EPN 111

Salary sacrifice: impact on pension benefits

ISSUE

A number of employers have introduced, or are planning to introduce, salary sacrifice arrangements under which employees will receive childcare vouchers or other benefits. Such arrangements could reduce the pension of some members.

This Notice will be of particular interest to:

- **HR policy teams**
- **HR managers who are dealing with childcare provision, the Home Computing Initiative or other salary sacrifice issues**

ACTION

- *If your organisation currently operates such arrangements or is planning to do so, you will need to incorporate the information given in this EPN in any guidance you issue.*
- *You must make members of **premium** and **classic plus** aware of the potential impact of salary sacrifice arrangements on their civil service pension and also inform them of the potential impact on any future state benefits they may claim. For this purpose, you will find model text at the end of this EPN.*

TIMING

Immediate.

This advice is provided as additional pages for section 5 of the Employers' pension guide. It will be incorporated when section 5 is next updated.

Contacts:	Enquiries about content: Employer Helpdesk employerhelpdesk@cabinet-office.x.gsi.gov.uk 01256 846414 Enquiries about distribution of EPNs: Judith Hornby judith.hornby@cabinet-office.x.gsi.gov.uk 01256 846201
***Reference**	All EPNs and forms may be found on the website: www.civilservice-pensions.gov.uk in the Employer and APACs section Username: employers Password: mc2fxqfy

26 October 2004

Salary sacrifice

5.1.14 A salary sacrifice happens when an employee gives up the right to receive part of the cash pay due under his or her contract of employment. Usually the sacrifice is made in return for the employer's agreement to provide the employee with some form of non-cash benefit. The "sacrifice" is achieved by varying the employee's terms and conditions of employment relating to pay.

5.1.15 Salary sacrifice is a matter of employment law, not tax law, although it can lead to a reduction in the tax and national insurance payable. Where an employee agrees to a salary sacrifice in return for a non-cash benefit, they give up their contractual right to future cash remuneration. Employers who are thinking of entering into such arrangements would be well advised to obtain legal advice on whether their proposed arrangements achieve the desired result.

5.1.16 The **Inland Revenue** determines how the tax and NICs legislation applies to the various elements in the employee's remuneration package. Many payments and benefits are treated in the same way for both tax and NICs. But, in some cases, where a particular benefit may be exempt from tax and/or NICs or subject to Class 1A NICs, the tax and NICs outcome will be different. For example where a salary sacrifice arrangement reduces the salary that an individual is entitled to receive, and instead they receive a tax-free benefit, then their tax bill should be reduced.

5.1.17 There are three Government initiatives in which the benefits are free from tax and/or NICs.

- An individual with children can receive up to £2,600 in childcare vouchers without the vouchers being subject to NICs or, from 6 April 2005, income tax.
- Under the Home Computing Initiative (HCI), any employee can be supplied with a computer to use at home without being subject to tax and NICs provided the benefit is worth less than £500 per year.
- An employee can be lent a bicycle to get to and from work, along with suitable safety equipment, without the benefit being subject to tax or NICs.

5.1.18 Since a salary sacrifice arrangement includes a reduction in the basic pay that an individual receives, then any pension based on that salary would be affected unless the scheme rules either disregard the sacrifice or include the value of the benefit in the final salary calculation. Also any action that reduces the taxable earnings of a member has the potential to reduce the benefits that the pension scheme can pay to the member without contravening **Inland Revenue** limits. Within the **PCSPS** rules the treatment of such sacrifices within **classic** and **premium** is different and therefore they are set out separately below.

classic benefits

5.1.19 Within **classic** the rules on pensionable pay include an historical provision which means we can ignore any reduction in pensionable pay that arises "when pay is voluntarily surrendered in whole or in part." You will be aware that this provision was not introduced to deal with things like HCI, but it nevertheless allows us to ignore salary sacrifice. This could result in the payment of benefits, to **classic members**, which exceed the current IR limits. Where our rules historically allow the payment of benefits that exceed IR limits we are not obliged to change our rules to restrict these benefits.

5.1.20 In conclusion, in **classic** a **member's** pension will not be affected if they take part in a salary sacrifice arrangement, as their salary sacrifice will be disregarded in calculating pensionable pay. It is our intention to include a provision in the next amendment scheme to require member's contributions to be calculated on the pre-sacrifice salary. This provision will also take effect from 6 April 2005.

premium and **classic plus** benefits

5.1.21 The **premium** rules do not currently include an equivalent provision but it is our intention to introduce one. It is HM Treasury policy that all rule changes to public service pension schemes are consistent with those that would be acceptable in a tax-approved scheme, and we are therefore required to obtain **Inland Revenue** consent for **PCSPS** rule changes. The **Inland Revenue** will not consent to a rule change that would permit us to pay benefits that exceed their limits. They would however agree to a change, if we include a provision that the pension paid under the **premium** rules is restricted to their limits. It is our intention to introduce such a provision as part of the next amendment scheme, with the new rules taking effect from 6 April 2005. This would still mean that it would be possible that a **member's** pension could be reduced if they take part in a salary sacrifice arrangement, however very few, if any, will be affected in such a way.

5.1.22 From 6 April 2006 the **Inland Revenue** limits on pensions will be simplified and will no longer be linked to final taxable earnings in this way. Therefore any **members** who leave from this date onwards, either with a preserved award or with a pension, will not have their benefits restricted by any reduction in taxable earnings.

5.1.23 Initially awards in **premium** and **classic plus** will need to be checked against **Inland Revenue** limits whereas **classic** awards will not be. This will minimise the number of cases where awards will need to be checked and the treatment will be consistent from 6 April 2006 onwards.

Who could be affected by **Inland Revenue** limits?

5.1.24 The following will not be affected by **Inland Revenue** limits:

- **Members** who do not retire, leave or die in service before 6 April 2006
- **Members** of **classic** – there is no provision in **classic** rules restricting benefits to **Inland Revenue** limits
- **Members** with non-pensionable pay that exceeds the amount of the sacrifice – see paragraph 5.1.25.
- **Members** with less than 20 years **reckonable service** provided they sacrifice less than half their pay and do not have significant pension benefits from a previous employment – see paragraph 5.1.26.
- Most **members** with more than 20 years **reckonable service** – see paragraph 5.1.27.

5.1.25 Benefits in **premium** and **classic plus** are not based on all elements of taxable earnings that the **member** may receive; for example overtime and some allowances are excluded. However the **Inland Revenue** restriction on benefits are based on taxable earnings so if a **member** has earnings, which are taxable but not pensionable, and which exceeds the amount of the sacrifice then the **Inland Revenue** limit will always exceed their scheme benefits.

5.1.26 **Inland Revenue** limits benefits to 1/30 of final taxable earnings for each year of service with an overall limit of 2/3 of final taxable earnings. **Premium** benefits are based on 1/60 for each year of service and therefore anyone who has less than 20 years' service and who sacrifices less than half of their taxable earnings will not have their pension affected. The assessment of **classic plus** benefits uses a more complicated formula (to take account of the lump sum) but the outcome for someone with less than 20 years service, and who is sacrificing less than half their salary, is the same. Where a member has benefits in another pension scheme, including Additional Voluntary Contributions, these may count towards the limit on benefits. Your APAC should be able to advise in individual cases.

5.1.27 For **members** with more than 20 years **reckonable service** the amount they can sacrifice, without their pension being affected, reduces as their service increases. For example, someone with 30 years service can sacrifice up to ¼ of their salary, whereas someone with 40 years service will always be affected unless they have sufficient non-pensionable earnings (see paragraph 5.1.25).

5.1.28 There is a simple spreadsheet available on our website, which will allow you and/or your **APAC** to assess whether a particular salary sacrifice arrangement is likely to affect a **member's** pension. You can access this under CSP forms via the employers/APACs tab.

Implications for **ASLCs** and **member** contributions

5.1.29 The practice outlined in here should ensure that most **members** will receive pensions based on their pre-sacrifice salary. Our policy is that **ASLCs** should reflect the cost of the benefits provided, and therefore you should base **ASLCs** on the pre-sacrifice salary.

5.1.30 Currently contributions will be based on the reduced salary but it is our intention to bring in a rule that will require **members** to pay contributions based on the pre-sacrifice salary used for calculating the pension. This rule change, which will effect **classic**, **classic plus** and **premium** members, will be brought into effect at the same time as the required changes to the **premium** rules. (see paragraph 5.1.21).

Implications for payroll

5.1.31 Employers should ensure that the amount of the salary sacrifice is recorded on their payroll system as a permanent pensionable allowance. This should ensure that the correct information is automatically sent to the relevant APAC.

Impact on state benefits

5.1.32 Any reduction in taxable earnings may also have an impact on state benefits. The model text at Annex 5A includes guidance on this issue.

Annex 5A

5A

Model text for office notice or letters

Important note

This text is for guidance only and will have to be edited to take into account the details of any salary sacrifice arrangement you currently operate or plan to operate.

A salary sacrifice happens when you give up the right to receive part of the cash pay due under your contract of employment. Usually the sacrifice is made in return for your employer's agreement to provide you with some form of non-cash benefit. The "sacrifice" is achieved by varying your terms and conditions of employment relating to pay. You cannot reduce your salary below the minimum wage.

Salary sacrifice can lead to a reduction in the tax and national insurance payable. For example, where a salary sacrifice arrangement reduces the salary that an individual is entitled to receive, and instead receives a tax-free benefit, then their tax bill should be reduced.

There are three Government initiatives in which the benefits are free from tax and/or NICs:

- An individual with children can receive up to £2,600 in childcare vouchers without the vouchers being subject to NICs or, from 6 April 2005, income tax.
- Under the Home Computing Initiative, any employee can be supplied with a computer to use at home without being subject to tax and NICs provided the benefit is worth less than £500 per year.
- An employee can be lent a bicycle to get to and from work, along with suitable safety equipment, without the benefit being subject to tax or NICs.

Since a salary sacrifice arrangement involves a reduction in your basic salary this could have an impact on your pension.

classic benefits

If you are in **classic**, your pension will not be affected if you take part in a salary sacrifice arrangement. There may still be an impact on state benefits (see below).

premium and **classic plus** benefits

In **premium** and **classic plus** a reduction in basic pay would currently lead to a reduction in pension benefits. However Civil Service Pensions Division intend to update these rules to allow us to disregard any salary sacrifice from 6 April 2005. As part of these changes we will be required to ensure that any pensions payable do not exceed limits currently imposed by Inland Revenue. These limits are based on your final taxable earnings and any salary sacrifice that reduces your tax bill could reduce the pension benefits we can pay you.

From 6 April 2006 the Revenue limits on pensions will be simplified and will no longer be linked to final taxable earnings in this way. Therefore any members, who leave from this date onwards, either with a preserved award or with a pension will not have their benefits restricted by any reduction in taxable earnings.

Who won't be affected by Inland Revenue limits?

The following will not be affected by Inland Revenue limits:

- Members who retire or leave after 6 April 2006.
- Members of **classic** – there is no provision in classic rules restricting benefits to Inland Revenue limits
- Members with non-pensionable but taxable pay (e.g. overtime) that exceeds the amount of the sacrifice.

- Members with less than 20 years reckonable service who sacrifice less than half their pay and who do not have significant pension benefits from a previous employment.

Who will be affected?

You are more likely to be affected the closer you are getting to 40 years service. You are also more likely to be affected if you are sacrificing a high proportion of your salary.

The amount you can sacrifice without your pension being affected reduces as your service increases. For example a member of premium with 30 years service can sacrifice up to ¼ of their salary whereas a member with 40 years service will always be affected unless they have sufficient unpensionable earnings.

If you think your pension might be affected by a salary sacrifice arrangement you are considering then your employer should be able to offer guidance.

Members’ Contributions

If you choose to accept a salary sacrifice, your civil service pension contributions will be based on your pre-sacrifice salary from 6 April 2005.

Impact on State Benefits

Any reduction in your National Insurance Contributions could reduce your entitlement, should you make any future claim, to the State Pension, Incapacity Benefit, Jobseekers’ Allowance, Statutory Sick Pay, Statutory Maternity Pay, Maternity Allowance, Statutory Paternity Pay, Statutory Adoption Pay, the State Pension and any means-tested benefits or tax credits.

Important note

Guidance on the impact on state benefits can be found at:

http://www.inlandrevenue.gov.uk/specialist/salary_sacrifice.pdf

For further information you should contact the Department for Work and Pensions. For general enquiries about state pensions either contact your local social security office or pension centre, or go into The Pension Service website (www.thepensionservice.gov.uk). The Department for Work and Pensions offer a free pension forecast. More information about this free service can be found at: www.thepensionservice.gov.uk/atoz/atozdetailed/rpforecast.asp.

For enquiries about other benefits or allowances either contact your local social security office or Jobcentre Plus office, or go into the Jobcentre Plus website (www.jobcentreplus.gov.uk).