

Salary sacrifice arrangements



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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 ways in which salary sacrifice schemes are used is for pension contributions. Other common types of non-cash benefit include cycle to work schemes and childcare vouchers (although the latter schemes are now winding down).

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 in return for an additional non-cash benefit 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, to reduce administration many employers operate the arrangements on the basis that the salary sacrifice will remain in place for at least 12 months unless the employee experiences a lifestyle event. 'Lifestyle' events include pregnancy/ maternity, marriage and divorce. Depending on the benefit provided there may also be adverse tax consequences if employees can opt into or out of salary sacrifice at will.

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.

An optional remuneration regime was introduced in 2017 which restricts the benefits that attract tax and NICs advantages when provided as part of an optional remuneration (including salary sacrifice) arrangement. The only benefits that can be provided tax efficiently via salary sacrifice arrangements are:

- employer pension contributions to registered plans
- pensions advice
- employer supported childcare consisting of either:
 - childcare vouchers provided by the employer for qualifying childcare, but only if the employee joined the relevant scheme prior to 4 October

2018; or

- directly contracted or employer contracted childcare, where the employer arranges for the provision of qualifying childcare
- cycle to work schemes
- ultra-low emission cars.

These benefits are exempt from income tax and/ or employee and/or employer NICs if certain conditions are satisfied. In other words, if the relevant conditions are satisfied and the benefits are provided via salary sacrifice, 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. In particular, HMRC will want to be satisfied that the salary was sacrificed prior to the employee becoming entitled to 'receive' it for tax purposes. Further guidance on this is available on the HMRC website at: <https://www.gov.uk/guidance/salary-sacrifice-and-the-effects-on-pay>

There is no tax advantage in providing any benefits other than the five benefits listed above by way of salary sacrifice, including charitable donations. If salary sacrifice is used to provide other benefits, income tax and NICs arise on the higher of the:

- amount of salary sacrificed; or
- cash equivalent of the benefit

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, otherwise the salary sacrifice may be ineffective for tax purposes.

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.

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.

Employees who are entitled to claim tax credits should also consider the effect of entering into a salary sacrifice arrangement. HMRC has produced detailed technical guidance on this issue here: <https://www.gov.uk/hmrc-internal-manuals/tax-credits-technical-manual/tctm04104>

The way in which contractual salary-related payments and benefits 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).

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. cycle to work scheme) 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 amount of the contributions that the employee was previously making.

There is a tax advantage to this because the employee is receiving a reduced salary in return for employer contributions. As employer contributions are not subject to NICs, this saves both employee and employer NICs. The

employer may pass some or all of its employer NICs saving onto the employee in the pension contribution that it makes. In addition, it saves the employee from having to claim higher or additional rate tax relief on their pension contributions via self-assessment.

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 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).

Pension salary sacrifice during maternity leave

Pension salary sacrifice arrangements are essentially the same as other salary sacrifice arrangements in all respects, save for the position during unpaid additional maternity leave (AML) (weeks 27 to 52 of maternity leave, with SMP normally being payable for up to 39 weeks).

Social security legislation provides that employer pension contributions should continue during OML and any paid period of AML 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 (e.g. 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 OML and paid AML.

The upshot is that employers would not be obliged to continue making pension contributions during unpaid AML (i.e. the last 13 weeks of the maternity leave period). This seems to be the view taken by both the Department for Business, Energy and Industrial Strategy and HMRC.

However, the position is by no means clear. There is some doubt over whether the legislation properly implements European law, so it may be open to challenge. There is also a question mark over 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 need to be continued during the whole of maternity leave, and employers often query what happens once employees exhaust any enhanced maternity pay and move onto SMP only or unpaid leave.

Following the launch of a government childcare voucher scheme, employer-supported childcare voucher schemes have been closed to new participants since October 2018. The issue is therefore likely to become less important over time, but is still relevant to those who participate in legacy schemes.

The issue turns on whether childcare vouchers are classed as benefits, or whether they should be categorised as remuneration.

The view taken by HMRC is that childcare vouchers are non-cash benefits and non-transferable. On that basis, employers would be obliged to continue to provide them throughout the full period of maternity leave in the same way as other contractual benefits.

In contrast, the Employment Appeal Tribunal decided in *Peninsula Business Services Ltd v*

Donaldson in 2018 that childcare vouchers provided under a salary sacrifice scheme are part of 'remuneration' and so it is not sex discrimination if an employer does not provide them at all during maternity leave (as there is no entitlement to remuneration, other than maternity pay). However, this decision seems to be based on a misunderstanding of how salary sacrifice affects contractual pay and so should be treated with caution, not least because potentially it may result in HMRC arguing that the salary sacrifice arrangements were not implemented correctly. At the time of the Peninsula case, HMRC indicated that it would issue guidance for employers on this matter but no guidance has been published to date.

There is a further question as to whether childcare vouchers could be categorised as an 'employment-related benefit scheme' in the same way as pension contributions and therefore fall within the exception in the maternity legislation referred to above. If so, and assuming that the 'employment-related benefit scheme' exception can properly override the general requirement in the Maternity and Parental Leave Regulations 1999 that benefits continue throughout maternity leave, they would arguably only be payable for 39 weeks. However, as illustrated by the arguments in the Peninsula case, the main issue is whether they are categorised as remuneration or benefits.

Adopting a cautious approach, employers who want to avoid any risk should continue payment of childcare vouchers throughout maternity leave in the same way as other contractual benefits.

For further information on this subject please contact:

Carolyn Soakell

Partner

+44 (0) 20 7074 8225

carolyn.soakell@lewissilkin.com