

The Local Government Pensions Committee
Secretary: Mike Walker

CIRCULAR

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No. 187 – JULY 2006

SALARY SACRIFICE SCHEMES

Purpose of this Circular

1. This Circular has been issued to provide authorities with guidance on the pension implications of salary sacrifice schemes.

Background

2. A number of authorities have approached the LGPC for information on the pension implications of salary sacrifice schemes. These may take a number of forms and those that have been raised with the LGPC recently are covered in this Circular i.e.
 - child care
 - home computing initiative (for those covered before the removal of the scheme from 6 April 2006)
 - green schemes – bicycles, public transport
 - purchase of additional annual leave
3. Information is also provided on why it is not permissible for an employee to forego salary of an amount equivalent to their normal pension contributions and for the employer to pay a sum equal to the foregone salary into the LGPS.
4. The effects of other forms of salary sacrifice on pension contributions would need to be considered separately, based on the circumstances of each case, the rules of the Local Government Pension Scheme and the relevant tax legislation.

Email info@lge.gov.uk

www.lge.gov.uk

Managing Director Jan Parkinson

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Registered office: Local Government House, Smith Square, London SW1P 3HZ

Child care - salary sacrifice for workplace nursery provision¹

5. The workplace nurseries exemption exempts an employee from tax on the benefit of a place in a workplace provided nursery, subject to specified conditions being met. Section 318 of the Income Tax (Earnings and Pensions) Act 2003 states that “no liability to income tax arises by virtue of Chapter 10 of Part 3 (taxable benefits: residual liability to charge) in respect of the provision for an employee of care for a child if [specified] conditions ... are met.” The conditions are set out in section 318.
6. Regulation 13(10) of the Local Government Pension Scheme Regulations 1997² states that “no sum may be taken into account in calculating [pensionable] pay unless income tax liability has been determined on it.”
7. So, how do section 318 of the Income Tax (Earnings and Pensions) Act 2003 and regulation 13(10) of the Local Government Pension Scheme Regulations 1997³ interact? Are pension contributions payable on the gross pay (prior to the salary sacrifice) or only on the reduced pay after the salary sacrifice?
8. Her Majesty’s Revenue and Customs (HMRC) have confirmed that, in their view, the salary sacrifice is assessable to income tax under section 203 in Chapter 10 of Part 3 of the Income Tax (Earnings and Pensions) Act 2003. Section 318(1) then operates to remove the liability to income tax. Thus, income tax liability has been determined and the gross salary that would have been pensionable prior to the salary sacrifice remains the amount to be subject to pension contributions.
9. In order to ensure there is no doubt, and hence ensure there is no possibility of the employee’s pensionable pay being reduced on account of the salary sacrifice, it is recommended that the value of the child care benefit (i.e. the amount of salary foregone) should be specified in the employee’s contract as being a pensionable emolument (under regulation 13(1)(c)⁴).
10. The DCLG have also given their informal view which concurs with that provided by HMRC.

Child care vouchers (whether via salary sacrifice or paid in addition to normal salary)

11. Regulation 13(10) of the Local Government Pension Scheme Regulations 1997⁵ states that “no sum may be taken into account in calculating [pensionable] pay unless income tax liability has been determined on it.”

¹ More information about employer supported childcare can be found at <http://www.hmrc.gov.uk/childcare/>

² Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

³ Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

⁴ Regulation 12(1)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

⁵ Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

12. Schedule 13 of the Finance Act 2004 made various changes to the Income Tax (Earnings and Pensions) Act 2003 concerning childcare and childcare vouchers from April 2005. Childcare vouchers are earnings that are assessable to tax but section 270A(1) then operates to remove the liability to income tax on the first £55 of childcare vouchers⁶. Thus, tax liability has been determined on the whole value of the childcare vouchers; it's just that no tax is payable on the first £55 per week (£243 per month).
13. In order to ensure there is no doubt that the full value of the vouchers is pensionable (whether taken via salary sacrifice or in addition to normal salary), it is recommended that the vouchers should be specified in the employee's contract as being a pensionable emolument (under regulation 13(1)(c)⁷ of the Local Government Pension Scheme Regulations 1997).

Home Computing Initiative

14. As from April 1999 an employer was able to lend computer equipment to their employees for private use without any tax being due on the benefit in kind, providing the annual value of the benefit to the employee did not exceed £500. This meant that computer equipment up to a value of £2,500 (including VAT) could be made available to employees for private use tax-free. In January 2004 the Cabinet Office and the Department of Trade and Industry launched the Home Computer Initiative (HCI) which was underpinned by the tax exemption introduced in April 1999.
15. The tax exemption for computer equipment loaned by employers to their employees for private use was however removed in the 2006 Budget. The exemption ceased to be available with effect from 6 April 2006 but all employees taking part in a HCI scheme at 5 April 2006 are able to continue to participate and get the benefit of the tax exemption on the loan of a computer until that scheme comes to an end. The usual duration of a scheme is three years.
16. HMRC also put in place transition arrangements to help employers who could demonstrate they were in the process of setting up a Home Computer Initiative scheme prior to that 6 April 2006.
17. HMRC agreed that where the employer and employee had agreed the terms on which the computer was made available in writing before 6 April e.g. specifications of the equipment, cost/value and details of the salary/tax impact upon the employee, the tax exemption would apply, even if, due to circumstances beyond their control, the employee wasn't able to take physical possession of the computer equipment before 6 April 2006.
18. The transitional arrangements can be viewed at:
<http://www.hmrc.gov.uk/news/home-computer.htm>

⁶ There is also no liability to class 1 NICs on the first £55 p.w.

⁷ Regulation 12(1)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

19. For those staff covered by paragraphs 15 to 18 above, the gross salary before the salary sacrifice is the amount that is pensionable. However, it is advisable to specify the value of the salary foregone in lieu of the loan of computer equipment as a pensionable emolument in the employee's contract of employment.

Green schemes – cycle to work scheme

20. Regulation 13(10) of the Local Government Pension Scheme Regulations 1997⁸ states that “no sum may be taken into account in calculating [pensionable] pay unless income tax liability has been determined on it.”
21. Section 244 of the Income Tax (Earnings and Pensions) Act 2003 prevents an employee being chargeable to income tax under section 154 in respect of the provision of a cycle or associated safety equipment.
22. To take advantage of the tax (and Class 1A NICs exemption), an employer can simply buy a cycle and cyclists' safety equipment and loan it to an employee for qualifying journeys to work. This arrangement means that the employee's normal salary arrangements are not affected. It may be, however, that the employer wants to recover the cost of providing the cycle and safety equipment loaned to the employee. Usually this would be done through a salary sacrifice arrangement.
23. If a salary sacrifice arrangement is entered into, income tax liability will have been determined i.e. no tax is due by virtue of section 244 of the Income Tax (Earnings and Pensions) Act 2003 and so the gross salary that would have been pensionable prior to the salary sacrifice remains the amount to be subject to pension contributions.
24. In order to ensure there is no doubt, and hence ensure there is no possibility of the employee's pensionable pay being reduced on account of the salary sacrifice, it is recommended that the value of the cycle and associated safety equipment (i.e. the amount of salary foregone) should be specified in the employee's contract as being a pensionable emolument (under regulation 13(1)(c)⁹).
25. More information on cycle to work schemes can be obtained at http://www.dft.gov.uk/stellent/groups/dft_susttravel/documents/page/dft_susttravel_038228.hcsp

Green schemes – support for public bus services

26. Section 243 of the Income Tax (Earnings and Pensions) Act 2003 excludes from the tax charge under section 154 the benefit arising from any financial or other support provided by one or more employers for a public bus service that their employees use for journeys to and from the workplace, or between workplaces.

⁸ Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

⁹ Regulation 12(1)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

27. It may be that the employer would wish to recover the cost of the financial support from the employee. This could be done through a salary sacrifice arrangement, but would the sum sacrificed be pensionable under regulation 13 of the Local Government Pension Scheme Regulations 1997¹⁰?
28. Regulation 13(1) of the Local Government Pension Scheme Regulations 1997¹¹ defines pensionable pay as:
- (a) all the salary, wages, fees and other payments paid to him for his own use in respect of his employment; and
 - (c) any other payment or benefit specified in his contract of employment
- as being a pensionable emolument.
29. But regulation 13(2)(b)¹² says that an employee's pensionable pay does not include "any travelling, subsistence or other allowance paid in respect of expenses incurred in relation to the employment". The question, therefore, is whether a travel benefit would be an "*allowance*" and whether the allowance is "*paid in respect of expenses incurred in relation to the employment*".
30. If the travel benefit is, for example, in the form of a season ticket it could be argued that it is not an allowance i.e. it is either a voucher, a credit token, or a symbol of authority to use the bus. If this view is taken, then the value would not be excluded by regulation 13(2)(b)¹³ and so could be pensionable.
31. If, however, one were to take the view that there is an allowance, one would need to decide whether the allowance is "*paid in respect of expenses incurred in relation to the employment*". [Note: in former LGPS regulations this was expressed as "expenses incurred by him for the purposes of his employment"].
32. ODPM appeal determination LGS333 concerned a payment made to an employee who was compulsorily re-deployed and as a result of which he was paid money for extra travelling expenses. The payment was made to cover additional travelling costs incurred as a result of travelling to a new work base. The ODPM took the view that the term "for the purposes of his employment" related to the tasks which an employee is required to carry out in the cause of his service with a local authority. It follows therefore that an allowance for travelling incurred when an employee is not actually fulfilling the purpose of his employment cannot be regarded as an allowance paid to cover expenses incurred by him for the purposes of his employment. The conclusion was therefore reached that the payment did not fall within the travelling expenses exclusion and would be regarded as pensionable pay.

¹⁰ Regulation of the Local Government Pension Scheme (Scotland) Regulations 1998

¹¹ Regulation 12(1) of the Local Government Pension Scheme (Scotland) Regulations 1998

¹² Regulation 12(2)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

¹³ Regulation 12(2)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

33. Thus it would appear from the appeal determination that any money paid to an employee for travelling to work and back home is not an expense incurred in relation to the employment and so could be pensionable.
34. However, if the travel benefit is deemed to be an allowance and has duality of purpose (e.g. it can be used to travel to / from work but can also be used to travel between workplaces whilst at work) it would seem that only that part of the benefit that relates to travel to / from work could be pensionable.
35. If the travel benefit (in whole or in part) could be pensionable, regulation 13(10) of the Local Government Pension Scheme Regulations 1997¹⁴ would also need to be satisfied. This states that "no sum may be taken into account in calculating [pensionable] pay unless income tax liability has been determined on it."
36. If a salary sacrifice arrangement is entered into, income tax liability will have been determined i.e. no tax is due by virtue of section 243 of the Income Tax (Earnings and Pensions) Act 2003 and so regulation 13(10) of the Local Government Pension Scheme Regulations 1997¹⁵ would be satisfied.
37. Assuming that the employer has satisfied itself that the travel benefit could be pensionable under the foregoing paragraphs, it is suggested that the value of the benefit should be specified in the employee's contract as being a pensionable emolument (under regulation 13(1)(c)¹⁶).

Purchase of additional annual leave

38. With regard to the buying and selling of annual leave there are two possible scenarios. Firstly, an employee could forego, say, 5 days salary in order to purchase 5 additional days leave. Conversely, an employee could forego, say, 5 days leave and receive 5 days additional salary instead.
39. The starting point should be that an employee should not be able to influence their pay or final years pay for pension purposes. To achieve this result, the following logic applies.
40. An employee who foregoes 5 days salary in return for 5 days additional leave is, in effect, on unpaid leave of absence for those 5 days and so the provisions of regulation 17 of the Local Government pension Scheme Regulations 1997¹⁷ would apply i.e. the employee and the employer would be required to pay contributions on notional full pay for those 5 days (as the regulation requires contributions to be paid on unpaid leave of absence of up to 30 days).
41. Conversely, an employee who foregoes 5 days leave in order to receive 5 extra days pay is receiving pay in consideration for the loss of holiday and so the 5

¹⁴ Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

¹⁵ Regulation 12(10) of the Local Government Pension Scheme (Scotland) Regulations 1998

¹⁶ Regulation 12(1)(b) of the Local Government Pension Scheme (Scotland) Regulations 1998

¹⁷ Regulation 16 of the Local Government Pension Scheme (Scotland) Regulations 1998

days extra pay is not pensionable by virtue of regulation 13(2)(c) of the Local Government Pension Scheme Regulations 1997¹⁸. Regulation 13(2)(c) says that "any payment for consideration of loss of holidays" is not pensionable. It does not specify that this has to be a compulsory loss of holiday. It can be argued, therefore, that it covers voluntary as well as enforced loss of holiday.

42. The above approaches achieve the desired result of ensuring that pay and final pay for pension purposes are not affected by an employee's decision to purchase or forego annual leave in return for a reduction or addition to pay.
43. On a general point, the ECJ ruling in the joined cases of *Robinson-Steele v RD Retail Services Ltd* (C-131/04); *Clarke v Frank Staddon Ltd*; and *Caulfield v Hanson Clay Products Ltd* (C-257/04) which was announced on 16 March 2006 indicated that "rolled-up" holiday pay is unlawful even if it is clear in the contract of employment what proportion or amount of the rolled-up pay is holiday pay i.e. pay in lieu of holiday. Having considered the judgment, it is considered that it does not have any implications where an employee chooses to forego annual leave in return for additional pay. This is because, essentially, the judgment concerned cases where an employee was not given holiday leave and their pay rate was automatically adjusted to reflect this. In the scenario described in paragraph 41 above, the individual is entitled to holiday leave; they are simply volunteering to give some up in return for some other benefit. Thus, it is considered there would be no issues resulting from the ECJ ruling, provided the employee does not reduced their holiday leave to below the minimum Working Time Directive amount of 4 weeks (including Bank Holidays) [for a whole time employee].

Salary sacrifice equivalent to employee's pension contributions

44. We understand that in certain areas of the private sector, employees are given the option to forego an amount of salary equivalent to their normal pension contributions (thereby reducing the pay on which both the employee and employer pay NI contributions). The employer then pays the equivalent of the salary foregone as a contribution into the pension scheme.
45. Whilst this may be possible in private sector schemes it is not legally possible in relation to the LGPS. This is because under the statutory provisions of the LGPS Regulations, where an employee is a Scheme member, the employee and the employer must pay their respective contributions into the LGPS. There is no power under the LGPS Regulations that would permit an employer to pay the employee's foregone salary (being the equivalent of the employee's normal pension contributions) into the main LGPS on behalf of the employee nor is there a power for the employee's pension to be calculated on notional full pay (i.e. the full rate of pay as if no salary had been foregone).
46. Unless the employer is prepared to enter into a shared cost AVC arrangement under the LGPS Regulations and pay the equivalent of the foregone salary into the shared cost AVC, there would be no point in an employee opting for salary

¹⁸ Regulation 12(2)(c) of the Local Government Pension Scheme (Scotland) Regulations 1998

sacrifice. However, even if the employer paid the equivalent of the salary foregone into a shared cost AVC, the resultant benefits from such a scheme for the employee would be uncertain (as they are based on investment returns and, upon retirement, on annuity rates). Why, therefore, would an employee wish to forego salary and thereby potentially reduce their pension benefits?

47. From the employer's perspective, the danger would be if the employee decided in the last year before leaving / retirement to opt out of such a salary sacrifice arrangement and go back onto full pay. The LGPS benefits would then be based on full pay even though employee and employer contributions had only gone into the main LGPS on the reduced pay for a number of years. The cost of this "strain" would have to be met by the employer who, if they had paid into a shared cost AVC arrangement would, in effect, be meeting the pension cost twice over.

Possible affect of salary sacrifice schemes on other benefits

48. With salary sacrifice an employee gives up the right to receive part of the cash pay due under their contract of employment in return for the employer's agreement to provide an equivalent non-cash benefit, the value of which is exempt from tax and National Insurance Contributions (NICs). The advantage for the employee is a benefit equivalent to the tax and NICs otherwise payable on the sum sacrificed.
49. However, the benefits of salary sacrifice need to be balanced by the employee against the possible consequences for their income in future. Paying a reduced amount of NI contributions, even for a limited period of time, can affect future benefits to which the employee could be entitled.
50. For example, the State pension and other benefits such as Statutory Sick Pay and Statutory Maternity Pay can be affected by the level of NICs the employee makes. This is unlikely to affect full-time employees, but would affect those whose annual pay after salary sacrifice falls below the lower earning limit for NI. See HMRC guidance at: http://www.hmrc.gov.uk/specialist/salary_sacrifice.htm
51. Tax credits depend on a number of personal factors including the number of hours worked, the number of children and whether eligible childcare costs are paid. Salary sacrifice for childcare vouchers/benefit schemes can reduce relevant pay for tax credit purposes and this may increase the Working Tax Credit award. However this award could be reduced by the cost of the childcare voucher/benefit met by the employer. Employees will need to consider their own circumstances carefully in deciding whether to agree to a salary sacrifice for childcare vouchers/benefit schemes. See HMRC guidance at: <http://www.hmrc.gov.uk/childcare/esctc.htm> . Working Tax Credit/Child Tax Credit Helpline - 0845 300 3900 (text phone 0845 300 3909).

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LGPC
Local Government House
Smith Square
London
SW1P 3HZ

or email: terry.edwards@lge.gov.uk
tel 020 7187 7346