Salary exchange, reduced salary and auto-enrolment

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With auto-enrolment around, there are good reasons why salary exchange (or salary sacrifice as it is also known) should become even more popular. After all, employers will want to cut the costs of auto-enrolling new members, and the savings in employer national insurance contributions could at least pay for some of these costs. Salary exchange or paying a reduced salary lets them achieve this. However, there are problems with using either method for auto-enrolment, so we strongly recommend you talk to your financial adviser about your requirements.

In this factsheet, we discuss these problems and suggest possible solutions.

Should I read this factsheet?

We think this factsheet will be relevant to you if you:

- are already offering salary exchange to your employees or plan to introduce it

or

- you are planning to help fund the costs of your pension scheme by requiring all staff to take a pay cut or accept lower pay rises.

Salary exchange	Reduced salary
How does salary exchange work? • An employee agrees to give up part of their salary or bonus in exchange for a pension contribution paid by their employer. • The employer pays lower national insurance contributions (NICs) by paying the employee a reduced salary. • The employee also pays lower NICs and possibly less income tax. • Employers are free to use their NIC saving how they want. For example, some might use it to increase their contributions to the pension scheme. • Employees can use their savings to boost their pension provision or increase their take-home pay.	**What are the implications of reducing salaries?** • **New employees** – the employer could offer new employees a lower salary than would otherwise be the case, but make a higher employer contribution to the pension scheme. • **Existing employees** – the employer could negotiate a reduced salary with existing employees in return for a higher employer contribution to the scheme. • As a result, the employer and the employees would pay lower national insurance contributions (NICs). • The employees might also pay less income tax. • Employers are free to use their NIC saving how they want. For example, some might use it to increase their contributions to the pension scheme.

Why is there an issue with using salary exchange with auto-enrolment?

- Salary exchange is a voluntary reduction to the employee's contractual pay. Because of this, HMRC has made it clear that an employer must document and agree it with each employee before it takes place and the employer pays the altered contributions into the scheme.
- However, under auto-enrolment, the jobholder is automatically enrolled in the pension scheme and then given the right to opt out. This means salary exchange doesn't fit well with the auto-enrolment process and can't be made a condition for joining the pension scheme.
- So, to be on the safe side, employers should base both the employer and employee contributions on an unreduced salary when using salary exchange with auto-enrolment.
- However, employers could also promote the benefits of salary exchange and let members choose it either at the same time as or after they have been auto-enrolled. We discuss this in the section below.
- Employers who currently include salary exchange in members' joining packs will have to change the basis of the offer after they have started to auto-enrol employees.
- Previously there was an issue if the employee cancelled or opted out of the pension. This was because the salary exchange agreement had to remain in force even if the pension was cancelled. However, HMRC have now confirmed that if someone opts out or cancels, the salary exchange agreement will not remain in force.

What are the issues with reducing salary with auto-enrolment?

- Offering different terms for new employees is relatively easy. But employers must consider the knock-on effects of a reduced salary. In particular, The Pensions Regulator could view higher salaries for people not in the pension scheme as encouraging opt-outs.
- Reducing the salary of existing staff could be extremely difficult. Depending on employment contracts, it might be easier to reduce or remove salary rises instead.
- Employers should be careful not to discriminate against staff (for instance, on grounds of age, sex or religion) when changing salary or other terms and conditions of employment.
- Employers should also be careful not to unfairly penalise employees who repeatedly opt out of the pension scheme. The main reason for reducing the employee's salary or reducing or removing pay rises is to fund the employer's contributions. So, it could be argued that employers unfairly profit from employees who repeatedly opt out, as they would use the money saved for their own benefit not the employees'.
- We recommend that employers get legal advice about these issues.

Are there still ways of using salary exchange in an auto-enrolment scheme?

- Yes, but the process will be less streamlined than it was. These are the alternatives:

1. Make it the default position to auto-enrol people without salary exchange but offer them salary exchange at the same time

- Employers can do this, but there are some drawbacks:
- Employers will have to give the employee two illustrations at the same time, the first one assuming salary exchange doesn't apply, the second that it does. Providers may not wish to, or have time to, do this unless the employer is using the maximum deferral period possible.
- Unlike auto-enrolment, employees have to actively choose salary exchange, so many of them may not take advantage of it under these circumstances.

2. Write salary exchange into the contract of employment

- Another possible solution is to include salary exchange in the contract of employment. By signing the contract of employment, new employees agree to salary exchange, so there would be no conflict with the auto-enrolment process.
- It could be difficult to retrospectively change contracts of employment to auto-enrol existing employees who aren't in the scheme with salary exchange. This could also open up the employer to additional challenges about matters completely unrelated to salary exchange.
- Drafting salary exchange into a contract of employment needs considerable thought. For example, what happens if the employee opts out? Poor drafting could imply that they had rejected the offer of employment entirely! Even if that isn't the case, would the employer retain the exchanged pay until re-enrolment comes around, or should they give the employee an immediate pay rise? If the latter, The Pensions Regulator could decide the employer had encouraged opting out.

3. Use the postponement period (also known as the deferred period)

- Employers can choose a postponement period of up to three months for their auto-enrolment scheme. This allows them to postpone auto-enrolling staff between the date they first become eligible for auto-enrolment and the end of the postponement period. During this period, they could get the employee's agreement to salary exchange. So, when the employee is auto-enrolled it will be on the reduced salary.

4. Offer the employee salary exchange after auto-enrolment

- This involves waiting until the employee is in the scheme then selling in salary exchange as a positive benefit. However, some employees might be irritated by having to make two decisions about pensions quite close together, and it does make things more complex for employers than the current process.

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