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BRIEFING

Pensions: salary and bonus sacrifices

Employment, pensions and benefits: briefing 103

Executive summary

At a time when many employers are seeking ways of reducing pension costs, some are cutting benefits and/or increasing member contributions. However, one means of reducing costs which has a lesser effect on employees is salary sacrifice. This works by channelling NIC savings into the pension scheme. The potential savings are greater since 6 April 2003, when total NICs (employer and employee) on earnings above £89 per week rose by 2 per cent.

Salary sacrifices have always been an attractive way to reduce National Insurance Contributions (NICs), to allow employees to effectively contribute more than 15 per cent of their remuneration and to increase the maximum tax-free lump sum available. Now, with additional employer and employee NICs of 2 per cent on earnings above £89 per week effective from 6 April 2003, salary sacrifices may be even more attractive.

What is a salary sacrifice?

A salary (or bonus) sacrifice is a binding variation to an employment contract where the employee agrees to give up a specified amount of salary or bonus (above the minimum wage). In exchange, the employer agrees to procure that agreed additional pension benefits are provided. If the sacrifice is effective, the contributions will be treated as employer contributions and will not be subject to income tax or NICs. The employer will get tax relief on any additional contributions to the pension scheme as usual.

A sacrifice may be made in place of additional voluntary contributions (AVCs) or to reduce (or eliminate) ordinary compulsory employee contributions. Sacrifices across the workforce which effectively turn contributory schemes into non-contributory schemes (or reduce compulsory contributions) could bring significant savings to both employees and employers. At a time when many final salary schemes need to find additional resources, it is an attractive option to do this by reducing NIC liabilities.

Why would an employee be interested in a salary sacrifice?

- *More potential annual pension saving*: while the limit of 15 per cent of remuneration remains for employee contributions. Even though taxable remuneration is reduced as result of a sacrifice, the potential aggregate annual contribution will increase. The following table illustrates the additional ‘contributions’ which can be made within current Revenue limits using a sacrifice.

Gross salary	£80,000	£70,000
Salary sacrifice	–	£10,000
Employer NICs (approximately)	£9,650	£8,376
Employee NICs	£3,385	£3,285
Maximum employee contribution	£12,000	£10,500
Maximum total contribution including salary sacrifice	£12,000	£20,500

- *No NICs*: there are no employees’ (or employer’s) NICs on employer contributions to Revenue-approved schemes. The table below shows the changes to NICs effective from 6 April 2003. The table above shows that the total savings on a sacrifice of £10,000 for an employee on £80,000 per annum are about £1,375 per annum (pa).

	Below £89 pw	£89 pw- £595 pw	Above £595 pw
Employer NICs			
Before 6/4/03	–	11.8 per cent	11.8 per cent
From 6/4/03	–	12.8 per cent	12.8 per cent
Employee NICs			
Before 6/4/03	–	10 per cent	–
From 6/4/03	–	11 per cent	1 per cent

Previously, because employee NICs were capped at the Upper Earnings Limit and in practice sacrifices often would not bring remuneration below this level, there was less financial incentive for employees. Now a sacrifice achieves a 13.8 per cent saving on earnings above £89 pw.

- *Benefits are not subject to restrictions on AVCs*: currently there is a restriction against taking benefits from AVCs as a tax-free lump sum (for those who started paying AVCs on or after 8 April 1987). However, if an employee makes a sacrifice instead of paying AVCs, the restriction will not apply. The maximum lump sum will therefore be increased provided final remuneration (for Revenue purposes) is not affected (eg if the sacrifice takes place well before retirement so the reduced salary is not ultimately relevant to the calculation of final remuneration for Revenue limits). Of course, the advantage given to AVCs on a winding up would be lost as would the ability (under current law) to have AVCs refunded if benefits exceed Revenue limits.

Why would an employer agree to a salary sacrifice?

Funding pension benefits by way of salary sacrifice enables the provision of greater benefits at less cost because of the saving in NICs. NICs are payable on the member's salary, including the part the member contributes to the pension scheme. NICs are not payable on employer contributions to an approved pension arrangement.

What issues arise?

Salary sacrifices seem straightforward. However, in practice the effect on death benefits, unexpected early retirement benefits and non-pension benefits needs to be addressed to ensure that employees do not lose out. This requires thought, negotiation and careful documentation.

Timing

Salary (or bonus) must be sacrificed before it is earned ie before the employee has performed the services for which the remuneration is payable. Contractual payments generally accrue on a daily basis (this will be implied under the Apportionment Act 1870 if not expressly stated in the contract). Discretionary bonuses can be sacrificed before the decision to award them has been taken, unless they have become contractual (eg through custom and practice). Termination payments are generally earned when employment is terminated. Sacrifice may be able to be documented in a compromise agreement if the salary (or bonus) has not already been earned.

Type of remuneration	Safest sacrifice time
Wages/salary	Before start of period of employment for which wages are paid.
Discretionary bonus	Before actual payment (or decision to award if it may then become contractual).
Contractual bonus	Before the bonus has been earned. If bonus is calculated by reference to a period, before the reference period starts.

Pension benefits

Unless the sacrifice is of non-pensionable remuneration, final salary benefits will be reduced where the benefit is calculated by reference to final salary and years of service if appropriate amendments are not made. While this might be immaterial if the sacrifice does not occur near retirement, the effect on death benefits and ill-health early retirement benefits needs to be considered. A similar issue arises with a career average scheme. The effect on current Revenue limits (because remuneration is reduced) also needs to be considered. This may make sacrifice inappropriate for some.

Effect on other employment benefits

Similarly, the effect on other benefits, including life insurance, long-term incentive plans and maternity pay, needs to be addressed[1].

Other effects

The sacrifice could have effects outside the employment contract, for example on state benefits and mortgage borrowing limits. In practice these cannot be managed except by trying to minimise the effect with strategic timing or provision of alternative benefits.

Trustees

Pension enhancements or variations may need to be agreed by the trustees of the pension scheme. Unless the benefits to be provided are money purchase, additional contributions beyond those envisaged by the company may be required. The trustees should be consulted in advance to avoid surprises. Amendments may be needed to document the extra benefits to be provided and to avoid potential temporary reductions in benefits resulting from reduced pensionable salary (subject to Revenue limits).

Documentation

The Revenue guide on salary sacrifice (posted on their website on 25 February 2003) confirms that the salary sacrifice and the employer's commitment to contribute additional amounts to the pension scheme/provide extra benefits can be documented in the same letter. The documentation should set out the details of the reduction to the employee's remuneration and the pension benefits to be granted. It should highlight potential risks (see above) and address how the effect on other benefits will be dealt with (if at all).

Notifications

Sacrifices of more than £5,000 pa should be notified to the appropriate Schedule E tax district. It will decide if the sacrifice is effective and will notify the Revenue accordingly. The Revenue should be contacted separately if any amendment is required to the pension scheme.

Change ahead

The Revenue's radical tax proposals first published in December 2002 will have three significant effects on the suitability of salary sacrifices for some employees:

- maximum employee contributions will skyrocket from 15 per cent to 100 per cent of remuneration – the advantage of allowing for more potential annual saving will fall away in all but the most unusual cases;
- schemes will no longer be prohibited from paying AVCs as a lump sum – this advantage will therefore also fall away; and
- the removal of the link between taxable remuneration and maximum benefits will mean that there need not be a risk of an employee losing out if he dies or leaves pensionable service when his reduced salary is relevant for calculating maximum benefits (usually three years before the date of death or leaving pensionable service).

With the increased potential for NIC savings from 6 April 2003 and the proposed changes to pensions regulations in the future, employers would be well advised to review employee contribution limits and consider the financial advantages of salary sacrifice.

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[1] The Inland Revenue discusses these issues on its website at www.inlandrevenue.gov.uk/news/february.htm.