DC briefing, May 2021 – Salary sacrifice

Introducing salary sacrifice for the payment of pension contributions can result in a win-win outcome, with National Insurance savings for both you and your employees.

Salary sacrifice

Salary sacrifice, or salary exchange as it is sometimes known, is an arrangement which allows for employees' pension contributions to be paid more tax efficiently. It generates National Insurance savings for both employees and employers, and gives employees full and immediate tax relief on their pension contributions.

Its adoption is not limited to Defined Contribution schemes – many Defined Benefit schemes can benefit from its use too.

Salary sacrifice is an established way of making pension contributions (as well as certain other employee benefits) more efficient, but there has always been a degree of mistrust over its legitimacy.

HMRC is now more accepting of it, going so far as to provide guidance on how to operate the arrangement (viewing it as a matter of employment law, not tax law).

In April 2017, following a review of existing salary sacrifice arrangements, Government published a list of the types of benefits that could continue to be provided tax-efficiently through salary sacrifice. While this significantly restricted the range of benefits, Government did confirm that its use with pension arrangements would still be permitted.

How salary sacrifice work?

Salary sacrifice for pension contributions involves employees giving up part of their salary. In exchange, their employer makes a matching pension contribution on their behalf, in addition to their normal contribution.

This reduction in gross salary will require a change to members' terms and conditions of employment, and can potentially impact other benefits, such as life cover. This is normally addressed by the employer maintaining a 'reference' salary, effectively the pre-sacrifice salary.

Using salary sacrifice means National Insurance contributions (NICs) are only paid on the employee's reduced salary. This results in savings for both the employer and the employee. The employee's net take home pay increases because they are paying lower NICs.

The current thresholds for employee and employer NI rates for 2021/22 are:

Annual earnings	Employee NICs	Employer NICs
Up to £8,840	Nil	Nil
£8,840 to £9,568	Nil	13.8%
£9,569 to £50,270	12%	13.8%
Over £50,270	2%	13.8%

The table below compares the NICs payable with and without salary sacrifice for an example member. The example assumes that the employee earns £25,000, with 5% of their salary (£1,250) paid into a Defined Contribution pension scheme each year:

Salary sacrifice	Employee NICs	Employer NICs
Without salary sacrifice	(£25,000 - £9,568) x 12% = £1,851.84	(£25,000 - £8,840) x 13.8% = £2,230.08
With salary sacrifice	(£23,750 - £9,568) x 12% = £1,701.84	(£23,750 - £8,840) x 13.8% = £2,057.58
Annual savings	**£150**	**£172.50**

From this, we can see that the employee receives an increase in their take-home pay of £150 a year. At the same time, the employer makes a saving of £172.50.

When salary sacrifice is applied across the whole workforce, the annual savings generated for employers can be considerable. The employer can choose how to use these savings from a range of options, including sharing some or all of the savings with employees, or using them to provide other benefits. They are also able to retain them.

Is salary sacrifice suitable for everyone?

Care needs to be taken as the use of salary sacrifice arrangements may not be appropriate for all employees, especially low earners whose earnings fall below the Lower Earnings Limit (LEL), set at £6,240 p.a. in the 2021/22 tax year.

This is because if an individual's earnings fall below this level, their entitlement to certain state benefits would be impacted, including:

- New State Pension
- Statutory Sick Pay
- Employment and Support Allowance.

To overcome this problem, most employers set a minimum salary level for automatic inclusion in the arrangement.

Additionally, employees earning close to the National Minimum Wage or the National Living Wage should also be excluded from salary sacrifice because it is illegal to pay someone less than these amounts.

Because salary sacrifice is not suitable for all employees, any employer planning to introduce salary sacrifice should agree which employees to include and exclude automatically as part of any implementation project.

Communication

Communication is a key aspect of any pension change project and salary sacrifice is no exception. It's not an easy concept to explain to staff – employees are often instinctively suspicious of the arrangement as it doesn't seem logical that giving up salary will save them money!

It's possible to implement salary sacrifice with a straightforward letter explaining changes to the employee's contract. In our experience, however, the more successful implementations involve the use of staff booklets, FAQ documents, and staff presentations or webinars to maximise understanding and subsequent take-up by existing and future employees.

An additional factor in driving take-up is whether the arrangement is introduced on a positive affirmation basis (whereby employees elect to join), or an opt-out or negative affirmation basis (whereby employees are included unless they opt out). The latter option typically leads to a significantly higher take-up. However, as mentioned previously, care needs to be taken to establish it correctly and review it regularly to keep it appropriate and compliant.

Salary sacrifice modelling

To help you understand potential National Insurance savings with salary sacrifice, we can carry out modelling that will demonstrate the specific benefits of salary sacrifice for your pension schemes.

Our modelling can show your total potential employer saving and indicate the savings available for individual employees.

Having this information to hand will help you consider how salary sacrifice could benefit you and your employees.

How First Actuarial can help you

We have significant experience of designing, introducing and reviewing salary sacrifice arrangements for both Defined Contribution and Defined Benefit arrangements. We can also help you communicate details of the arrangements to employees.

To discuss how we can assist you, please contact your usual First Actuarial consultant or one of our DC consultants who specialise in salary sacrifice.

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