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W(h)ither salary sacrifice?

Edward Brunsdon and Margaret May
Honorary Research Fellows
CHASM/School of Social Policy, University of Birmingham

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Salary sacrifice (or salary exchange) incentives have become increasingly popular mechanisms for delivering employee benefits in the UK over the last decade. Advocated by consultants and benefit suppliers as win-win arrangements, they've been adopted by large organisations across the public, commercial and third sectors, while successive governments have sanctioned their use in implementing a range of employment, retirement and environmental policies. They have not however received universal acclaim. Critics, of differing political hues, have maintained that these arrangements are costly, complex and inequitable. At minimum, they argue, they should be curtailed if not scrapped completely. This briefing paper attempts to throw light on these differing viewpoints, suggesting that if there are to be major changes critics need to consider not simply why reform or abolition is necessary but how it could best be achieved.

What are salary sacrifice incentives?

Essentially, they are contractual agreements involving salary exchanges between workers and their employers in which the former give up a proportion of their salary entitlement in return for non-cash benefits of equivalent value. It is this shift from cash on which National Insurance (NI) and income tax are due to benefits that are wholly or partially exempt (from one or both) which provides the key economic rationale. An employee willing to forego £1,000 of gross salary in return for benefits of £1,000, for instance, is better off by £120 -

savings of 12 per cent on National Insurance Contributions (NICs) - and if the benefits are also income tax exempt (at the basic rate) £320. An individual with earnings in the higher tax band makes a net saving of £420 and one in the additional band £470.

Employers also save through the reduction in their NI liabilities for the revised salary.[1] At the current rate of 13.8 per cent, an employee sacrifice of £1,000 would produce a per capita saving of £138 for the employer (whatever the employee's salary). The establishment-level savings would however depend on a cluster of factors including the size and age distribution of the workforce (NIC relief does not apply to benefits-in-kind for those under 21), the range of benefits on offer, administrative costs and, of course, employee take-up. Lane, Clark and Peacock provide an illustration of a single benefit – occupational pensions – in which an organisation with 1,000 staff, a 45 per cent take up of its pension scheme with members spending on average £1,500 per year in sacrificed contributions (i.e. a total employee spend of £675,000) would save £93,150 in NIC liabilities.[2]

These incentives are not however as straightforward as the illustrations might imply. There are restrictions on eligibility, specific rules and qualifying conditions for each benefit exchanged as well as inequities in employee financial gains. With regard to eligibility, they are clearly not available to the self-employed, unemployed or those working for employers who either choose not to or are unable to support such an arrangement (typically, smaller businesses or third sector agencies that either cannot afford to administer them for themselves or add to the costs of outsourced payroll services). Moreover, not all employees within establishments offering schemes are considered suitable. The lowest earners are barred from participation if the 'sacrifice' takes their cash salaries below the National Minimum Wage or National Living Wage rates. Those just above these thresholds are also alerted to the fact that reducing their remuneration could impact on earnings-related state benefits (e.g. statutory sick pay, maternity and paternity benefits and employment and support allowance) as well as mortgages and loan applications.

[1] Although the savings made by small businesses, charities and community amateur sports clubs may be mitigated by the Employment Allowance (£3,000 in 2016-2017).

[2] Lane, Clark & Peacock (2015) *We can help you save on your current pension spend by introducing a salary sacrifice arrangement* www.lcp.uk.com

As important as issues of eligibility are, their intricacies pale into insignificance when compared with the intricacies that pervade the rules governing the incentives for particular provision. Some benefits (e.g. employer-supported childcare, counselling and bicycles-for-work) must be offered to all employees; others (e.g. mobile phones, laptops, white goods and company cars) can be supplied to designated members of staff. Several are exempt from NI *and* income tax (e.g. workplace nurseries and contributions to registered pensions); others receive NI relief but are taxable (e.g. company cars and private medical insurance). Adding to this complexity are a host of individual conditions based on criteria such as: the maximum sums that can be sacrificed (e.g. with childcare vouchers its £243 per month for basic rate taxpayers); the number of items permitted (e.g. one mobile phone per employee); how payment for benefits are made (e.g. for NI exemption, medical and dental insurances have to be contracted between employer and supplier) and the frequency of provision (e.g. tax and NI exempted health screening can only occur once a year).[3]

It is the tax treatment of such benefits in conjunction with these rules and conditions that forms the primary source of salary sacrifice inequities. It does not impact on employers (who get the pro rata NI savings on reduced contribution costs) but on employees. They are subject to differential gains with, in most instances, higher earners as the bigger beneficiaries.[4] In the current tax year (2016-2017), someone on £30,000 pa sacrificing £3,000 on tax-exempt pension contributions would have a reduced salary of £27,000 making an income tax saving of £600 and employee NIC saving of £360. Their total non-cash benefit would be £3,960 and their net gain £960. Compare this with a person earning £60,000 and sacrificing the same sum. They would make an income tax saving of £1,200, an employee NIC saving of £60, a total non-cash benefit of £4,260 and a net gain of £1,260.[5]

Even greater advantages are available to those on higher incomes where the amount sacrificed lowers the taxable sum in upper bands and/or triggers the retention of other allowances and benefits. Take, for instance, the case of personal allowance. On adjusted net

[3] See www.gov.uk/expenses-and-benefits-a-to-z
[4] There are specific exceptions e.g. childcare vouchers where basic rate taxpayers can sacrifice up to £933 pa per working parent while higher earners are limited to £623 pa.
[5] Drawn from data presented in Palin, A (2016) 'Salary sacrifice – how to do it and whether you should' Financial Times 23 March.

earnings over £100,000 the allowance reduces by £1 for every £2 earned, tapering to zero when it reaches £122,000. An employee on a salary within that range who exchanged a proportion of cash earnings for tax-exempted benefits would thus gain on income tax, employee NICs and recoup some personal allowance. A sacrifice of say £6,000 of a £122,000 salary on tax-exempt benefits would save £3,720 in income tax, personal allowance and employee NICs.[6] A second example would be child benefit where following the implementation of the higher income child benefit tax charge (HICBC) in 2013, families with an individual earning over £50,000 incur a levy of 1 per cent of their child benefit for every £100 of (net adjusted) income above that figure and lose the benefit completely at £60,000. A single breadwinner with a salary of £60,000 and one child would, by sacrificing £3,000 of salary, cut their income tax and NICs by £1,260 and save £323 in HICBC as well.[7]

Proponents and Critics

Advocates of salary sacrifice incentives tend to accentuate their common advantages. Consultants and benefits suppliers, for instance, whilst acknowledging the issues of eligibility largely discount the HMRC complexities and understate or disregard the inequities that can accrue. Their sales pitch to employers focuses on NIC savings but also includes the value of these arrangements for recruitment and retention, engagement, productivity and wellbeing. The marketing encouraging employee take-up follows a similar pattern. It combines the NIC and income tax gains with advantages such as the reduced costs of the benefits themselves and the back-up services obtained through their purchase. Outlay on cars, cycles, gym membership, laptops and mobile phones via salary exchange, for example, can lead to savings of up to a third on retail prices when combined with an organisation's block contracts or bulk purchasing and may enable employees to purchase items they could not otherwise afford. A number of benefits also come with 'free' support services (e.g. car leasing or purchasing can include insurance, maintenance and servicing, tyre replacements and breakdown cover).

[6] Cited in ibid
[7] Cited in ibid

Employers have drawn on consultants' and suppliers' initiatives to instigate a wide array of schemes. The key stimulus was the introduction of SMART pensions in 2003,[8] since when the arrangement has become part of mainstream remuneration in large organisations. It's been particularly important in enhancing reward packages when salaries have been frozen or cash increases limited. But if consultants, suppliers and large organisations remain avowed proponents of salary sacrifice, the same cannot be said of recent governments (Labour, Coalition and Conservative) whose enthusiasm has waned markedly. Each has accepted salary sacrifice as an important way of supporting employment, retirement and environmental policies but, in somewhat conflicted viewpoints, they have become increasingly troubled (none more so than the Conservative administrations) by the sums the Treasury has foregone in tax and NI.

HMRC holds no information on the specific attributable costs of salary sacrifice, so the apprehension has largely fed off indirect data such as the rise in PAYE clearance requests (that grew 30 per cent between 2009/10 and 2014/15) and organisations' P11D (and P11Db) returns.[9] These set alarm bells ringing for the Cameron administration which spoke of its concern about the increasing expense of salary exchange in the Summer Budget 2015 and announced in its Autumn statement of that year its intention to gather evidence on the arrangement's growth, scope and impact on tax receipts. The March 2016 Budget launched a consultation paper to take matters a stage further, intimating that it was looking to restrict the provision on which salary sacrifice relief could be claimed. It suggested that occupational pensions, childcare and provision of workplace nurseries and cycle-to-work schemes would continue to attract NI and tax relief but that many other benefits could lose these advantages.[10]

But would such reforms satisfy other more trenchant critics? The answer would have to be a resounding 'no'. Some, such as Sinfield, take a principled stance to ask why the tax-paying

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[8] See M. May (2015) 'SMART pensions in the UK: Salary sacrifice and auto-enrolment' Briefing Paper BP2/2015 www.birmingham.ac.uk/chasm

[9] A clearance request involves seeking written HMRC confirmation that salary sacrifice arrangements are applicable to specific benefits. P11Ds are organisations' end-of-year reports to HMRC for the expenses and benefits that have not been taxed through payroll; P11Db returns contain information on the amount of NI due.

[10] The current Conservative administration is continuing with this process which is due to start next month.

public should ever entertain subsidising these exchanges[11] especially given the cutbacks in social security budgets in recent years.[12] Liberal Democrats have expressed similar sentiments suggesting on grounds of fairness that *all* benefits-in-kind should be subject to tax and NICs.[13] Arguments for scrapping these financial incentives are also voiced by sources in the Centre for Policy Studies (CPS). They have combined concerns about the inequities and the general costs to the Treasury with their desire to simplify tax arrangements by merging NI with income tax. Their case is epitomised by Johnson who in his attack on the 'costly and ineffective' nature of pension reliefs suggests that 'salary sacrifice schemes are essentially a tax arbitrage at the Treasury's expense'[14] that would disappear in the proposed consolidation.

So, what should happen to these schemes? It's clear that support for the status quo would simply perpetuate the situation of unequal access for employees, uneven gains for participants and lost revenue to the Treasury. The suggested government adjustments to the number of benefits attracting relief under salary sacrifice arrangements would not be without repercussions. They would have a negative impact on take-home pay and add significantly to employer NI costs which in turn could have a bearing on the range of benefits offered and their take up. They could also lead to reductions in employer outlay on the very benefits (both mandatory and voluntary) that it wants to protect. Against this, the revisions would improve the Treasury's financial position, simplify the arrangements and, where tax and NI advantages have been removed, eliminate the inequities of differential access and uneven gains. Such issues would nonetheless remain for the protected provision, not least, for the highly inequitable and heavily subsidised occupational pensions.[15]

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[11] A. Sinfield (2016) 'Tax benefits and their impact on the social division of welfare,' http://fiscalwelfare.eu/wp-content/uploads/2016/04/as-fw-rev-to-Paris-5.16.pdf

[12] IFS (2015) Green Budget estimates that £17 billion was wiped from the social security budget between 2010 and 2015.

[13] Liberal Democrats (2013) Autumn Conference, Fairer Taxes: Policies for the Reform of Taxation, Policy Paper 111 www.libdemnewswire.com/files/2016/02/111-Fairer-Taxes-Policies-for-the-Reform-of-Taxation.pdf

[14] See Johnson, M. (2012) 'Costly and ineffective: why pension tax reliefs should be reformed' p.9 www.cps.org.uk/publications/reports/costly-and-ineffective-why-pension-tax-reliefs-should-be-reformed

[15] Johnson calculates the salary sacrifice costs of occupational pensions for the Treasury is between £1.3 and £4.1 billion in foregone taxation 'with the lower end of the range being the more likely' – M. Johnson (2016) 'The workplace ISA: reinforcing auto-enrolment,' Appendix 2, www.cps.org.uk/files/reports/original/160420095903-TheWorkplaceISAReinforcingautoenrolment.pdf.

But perhaps the greatest challenge for both government and, indeed, those who would scrap these incentives is how to undertake the changes. Is it simply a matter of taking away the inducements and living with the consequences, introducing a process of fiscal recompense to off-set the inevitable sharp rise in employer costs or engaging in a process of attrition, selectively removing the relief from benefits one-by-one over a number of years to cushion the negative impact? Possibly through the consultation process the government will develop its change agenda. It is not, as yet, a key feature of the abolitionists' programme. In the CPS proposals, for instance, salary sacrifice is but a by-product of the macro-economic issue of merging income tax and NI and the search for alternative tax mechanisms to generate the £110 billion[16] previously raised through NI receipts. But the issue does not disappear because it is not discussed. It's incumbent on those, from whatever political stance, who would scrap this arrangement to consider how best (both economically and politically) it could be achieved.

The views expressed in this Briefing Paper are the views of the authors and do not necessarily represent the views of CHASM as an organisation or other CHASM members.

[16] NI receipts in 2012-2013