Salary Sacrifice – what should we be thinking about?

Employment Tax



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Lee Knight provides an update on the new salary sacrifice rules and highlights some unwelcome complexities

Following a period of consultation last year, the Chancellor of the Exchequer's announcement in his Autumn Statement and the draft legislation issued on 5 December 2016, the income tax and employer National Insurance contributions (NIC) advantages of many salary sacrifice schemes are now set to be removed from 6 April 2017.

HMRC suggested that further guidance on this matter would be published before 31 January 2017, but at time of publication, no further guidance has been published. More detailed guidance from HMRC is urgently needed given that 6 April 2017 is just around the corner.

What is happening?

From 6 April 2017 the taxable value of benefits in kind provided where earnings are foregone in exchange for the benefit, will be the higher of the earnings foregone,

and the taxable value determined under the benefits code. We understand the policy intention to be that exempt benefits should be valued at NIL under the benefits code. This will ensure that the amount foregone provides the taxable value in respect of exempt benefits i.e. there will be no need to calculate the cost of provision of say car parking or a workplace gym, and the draft legislation will be amended to reflect this.

There is some good news. Firstly, these changes will not affect arrangements where employees are sacrificing salary for pension contributions, pension advice, cycle to work schemes, ultra-low emission vehicles (currently vehicles where the CO2 emissions figure does not exceed 75g/km), certain employer supported childcare, and intangible benefits such as annual leave and flexible working.

Furthermore, there are transitional rules which mean that salary sacrifice contracts entered into before 6 April 2017 will be protected until the earliest of:

- the date on which the salary sacrifice contract ends, or is changed, modified, varied or renewed; and
- 6 April 2018 – except where the benefit provided is a car with CO2 emissions exceeding 75g/km, living accommodation, or school fees, in which case the final date is 6 April 2021.

But if an employee starts a contract on or after 6 April 2017, the new rules will need to be applied immediately for that employee.

Example

An employee enters into a salary sacrifice arrangement with their employer to give up £1,000 of gross pay over 12 months in return for a parking space near their place of work. The parking space is an exempt benefit in kind. The employee previously funded the parking cost from their net salary.

If the employee enters into the salary sacrifice contract on 1 March 2017, the value of the benefit in kind (up until the salary sacrifice contract ends on 28 February 2018) is nil. The employee is a 40% taxpayer paying NICs at 2%, and so he will be better off by £420 over those 12 months, and the employer will save £138 in employer’s NIC. This is a ‘win-win’ arrangement for both the employee and the employer.

If the employee enters into the contract on or after 6 April 2017, although the parking space is still exempt, because it is provided in conjunction with salary sacrifice, the taxable value of the benefit is equal to the sacrificed salary.

The only saving now is the 2% saving in employee's NIC of £20. This change means the agreement will no longer be as financially advantageous for the employee and the employer.

Complexities and concerns

These new rules will undoubtedly add unwelcome complexities to the tax system, especially in the shorter term. These complexities will make these arrangements much more challenging to administer and will increase the probability of employers not applying the rules correctly. Consider, for example, the following points.

1. Optional remuneration arrangements

As suggested by the references to 'optional remuneration arrangements' in the draft legislation, these changes go much further than just changing the rules for standard salary sacrifice arrangements.

The draft legislation highlights two types of situation where the new rules will apply.

- Type A – where an employee gives up a right, or a future right, to receive an amount of earnings in return for a benefit. This addresses more standard salary sacrifice arrangements.
- Type B – where an employee is provided with a choice as to whether to receive a benefit or to receive a cash alternative.

It is the inclusion of type B arrangements which introduces a huge amount of complexity for employers and means that these rules will apply more widely to arrangements which do not involve salary sacrifice.

A typical situation caught under type B is where an employee is promoted and, on promotion, is offered a company car or a car allowance. If the employee opts for the company car after 6 April 2017, this will be caught by the new rules because the employee was offered a cash allowance as an alternative. The value of the car for benefit in kind purposes will be calculated by reference to what the cash allowance would have been if that is higher than benefit given by the benefits code.

There is no element of salary sacrifice here; this is just a normal part of the way a remuneration package changes as an employee's career progresses with their employer. Yet it still appears to be within the scope of the new rules, despite no earnings being 'foregone'.

2. Modifying or varying an optional remuneration arrangement

Under the transitional rules, employers and employees who have already been provided with a benefit under an optional remuneration arrangement before 6 April 2017 will not need to apply the new rules (they are said to be "grandfathered") until that arrangement ends, or is changed, modified or renewed (subject, of course, to the automatic 6 April 2018 and 6 April 2021 trigger dates highlighted above).

While the draft legislation states that a variation required as a result of accidental damage, or for other reasons beyond the control of the parties to the contract, can be ignored for these purposes, there is little further guidance at present explaining when HMRC will consider a contract to be modified or varied.

However, we understand that the policy intention is that grandfathering will be lost where the terms of the arrangements between employer and employee are varied within the control of those parties; where the variation is not within their control, grandfathering will be allowed to continue. We await further confirmation and guidance on this point but examples of difficult areas could include:

- An employee orders a car (>75g/km) before 6 April 2017, which is delivered in, say, June 2017. The employee varies the terms of the arrangement by changing the contract mileage associated with the car. This is within the control of the employee so grandfathering would be lost;
- An employee orders a car (>75g/km) before 6 April 2017, which is delivered in, say, June 2017. The terms of the arrangement between the employer and the employee mirror the key commercial terms of the supplier to make normal commercial amendments such as variations to accessories which are not available, or changes to the delivery date. These can have the consequential effect of varying the start date for the provision of the benefit and the amount and/or start date of any salary sacrifice adjustments under the arrangement between employer and employee. If these variations occur, they would arise under the terms of the arrangements and would not amount to a variation of those terms within the control of the parties, so grandfathering should

continue.

- The analysis becomes more difficult in cases where arrangements are established or amended in special circumstances. For example:
    - a union negotiation over rates of pay is settled by the provision of a benefit or an expense instead of a pay-rise;
    - a prospective employer is happy to provide any mix of pay or benefits up to a specified value – whatever the prospective employee chooses, will that be an optional remuneration arrangement?
    - an employer provides a flexible benefits scheme providing benefits with a value up to £5,000 but with no cash alternative if not taken. If employees want benefits above this value, they have to agree to sacrifice the excess from salary. An employee chooses a mix of benefits worth £6,000. Some are taxable, some are tax free. In what order should the benefits be matched with the £1,000 additional salary sacrifice, particularly if there is a mix of taxable and exempt benefits chosen?

Employers urgently need more guidance and clarity about what constitutes a variation to an optional remuneration arrangement to help them recognise when the transitional rules could cease to apply.

3. Benefit reporting

The potential complexity of the new rules is perhaps most obvious in the reporting of benefits in kind, especially in the four tax years to 5 April 2021.

There will be many situations where two (or more) employees will be receiving the same benefits but will be taxed differently because of the impact of these new rules. This might be because:

- one employee enters into a salary sacrifice agreement for a benefit in kind and the other does not (this will be especially confusing for exempt benefits);
- one employee is offered a cash alternative in respect of a benefit in kind and the other is not;
- one employee enters into a salary sacrifice arrangement before 6 April 2017 and the other enters the arrangement after 6 April 2017; or
- both employees enter into a salary sacrifice arrangement before 6 April 2017, but one triggers a variation to their salary sacrifice contract before 6 April 2018 or 6 April 2021.

For employers offering benefits through salary sacrifice, or where a cash alternative is offered, benefit in kind reporting looks to become far more complicated. This certainly is not simplifying the tax system.

4. Payrolling of benefits

The issue of employees and employers triggering variations to pre-6 April 2017 optional remuneration arrangements before 6 April 2018 or 6 April 2021 will be of a particular concern to those employers that are payrolling those benefits in kind.

Such employers will need to make sure that the correct figure is being payrolled immediately after the trigger point is hit. The same applies to all new optional remuneration arrangements from 6 April 2017.

5. Employee tax codes

It is inevitable that these new rules will, in certain circumstances, cause problems with employees' PAYE tax codes and lead to unexpected underpayments of tax.

Example

An employer provides an employee, who is a higher rate taxpayer, with work related training which is funded through a salary sacrifice agreement agreed on 1 March 2017. It is a two-year training course but the employee enters into a salary sacrifice arrangement in respect of the first year so as not to over commit himself.

Towards the end of the first year, the employee decides that he would like to complete the second year of the course, and on 6 April 2018 the salary sacrifice agreement is varied in respect of the cost of the second year. The cost of the course is £2,400 (including VAT) in each year and the employee sacrifices this amount of salary in each of the years.

For the 2017/18 tax year, because the salary sacrifice agreement was entered into before 6 April 2017, and the provision of the work related training is an exempt benefit in kind, no entry in respect of this benefit is required on the employee's 2017/18 form P11D.
For the 2018/19 tax year a taxable benefit does however arise, and this is equal to £2,400 (the amount sacrificed by the employee in the 2018/19 tax year). This is not recognised by the employer until the employee's 2018/19 P11D is submitted in June

2019 and is therefore never adjusted for in the employee's 2018/19 PAYE tax code. The employee faces a sudden underpayment of tax totalling £960 (i.e. £2,400 x 40%).

Another complexity arising with work-related training in particular, arises where the training is high value and the employer pays half the cost, while the employee covers the other half through a salary sacrifice. Say £50,000 each in relation to an MBA. In theory, the employee is sacrificing £50,000 and receiving a benefit worth £100,000; the higher of the cost and the amount foregone is £100,000. However, the employer's contribution would normally be exempt anyway. We understand that the policy intention is that the £50,000 sacrifice should be matched against the incremental benefit provided (rather than the whole benefit), so that only £50,000 will be taxable in this case. However, the draft legislation will need to be amended if it is to correctly reflect this policy intention.

Of course, problems with PAYE tax codes collecting the appropriate amount of tax already exist, but the impact of these new rules could certainly exacerbate this problem. We understand that HMRC does not intend to make any adjustments to PAYE codes for optional remuneration arrangements in 2017/18. This means that everyone whose benefit is increased in value by the new rules, will have a similar underpayment arising at the end of 2017/18. Employees need to be made aware when the taxable value of a benefit suddenly increases, in order that they can ask HMRC to update their PAYE tax code at the earliest opportunity.

6. HMRC checks of employer records

Consideration of whether these new rules have been correctly applied by employers will, no doubt, form an important part of HMRC's checks of employer records in the future.

Given all of the complexities highlighted above, and the high probability of employers applying these rules incorrectly, it is critical that employers are able to show that they have taken reasonable care to consider and implement the new rules so as to mitigate unexpected liabilities.

What else should employers do?

It is recommended that employers should:

- identify the elements of their salary sacrifice and cash alternative arrangements which are affected by this;
- assess the financial impact these changes could have both for their businesses and the employees concerned;
- consider how this will affect the reporting of employee benefits in kind, especially where employers are committed to voluntarily payrolling affected benefits;
- communicate to employees the effect these rules will have on the tax treatment of their benefits;
- ensure that employees are notified when a variation is made to a salary sacrifice contract and the possible impact on their PAYE tax codes;
- where appropriate, and subject to the above, encourage employees to sign up to existing salary sacrifice schemes before 6 April 2017;
- consider other affordable alternatives to salary sacrifice offerings; and
- document and file the above analysis and decision making process.

Conclusion

One thing is for certain: all employers using salary sacrifice or cash alternative arrangements will need to be familiar with the new rules, in particular how and when they will impact on their reporting obligations and when they are triggered.

Despite the issues highlighted above salary sacrifice may continue to be advantageous in certain circumstances. This will certainly be the case for pension contributions, pension advice, cycle to work schemes, ultra-low emission vehicles, and certain employer supported childcare.

For other benefits, there may also be continued advantages through NIC savings for employees and, more importantly, through the power of employer bulk purchase arrangements, allowing employers to negotiate a cheaper price than a single employee can.