What is salary or bonus sacrifice?

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A salary or bonus sacrifice involves an employee agreeing to change their terms and conditions of employment relating to pay. Under their revised employment contract, the employee is entitled to a lower salary or contractual bonus than before, offset by a new non-cash benefit from their employer. Normally, this is done to create tax or National Insurance savings without reducing the overall value of an individual's benefit package. To have legal effect, it's important that the contract change meets certain HMRC requirements.

Employee benefits from salary or bonus sacrifice

Cutting an employee's earnings usually means they'll pay less income tax and National Insurance (NI) than before.

- Cuts in earnings above the upper earnings limit produce a 2% NI saving for the employee.
- Employees start to lose their personal tax allowance when their adjusted net income goes over £100,000, but they can retain it by making personal contributions to a pension scheme and get an effective rate of tax relief of 60%. However, if the contributions are made by salary sacrifice, the effective rate of relief could be as much as 66%.
- Where employee pension contributions are paid under the relief at source system (as applies to personal pensions and SIPPs), using a sacrifice agreement to fund the pension instead has the advantage of effectively giving the benefit of any higher rate tax immediately.

Employer benefits from salary or bonus sacrifice

Cutting an employee's earnings usually means the employer will pay less NI than before.

- An employer must pay National Insurance on all earnings above the earnings threshold, so the employer sees a saving of 13.80% of the sacrificed amount.
- Employers often agree to share part of this saving with the employee, for example by way of a boost to their pension contribution for the employee, to increase the appeal of the salary or bonus sacrifice facility.

What are HMRC's requirements for a valid salary or bonus sacrifice arrangement?

An effective salary or bonus sacrifice arrangement must meet certain HMRC requirements:

- The employee's contractual right to cash remuneration must have been reduced in return for a non-cash employee benefit; and
- The employee must not have the right to revert to the higher cash salary whenever they want.

The employee's terms of employment must be changed before the salary or bonus sacrifice arrangement commences. In other words, the employee's right to the higher salary or bonus must be given up before it is treated as received for income tax or National Insurance purposes - it can't be done after the event.

The agreement can be documented as either a permanent contract change or a temporary change for a stated period of **at least 12 months**. If an employee reverts back to the pre sacrifice pay within 12 months of the arrangement being established, or **has the right** to revert to the pre sacrifice pay whenever they want, this wouldn't be considered to be a valid sacrifice.

However, HMRC accepts that certain lifestyle changes, such as redundancy, pregnancy, marriage or divorce, may justify changing a salary or bonus sacrifice arrangement before the intended period has elapsed. In such circumstances, an employer might agree to vary the existing contractual agreement.

Neither employers nor employees need to inform HMRC of any salary or bonus sacrifice arrangements that they adopt. In practice, however, many employers ask HMRC to comment to reassure themselves that the arrangements have been implemented properly and that they are accounting for the correct amount of income tax and NI.

How should salary or bonus sacrifice arrangements be documented?

To be effective for tax and National Insurance purposes, a salary or bonus sacrifice arrangement must result in a legally binding change to the employee's contract of employment.

Perhaps the most common method of documenting a change to an employee's contract of employment for the purposes of salary or bonus sacrifice is by the employee and employer agreeing to the change in an exchange of letters. It should mention both the reduction in salary and the non-cash benefit to be provided instead.

We understand that HMRC considers the following wording to be acceptable for a salary sacrifice:

> *"Please note that with effect from (DATE), your basic salary is reduced by (AMOUNT) from (AMOUNT) to (AMOUNT). The sum of (AMOUNT) is to be paid into a pension scheme for your benefit on retirement.*
>
> *(SIGNED BY THE EMPLOYER)*
>
> *I agree to the above.*
>
> *(SIGNED BY THE EMPLOYEE)*
>
> *(DATE)"*

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A letter in respect of a bonus sacrifice should be adapted accordingly.

Are there any drawbacks to salary sacrifice?

There can be drawbacks to entering a salary sacrifice arrangement, for example:

- The employee might not be able to revert to their old pre salary sacrifice if their circumstances change.
- The employee's ability to borrow could be reduced following their salary cut. This could affect the levels of mortgage, personal loan or credit card limit they can get. There are, however, some lenders who will base their calculations on the notional (before sacrifice) salary.
- Other salary related elements of the individual's employment package, such as contractual pension contributions, life assurance cover, PHI cover, overtime pay or future salary rises, may be affected by the salary sacrifice.
- Entitlement to some State benefits could be affected by the salary sacrifice.

Information in this document is valid for tax year 2023/24