Salary Sacrifice and Pension Contributions

Salary sacrifice (also known as Salary Exchange or SMART pensions) can be used in occupational pension plans. It is a method of making savings on national insurance contributions by reducing the amount of contractual pay received by the amount of employee pension deduction that would be applied to this pay. Employees give up a proportion of their salary or bonus, which is known as the sacrifice, while the employer makes additional contributions towards the employees' pension provision. The reduction in salary means that the National Insurance paid by both the employee and employer is also reduced. As a result, an employees take home pay is usually increased or remains the same.

For a salary sacrifice system to be implemented, two conditions must be met:

- The potential for future pay must be given up before it is treated as received
- The contract of employment must be redesigned to illustrate the employee salary or bonus has been reduced, and that the employer's additional contributions are being paid into a pension.

National Insurance Savings

The amount sacrificed would normally attract national insurance contributions for both the employee and the employer. Therefore, implementing a salary sacrifice system creates savings for both.

The national insurance savings made by the employer would ideally be used to increase the employees' pension savings. However, it should be highlighted that some employers may not want to reinvest the whole amount and this should be monitored. Some employers view the savings generated as a way of reducing pension costs.

Advantages of Salary Sacrifice

The one advantage to both employee and employer is the reduction in the amount of National Insurance paid. It should be noted that both parties make a saving here (not just the employees as some employer correspondence would lead you to think). As employers pay National Insurance at a higher rate, they stand to benefit more by introducing salary sacrifice.

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GMB would wish for all employers' savings on National Insurance to be regenerated to provide extra benefits to the workforce (e.g. through increased pension contributions). The saving seen by the employee can be used to increase take home pay or paid as an extra pension contribution.

Members who are receiving working tax credits may receive an indirect advantage from pension contributions through salary sacrifice. As their gross basic salary is reduced, the level of tax credits due may increase.

Disadvantages of Salary Sacrifice

There are several potential disadvantages to employees who take part in a salary sacrifice scheme:

- The reduction in earnings may take employees below the lower earnings limit (£90 per week in 2008/09) meaning that they would not build up entitlement to any state benefits, including:
  - Basic state pension
  - Additional state pension (if contracted-in)
  - Jobseeker's allowance
  - Incapacity benefit
  - Widowed parents' allowance
  - Bereavement allowance and payment
- For employees who are contracted in to the State Second Pension, the amount of pension paid is linked to the level of earnings on which National Insurance has been paid. A lower level of earnings could result in a lower level of State Second Pension.
- Future benefits based on reduced earnings, such as future pay increases, pensions, death in service lump sums or bonuses may be reduced.
- Mortgage or loan applications may be affected as banks etc may base a decision on the reduced salary.

There are ways to account for these disadvantages. GMB would expect each employer operating a salary sacrifice arrangement (or seeking to implement one) to carry out a thorough investigation of each employee to see if they would lose out on state benefits (including State Second Pension) by partaking in salary sacrifice. To counter the two negative effects outlined in the third and fourth bullet points above, many employers have established a "reference salary" equal to the salary the employee would receive if they weren't partaking in the salary sacrifice. Employment benefits can be based on these reference amounts and this figure can be disclosed to financial institutions in support of any loan or mortgage application.

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GMB View

Salary Sacrifice can be viewed as a legitimate way of avoiding National Insurance payments, which are needed to secure the United Kingdom's National Insurance fund. This fund is needed to ensure future generations will receive old age pensions and that jobseekers, the bereaved and incapacitated will continue to receive support when they need it most. As such GMB generally does not support such arrangements for core employee benefits such as pensions.

Salary Sacrifice can result in a favourable win-win scenario for both employees and employers. However it should be implemented and administered with great care. We would wish to see the financial circumstances of every employee considered and those who would be worse off by participating excluded from the exercise. The position of employees should be kept under review.

We would also wish to see the establishment of a "reference salary" on which employment benefits and future pay increases would be based.

The saving made by the employer on their National Insurance bill should be recycled for the benefit of employees, through extra pension contributions or otherwise.

It is key that employees fully understand the changes that would be brought about by the implementation of salary sacrifice. To ensure this we would wish for all salary sacrifice arrangements to be "opt-in" meaning that employees should actively elect to partake, rather than be automatically enrolled into the arrangement without an appreciation of the risks involved.

Example of How Salary Sacrifice of Pension Contributions Works

Mohammed's annual salary is £20,000. He pays pension contributions of 5%, so his annual pension contributions are £1,000. He is contracted in to the state second pension, so pays full national insurance contributions.

He pays national insurance on his full salary before the company pension contributions are deducted. His normal pay (after national insurance and his pension contribution have been deducted, but before income tax is deducted) is approximately £17,401.

His employer elects to start a salary sacrifice arrangement meaning that his annual salary is £19,000 and there are no pension contributions deducted. The employer pays the £1,000 pension contribution on his behalf. After national insurance is deducted, his normal take home pay (before income tax) is approximately £17,511 – an increase of £110. The difference comes from the fact that national insurance is not payable on the £1,000 pension contribution when this part of Mohammed's salary is sacrificed.

Mohammed's employer also makes a saving on their national insurance payments. Under the first arrangement their annual national insurance payment for Mohammed would be approximately £1,832. On implementing a salary sacrifice arrangement, their annual contribution is reduced to approximately £1,706.

(Note that the above calculation is based on the earnings limit of £5,460pa in 2008/09 and the national insurance contribution rate of 11% on band earnings for an employee with a corresponding employer contribution rate of 12.8%)

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