Salary Sacrifice

When an employee gives up the right to receive part of the cash pay due under his or her employment contract, this is called a 'salary sacrifice' (sometimes known as 'salary exchange').

Q: Why would someone give up part of their salary?

A: Usually in return for the employer undertaking to provide some form of non-cash benefit – perhaps on-site childcare, or help with childcare costs, or a better company car.

Salary sacrifice is a matter of employment law, not tax law. However, HM Revenue & Customs will be keen to ensure that each element of an employee's remuneration package is correctly treated in accordance with tax and national insurance contribution (NIC) legislation. Thus tax and/or NICs will be charged on the replacement benefit, if that is what the rules say. However, in some cases the benefit is exempt from tax and NICs, which can mean that the reduction in net cash pay could perhaps be less than the value of the benefit provided.

The tax and NIC advantages of salary sacrifice schemes were removed from April 2017, except for arrangements relating to pensions (including advice), childcare, cycle to work schemes and ultra-low emission cars.

Where a salary sacrifice is claimed, there must be a proper contractual change evidencing that employees have given up the right to some of their cash pay in return for the benefit. There are two conditions that have to be met:

- the potential future remuneration must be given up before it is treated as received for tax or NICs purposes (it cannot be given up retrospectively); and
- the revised contractual arrangement must be that the employee is entitled to lower cash remuneration and a benefit.

In other words, it is not sufficient if the arrangement allows employees to remain entitled to the higher level of cash remuneration and they have merely asked the employer to apply part of that cash remuneration on their behalf.

Before entering into a salary sacrifice arrangement, employees need to consider:

- their future right to the original (higher) cash salary
- possible breach of the National Minimum Wage/National Living Wage
- possible reduction of pay below the lower earnings limit which would affect entitlement to contribution-based benefits and statutory sick, maternity, paternity or adoption pay.

When looking at the possible tax savings from entering a salary sacrifice arrangement, Scottish resident taxpayers may also need to consider the differing rates of tax payable on non-savings and-non dividend income (this includes wages, pensions, taxable state benefits, profits from self-employment and rental income).