

**SCOTTISH WIDOWS**

*official pensions and investment provider*



# Employer Guide to Salary Exchange



## Introduction

A pension scheme is a benefit that should be valued by both employers and employees. For employees, it provides a means to save for retirement and it can often mean their own contributions are topped up or matched by their employer, so there's more being paid into their pension. For employers, it can help to attract and retain good quality staff.

However, it's not always easy to promote the benefits of a pension scheme to employees. Some employees may think they are too young to start worrying about a pension or maybe some think they can't afford to start paying into a pension just yet.

By making payments through salary exchange (sometimes referred to as salary sacrifice) rather than directly, your employees can reduce the amount of National Insurance Contributions (NICs) that they pay. Plus, it will also save you money as your NICs will reduce.

## What is salary exchange?

Salary exchange is an arrangement where an employee gives up part of their future earnings or bonus in exchange for a non-cash benefit.

As the salary is being 'exchanged' rather than paid, the employee does not pay NICs on the exchanged amount. In addition, you won't pay NICs on the amount of salary exchanged either. The exchanged amount can then be paid to the employee's pension plan as an employer contribution. The exchanged amount will therefore be included in any employer contribution shown in our illustrations and annual statements.

There are a number of different ways the NIC saving can be used – we'll look at these later on in this guide.

## How does salary exchange work?

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

- The employee decides to opt-in to salary exchange and an amount is agreed between the employer and employee to be exchanged.
- The employee's gross salary is reduced by the agreed amount and this money can then be paid into their pension plan.

## What about Smart Pension Schemes?

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

Rather than obtaining separate agreement from each employee to go ahead with their exchange, smart pension schemes instead rely on employees who do not wish to participate to opt out of the proposed exchange.

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. Scottish Widows recommend a minimum of 4-8 weeks notice.

## Why consider salary exchange?

The key reasons to think about salary exchange are:

- You will pay less NICs.
- Potential to increase your employees' pension.
- Adding value to your benefits package.

We'll now look at this in more detail.

## You'll pay less NICs

As your employees' pre-tax salary will be lower, this results in a reduction in the amount of NICs your company pays.

You can quickly work out the amount of NICs you could save by adding up the employee contributions and multiplying it by the employer NIC rate of 12.8%. Please note, it has recently been announced that from 2011/12 tax year National Insurance contributions will increase for employers and employees by 1%.

Let's have a look at an example:

Average employee salary	£20,000
Average employee contribution rate	x 5%
Annual employee contribution	= £1,000
Active members	x 50
Total	= £50,000
Employer NIC rate	x 12.8%
Annual employer NIC saving	= £6,400

## Increased pension contributions for your employees

Initially, paying by salary exchange rather than directly may be off-putting to employees, as they'll be receiving a lower pre-tax salary. However, the individual will benefit from exchanging part of their salary towards providing for their retirement and at the same time, benefit from reduced NICs. This saving can be used to further enhance their pension contribution or alternatively increase their take home pay.

There are different options available for the structure of the scheme which we cover in more detail on pages 2 and 3.

## Adding value to your benefits package

Introducing salary exchange can improve your employee's perception of your benefits package particularly if you agree to reinvest some or all of your NIC savings to further increase the pension contributions. This may encourage employees to join the scheme.

It is worth noting that although you do not have to reinvest any of your NIC savings, it may prove difficult to promote salary exchange to employees if they weren't going to see any benefit of the employer's NIC savings.

## How can salary exchange be used?

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

### Let's look at the options

There are 4 main options. The scenarios below assume an employer provides a Group Personal Pension arrangement. The employee earns £25,000 a year with both the employer and the employee currently paying a contribution of 5% of gross salary.

The examples show the different ways salary exchange works if the employee percentage is no longer paid by the employee but is exchanged and paid direct by the employer.

#### Option 1 *(employer and employee NIC reinvestment)*

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 NI savings are reinvested into the pension scheme so the contributions are increased and it's cost neutral for both the employer and the employee.

OPTION 1		Before Exchange	After Exchange	Benefit
Employer position	– Total cost (salary, pension & NICs)	£28,717.84	£28,717.84	£0.00
Employee position	– Take home pay	£18,174.20	£18,174.20	£0.00
Total gross pension contributions		£2,500	£2,884.78	£384.78

#### Option 2 *(only employer NIC reinvestment)*

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 tax and NICs at a reduced salary.

OPTION 2		Before Exchange	After Exchange	Benefit
Employer position	– Total cost (salary, pension & NICs)	£28,717.84	£28,717.84	£0.00
Employee position	– Take home pay	£18,174.20	£18,311.70	£137.50
Total gross pension contributions		£2,500	£2,660	£160

#### Option 3 *(no employer NIC reinvestment)*

Employer's costs reduce, the employee's take-home pay increases and pension contributions remain at same level. With this option, none of the employer's or employee's NIC savings are reinvested in the pension scheme, but the employee pays less NICs on a reduced salary, which increases their take home net pay.

OPTION 3		Before Exchange	After Exchange	Benefit
Employer position	– Total cost (salary, pension & NICs)	£28,717.84	£28,557.84	£160.00
Employee position	– Take home pay	£18,174.20	18,311.70	£137.50
Total gross pension contributions		£2,500	£2,500	£0.00

## Option 4 (no employer NIC reinvestment)

Employer's 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 NI savings are reinvested.

OPTION 4	Before Exchange	After Exchange	Benefit
Employer position – Total cost (salary, pension & NICs)	£28,717.84	£28,532.33	£185.51
Employee position – Take home pay	£18,174.20	£18,174.20	£0.00
Total gross pension contributions	£2,500	£2,699.28	£199.28

The figures are based on tax and NI for 2009/10 tax year and a single personal allowance of £6,475. The value of the tax benefits of a pension plan depend on an individual's circumstances. These circumstances and tax rules may change in the future.

**Our salary exchange calculator allows you to use your own examples in order to calculate which option will best meet your and your employees needs. To request a copy of this please contact your financial adviser or your Scottish Widows Account Manager.**

## Options at a glance

Options	Employer costs	Employee take home pay	Pension Contribution	Summary
1	↔ no change	↔ no change	↑ increase	This is cost neutral. <b>Employer</b> – NIC saving is reinvested <b>Employee</b> – sacrifices slightly higher amount to keep their take home pay at the same level so pension contributions are increased.
2	↔ no change	↑ increase	↑ increase	<b>Employer</b> – NIC saving is reinvested <b>Employee</b> – does not have to pay NIC on the amount sacrificed, so this increases their take home pay. Benefits from higher pension contribution due to employer NIC reinvestment.
3	↓ decrease	↑ increase	↔ no change	<b>Employer</b> – no reinvestment of NIC savings <b>Employee</b> – as salary is reduced, the amount of NIC paid is also lower, so this increases their take home pay.
4	↓ decrease	↔ no change	↑ increase	<b>Employer</b> – no reinvestment of NIC savings <b>Employee</b> – sacrifices a slightly higher amount so that they can get the same take home pay. The higher sacrifice means they get an increased pension contribution.

## Which option?

There is no right or wrong answer. It's down to you to decide which option works best for you and your employees. Your adviser or Scottish Widows Account Manager will be able to help you decide which one best meets your objectives.

## Setting-up salary exchange

### HM Revenue & Customs (HMRC) guidelines

You can view the full HMRC guidelines on salary exchange on their website by visiting

[http://www.hmrc.gov.uk/specialist/salary\\_sacrifice.htm](http://www.hmrc.gov.uk/specialist/salary_sacrifice.htm)

The main points to bear in mind are:

- Salary exchange is a contractual agreement. This means that you need to alter the terms and conditions of employment for the employees who choose to opt-in.
- HMRC cannot give advice on the terms and conditions of an employee's contract; it's a matter to be agreed by the employer and the employee.
- HMRC main objective is ensuring that the exchange is 'effective'. Their website gives examples of effective and ineffective arrangements.
- HMRC cannot comment on the arrangement until it has been set up. They won't advise on how to set it up or how to draft the documentation. They will require "full details of the scheme and of the contractual arrangements", when it's set up. HMRC recommend legal advice should be taken if you are unsure.
- An employee's gross salary must not fall below the National Minimum wage as a result of salary exchange.
- It is up to the employer to determine the length of time that the exchange will last for (this is usually 12 months).
- The employer 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. HMRC do not define 'lifestyle changes', generally it would be an unforeseen event. The employer is responsible for defining the 'lifestyle changes'.

## Things to consider

Salary exchange may not be suitable for everyone. It's important you and your employees are fully aware it is a legally binding contract you are entering into and think about the impact a reduction in their gross salary will have.

### Employees

- Other benefits which are linked to their salary, for example, benefits on death, redundancy payments and over-time rates may be impacted.
- Statutory benefits linked to lower salary may also be impacted.

These include:

- Basic state pension and State Second Pension.
- Statutory maternity, paternity and sick pay.
- Working or child tax credit.

There is more information on the HMRC website on which benefits can be impacted.

- As mortgage lenders usually base the amount which can be borrowed on the salary after the exchange, this will reduce the amount that the employee can borrow. However, if you wish, you can retain a 'notional or reference salary' (salary before exchange) for employees as mortgage lenders may use this figure in their calculations.
- Rules for an Occupational Pension Scheme (OPS) state that if an employee dies while in pensionable service or if they decide to leave the scheme with less than two year's pensionable service, their contributions would be returned. This would not be the case with salary exchange, as the contributions would be considered employer contributions and therefore, contributions would not be returned.

### Employer

- What you plan to do with the NIC saving – you don't have to reinvest it but it may be difficult to promote salary exchange to employees if they are not going to benefit from this saving.
- Retaining a 'notional or reference salary' for employees. This would mean their pre-exchange salary could be used for things like mortgage references, over-time rates and pay increases. HMRC provide more information on this at: <http://www.hmrc.gov.uk/manuals/eimanual/EIM42771.htm>
- The potential costs should an employee be absent from work for a long period of time, for example long-term sick. The new contract of employment moves the responsibility for making the pension contributions from the employee to the employer so you would 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.
- Employers considering a Smart 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 this should be formally agreed between the employee and the employer, for example in a letter. A copy of this agreement letter should be kept with the employees original contract of employment. It is essential that the agreement is in place before the salary is exchanged, and well in advance of the first payment.

For Smart Pension schemes, 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.

## Change to contract of employment continued

It is up to the employer to specify the length of time the arrangement will last for (this is usually a 12 month period). The employer may wish to include the option to change the arrangement if an employee were to experience a 'lifestyle change'. The employer should define the 'lifestyle changes' applicable to the arrangement.

## Changes to payroll

The introduction of salary exchange may result in changes to your 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 will need to change to show the amount being exchanged. This must not show as a deduction for the primary reason it is not a deduction but an exchange. The entry can be described in any way, so long as it is clear enough for the employee to recognise it is the exchanged amount. We have produced a sample payslip which you can find on page 6.

Some payroll software can only hold one salary. As long as the amended terms and conditions of employment are clear, the salary exchange will be valid.

## Costs

The costs associated with salary exchange are mainly related to any extra administration and employee communications.

There are 3 ways you can cover the costs:

- Bear the full cost of the set up.
- Use some of your NIC saving to cover part of the costs.
- Use all of your NIC saving to cover the costs.

## Can salary exchange be altered?

It is up to you to determine how long the salary exchange agreement will last for, however it is normally a 12 month period. You should also consider whether 'lifestyle changes' which allow the employee to alter or stop the exchange will be applicable and, if so, you should define the 'lifestyle changes'.

## Salary exchange calculator

We've developed a salary exchange calculator which you can request through your financial adviser or your Scottish Widows Account Manager. This calculator demonstrates how salary exchange works and provides:

- bulk calculations which can be saved
- links to our salary exchange website and literature
- sample letters
- information on how salary exchange works.

## Communication

It's important that salary exchange is clearly communicated to your employees so they understand fully whether it is suitable for them. To ensure they get the most out of it, you should detail the benefits plus highlight any potential disadvantages. It would be frustrating to take the time to set up the scheme only to find take up is low.

To help you with this we have developed a member joining guide specifically covering salary exchange that details the benefits of joining the scheme, including case study examples. To accompany this we have also produced two employee 'quick' guides highlighting the key benefits and potential disadvantages of salary exchange. One covers employer NIC reinvestment and the other no employer NIC reinvestment.

## Next steps

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

You can find more information at

[www.scottishwidows.co.uk/salaryexchange\\_employers](http://www.scottishwidows.co.uk/salaryexchange_employers)

## Sample payslip

Company name

Employee name

Pay Period

NI number

Tax code

Employee payroll number

Employer tax office reference

Contact telephone number

Joe Bloggs

12

AA 12 34 56 C

512L

00000001

XXX / X

01XXX XXX XXX

### Payments

### Amount

Basic Pay

£

**Salary Exchange**

**-£**

Overtime

£

Bonus

£

**Total**

**£**

### Deductions

### Amount

Tax

£

National Insurance

£

### Net Pay

### Amount

£

Bank account details: XXXXXXXXXXXXXXXXXXXXXXXX

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