Salary Exchange – a guide for employees

one pension consultancy

What is salary exchange?

Salary exchange (also known as salary sacrifice) is a tax efficient way of paying personal contributions into your workplace pension. With salary exchange, instead of a contribution being deducted from your take home pay, which is then paid across to the pension provider, your gross salary is reduced by the amount you want to pay into the pension. Your employer will then pay this across to the pension provider along with the regular contribution they pay in. Because this isn't classed as pay, you won't pay National Insurance on this amount.

Example

Ben elects to pay 3% of his salary into his pension via salary exchange. His employer will match the contribution he pays in. His annual salary (pre-salary exchange) is £20,000. By using salary exchange his salary reduces to £19,400. His employer will pay 6% of his pre-exchange salary (£20,000) into the pension. This is made up of the regular 3% employer pension contribution plus the 3% Ben has exchanged in this way. Ben saves National Insurance on the 3% of salary he has exchanged in this way.

	Without salary exchange	**With salary exchange**
Annual salary	£20,000	£19,400
Annual employee pension contribution (gross)	£600	Nil
Annual employer pension contribution	£600	£1,200
Total pension contribution	£1,200	£1,200
Employee National Insurance payable	£1,420.32 pa	£1,348.32 pa
National Insurance saving	N/A	£72 pa

Why use salary exchange?

As outlined above, if you use salary exchange you will save National Insurance on the amount you are exchanging. This will be at either 12% or 2% depending on your level of earnings. Any earnings between £8,164 and £45,000 per annum (2017/18) attract National Insurance at 12%. Earnings above £45,000 will attract National Insurance at 2%.

Some other reasons you may wish to use salary exchange:

If you are a higher rate or additional rate tax payer you will no longer need to reclaim any additional tax relief you may be entitled to. You will effectively receive the tax relief immediately.

If your earnings exceed £100,000 (2017/18) you may start losing your Personal Allowance. You may be able to use salary exchange to reduce your earnings below this threshold thereby allowing you to keep some or all of the Personal Allowance.

As salary exchange reduces your earnings, this may mean that using salary exchange can help you keep some or all of any child benefit payable.

Are there any downsides to salary exchange?

Salary exchange reduces your earnings and although you will receive this money in the form of an additional employer pension contribution, it may impact on your ability to borrow. However, as salary exchange is widely used these days, most lenders are able to accept a letter or similar evidence from your employer outlining your pre-exchange earnings.

You shouldn't use salary exchange if this will reduce your earnings below the National Living Wage (or National Minimum Wage if you are under 25). It also isn't recommended you use salary exchange if this will reduce your earnings below the Personal Allowance (£11,500 per annum for 2017/18).

Salary exchange can potentially impact on earnings related benefits from your employer such as Life Assurance cover, Income Protection benefit, bonuses and pay rises. However, most employers will use a "notional" pay figure (effectively your pre-exchange salary) to ensure you are not penalised in this way.

Some state benefits (such as Employment and Support Allowance, Jobseeker's Allowance, and State Pension) are based on your National Insurance contribution record. This means that so long as you do not reduce your earnings below the Lower Earnings Limit (£5,876 for 2017/18), these benefits shouldn't be impacted by using salary exchange.

Other benefits (such as Statutory Maternity Pay, Statutory Paternity Pay, Statutory Adoption Pay, Statutory Sick Pay, means tested benefits and tax credits) are earnings related. Using salary exchange could impact on these benefits. However, whilst you are on paid maternity leave, the contribution from your employer (which as you are using salary exchange will effectively include your personal contribution) should continue based on your pre-maternity salary. This means that the pension contribution you receive during maternity leave may be higher. You can, of course, opt out of salary exchange at any point in time.

Can I use salary exchange to pay a bonus into my pension?

Yes, you can exchange a bonus you are due to receive in much the same way and have this paid into your pension as an additional employer pension contribution. You must however give up the right to the bonus before it is treated as received for Income Tax purposes.

Can I opt out of salary exchange?

Many employers operate salary exchange as the default position. This means that if you are a pension member you will automatically be entered into salary exchange unless you opt out of this. Note that opting out of salary exchange isn't the same as opting out of the pension. These are separate decisions.

Technically, once you have entered into salary exchange, you can opt out of this at any point in time although you should check this with your employer.

How do I receive tax relief if I am using salary exchange?

If you are using salary exchange all contributions will effectively be deemed to be employer contributions. This means you do not need to reclaim any additional relief if you are a higher rate or additional rate tax payer.

However, this doesn't mean you are losing out on the tax relief. With salary exchange, as your earnings are lower, this means you will pay less tax. The net effect will be the same as the tax relief you would have received had you paid these as personal contributions to the pension. If you are a higher rate or an additional tax payer it does mean that you will receive the effect of the tax relief immediately without having to reclaim this.

Is salary exchange likely to alter in future?

There are no guarantees that salary exchange will continue indefinitely and potentially this is something that the government could close in the future.

Important Notes

The information contained in this document is based on One Pension Consultancy's understanding of the legislation as at May 2017. This document is for information purposes only and does not constitute advice.

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