



Technical Note – Salary Sacrifice

References in this presentation to legislation and tax are based upon Guardian Pension Consultants understanding of law and HM Revenue & Customs practice in the UK as at the date of presentation. Tax and legislation are likely to change.

The value of tax relief will depend on the circumstances of the individual.

Responsibility for advice

These examples provide a suggested approach only – other approaches may be equally suitable. Every client's circumstances will be different and require advice.

Guardian Pension Consultants accepts no responsibility for advice which may be formulated on the basis of these examples.

This document is for qualified advisers only and must not be relied on by anyone else.

Dividend, Salary/Bonus or Pension?

What's the problem?

From the 6th April 2006, employer payments to registered pension scheme were 'unlimited' – the problem was, would the employer get corporation tax relief on the payment? Obviously, if there is an element of doubt over whether a payment by the employer will qualify for Corporation Tax relief, the employer will tend to cool on the idea of making the payment in the first place!

What has been the experience so far?

In the few months since this change came in, the local inspectors generally have been allowing employer payments up to 100% of a director's/ relative's earnings as a deduction for tax purposes, although there have been a few cases reported where they have restricted the deduction to 70% of earnings. These percentages are not plucked from the air. They come from the Business & Employment Income Manuals used by the local inspectors.

We have also been told that any employer payments that exceed this level are being referred to the Audit & Pension Schemes Services (APSS) group in Nottingham before any decision is made as laid out in the Guidance issued to the local inspectors.

What 'earnings' can be included in this 100%?

I mentioned that the local inspectors do generally seem to be accepting employer payments up to 100% of earnings. Earnings *do not* include dividends, termination payments of £30,000 or less and unearned taxable income such as Investment Companies. HMRC have been promising guidance on them for some months now but it still hasn't appeared. So something can be pensioned for Directors of Investment companies – we just don't know what yet!

So what will count? Most of this is fairly obvious and you would have been used to this under the old 'relevant earnings' definitions. So:-

- Employment income such as salary, bonus, commission etc taxable under s7 (2) of the Income Tax (Earnings and Pensions) Act 2003 (ITEPA2003).
- Taxable termination payments, above £30,000 are also deemed employment income under s403 (1) of the same Act and can be included.
- For the self-employed we have the income derived from the carrying on of a trade, vocation etc and chargeable to tax under pt 2 Income Tax (Trading and Other Income) Act 2005.

So nothing odd so far, although not everyone seemed to know about the taxable termination payments. Also, the following can be included (although a bit less common)

- Income to which s529 ICTA 88 applies and is treated as earned income under s833 (5B). This is patent income arising from inventions.
- Finally earnings of Overseas Crown employees subject to UK tax under s28 and we're back to the ITEPA 2003 Act again.

....and that's it!

Is there a solution?

There was an interesting section in the local inspector's Business Income Manual (BIM) available on the HMRC web site where it states that a salary or bonus sacrifice could be used to justify an employer payment into a registered pension scheme and be sure of the payment qualifying for deduction for corporation tax purposes under the 'wholly and exclusively' rule. All of the following comes from HMRC's own Business & Employment Income Manuals (BIM&EIM).

BIM46020 says:-

"A salary sacrifice happens when an employee gives up the right to part of the cash remuneration due under their contract of employment. An employee may also sacrifice a one off item such as a bonus.

Usually, the sacrifice is made in return for the employer's agreement to provide the employee with some form of non cash benefit, such as an increased contribution by the employer to a pension scheme. **An increased pension contribution by an employer resulting from a salary sacrifice arrangement of the type set out in EIM at EIM42750 onwards, will be wholly & exclusively for the purposes of the trade and allowable as a deduction in arriving at the employer's taxable profits."**

All they are saying here is that any employer payment to a pension scheme which results from an 'effective sacrifice arrangement' **will be deductible for tax purposes**. So this removes the element of doubt. EIM42750 onwards covers what is an effective sacrifice (and it is a pretty lengthy section!). These sections also confirm that they can sacrifice a one off item such as a bonus.

Section EIM42753 covers how the terms of the package are varied. In this, one of the options is the use of letters to confirm the reduction in income/surrender of bonus.

A successful sacrifice!

Section EIM42760 summarises the conditions for a successful sacrifice and basically says the contractual right to cash remuneration **must** be reduced but

- 1) The reduction takes place **before** he receives the cash and
- 2) The employee is entitled to lower cash remuneration and a benefit.

EIM42769 gives a useful list of questions to ask to determine whether the sacrifice is liable to be effective.

The world of the bonus sacrifice!

For a bonus sacrifice to be effective there has to be an entitlement to a bonus on a specified date in the future. Prior to receiving the bonus, the employee gives up the right to their bonus/part of their bonus in return for the employer making a payment for the same amount into a registered pension scheme.

The documentation has to make it clear that he has given up the right to the bonus, that he does not have the right to change his mind and that in return he has lower cash remuneration and a benefit i.e. the payment to a pension scheme.

A practical example

So that's all the HMRC references but how does it work in practice? If we base an example on the following assumptions:-

Assumptions

Corporation tax rate 19%
Director, 40% tax payer earning above employee's upper earnings limit
Tax Year 2006/07,
£10,000 to distribute

If we pay the £10,000 as a dividend tax situation is as follows:-

Dividend

<u>Company</u>	<u>Director</u>	
Pre tax profit £10,000	£8,100	
Corp. tax £ 1,900	Grossed up by £ 900	
Net £ 8,100	10% tax credit £9,000	
	Less:	
*Divided not deductible	Tax @ 32.5%	£2,925
	Tax credit	£ 900
	Tax to pay	£2,025
	Net divided	£6,075

Effective rate of tax 39.25%

If we pay as salary/bonus

Salary/bonus

<u>Company</u>	<u>Director</u>		
Salary/bonus £8,865	£8,865		
Emp'er NI £1,135	Higher rate tax	£3,546	
£10,000	1% NI	£ 89	
	Net	£5,230	

*All deductible

Effective rate of tax 47.7%

Or if we use £1 for £1 funding we get:-

Pension

<u>Company</u>	<u>Director</u>		
Salary/bonus £4,699	£4,699		
Emp'er NI £ 602	Higher rate tax £1,880		
£5,301	1% NI	£ 47	
Pension £4,699	Net	£2,772	
£10,000*	Pension	£4,699	
	Total benefit	£7,471	

*All deductible

Effective rate of tax 25.29%

In this last example with the £ for £ funding, all I am doing is making use of an A-Day change. You are aware the difficulty pre A-Day was the need for quite substantial increases in earnings to justify the payments to pension schemes due to the Occupational Scheme maximum funding rules of Personal Pension/Retirement Annuity payment limits and these salary increases brought with them increased income tax and NI.

The old pre A-Day payment limits and maximum funding rules have now gone. Instead we know that salary can be matched £1 for £1 with a payment into a registered scheme and even if this is an employer payment, it will probably be deductible up to 100% of the recipient's earnings based on the experience so far. So, this time, we pay £4,699 as additional salary or as a bonus. Yes, we still have employer NI, but this payment can be matched with a £4,699 employer payment towards pension and all of this is deductible against corporation tax based on the experience so far with the local inspectors. On the director's side, he receives £4,699 as salary/bonus, higher rate tax and the NI surcharge is still there, but even so he still receives £2,772 in his hands plus £4,699 has been paid towards pension benefits for him. So the total benefit here is £7,471 and the effective tax rate is 25.29%.

Now this 3rd option seemed a pretty good solution as it had a lower tax rate than dividends plus a higher overall benefit for the director. But, of course, that was before I unearthed the sacrifice route.

So far the same director, arrange to pay the £10,000 as a contractual bonus, sacrifice it, make an employer payment to the pension scheme and the effective tax rate is nil plus the director gets the full benefit of the £10,000 (deferred to the future admittedly but it depends what they are looking for).

Obviously, all this varies depending on the tax rates but I am sure you can see there is huge scope for advice here.

What problem does this solve?

Ask yourself:-

- Do I have clients' whose funding towards pension has been limited in the past due to a smaller salary/large dividend being paid?
- Would these clients' like to fund more towards pension but don't want to pay additional income tax & NI?
- Do these clients' want to be sure that the employer will be able to benefit from corporation tax relief regardless of the size of the payment to the scheme?

If the answers are "Yes" then the solution is simple – instead of distributing profits as a dividend, distribute as a contractual bonus, sacrifice it following the sections in this note and the employer then makes the payment to the registered pension scheme. The type of pension scheme is irrelevant (with possibly one exception). Remember, however, that the Annual Allowance will still apply but I doubt many individuals will want to pay in excess of £215,000 gross into a registered pension scheme this year.

Does this need to be documented?

Oddly enough there is no requirement to report sacrifice arrangements to the local inspector apart from one exception and that is:-

- A payment to an Occupational Pension Scheme where the reduction is £5,000 p.a. or more

This is mentioned in one version of the local inspector's manual but is missing from another version and even they don't seem to be too sure which version is correct!

However, employer payments to something like a personal pension or a SIPP resulting from a sacrifice do not have to be reported. That does not mean, however, that a sacrifice should not be documented. There is no requirement to use letters to document the sacrifice but, since HMRC have the power to ask to see the documentation backing up the sacrifice, a letter is probably as good a method as any.

As far as HMRC is concerned, a sacrifice is an agreement between employer and employee so it is not a matter for them to comment on. This is not a perfect situation when it comes to what should be documented but, looking again to the EIM, if we follow what is required for an 'effective sacrifice' the following should be reasonably accurate to tie in with the requirements.

A single letter should suffice:-

The letter should be addressed to the employee and state:-

- When the sacrifice will happen (remember you need to show the cash remuneration was sacrificed before it was received)
- The amount of the sacrifice and that salary or bonus has been reduced from £x to £y (remember you need to show there has been a real reduction in cash remuneration)
- What is the benefit e.g. an employer payment of £z to ABC pension scheme (remember to be an effective sacrifice there has to be a cash reduction and a benefit)
- Of course, the letter should be signed and dated by both parties.

The letter then just has to be retained on file for the cases where there is no requirement to report the sacrifice.

What should I do next?

Remember we are talking about employer payments to registered pension scheme here and employer payments where a problem is likely to occur over tax relief under s74ICTA88. In the main we are looking at employer payments for directors and relatives e.g. an employed spouse.

The sacrifice route is liable to be most useful for directors particularly where there has been a history of smaller salary/large dividend. In these cases there is a need to persuade their accountant to restructure the package.

Work closely with the accountants on this. They are the people who really know their way around the BIM & EIM but remember an employer payment to a registered pension scheme arising from an 'effective sacrifice'

'.....will be wholly & exclusively for the purposes of the trade and allowance as a deduction in arriving at the employer's taxable profits.'

BIM 46020

If anyone knows how to ensure a sacrifice is effective it will be the accountant.

The tax position will obviously vary depending on the current level of salary/dividend but I am sure that it is obvious that there are major opportunities for some very creative planning with directors' remuneration.

On the subject of 'creative planning' why not look at a combination of £ for £ funding and sacrifice? £ for £ isn't a bad idea and it still leaves the director with some cash in hand.

Finally, in case you are in any doubt over a director being an employee – they are. It's just that director is defined in a different section of the Income & Corporation Taxes Act 1988 (as amended).