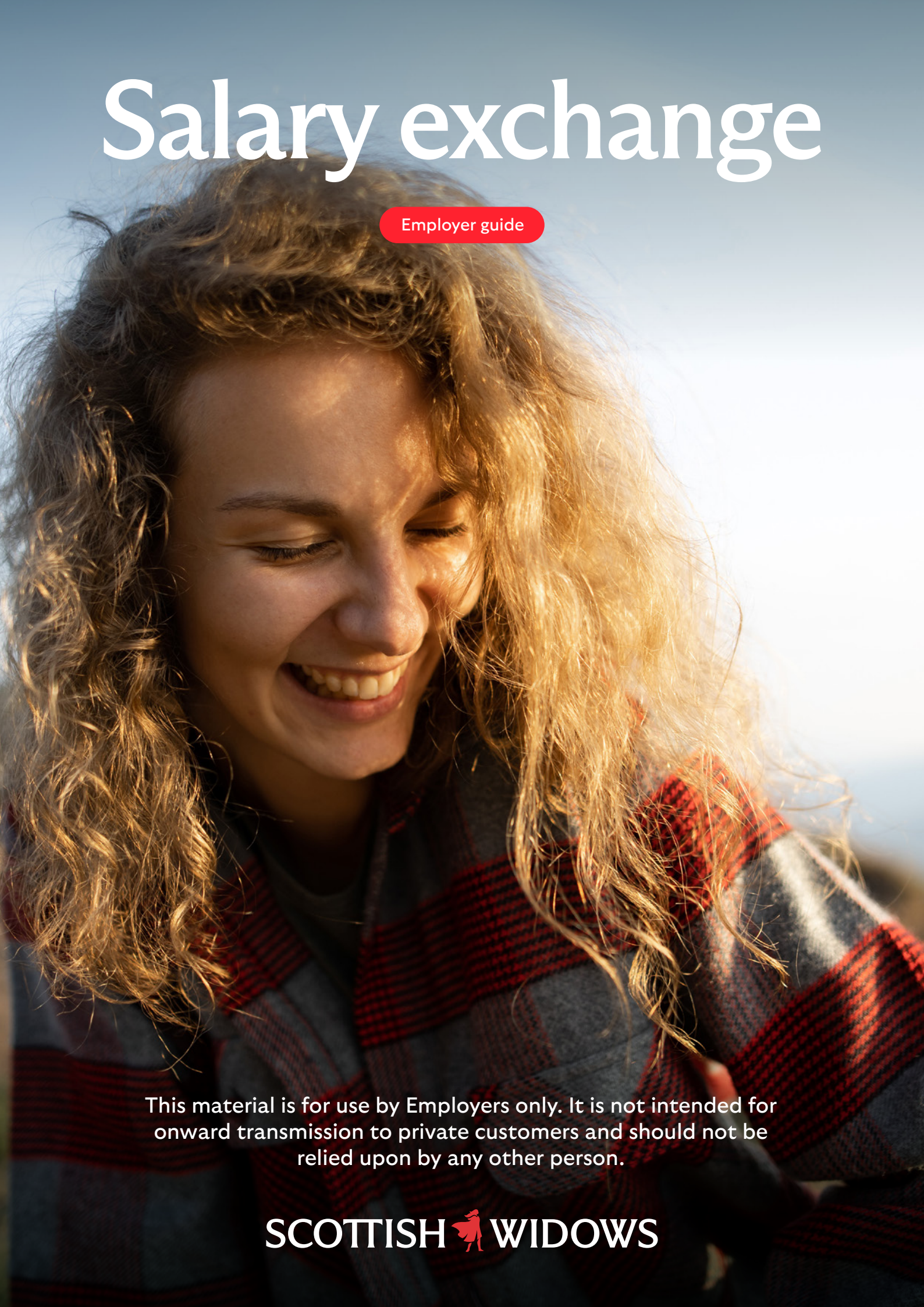
Salary exchange

Employer guide



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SCOTTISH WIDOWS

Introduction

As an employer, you'll want to make sure that you maximise the value of your workplace pension scheme, both for your employees and your business. This guide explains the benefits and key things to consider when implementing a salary exchange agreement with your employees. Salary exchange can create tangible savings and can also help boost employees' retirement savings.

By having your employees make payments through salary exchange (sometimes referred to as salary sacrifice) rather than directly, you can benefit from an annual reduction in your National Insurance Contributions (NICs). You can use this saving to increase your employees' pension contributions or invest the savings back into your business. Employees will also benefit from salary exchange as the amount of NICs that they pay will reduce.

Q What is salary exchange?

A

Salary exchange is an arrangement where an employee gives up part of their future earnings in exchange for a non-cash benefit, in this case an employer pension contribution.

An employee can also decide to give up part of their bonus, this is known as bonus exchange.

As the salary is being 'exchanged' rather than paid, neither the employee or employer pay NICs on the exchanged amount.

The exchanged amount can then be paid into the employee's pension plan as an employer contribution. The exchanged amount will therefore be included in any employer contribution shown in our illustrations.

The government has announced a future change to how pension salary exchange works.

From April 2029, the National Insurance (NI) saving on pension salary exchange will be limited to the first £2,000 an employee contributes each year. If an employer allows an employee to exchange more than £2,000, the amount above this will still go into the their pension, but it won't receive the National Insurance saving.

What isn't changing

- Pension income tax relief stays the same
- Salary exchange is not being removed
- If the employee exchanges £2,000 or less a year, nothing changes for them.

This change does not take effect until April 2029, so there is no immediate impact.

Q How does salary exchange work?

A

Each salary exchange scheme will be tailored to meet the needs of the employer and the employee, however, the simplest explanation is:

- You offer to set up salary exchange for any of your employees that wish to take part.
- Your employees decide to opt in to salary exchange (or opt out if it's being established on an opt out scheme basis, which can also be known as negative affirmation or smart salary exchange) and the amount to be exchanged is documented in an amendment to the contract of employment.
- Your employees' gross salary is reduced by the agreed amount and this money can then be paid into their pension plan as an employer contribution.
- We have included an example of a salary exchange and bonus exchange letter at the end of this guide.

Q What is Bonus Exchange?

A

Bonus exchange can be an efficient way to contribute to a pension. There are two different ways this can be set up.

Contractual Bonus Exchange

- The exchange agreement must be put in place before the employee's right to receive the bonus occurs.
- If the exchange is agreed after the right occurs, HMRC will view it as the employee receiving the bonus and then making a payment, losing the tax advantages.
- The employment contract may need amendment to incorporate the exchange.
- It can be challenging to implement as timing is critical and often predetermined.
- Consider wording to ensure the right to the bonus only arises after the sacrifice election is made.

Discretionary Bonus Sacrifice

- The discretionary nature means it's generally easier to implement as employer has more control over timing.
- Can structure the scheme so employees make their exchange before the bonus is awarded and that exchange communication is part of the process.

Common considerations for both

- Must be a genuine exchange with no contractual right to revert back.
- The employee must understand they are giving up their right to cash.
- Consider impact on other employment rights and benefits.
- The employer must maintain records to demonstrate effective implementation.
- Need to ensure National Minimum Wage requirements are met.

Q What are main methods for implementing a salary exchange scheme?

A

Deciding on which method to use to implement salary exchange will depend on many factors, namely workforce size and make up, administrative and payroll capabilities, organisational culture and communication methods.

Here are the main methods for implementing a salary exchange scheme and an explanation of each:

	Mechanism	Advantages	Considerations
Contractual enrolment	Salary exchange details (salary and pension contribution) included in employment contracts for new employees and contract variations for existing employees. Communication around the treatment of salary related benefits should also be included.	No additional communications needed as details are in the contract. Clear audit trail.	Legal review of contract amendment is advised. Potential additional administration.
Opt out Can also be known as negative affirmation or smart salary exchange	Employees are enrolled into the salary exchange arrangement automatically, although they can choose to opt out.	Generally higher participation rates than opt in, therefore higher comparable employer savings. Aligned with automatic enrolment approach.	Clear communication and opt out instructions must be given. Adequate time must be given to the employee to allow them to opt out before the first pension deduction is made.
Opt in	Employees choose to opt in to salary exchange through an exchange of letters with the employer. This should detail the exchange, including the reduction in gross salary and the resulting pension contribution.	Gives the employee a choice. Simple and easy to implement quickly.	Potentially lower participation rate and therefore lower savings for the employer. Administratively onerous if large scheme. Good practice would be to renew the letters every 12 months.



Q How does salary exchange benefit employers?

A

As employees' pre-tax salary will be lower, this results in a reduction in the amount of NICs you'll pay as an employer, provided that the original salary was above the relevant NICs threshold.

You can quickly work out the approximate amount of NICs you could save by adding up the employee contributions and multiplying it by the employer NIC rate of 15%.

Let's have a look at an example:

Average employee salary		Average employee contribution rate		Annual employee contribution		Active members		Total		Employer NIC rate		Annual employer NIC saving
£25,000	×	5%	=	£1,250	×	50	=	£62,500	×	15%	=	£9,375

Q How does salary exchange benefit employees?

A

Employees will benefit from reduced NICs by exchanging part of their salary. This saving can be used to enhance their pension contribution or increase their take home pay.

As the employer, you can add further value to the benefits package by reinvesting some or all of the NIC savings to increase your employees' pension contribution. This can make a substantial difference to your employees' retirement fund over time, something worth communicating with them.

Although you don't have to reinvest any of your NIC savings, it may prove difficult to promote salary exchange to employees if they won't see any benefit of the employer's NIC savings.

There are different options available for the structure of the salary exchange scheme which are outlined in more detail on the next page.

What are the main options available?

There are no set rules as to how employers should set up a salary exchange scheme, but reinvesting NIC savings back into the pension scheme will give employees the most benefit and may encourage scheme take-up.

Let's look at the options:

Options	Summary	Employer costs	Employee take home pay	Pension Contribution
1	This is cost neutral. **Employer** – 100% NIC saving is reinvested. **Employee** – exchanges slightly higher amount of their salary to keep their take home pay at the same level so pension contributions are increased.	NO CHANGE	NO CHANGE	INCREASE
2	**Employer** – 100% NIC saving is reinvested. **Employee** – does not have to pay NIC on the amount exchanged, so this increases their take home pay. Benefits from higher pension contribution due to employer NIC reinvestment.	NO CHANGE	INCREASE	INCREASE
3	**Employer** – no reinvestment of NIC savings. **Employee** – as salary is reduced, the amount of NIC paid is also lower, so this increases their take home pay.	DECREASE	INCREASE	NO CHANGE
4	**Employer** – no reinvestment of NIC savings. **Employee** – exchanges a slightly higher amount of their salary so that they can get the same take home pay. The higher exchange means they get an increased pension contribution.	DECREASE	NO CHANGE	INCREASE

Which option?

It's up to you as the employer to decide which option works best for you and your employees.

Important points to consider when adopting salary exchange

Although salary exchange can provide valuable benefits for you and your employees, it may not always be a suitable option. It's important both you and your employees are aware that you'll be entering into a legally binding contract and have considered what a reduction in gross salary will mean for your employees.

Employees

- Salary exchange should not be offered to the following employees:
  - **Those that earn under the personal allowance (currently £12,570)** as they'd benefit more from paying personal contributions to a relief at source scheme where they get 20% tax relief, despite paying no income tax.
  - **Those that earn below the primary (employee) and secondary (employer)** NICs thresholds as they don't pay NI, so won't benefit from taking part in salary exchange.
  - **Employees that would be taken below the minimum wage** if they took part in salary exchange.
  - **Those who earn above the Tapered Annual Allowance** 'Threshold Income' limit as they may be disadvantaged by salary exchange.
- **Statutory benefits linked to lower salary may also be impacted.** These include:
  - State pension.
  - Statutory maternity, paternity and sick pay.
  - Working or child tax credit.

  There's more information on the HMRC website on which benefits can be impacted.
- Other benefits which are linked to their salary, for example, benefits on death, redundancy payments and overtime rates may be impacted.

Employer

Notional Salary

- Retaining a 'notional or reference salary' for employees. This would mean their pre-exchange salary could be used for things like overtime rates and pay increases. HMRC provide more information on this at: **https://www.gov.uk/hmrc-internal-manuals/employment-income-manual/eim42771**

Absence

- You must consider the potential implications of having an employee be absent from work for a long period of time, for example long-term sickness. The new contract of employment moves the responsibility for making the pension contributions from the employee to the employer so you may have to continue making the payments for the remaining exchange period if the employee is not receiving occupational sick pay. This would also apply to maternity leave.

Opt Out Pension Schemes (can also be known as negative affirmation or smart salary exchange)

- Employers considering an opt out pension scheme should seek legal advice.

Change to contract of employment

To set up salary exchange, the employee's contract of employment must be changed and formally agreed between you and your employee, for example in a letter, depending on how the salary exchange scheme is being implemented. For opt in schemes, you can find examples of a salary exchange and bonus exchange letter at the end of this guide.

The agreement must be in place before the salary is exchanged and well in advance of the first payment.

The amended terms and conditions of employment must be effective for tax purposes. Legal advice is required.

Opt out pension schemes can also be effective for reducing the NICs liability. The revised terms and conditions of employment must be communicated to employees in advance of the salary exchange arrangement being introduced. Employees who do not opt out are accepting the variation to their employment contract.

Changes to payroll

The introduction of salary exchange may result in changes to payroll administration and the layout of payslips will also need to change.

You may wish to consider:

- Will your computer systems need to be updated?
- Will any manual practices need to change?
- How will you let employees know about the changes?

Payslips

- Payslips will need to change to show the amount being exchanged. This must not show as a deduction as it's an exchange.
- The entry can be described in any way, so long as it's clear enough for the employee to recognise it's the exchanged amount.
- Some payroll software can only hold one salary.

Supporting material and information

It's important that salary exchange is clearly communicated to employees so they understand fully whether it is suitable for them.

To help with this, we've developed a range of employee and employer facing material specifically focusing on salary exchange.



Setting up salary exchange

HM Revenue & Customs (HMRC) guidelines

You can view the full HMRC guidelines on salary exchange on their website **https://www.gov.uk/guidance/salary-sacrifice-and-the-effects-on-paye**

The key points to consider:

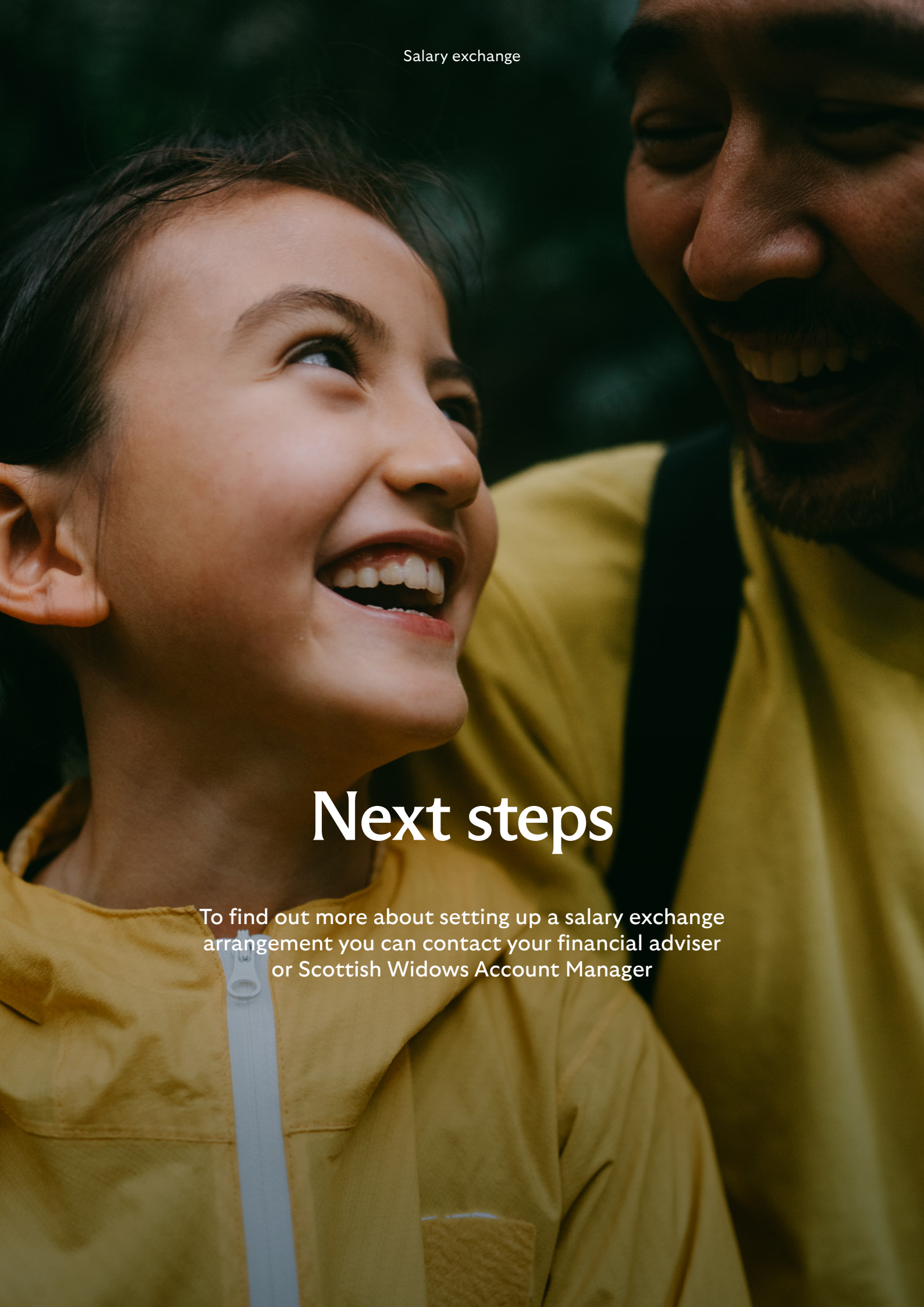
Salary exchange is a contractual agreement.

This means that you need to alter the terms and conditions of employment for the employees who join.

An employee's gross salary must not fall below the National Minimum wage as a result of salary exchange.

It's up to you to determine the length of time that the exchange will last for (this is usually 12 months for some benefits, but this doesn't apply to pensions salary exchange).

You may wish to include the option to change the arrangement if an employee were to experience a 'lifestyle change' for example marriage or the birth of a child. It's your responsibility to define the 'lifestyle changes'.



Next steps

To find out more about setting up a salary exchange arrangement you can contact your financial adviser or Scottish Widows Account Manager

Sample Salary Exchange Letter

[Employee's name]

[Address]

[Postcode]

[Date]

Dear [employee's name]

Salary exchange opt-in letter – alteration to terms and conditions of your employment

This letter is used to opt in to the salary exchange option being offered by [employer's name]. In order for the salary exchange to take place your terms and conditions of employment must be altered. By signing this letter you are agreeing to the amended terms and conditions. If you agree then your terms and conditions will be altered as follows:

From [Date], your contractual gross salary (this is your salary before tax) will be reduced from [£x p.a.] to [£x p.a.].

As from this date your revised pension contribution collected through salary exchange will be [£x].

If you pay higher-rate income tax or above, the exchange may affect your tax coding and alter the amount of your income tax collected under PAYE.

This change to your terms and conditions will remain effective until [Date].

Yours sincerely,

On behalf of [employer's name] [Date]

I agree to the change in my terms and conditions of employment as described above.

Signed _____

Dated _____

Sample Contractual Bonus Exchange Letter

[Employee's name]

[Address]

[Postcode]

[Date]

Dear [employee's name]

Contractual bonus exchange opt-in letter – alteration to terms and conditions of your employment

This letter is used to opt in to the contractual bonus exchange option being offered by [employer's name]. In order for the bonus exchange to take place your terms and conditions of employment must be altered. By signing this letter you are agreeing to the amended terms and conditions. If you agree then your terms and conditions will be altered as follows:

From [Date], you have agreed to exchange [£x p.a.] of your contractual bonus in lieu of an employer contribution to your pension plan.

If you pay higher-rate income tax or above, the exchange may affect your tax coding and alter the amount of your income tax collected under PAYE.

This change to your terms and conditions will remain effective until [Date].

Yours sincerely,

On behalf of [employer's name] [Date]

I agree to the change in my terms and conditions of employment as described above.

Signed

Dated _____

_____

SCOTTISH WIDOWS

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