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Adviser factsheet

nucleus

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Salary sacrifice

Introduction

This factsheet explains the fundamentals of salary sacrifice arrangements and how they can result in a larger pension contribution for employees at no cost to the employer.

What is salary sacrifice?

It occurs when an employee gives up the right to receive part of the salary due under their contract of employment, usually in return for the employer's agreement to provide the employee with some form of non-cash benefit. From 6 April 2017, the non-cash benefits that can be used for salary sacrifice have been restricted. For our purposes, we assume this non-cash benefit is an employer pension contribution, which is allowable.

What is the benefit of salary sacrifice?

Where salary is successfully sacrificed in return for an employer pension contribution, the future salary sacrificed is not taxable and the employer pension contribution will not be taxable on the employee. From the employer's perspective, whether salary or a pension contribution is paid, either should be deductible for corporation tax providing the payment meets the 'wholly and exclusively for the purposes of the trade' test. The reduced salary will, however, lead to a reduction in employer and employee national insurance contributions (NIC), and this saving can be channelled into increasing the employer pension contribution.

Who can benefit from salary sacrifice?

Both employees and directors can benefit. Salary sacrifice provides the employer with an opportunity to offer individuals an enhanced package at no cost.

What are the 2025-26 main rates and bands for income tax and NIC?*

- Personal tax allowance £12,570
- Basic rate tax threshold £37,700
- Starting point for higher rate tax £50,270 (£12,570 + £37,700)
- Employee NIC @ 8% £12,570 to £50,270
- Employee NIC @ 2% excess over £50,270
- Employer NIC @ 15% excess over £5,000

* Scotland has its own income tax rates and bands for earned income which aren't covered in this factsheet but the NICs are the same for the whole of the UK.

Salary sacrifice opportunities

The alignment of the upper earnings limit for employee NICs with the starting point for higher rate tax presents opportunities. A higher rate employee with taxable benefits will be subject to 40% income tax plus 10% (8% on the first £37,700 and 2% on salary above this after the personal allowance has been applied) NIC on part of their earnings – 50% in total. Case study 1 illustrates this.

Case study 1

Walter is an employee in a London based company who earns £50,270. In addition he has a company car which has a benefit in kind value of £5,000. NICs will be levied on the employer and not the employee for this taxable benefit.

His accountant friend produces the following calculation to show Walter what his net spendable income will be after income tax and NICs:

	£
Salary	50,270
Taxable benefit	5,000
Personal allowance	(12,570)
Income after personal allowance	42,700
Income Tax (£)	
37,700 @ 20%	7,540
5,000 @ 40%	2,000
	9,540
NICs (£)	
37,700 @ 8%	3,016
Total tax and NICs	12,556
Net income after tax and NICs	37,714

After seeing this calculation, Walter is concerned that he seems to be paying 50% tax on some of his income – 40% income tax plus 10% total in NICs on the different levels on income. Accordingly, in conjunction with his employer he enters into a salary sacrifice arrangement with his employer to sacrifice £5,000 of salary for an employer pension contribution. This produces the following result.

	£
Salary	45,270
Taxable benefit	5,000
Personal allowance	(12,570)
Income after personal allowance	37,700
Income Tax (£)	
37,700 @ 20%	7,540
NICs (£)	
32,700 @ 8%	2,616
Total tax and NICs	10,156
Net income after tax and NICs	35,114

Accordingly, an employer pension contribution of £5,000 has been achieved at a cost to Walter of only £2,600. In other words, a tax and NIC saving of £2,400 has occurred. This can be explained as follows:

£50,000 down to £45,000

Band of income	£5,000	
IT saving	£2,000	(40%)
NIC saving	£400	(8%)
Total	£2,400	

What is the end result of a successful salary sacrifice arrangement?

Where you have an employee paying a personal pension contribution which is then replaced by an employer contribution, typically the employee's net spendable income remains identical, but the gross amount invested in pension will be greater, especially if the company contributes its employer's NIC saving. Case study 2 below illustrates this.

Case study 2

Frothy Mugs is a London based company selling German style beer steins to specialist pubs. It employs 20 staff and in recent months trading conditions have been difficult with sales orders in decline as their customers lose business to cheaper pubs not offering premium beers.

As a result the staff have been put on a pay freeze. Following a presentation by the financial adviser, the directors decided to implement a salary sacrifice arrangement as a means of rewarding staff for their hard work in these difficult times.

After taking this decision, the directors organised a presentation to staff with subsequent correspondence sent to each individual person.

Consequently, Tom who is a Technical Manager on a salary of £60,270 received an explanatory guide together with the following letter on Frothy Mugs headed notepaper:

Date: 1st March 2025

Dear Tom,

Please note that, with effect from 6th April 2024, your annual salary will be reduced by £5,172 to £55,098. If you cancel your planned net contribution of £4,000 (£5,000 gross) to your pension scheme then your net spendable income as detailed in the attached illustration will remain the same.

In return the Company will make a contribution to your registered pension scheme of £5,948 which includes the company's saving in respect of employer's National Insurance Contributions. Accordingly, the amount invested in your pension will increase by £948 representing an increase of 18.96%.

This letter constitutes a change to your contract of employment.

To indicate your agreement please sign and return the attached in the envelope provided prior to 6th April 2025.

Yours sincerely,

Company Secretary

Frothy Mugs

I agree to the terms of the above letter

Signed: Date:

Case study 2 continued

Tom also receives the following personalised illustration.

Before salary sacrifice

	£
Salary	60,270
Personal allowance	(12,570)
Income after personal allowance	47,700
Income Tax (£)	
37,700 @ 20%	7,540
5,000 @ 20%	1,000
5,000 @ 40%	2,000
47,700	10,540
NICs (£)	
37,700 @ 8%	3,016
10,000 @ 2%	200
	3,216
Total tax and NICs	13,756
Income after tax and NICs	46,514
Net pension contribution	(4,000)
Retained income	42,514
Grossed up pension contribution	5,000

After – salary given up £5,172 (salary reduced to £55,098)

	£
Salary	55,098
Personal allowance	(12,570)
Income after personal allowance	42,528
Income Tax (£)	
37,700 @ 20%	7,540
4,828 @ 40%	1,931
42,528	9,471
NICs (£)	
37,700 @ 8%	3,016
4,828 @ 2%	97
	3,113
Total tax and NICs	12,584
Income after tax and NICs	42,514
Retained income	42,514

If salary is given up then the employer's NIC saving at 15% will be £776. This allows a pension contribution of £5,948 to be made representing an increase of £948.

Please note that figures have been rounded for illustrative purposes.

Does HMRC view this as tax evasion?

No. In fact, HMRC offers guidance on its website www.gov.uk/guidance/salary-sacrifice-and-the-effects-on-paye. It's important to note that salary sacrifice is a matter of employment law, not tax law. This is because the individual is giving up a contractual right to future cash remuneration. Once the arrangement is in place, there is no requirement for the employer to inform HMRC, but if an employer does so for reassurance, HMRC may agree that the changes to the employment terms and conditions do affect the employee's entitlement to earnings for tax and NI purposes.

From 6 April 2017, the use of salary sacrifice was restricted but is still allowable for pension contributions.

Are there any disadvantages?

Individuals need to consider whether the reduction in pay could present any personal issues. For example:

- Mortgage or income protection applications
- Entitlement to working tax credit or child tax credit
- Their future right to the original higher salary
- Entitlement to state pension or other benefits.

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