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Salary Exchange Q&A



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What is salary exchange?

Salary Exchange is an agreement between an employee and their employer. The employee agrees to exchange part of their gross (before tax) salary in return for a non-cash benefit such as a pension contribution.

As part of the salary is being exchanged rather than paid directly, the employee is paid less salary or bonus and so both the employer and the employee pay less National Insurance Contributions (NICs).

How does salary exchange work?

Each arrangement will be specific to the circumstances of the employer and the employee, however, the most straightforward explanation is:

- The employee and employer agree an amount to be exchanged.
- The employee's gross salary is reduced by the agreed amount and this money is then paid, for example, into the employee's pension plan as an employer contribution.

What type of pension plan can salary exchange be used with?

It can be used with any type of UK registered pension scheme, including group personal/stakeholder pension schemes and occupational money purchase schemes.

Can the self-employed use a salary exchange arrangement for pension planning?

As there's no employer to make a pension payment on their behalf, the self-employed cannot set up a salary exchange arrangement. The main point to remember is that there must be an employer willing and able to make payments to the scheme after the exchange is agreed.

Setting up a pension salary exchange arrangement

To meet HM Revenue & Customs (HMRC) rules, it's vital that any salary exchange is agreed with the employee **before** the salary or bonus is received. As the agreement is a change to the employee's contract of employment, it should be formally agreed between the employee and employer, for example in a letter.

A copy of this agreement letter should be kept with the employee's original contract of employment.

What about Smart Pension Schemes?

The basic principle of the employee giving up part of their salary in exchange for a non-cash benefit doesn't change with a smart pensions scheme; but the sign up method is different.

Rather than gaining approval from each employee to go ahead with the exchange, smart pension schemes instead rely on employees who do not wish to participate to opt-out.

Employers would communicate to their work force, advising them that the proposed salary exchange will take effect from a specified date (this date must be in the future). Any employees who do not wish to take part must actively opt-out. The employer must ensure that employees are given plenty of time to make their decision.

HMRC is satisfied that as long as the revised terms and conditions of employment are communicated to employees in advance of the salary exchange arrangement being introduced, then employees who do not opt out are accepting the variation to their employment contract. For contract based schemes, it should be noted that there may be additional contract and/or employment law considerations. Where employers intend to implement a salary exchange arrangement without obtaining the employees' explicit consent, we strongly recommend that legal advice is sought before any change is made.

How can salary exchange be used?

There are no set rules as to how a salary exchange arrangement should be set up, although there are basically 4 options:

Option 1 – Employer NIC is reinvested and Employee NIC reinvested

The employer costs stay the same, the employee's take home pay stays the same and the pension contribution increases.

With this option, all the employer's and employee's NIC savings are reinvested into the pension scheme so the contributions are increased. There is no additional cost to the employer.

Option 2 – Employer NIC reinvested, No employee reinvestment

The employer costs stay the same, the employee's take home pay increases and the pension contribution increases. In this option, only the employer's NIC saving is reinvested, resulting in a higher pension contribution. The employee's take-home pay increases as they are paying less NICs on a reduced salary.

Option 3 – No employer reinvestment, No employee reinvestment

The employer costs reduce, the employee's take-home pay increases and pension contributions remain at the same level. With this option, none of the employer's or employee's NIC savings are reinvested in the pension scheme. The employee's take-home pay increases as they are paying less NICs on a reduced salary.

Option 4 – No employer reinvestment, Employee NIC reinvested

The employer costs reduce, the employee's take-home pay stays the same and pension contributions increase. With this option, the employee sacrifices a slightly higher amount to produce exactly the same take home pay. Because they've exchanged slightly more, their pension contribution increases. In this example, none of the employer NIC savings are reinvested.

What information do HMRC need to see after a salary exchange is set up?

Employers are not obliged to consult HMRC when implementing a salary exchange arrangement. However, once a salary exchange arrangement has been put in place, employers can ask HMRC to confirm the correct tax treatment of the arrangement. Details should be sent to:

HMRC Clearances Team
Alexander House
21 Victoria Avenue
Southend-on-Sea
Essex SS99 1BD

Alternatively they could Email: HMRC Clearances Team

This gives the employer reassurance that the arrangement has been implemented properly and they are acting correctly when not declaring benefits for tax purposes, operating PAYE and paying National Insurance Contributions.

If HMRC is asked to comment on a salary exchange arrangement they'll need to check two things.

- That an effective variation of the contractual terms and conditions has taken place, reducing some of the employee's cash earnings and providing a benefit-in-kind.
- What is the correct tax and NICs treatment of the benefit-in-kind.

Tax treatment depends on your clients individual circumstances. Circumstances may change in the future.

Can a salary exchange be altered or terminated?

Not normally. The change to the employee's contract of employment will normally last for the duration detailed in the agreement letter, usually 12 months, although this may be longer depending on how the agreement letter is drafted.

However, the employer can decide that certain 'lifestyle events' may allow the employee to terminate the agreement earlier than this. Importantly, an employer can insist that the salary exchange arrangement continue until the end of the agreement even if a 'lifestyle event' occurs.

Lifestyle events are significant changes to an employee's circumstances and can be defined by the employer. Examples may include the birth of a child, divorce, a change to working hours or starting maternity leave.

In addition, an employer may stipulate that exercising a lifestyle event within a certain period, say 3 months, from the agreement review date is prohibited.

Can a salary exchange take pay below the National Minimum Wage?

No. Benefits provided in return for a reduction in salary cannot take an individual below the minimum wage.



Is salary exchange suitable for everyone?

Not necessarily – salary exchange reduces an individual's gross salary and can affect certain state and other benefits.

For example, it may have an impact on the following:

Mortgages and other borrowing

Lenders may base the amount that they are willing to lend on either a multiple of salary or affordability. Whilst the employer can provide a pre-exchanged salary reference, this may not be accepted by some lenders.

Other employer related benefits

Although it is a reduction in gross salary, a notional salary can be used for the purposes of things such as Death in Service and other flexible benefit options. This notional salary will also be used when calculating pay rises and bonuses.

Student Loans

Repayments of student loans are triggered where earnings are currently above £15,000. If a salary exchange reduces earnings to below this threshold then repayments may reduce or stop. This may mean that it'll take longer to repay any student loan.

State Pension Benefits

Salary exchange should not affect the Basic State Pension as it is dependent on the number of National Insurance Contributions made as opposed to the amount paid. The earnings must not however drop below the Lower Earnings Limit (LEL). Salary exchange may have an impact on the State Second Pension (S2P) entitlement – the impact (if any) will depend on the individual's personal circumstances.

Statutory Maternity/ Adoption Pay (SMP/SAP)

SMP/SAP are based on gross earnings that are subject to Class 1 NICs and tax. As these earnings will reduce as a result of salary exchange, there'll be an impact on SMP/SAP entitlement, and they may also reduce.

Earnings below the Lower Earnings Limit

Earnings should not be exchanged below the lower earnings limit as this means that the employee would lose the rights to state benefits such as statutory sick pay.



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