

# Salary Sacrifice Pension Schemes

## Background

Most employers who operate Stakeholder or Group Personal Pension Schemes (defined contribution schemes) require employees to make contributions out of their net pay. This means that employees make their contributions from pay on which tax and national insurance has already been deducted. Employers will often match or enhance the employees' contributions.

The employees' contributions are grossed-up, upon receipt by the pension funds, by the basic rate of tax. This currently results in tax relief at 20% on the grossed-up contributions. (The employer's contribution is not grossed-up.)

By way of example, a net pay contribution of £100 by an employee will currently be grossed-up to £125 by the pension fund.

A higher-rate taxpayer will also receive tax relief at 20% on their grossed-up contributions but can seek additional tax relief (up to 40%) through their annual tax return. The additional tax relief will be given either as a cash refund, or as an adjustment to their tax code.

## Salary Sacrifice Pension Scheme

Under a salary sacrifice pension scheme, there are no contributions from employees out of their net pay. Instead, the employer contribution is increased, in return for the employee agreeing to an equivalent reduction in their gross salary (the salary sacrifice). If an organisation is converting to a salary sacrifice pension scheme, the new employer contribution will normally be calculated to be at least equivalent to the sum of the previous employer's and employee's contributions.

## Advantages of Salary Sacrifice Pensions

There are some significant savings available for employers and employees by operating a salary sacrifice pension scheme:

### Savings for the employer:

The employer will make savings in employers' national insurance contributions, calculated at 12.8% of the value of the gross salary reductions (the salary sacrificed). This is the most compelling reason for employers to adopt a salary sacrifice pension scheme.

Employers can choose to use this saving to enhance pension contributions (in full or in part) or apply these savings elsewhere (sometimes to fund other benefits).

To illustrate the savings, one employer who recently converted 100 employees from a net pay contribution to a salary sacrifice pension scheme has enjoyed employers' national insurance savings of £15,000 per annum, on-going. (The average gross salary was £25,000, with pre-sacrifice employee net pay contributions of 3% of gross salary. Employees were split evenly between basic and higher-rate taxpayers.)

#### **Savings for employees – Basic-rate taxpayers (Those paying tax at 20% and NI at 11%):**

There is no tax-saving for a basic-rate taxpayer but there is a saving in employees' national insurance at 11% of the salary sacrificed. By way of example, an employee who previously contributed £100 from net pay (resulting in a gross contribution of £125 into the pension fund) will see, under a salary sacrifice pension, the pension contribution enhanced to £144, without any loss in take-home pay. This assumes that the employee's national insurance saving is applied to the pension contribution; the employee may elect to take the saving in increased take-home pay instead.

Employers may decide to additionally apply some of their national insurance savings to further enhance the pension contribution.

#### **Savings for employees - Higher-rate taxpayers (Those paying tax at 40% and NI at 11%):**

Similarly, overall savings are limited to national insurance savings for a higher-rate taxpayer and this is usually limited to only 1% of the salary sacrificed (for those earning over £43,875 per annum). There are, however, other benefits:

- Tax relief is effectively given straightaway at 40%. There is no need to claim the difference between 20% and 40% through a tax return. (A surprisingly large number of potential beneficiaries forget or omit to claim this additional relief.)
- Those that do receive the additional tax relief through their tax return receive the refund in cash or as an adjustment to their tax code; the refunded amount is rarely invested into their pension fund. Through salary sacrifice, employees who previously contributed £100 from net pay (£125 into the pension fund plus further tax relief rebated) will see their contribution enhanced to £169, which is immediately vested, without any loss in take home pay.

## **Implementation of a Salary Sacrifice Scheme**

Consulting with employees, planning the implementation and communicating effectively are all key ingredients of a successful scheme. The approach varies depending on whether employees are being asked to convert from a net pay scheme or whether the scheme is a new offering.

### **As a new scheme**

Any employer in the throws of constructing a new or revised pension scheme should consider salary sacrifice. There is little additional administration and the cost savings are significant. As with any salary sacrifice, the employee is agreeing to a change in the terms and conditions of their employment and a suitable addendum to their employment contract must be put in place. Employers must also ensure that their payroll system treats the salary sacrifice deductions correctly.

### **Converting to Salary Sacrifice**

With good planning and communication, transferring to a salary sacrifice pension scheme is a relatively painless exercise. The employees will benefit from real savings in their own national insurance, which may be further enhanced by the employer. In a transfer situation, salary sacrifice schemes are usually set-up so that the employees' national insurance savings are applied to the pension fund contributions. Employees then see the benefits of the transfer as a way of increasing their pension contributions without any effect on their take home pay.

Employers will need to consider whether or not they pass-on some of their own national savings to employees. This will depend on a number of factors but consideration needs to be given to the make-up of the workforce, the objective of the employer and the benefit as perceived by the employees.

### **Offering Salary Sacrifice Pensions as a Pre-Cursor to Flexible Benefits**

Whilst not essential, allowing employees some flexibility in how much they can contribute (through salary sacrifice) can significantly improve the attraction of a salary sacrifice pension scheme. Each employee's circumstances are different; some employees will want to contribute the minimum whilst others will want to increase their contributions significantly.

Introducing flexibility into any pension scheme gives rise to some additional administration but the advantages can be significant. A number of employers have set-up pensions on this basis as the first step towards flexible benefits.

### **As part of a Flexible Benefits Package**

It is very common to see flexing of pension contributions in organisations that offer flexible benefits packages. It is often the savings that are gained by the employer from the salary sacrifice pension scheme (employers' national insurance) that are seen as 'funding' the costs of implementing flexible benefits, or offsetting the cost of other benefits that do not operate through salary sacrifice.

## Things to Watch Out For

### The Effect on Other Benefits

As with all salary sacrifice schemes, employees need to be aware that statutory benefits can be affected because taxable pay is reduced. The state second pension may also be affected, for those earning between the Lower and Upper Earnings Limits.

Furthermore, a salary sacrifice should not be put in place if the effect is to take the employee's pay below the National Minimum Wage, or the Lower Earnings Limit.

### Will Salary Sacrifice Pensions Last?

The concept of salary sacrifice and its application to pension schemes has been around for many years and there are currently no moves afoot to withdraw the schemes. In essence, the structure of a salary sacrifice pension scheme is the same as a standard, non-contributory pension scheme, where the employee might be happy to accept a lower salary at the outset of employment, in the knowledge that they do not have to make personal pension contributions.

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