



---

# Salary sacrifice arrangements

## Inside



- How does salary sacrifice work?
- Effect on tax and NICs
- Salary sacrifice during maternity leave
- How are pensions affected?
- Childcare vouchers

## Introduction

A salary sacrifice arrangement is where an employee gives up the right to receive part of the cash salary due under their contract of employment in return for the employer's agreement to provide some form of non-cash benefit.

One of the most common forms of benefit provided under salary sacrifice arrangements is an entitlement to childcare vouchers or workplace nursery schemes. Other common types of non-cash benefit include bicycle loans or pension contributions.

This Inbrief provides a general summary of how salary sacrifice arrangements operate and the main issues to watch out for. In particular, it deals with tricky issues relating to maternity leave.

### What is the effect of salary sacrifice?

Under this type of arrangement, the employee's 'sacrifice' of part of their salary will involve a contractual change to the terms of their employment. The employee becomes entitled to a reduced cash salary but gains the additional benefit of the non-cash benefit being provided by the employer.

Once the 'sacrifice' and change to contractual terms has been made, the non-cash benefit is treated like any other benefit and is not dependent upon the employee being in receipt of sufficient salary from which the value of the benefit can be deducted. (Note, however, the section dealing with pension contributions below).

Once employees have entered into a salary sacrifice arrangement, they cannot simply opt in and out when they want. This is on account of the tax requirements of salary sacrifice schemes. Usually, employees will need to stay in the scheme for the scheme year, subject to leaving for 'lifestyle' events such as pregnancy/maternity.

### How are tax and national insurance affected?

The effect of a salary sacrifice arrangement on income tax and national insurance contributions (NICs) will depend on the non-cash benefits that the employee is receiving. Some benefits are still subject to income tax and NICs in the same way as cash.

However, many benefits are exempt from income tax and/or employee and/or employer NICs. In these cases, the salary sacrifice will mean that the employee will have a reduced liability to tax and NICs and the employer will also save on NICs. Because of the potential effect of the arrangement on tax and NICs, Her Majesty's Revenue & Customs (HMRC) will need to be satisfied that the salary sacrifice is effective and meets certain conditions. Further guidance on this is available on the HMRC website at: [www.hmrc.gov.uk/specialist/salary\\_sacrifice.pdf](http://www.hmrc.gov.uk/specialist/salary_sacrifice.pdf)

### What does agreeing to a reduced salary mean?

Before entering into a salary sacrifice arrangement, employees need to be aware of the practical effect that a reduction in pay might have.

An employee's earnings and NICs will be lower as a result of the reduced salary. This might affect contribution-based or earnings-related state benefits. Contribution-based benefits include incapacity benefit, jobseekers' allowance and the state pension. Earnings-related benefits include maternity allowance and the State second pension.

Work-related statutory payments — i.e. payments paid by the employer and based on average earnings over a fixed period — will also be affected as the reduced salary figure will be used in any calculations. Work-related payments include statutory maternity pay (SMP) and statutory sick pay (SSP).

Employees who are entitled to claim tax credits should also consider whether it is beneficial to claim tax credits before entering into a salary sacrifice arrangement. This may be a particular issue for an employee who is able to claim tax credits for childcare costs and who is being offered childcare vouchers under a salary sacrifice arrangement. For examples, see [www.hmrc.gov.uk/childcare/interaction-tc-cv.htm](http://www.hmrc.gov.uk/childcare/interaction-tc-cv.htm)

The way in which other salary-related payments are calculated is usually up to the employer. For example, the employer may decide that in respect of life assurance, occupational pension contributions, overtime rates, pay rises and so on it will use the notional salary figure rather than the new, reduced cash salary figure. Employers need to consider carefully what the implications of this might be (e.g. during maternity leave – see below).

### Salary sacrifice and maternity leave

As mentioned above, maternity allowance and SMP will be calculated using the reduced salary figure. If the employee is entitled to contractual maternity pay, this may or may not be affected, depending on whether the employer uses the notional salary

figure or the reduced, cash salary figure in its calculations.

Employee benefits must continue to be provided throughout ordinary and additional maternity leave (i.e. for the full 52-week period of leave) to comply with current legislation. Previously, benefits only continued during the 26-week period of ordinary maternity leave (OML).

This means that where a salary sacrifice arrangement has been put in place, the non-cash benefit that the employer has agreed to provide must continue to be provided throughout the full maternity leave. This applies even where the woman is not or is no longer entitled to receive pay. However, there is debate about whether this applies in the same way to pension salary sacrifice arrangements and in relation to childcare voucher schemes (see further below).

Detailed HMRC guidance on maternity leave in relation to salary sacrifice arrangements and non-cash benefits, including worked examples, is available at: [www.hmrc.gov.uk/employers/sml-salary-sacrifice.pdf](http://www.hmrc.gov.uk/employers/sml-salary-sacrifice.pdf)

### How does salary sacrifice affect pensions?

As already mentioned, it is up to the employer whether a salary sacrifice arrangement providing for a non-pension benefit (e.g. childcare vouchers) will affect contributions into pension schemes. Employers often use the notional salary figure to calculate employer and employee pension contributions so that employees who participate in salary sacrifice schemes are not disadvantaged in the value of their pension contributions.

It is, of course, possible to make pension contributions via a salary sacrifice arrangement. In return for accepting a lower salary, the employee no longer makes their own contributions into the pension scheme. Instead, the employer makes contributions into the scheme that are equal to the payments no longer made by the employee.

There is a tax advantage to this because NICs are payable on employee contributions but not on employer contributions. The employer may pass

some or all of this advantage onto the employee in the pension contribution that it makes.

### Pension salary sacrifice during maternity leave

Pension salary sacrifice arrangements are essentially the same as other salary sacrifice arrangements in all respects, save for a debate about the position during unpaid maternity leave.

Social security legislation provides that employer pension contributions should continue during any **paid** period of maternity leave at the same rate as before leave, based on the employee's actual salary. Any matching employee's pension contribution only needs to be based on the pay they are receiving at the time (i.e. SMP).

The general position is that benefits provided under salary sacrifice arrangements continue throughout full maternity leave. But there is an exception in the maternity legislation relating to 'employment-related benefit schemes' (which would include normal pension contributions). It appears the intention was to leave the employer's obligations under social security legislation unaffected, so that pension contributions are only payable during paid maternity leave.

The upshot is that employers would therefore **not** be obliged to continue making pension contributions during **unpaid** maternity leave (i.e. the last 13 weeks of the maternity leave period). This seems to be the view taken by both the Department for Business Innovation & Skills (BIS) and HMRC.

However, the position is by no means clear. There is some doubt over whether the legislation properly implements European law, so they may be open to challenge. Moreover, it is questionable whether the exception that is intended to maintain the existing position regarding pension contributions can properly override the requirement to continue provision of benefits throughout maternity leave.

### Childcare vouchers during maternity leave

There is some debate over whether childcare vouchers fall within the exception relating to 'employment-

related benefit schemes' mentioned above. That would mean the vouchers should be payable only during the 39-week period of paid maternity leave.

The answer to this question turns on whether childcare vouchers count as benefits payable in 'money's worth'. If they can be categorised in this way, they would arguably only be payable for 39 weeks. (This is assuming that the 'employment-related benefit scheme' exception can properly override the general requirement that benefits continue throughout maternity leave).

This is clearly not the view taken by HMRC. Its guidance concerning maternity leave and salary sacrifice and non-cash benefits expressly states that childcare vouchers are non-cash benefits and non-transferable. As such, it says they should continue to be paid throughout the full period of maternity leave: see [www.hmrc.gov.uk/employers/sml-salary-sacrifice.pdf](http://www.hmrc.gov.uk/employers/sml-salary-sacrifice.pdf)

Therefore, adopting a cautious approach, employers should continue payment of childcare vouchers throughout maternity leave in the same way as other contractual benefits.

What about the position where a woman wishes to enter into a salary sacrifice arrangement when she is already on maternity leave? Does the employer have to allow this?

It would be unlawful sex discrimination to deprive a woman of the right to enter into a salary sacrifice scheme simply because she is on maternity leave. For example, a woman who already has one child and then goes on maternity leave for a second time might decide, during that second period of leave, that she needs to put childcare in place for the first child and that she wants to make use of childcare vouchers or a salary sacrifice arrangement. She should not be prevented from doing so just because she is on maternity leave.

On the other hand, the employer's salary sacrifice arrangements may only permit employees to join at a particular time (e.g. at the start of the scheme year, or on commencement of employment). If all employees have to observe these, including maternity

leavers, it is much less likely that this will be found to be unlawfully discriminatory.

---

### Can employees get 'free' childcare?

If a woman is in receipt solely of SMP (either because that is all the employer offers, or because she has not qualified for contractual maternity pay) and decides just before or during her maternity leave that she wants to take advantage of a salary sacrifice arrangement, she may effectively receive a windfall.

The period for calculating her SMP is the eight weeks ending with the 15th week before her Expected Week of Childbirth. Any reduction in pay after that does not affect SMP. So the first six weeks of earnings-related SMP will be based on her old higher salary, and it is not possible to make deductions from the prescribed rate of SMP for the remaining 33 weeks. The employee will continue to enjoy the benefit of the vouchers/salary sacrifice arrangement through her leave (including any unpaid period).

The employer may be able to reduce any additional burden where employees are receiving **contractual** maternity pay. If a salary sacrifice arrangement is entered into during a period of contractual maternity pay then, assuming the employer's maternity policy is drafted to reflect this, the contractual pay would be reduced at the commencement of the salary sacrifice arrangement in line with the employee's agreement to receive a lower salary.

For further information on this subject, please contact:

Carolyn Soakell  
Partner  
T: +44 (0) 20 7074 8225  
E: carolyn.soakell@lewisilkin.com

or another member of our Employment, Reward and Immigration Department known to you.