

Salary sacrifice

What is a salary sacrifice?

A salary sacrifice happens when an employee gives up the right to receive part of the cash pay due under his or her contract of employment. Usually the sacrifice is made in return for the employer's agreement to provide the employee with some form of non-cash benefit. The 'sacrifice' is achieved by varying the employee's terms and conditions of employment relating to pay.

Salary sacrifice is a matter of employment law, not tax law. Where an employee agrees to a salary sacrifice in return for a non-cash benefit, they give up their contractual right to future cash remuneration. Employers and employees who are thinking of entering into such arrangements would be well advised to obtain legal advice on whether their proposed arrangements achieve their desired result.

What is the role of HM Revenue & Customs (HMRC)?

The nature of an employee's contract of employment is a matter for the employer and employee.

HMRC interest is in determining how the tax and National Insurance Contributions (NICs) legislation applies to the various elements in the employee's remuneration package. Many payments and benefits are treated in the same way for both tax and NICs. But, in some cases, where a particular benefit may be exempt from tax and/or NICs or subject to Class 1A NICs, the tax and NICs outcome will be different.

Where a salary sacrifice has been put in place for the purpose of converting cash pay that is subject to tax and Class 1 NICs to a benefit that has a different tax/NICs treatment, HMRC has to be satisfied that the salary sacrifice is effective. The effect of the contractual change must be that the employee has given up the right to some of their cash pay in return for the benefit. Only then can HMRC deal with the benefit under the relevant employee benefits legislation.

This is particularly important where the benefit is exempt from tax and/or NICs.

When is salary sacrifice effective?

Salary sacrifice arrangements are effective when the contractual right to cash pay has been reduced.

For that to happen two conditions have to be met:

- the potential future remuneration must be given up before it is treated as received for tax or NICs purposes

- the true construction of the revised contractual arrangement between employer and employee must be that the employee is entitled to lower cash remuneration and a benefit

When is salary sacrifice not effective?

A salary sacrifice is not effective if, in practice, the arrangement enables the employee to continue to be entitled to the higher level of cash remuneration. In other words he has merely asked the employer to apply part of that cash remuneration on his behalf.

What information does an employer need to provide to HMRC?

In order to decide whether a salary sacrifice is effective or not HMRC has to consider what the true construction of the revised contractual arrangements is. The employer should provide full details of the scheme and of the new contractual arrangements. The employer will need to satisfy HMRC that the employee's entitlement to cash pay has been reduced, that a non-cash benefit has been provided by the employer, and that the employer is not simply meeting the employee's own financial commitments.

Why can't HMRC comment on a salary sacrifice scheme before it is set up?

HMRC cannot comment on:

- how to set up a salary sacrifice arrangement or
- whether draft documentation will achieve a successful salary sacrifice

HMRC only comments on proposed transactions in a limited range of circumstances which does not include proposed salary sacrifice. The limited circumstances are set out in the booklet [Code of Practice 10 - Information and Guidance](#).

As a salary sacrifice involves an alteration of the contractual arrangements between employer and employee it would not be appropriate for the HMRC to become involved in advising how it should be set up.

What do employees need to consider if they are thinking about entering into a salary sacrifice arrangement?

When entering a salary sacrifice arrangement to replace part of cash pay with a benefit that is tax and/or NICs exempt it is essential to understand what the sacrifice will mean in practical terms. Employees should consider carefully the effect, or potential effect, that a reduction in their pay may have on:

- their future right to the original (higher) cash salary
- any pension scheme being contributed to
- entitlement to Working Tax Credit (WTC) or Child Tax Credit (CTC)

- entitlement to State Pension or other benefits such as Statutory Maternity Pay (SMP)

Where is there more information about tax and NICs and employer provided childcare?

[Leaflet IR115](#) provides information about the tax and NICs treatment where an employer provides or supports childcare as an employment benefit.

Where is there more information about Childcare Tax Credits?

Tax Credit guidance is available on the [Directgov website](#).

Salary sacrifice and the National Minimum Wage

A salary sacrifice cannot reduce your cash pay below the National Minimum Wage.

The National Minimum Wage provides a legally binding minimum hourly rate of pay to workers aged 18 years or over - with few exceptions. There are different levels of the National Minimum Wage:

Description	Amount
A rate for workers aged 22 years and above	£5.35* ¹ per hour rising to £5.52* ² per hour
A development rate for workers aged 18 - 21 years inclusive, and, For workers aged 22 years and above starting a new job with a new employer and doing accredited training* ³	£4.45* ¹ per hour rising to £4.60* ² per hour
A development rate for workers aged 16 - 17 years inclusive* ⁴	£3.30* ¹ per hour rising to £3.40* ² per hour

Notes

*¹ Rates in force from 1 October 2006

*² Rates in force from 1 October 2007

*³ accredited training means a course approved by the UK Government to obtain a vocational qualification

*⁴ 16 and 17 year old apprentices are exempted from the young workers rate

Although workers aged 22 years and over can be paid the development rate in the circumstances described above, it can only be paid for the first six months after which they must be paid at least the National Minimum Wage rate.

The National Minimum Wage applies to new and existing workers and takes no account of how the worker is paid, be it hourly, daily, weekly, or by session.

How could a salary sacrifice affect my future entitlement to the State Pension, benefits and Tax Credits?

A salary sacrifice may affect your entitlement to state benefits and tax credits and you should carefully consider the possible effects before you decide to go ahead with a change in your employment contract. The information that follows is based on the rules that apply at the time of writing.

When you sacrifice cash pay in return for a benefit that is exempt from NICs, for example, childcare vouchers - you will not pay NICs on the cost of providing the vouchers. Although this means that you save NICs and can therefore get more vouchers than cash for the same cost to your employer, it also:

- cuts the earnings on which you can pay NICs
- may take your earnings for which NICs are due below the Lower Earnings Limit (LEL), which is £87 per week for the tax year 2007-08

As your entitlement to some benefits is based on the amount of NICs that you pay, and others on the amount of your earnings, entering into a salary sacrifice may affect your current or future entitlement to a range of benefits.

For most employees paying less NICs may not adversely affect your benefit entitlement as:

- you may still be paying enough NICs to qualify for benefits
- your earnings may still be between £87 and £100 a week (the LEL and the Primary Threshold for tax year 2007-08), so that you are deemed to be paying NICs and you can still build up benefit rights even though you are not actually paying NICs
- you may already be earning below the LEL before the salary sacrifice
- if you only sacrifice salary for a short period, your contribution history will only be affected for that period, so the effect on your benefit entitlement will be minimal

It is important to note, however, that not only will entitlement to the State Second Pension be affected if your reduced earnings fall below the LEL (£87 per week), but it may also be affected if your reduced earnings fall between the Lower Earnings Threshold (raised to £13,000 in 2006/07) and the Upper Earnings Limit (£34,840 in 2007-08).

Entering into a salary sacrifice arrangement may also affect your entitlement to Statutory Sick Pay (SSP), SMP, Statutory Paternity Pay and Statutory Adoption Pay, the State Pension and any means-tested benefits or tax credits. You should consider these effects before you decide whether to enter into a salary sacrifice.

Salary sacrifice and contribution-based benefits

Your entitlement to contribution-based benefits is related to the amount of NICs you have paid, or are deemed to have paid. Reducing your cash pay through a salary sacrifice may reduce the amount of earnings on which you pay NICs to below the LEL, so that you are no longer paying (or deemed to be paying) NICs. Even if your earnings remain above the LEL, because you are paying (or deemed to be paying) less NICs, this may reduce your entitlement to contribution-based benefits.

Contribution-based benefits include:

Incapacity Benefit

If your deductible earnings fall below the LEL, you may not be entitled to Incapacity Benefit. If this happens, you may be entitled to Income Support based on incapacity, which is a means-tested benefit.

Jobseeker's Allowance (JSA) (contribution-based)

If your deductible earnings fall below the LEL, you may not be entitled to any JSA (contribution-based), as this benefit is paid at a set amount which cannot be reduced. If you have not paid (or are not deemed to have paid) enough NICs, you will lose entitlement to this benefit. If this happens, you may still be able to claim JSA (income-based), which is a means-tested benefit.

State Pension

If you have not paid (or are not deemed to have paid) enough NICs on your income, you may have a reduced State Pension when you retire, or none at all. You should also consider if your State Second Pension could be affected (this is covered below under earnings-related benefits).

Salary sacrifice and earnings-related benefits

Your entitlement to earnings-related benefits is based on your level of earnings, not including any amount sacrificed in return for a NICs exempt benefit. If your cash earnings are reduced below the LEL your entitlement to earnings-related benefits will be reduced.

Earnings-related benefits include:

Maternity Allowance

If your cash earnings fall below £30 per week you will lose your entitlement to MA. If your cash earnings fall between £30 and £125 per week you will still be entitled to MA, but at a variable rate. If your earnings are £125 a week or more you will receive the full standard amount of MA.

The State Second Pension

The State Second Pension forms part of the State Pension. If your annual pay (less the amount of the salary sacrifice) is between the annual LEL (£4,524) and £13,000, you are treated as if you earn £13,000 for the purposes of calculating your entitlement. If your salary sacrifice brings your pay to less than the LEL your entitlement to the State Second Pension will be reduced. Your entitlement to State Second Pension may also be reduced if your salary sacrifice reduces your annual pay to a figure between £13,000 and the Upper Earnings Limit (£34,840 for 2007-08).

Salary sacrifice and work-related payments

Work-related payments are paid by your employer and are based on your average earnings over a fixed period before you begin to receive them. Sacrificed cash pay will not count as part of your average earnings for calculating these payments, so they may be reduced as a result of a salary sacrifice.

Work-related payments include:

Statutory Maternity Pay

If your average weekly earnings (for SMP entitlement purposes) fall below the LEL, you will lose your entitlement to SMP. If this happens you may still be entitled to MA, which is an earnings related benefit. Even if you are still entitled to SMP, the higher rate, which you can receive during the first six weeks of maternity pay, will decrease, as it is based on the amount of your cash earnings. If your employer operates an occupational maternity pay scheme, you may still be entitled to maternity pay through that scheme.

Statutory Sick Pay

If your average weekly earnings (for SSP entitlement purposes) fall below the LEL, you will lose your right to SSP. If this happens you may still be entitled to Income Support based on incapacity or Incapacity Benefit, if you meet the qualifying conditions. These will be paid at a rate less than the normal rate of SSP. If your employer operates an occupational sick pay scheme, you may still be entitled to sick pay through that scheme.

Salary sacrifice and Tax Credits

The WTC and CTC were introduced in April 2003 to help families on middle incomes. The amount of WTC award depends on a number of factors including the number of hours you work, how many children you may have and whether you pay any eligible childcare costs.

A salary sacrifice for childcare vouchers or the provision of an employer provided nursery place can reduce your relevant pay for tax credit purposes as the value of these benefits are not included as income. This may have the effect of increasing your WTC award.

If you have childcare costs that are eligible for the childcare element of WTC, the costs eligible for the childcare element of the tax credit will be reduced by the amount of those costs met by your employer (eg the cost covered by a voucher). The childcare element of WTC may therefore be reduced.

You should consider whether it is beneficial to claim tax credits before agreeing to a salary sacrifice arrangement.

Salary sacrifice and income-related benefits

If you enter a salary sacrifice arrangement this may affect your entitlement to income-related benefits. If you are receiving Income Support or Jobseeker's Allowance you should contact your local social security or Jobseeker Plus office to find out more. If you are not receiving either of these benefits, but are receiving Housing Benefit and/or Council Tax Benefit you should contact your Local Authority.

How will a salary sacrifice affect married women paying reduced rate contributions?

If you sacrifice cash pay in return for a benefit that is exempt from National Insurance contributions, and this reduces the amount of your cash earnings to below the LEL (£87 a week in 2007-08), then you will not pay any contributions.

If you are a married woman and your earnings are below the LEL for two consecutive tax years, and you are not self-employed in those years, you will automatically lose the right to pay reduced rate contributions.

If you enter into a salary sacrifice and the reduced amount of cash earnings is between the LEL and the Primary Threshold (£100 a week for 2007-08) you will also not pay contributions but you will be treated as having paid contributions on those earnings. But as those contributions will be at the reduced rate they will not count for benefit or pension purposes.

Where your earnings are between the LEL (£87 per week for 2007-08) and the Primary Threshold (£100 per week for 2007-08) it might be beneficial for you to change to paying full rate contributions. Although you will not have to pay contributions and your contributions will be treated as paid, the deemed contributions will be at the full rate and will therefore count towards helping you build up entitlement to contributory benefits. If you do choose to cancel your right to pay reduced rate contributions, you cannot change back.

You can find further information about reduced rate contributions in [Form CF9](#).

Where can I find out more information about the possible effect of a salary sacrifice on benefit entitlement?

You should contact the Department for Work and Pensions. For general enquiries about pensions go into [The Pension Service website](#). The Department for Work and Pensions offers a free pension forecast. More information about this free service can be found on [The Pension Service website](#).

For enquiries about other benefits or allowances either contact your local Jobcentre Plus office, or go into the [Jobcentre Plus website](#).