Money Matters – It's good to make a sacrifice!

Over the next few months I will feature an aspect of financial planning that I hope will highlight some of the opportunities that are available. In this one I am going to cover saving for pensions through salary sacrifice.

Why save in a pension?

From a tax efficiency point of view a pension is the one of the most tax efficient options available (especially if you are a higher rate tax payer). Against this there is a loss of flexibility as you can only take benefits from age 55 (50 until 6 April 2010); it's possible to take 25% as a tax free lump sum but the rest of the pension fund must be taken as an annuity or another form of income such as an unsecured pension. By contrast an Individual Savings Account (ISA) is also tax efficient and is always accessible.

As a means of comparing the two, the table below shows the effective value of a lump sum investment of £10,200 into a pension or an ISA for a period of 15 years.

Fund values

	Higher rate tax payer (tax at 40%)	Basic rate tax payer (tax at 20%)
Pension with 40% relief	21,431	26,024
Pension with 20% relief	16,073	19,518
ISA	18,370	18,370

Example for illustration purposes only

The fund values assume growth of 4% per annum and assume that for the pensions 25% of the fund is free of tax when benefits are taken.

Although pensions are much maligned, I believe they are an effective source of retirement income.

What's salary sacrifice?

Salary sacrifice is a means by which an individual can agree with their employer to forgo salary in lieu of pension contributions. This could potentially result in the individual receiving the same net income and making an increased contribution to their pension fund. It's a way of making saving for a pension even more tax efficient.

Here's an example of how it works

Individual earns £24,000 per annum and both the employee and the employer are contributing 5% of salary towards a pension. The employee agrees to a salary sacrifice of £1,391 per annum and the employer makes this as a pension contribution.

	Before salary sacrifice	After salary sacrifice
Employee view		
Gross income	£24,000	£22,609
Tax	£3,505	£3,227
National Insurance Contribution (NIC)	£2,011	£1,858
Current pension contribution (net of tax)	£960	
Gross earnings less tax and NIC	£17,524	£17,524
Employer view		
Gross income	£24,000	£22,609
Employer NIC	£2,340	£2,162
Employer pension contributions	£1,200	£2,769
Cost of employee	£27,540	£27,540

Example for illustration purposes only

In this example, the employee has the same net pay and gains from an increase in the pension contribution being made from £2,400 to £2,769. This example also assumes that all of the employer NIC savings are passed onto the employee but it mat be that some of this is held back to cover administrative costs. Clearly the above example is slightly artificial to simplify the numbers but the logic will apply in other cases.

As with all things, there is a small caveat – as salary is being sacrificed other salary related benefits may be affected by the reduction, including borrowing for mortgage purposes, personal loans and some State benefits such as Statutory Sick pay and incapacity benefits.

Setting up a salary sacrifice arrangement
Salary sacrifice needs to be set up as a formal arrangement whereby the employee gives up his right to future salary or bonus in return for the employer making a pension contribution.

If this arrangement is something that interests you either as an employee or an employer please give me a call.

Will
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