replacing cash salary with BiKs. This is limited to employees of a small number of employers who offer salary sacrifice schemes or offer BiKs with a cash alternative. The tax and NICs savings available have an Exchequer cost which is borne by the majority of taxpayers.

To address this unfairness, the government intends to limit the Income Tax and employer NIC advantages of salary sacrifice arrangements (and employee NIC advantages where these are already chargeable to employee NICs).

Valuing the BiK based on the higher of the salary sacrificed or the current taxable value of the BiK will ensure that tax and NICs is charged on an amount that reduces the current inequalities.

Since April 2017, HMRC has embarked on a series of progressive changes to legislation that have directly impacted access to tax or NIC savings from the use of salary sacrifice arrangements. Under these changes:

- All arrangements involving cars, vans, fuel, living accommodation and school fees were protected until 5 April 2021.
- Any renewals or variations in benefits (apart from limited exclusions) lost the above extensions/protections.

Which salary sacrifice features provide tax and NIC savings?

HMRC has confirmed that the following benefits will continue to provide employers and employees with a combination of tax and NIC savings. They include:

- certain childcare support schemes (that started on or before 4 October 2018);
- contributions to registered pension schemes;
- employer provided pension advice;
- the provision of cycles or cyclist's safety equipment;
- workplace pensions

For example, consider an employee that is offered a bonus of £5,000. Under normal circumstances this would be taxed and subject to both employer's and employee's NIC contributions at the appropriate rates. If the bonus was "sacrificed" in exchange for a direct payment by the employer into their pension scheme, then no Income Tax or NIC charges would be payable. The full amount would be invested in the registered pension scheme.

How much tax and NIC can be saved using salary sacrifice?

With regard to the exempt benefits listed in the preceding section, tax and NIC savings could be:

- For employees subject to basic rate Income Tax, savings could be a combined rate of 32% (20% Income Tax plus 12% NIC).
- For employees subject to the higher rate of Income Tax, savings could be a combined rate of 42% (40% Income Tax plus 2% NIC).
- Employers can save up to 13.8% NIC contributions on exempt salary sacrifice benefits provided.

Salary sacrifice – future strategies

Following the changes in April 2017, we suggested that all salary sacrifice arrangements in place at that time were reviewed, and no changes to these arrangements were, or will be implemented without due consideration of the consequences set out in the "HMRC tightens the restrictions on salary sacrifice schemes" notes above.

Regarding new arrangements, careful consideration of those benefits that still provide Income Tax and NIC savings should be investigated.

In the case of owner managed companies, where the employer and employee are basically the same person(s), there is an opportunity to re-examine salary sacrifice arrangements to optimise benefits for both parties.

The work that needs to be done is to calculate the present and future tax and NIC costs based on current arrangements and compare this with alternatives that may offer a lower tax and NIC impact. For example, substituting BiKs that have a higher cash value than the standard BiK valuation method with BiKs that retain exemption from the new rules.

What are the effects of salary sacrifice arrangements on benefits?

- **Earnings related payments**
  Employers usually decide how earnings-related payments such as occupational pension contributions, overtime rates, pay rises, etc are calculated. Such payments can be based on the notional salary or the new reduced cash salary, but this must be made clear to the employee.
- **Earnings related benefits**
  Salary sacrifice can affect an employee's entitlement to earnings related benefits such as Maternity Allowance and Additional State Pension. The amount they receive may be less than the full standard rate or they may lose the entitlement altogether.
- **Contribution based benefits**
  Salary sacrifice may affect an employee's entitlement to contribution-based benefits such as Incapacity Benefit and the State Pension. Salary sacrifice may reduce the cash earnings on which NICs are charged. Employees may therefore pay – or be treated as paying – less or no NICs.

Employees who currently qualify for Tax Credits should ascertain if the receipt of childcare support from their employer affects their entitlement.

Certainly, employers and employees should take professional advice before deciding on an appropriate course of action. We, of course, would be delighted to help.

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