



not for profit | trading places - salary sacrifice

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Salary sacrifice schemes offer an appealing way of achieving cost savings for independent schools. Lorraine Owens explains what they are, how they work and investigates the potential benefits enjoyed by staff.

Salary sacrifice schemes are well established and accepted by HM Revenue & Customs (HMRC) as a legitimate planning opportunity. A salary sacrifice occurs when an employee gives up their right to receive part of the cash pay due under their contract of employment in return for the employer's agreement to provide the employee with some form of non-cash exempt benefit. The "sacrifice" is achieved by varying the employee's terms and conditions of employment relating to pay.

Salary sacrifice is a matter of employment law, not tax law. 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. It is important to ensure that the sacrifice is "effective" otherwise the scheme fails, but it is not a difficult result to achieve.

Salary sacrifice arrangements are effective when the contractual right to cash pay has been reduced.

For that to happen, two conditions have to be met:

- the potential future remuneration must be given up before it is treated as received for tax or national insurance contribution (NIC) purposes; and
- the true construction of the revised contractual arrangement between employer and employee must be that the employee is entitled to lower cash remuneration and a benefit.

Typically, salary sacrifice is used to offer exempt benefits such as childcare vouchers up to £55 per week, work related training, bike to work schemes or additional pension contributions, because all of these benefits are exempt from tax.

The result is that the employee receives a benefit, tax and NIC free and, although they are sacrificing salary to obtain the benefit, the amount they need to sacrifice is the net rather than gross amount.

school fees for employees' children

By extension, salary sacrifice is just as tax-effective for discounted school fees. Although discounted fees are not an exempt benefit, as the benefit-in-kind charge is limited to the marginal cost, there is still significant scope to make savings.

HMRC accepts, following the landmark *Pepper v Hart* case, that the benefit-in-kind charge arising is limited to the marginal cost to the school of providing the place, 15 per cent of the total fee is accepted automatically, although a lower figure may be used if a reduced marginal cost can be evidenced.

employee contract terms

Contractual terms are also a factor, where contracts of employment state that the employee is entitled to X per cent fee remission, legal advice should be sought as it may not be possible to effect a contract change to remove the benefit. Contract terms may also be varied by mutual agreement. Contracts for new employees can, of course, be structured differently from the outset.

example:

A teacher currently enjoys a 50 per cent fee remission on annual fees of £15,000. The balance of fees due is £7,500 and this is paid by the teacher, assuming the teacher is a basic rate taxpayer, from taxed income of £10,869. No P11D report is required as the employee is paying more than the marginal cost.

Pre-salary sacrifice: basis rate taxpayer	
Gross salary	£10,869
Less tax and NIC	£3,369
Net salary	£7,500
School fees	£7,500
Balance remaining	nil
Employer's NIC on gross salary	£1,391

The teacher, instead, decides to enter into a salary sacrifice arrangement to sacrifice an amount of £7,500 to cover the balance of fees.

Post-salary sacrifice: basis rate taxpayer	
Gross salary	£10,869
Less salary sacrifice	£7,500
New gross salary	£3,369
Less tax and NIC on new gross salary	£1,044
Less tax on P11D benefit *	£450
Balance remaining/saving for employee	£1,875
Employer's Class 1 NIC on new gross salary	£431
Employer's Class 1 NIC on P11D benefit	£288
Employer's NIC saving	£672

*The employee will have a benefit-in-kind of 15 per cent of the fees equaling £2,250; the employee will pay tax of £450 and the employer Class 1A NIC of £288 on this benefit.

A higher rate taxpayer would achieve a saving of £2,174; the employer saves NIC of £672, giving a total saving of £2,846.

The arrangements will vary from school to school and discounts range from nil to 100 per cent. If a school is already giving more than an 85 per cent fee discount, any salary sacrifice saving should be reviewed since the saving may be minimal and probably not worth pursuing.

scheme considerations

When entering into a salary sacrifice arrangement to replace part of cash pay with a benefit that is tax and / or NICs exempt, it is essential to understand what the sacrifice will mean in practical terms. For example, employees should consider carefully the effect, or potential effect, that a reduction in their pay may have on:

- their future right to the original (higher) cash salary;
- any pension scheme being contributed to (see Teachers' Pension Scheme below);
- entitlement to working tax credit (WTC) or child tax credit (CTC); and
- entitlement to state pension or other benefits such as statutory maternity pay (SMP).

An employee's salary post-sacrifice cannot fall below the national minimum wage. Most salary sacrifice schemes allow the employee to receive overtime payments, pension contributions and so on based on the pre-sacrifice salary level. This is a matter for the employer to decide and HMRC will not be concerned about these aspects.

teachers' pension scheme

Salary sacrifice can affect pensions and consideration must be given to what will still count towards pensionable earnings: in most pension schemes, the scheme rules can be varied, if necessary, to ensure that the pre-sacrifice salary is what is used for pension contributions. The Teachers' Pension Scheme allows teachers to participate in salary sacrifice for childcare vouchers, bicycles and mobile phones without the sacrifice reducing the pensionable salary (Source: Teachers' Pensions News Issue 20 Summer 2006). Participating in salary sacrifice for other benefits is still possible but may affect pensionable earnings.

The Teachers' Pension Scheme determines the final pension using a formula which refers only to the last ten years of service. For example, in the Teachers' Pension Guide (dated September 2008), it states that: "If you retire after 31 December 2008, your average salary is the better of the following:

- the salaries for the last ten years are increased to current day value using the RPI. The average of the best consecutive three years re-valued salaries in those ten years is used; or
- the pensionable salary received in the last 12 months before the date of retirement.

It may be that other benefits such as death-in-service benefits and survivor benefits may be reduced as a result of a salary sacrifice and this should be considered carefully.

school teachers' pay and conditions

Independent schools are not obliged to comply with the Conditions of Service for School Teachers in England and Wales (The Burgundy Book), so may have the scope to implement salary sacrifice arrangements.

set periods of time and opting in and out

It is a matter for agreement between the employer and employee as to how long the salary sacrifice is in place. Usually, salary sacrifice arrangements are put in place for a year or more. It is important that the employee does not have the right to opt in and out at will because this may result in the scheme failing. There are certain lifestyle changes which HMRC will accept as justification for an employer to disturb an employee's terms and conditions eg redundancy of a partner, pregnancy of employee or partner, marriage or divorce, death and serious illness of partner or children.

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