This paper addresses the use of salary sacrifice (SalS) as a means of mitigating the cost of commercial and third-sector organisations’ pension schemes. More accurately termed ‘salary exchange’ this is a contractual arrangement capitalising on the National Insurance (NI) exemption for employer pension contributions that, far from involving a ‘sacrifice’, generates savings for employees and their organisations. In essence it involves employees agreeing to reduce their gross pay by the amount of their pension contributions in exchange for equivalent employer contributions, thus maintaining their pension entitlements, lowering their NI liabilities and hence raising their net pay and overall remuneration (1). Crucially it also enables employers to save their NI contributions (NICs) on the pay foregone.

Reflecting its contractual base, SalS is governed by employment rather than tax law and not subject to a reporting requirement making it difficult to assess its precise extent and role in retirement saving. The available data, however, suggests the provision of pension SalS has grown significantly over the last decade and the paper starts by considering the factors
driving this development. It then focuses on the issues posed by this growth, pointing particularly to the cost in terms of reduced NICs, the way in which its use can exacerbate inequities in pension saving, the extent to which employers are the main beneficiaries and the need for greater transparency on its place in the pension nexus.

The use of SalS in pension provision is far from new. Historically though it was largely confined to schemes for executives and key employees, arrangements for whom can be traced back to the ‘top-hat’ pension plans of the post-war era highlighted in Titmuss’ work (1958, 1962) on fiscal welfare. Whilst this usage was forestalled it remained a feature of senior personnel’s reward packages and one that has recently been extended to other staff (2). Active membership of Group Personal Pension schemes operating SalS for instance grew from 33% in 2009 to 46% in 2011 and 66% by 2013. The proportion of members in SalS Stakeholder Pensions plans has also risen, from 42% in 2009 to 53% in 2011 and 62% by 2013, whilst those belonging to open and closed SalS occupational schemes increased from 56% to 68% between 2011 and 2013 (Forth and Stokes, 2010; Forth et al, 2012, Forth et al, 2014) (3).

The origins of this expansion lie in the 1990s when some companies offered SalS to smooth shifts from DB to DC plans or facilitate organisational mergers. But the key stimulus was the promotion of a cheaper way for employers to offer SalS in the face of the rising cost of pension provision. This was triggered by Deloitte’s launch in 2003 of ‘nudge-style’ SMART (Save Money and Reduce Tax) pension schemes and their approval by HMRC in 2004. Until then SalS usually involved costly individual agreements, whereas these automatically
entered employees unless they opted out, promising high take-up and hence substantial employer savings, especially in the light of the increase in NI imposed in 2003.

Awareness of these was heightened by similar promotions from other leading consultancies, the CBI’s (2006a; 2006b) SalS-based ‘Pension Builder’ proposals and Labour’s endorsement of SalS for other employee benefits. More directly provision was eased by pension simplification in 2006 and, despite the concern of some, growing union support. The main cost-drivers, however, were a further rise in NI in 2011 and the advent of workplace pension auto-enrolment, the build-up to which saw many large organisations move their schemes onto a SMART pensions footing. Crucially, in 2012 HMRC guidance enabled their use alongside auto-enrolment (4). This prompted a further surge in provision, with some industry analysts reporting around 65% of new auto-enrolment schemes were utilising SalS and that employers generally were relying on it to alleviate its costs (Plager, 2014).

Economic and human resource management pressures gave this process further traction, SalS being widely marketed as a way of ‘squeezing out value from the wage bill’ (Blundell and Cookson, 2010) while softening pay austerity and assisting staff faced with rising living costs including, for many, new pension contributions.

The spread of SalS alongside auto-enrolment has, however, developed with little public discussion of its use or ramifications. Individually the boost to employee’s pay is modest and varies with their salary, contribution level and marginal rate of NI saving, amounting for most in contracted-in schemes to 12% of their pension contribution, and 2% for higher earners (5). But as a pension-saving mechanism for many employees SalS is more cost-effective than direct contributions or other tax-favoured vehicles and for higher earners can
deliver other gains (6). The main benefits though accrue to employers who for every £ an employee in a contracted-in scheme sacrifices generally make an NIC saving of 13.8%, lowering payroll costs significantly.

Gauging the numbers taking advantage of pension SalS and the consequent loss in NI revenue for the Treasury however is far from straightforward. As noted earlier, there is no reporting requirement for SalS and, partly accounting for the lack of public scrutiny, no official data on its take-up for pension saving (7). Nor is the cost detailed in that on NIC relief on employer pension contributions which in 2011/12 stood at £15 billion (HMRC, 2014). In that year, however, HMRC acknowledged that of foregone employee NICs was £4.8 billion (Johnson, 2014) (8). With commercial surveys pointing to employee SMART pension take-up rates of 70% or more this subvention may have boosted retirement saving. But it has also added to inequities in provision which could deepen as auto-enrolment phases in.

Firstly, though auto-enrolled employees are likely to be suitable for SalS, it cannot reduce their pay below the NMW and can affect some state benefits if it falls below the NI lower earnings threshold (9). Hence, though employers normally take steps to ensure those ‘at risk’ do not participate in SMART schemes, employees are expected to check their appropriateness. Secondly, though little is known about this group, not all eligible employees take advantage of them. Critically, moreover access varies inter and intra-sectorally. Adding a little noted dimension to pension differentials public service scheme rules preclude SalS whilst commercial studies point to disparities within the private sector, particularly between large and other employers. Hitherto, the former, who stand to gain most and have the resources to run SMART schemes have dominated provision. Whether
this unevenness will continue as auto-enrolment extends to smaller organisations is unclear. But, given their headcounts, pay and administrative structures a number of analysts have suggested those working for small entities will remain the least likely to be offered SalS, adding to gender and other differences in saving.

Infringing one of the main principles of fair taxation, these varying disparities also mean employees with equivalent remuneration may pay different amounts of NI. Adding to these asymmetries are differences stemming from employers’ use of their NI savings. These can be shared with employees or retained. The former was often promoted as a way of engaging staff with the switch to SMART pensions and in many unionised organisations implementation agreements committed some of the employers’ savings to boosting either the scheme and/or individual contributions or funding other benefits. Overall though it appears that sharing is mainly utilised by organisations with highly-paid workforces, for whom it is a means of encouraging participation by staff who would otherwise only gain the 2% marginal NI saving (Calnan, 2014). Commercial surveys indicate that most employers keep their savings, a pattern also reported by the ONS (2012) for DC SalS schemes, only a minority of active members of which in 2011 were in ones adding some of the employer’s saving to their pensions. Whether it was shared in other ways is unclear. But what is clear is the extent to which SMART schemes provide a form of corporate welfare alleviating the cost of auto-enrolment.

The forthcoming pension liberalisation has raised further issues, with some forecasting it could lead to over-55s, particularly high earners using SalS to ‘wash’ their salary or bonus through immediately accessible pensions. Whilst the possible tax leakage is to be
monitored, it has drawn attention to other aspects of the use of SalS, concerns over which had already filtered into the work of the OTS (2014; HMRC, 2014). In the context of fiscal constraint these have also prompted suggestions for curtailing pension SalS in ways compatible with its legal base through, for instance, making employee contributions compulsory, removing NI relief for employer contributions or merging NI and income tax. Each of these opens up other debates. They are also countered by the view that SalS is an effective way of making pensions affordable, particularly as contribution levels rise, with some advocating its extension to the self-employed (Merrett, 2014). Assessing this contention and the overall impact of pension SalS, however, requires, as with much fiscal welfare, greater transparency as to its scale and a systematic investigation of the role of what in effect is a subsidy for pension saving, particularly for employers.

*The views expressed in this briefing are the views of the author(s) and do not necessarily represent the views of CHASM as an organisation or other CHASM members.*

**Notes**

1. Pension SalS can also be used for contractual bonuses.

2. The use of SalS for other employee benefits has also been expanded.

3. A routing error means the proportion for occupational schemes in 2009 (49%) is not strictly comparable.

4. This exempted pensions from the general rule that except for unforeseen life-style events SalS should apply for at least 12 months.
5. Employees contracted out of the second state pension pay a lower rate, the cessation of the NI rebate for which in 2016 is predicted to increase the appeal of SMART schemes.

6. E.g., preserving child benefit, all/part of the personal allowance.

7. Employers are advised, however, to gain HMRC confirmation that the SalS is tax-compliant.

8. As Johnson notes this does not include the cost of lost income tax. Nor is it clear how far SalS may have affected the changing balance between employer and employee contributions.

9. Any contribution refunds for those who leave within two years of joining a scheme are usually also forfeited. Pay increases and pay-related occupational provisions are usually protected through the use of notional salaries as are mortgage applications.

References
Plager, A. (2014)‘On the up’, Taxation, 12 Sept, www.taxation.co.uk/taxation/Articles/2014/02/12/320411