

Pension Post



Salary sacrifice and employer pension contributions

Tony Gilhawley of Technical Guidance Ltd looks at salary sacrifice arrangements and employer pension contributions.

Tax law imposes a benefit in kind (BIK) income tax charge when an employee forgoes part of their contractual remuneration in return for a benefit provided by the employer. This can result in some employer pension contributions being taxed as if they were employee contributions.

Example

An employee of a multinational has a contract of employment which provides for a salary and the payment of a variable bonus each year, to be determined by the employer based on certain criteria.

The company has had a good year and the employer is going to pay the employee a bonus of 40% of their salary. However, the employee suggests to the employer that instead of paying the bonus, the employer pay it as an employer's pension contribution for him or her.

Is this ok?

I'm afraid not. What should happen is this:

- ▶ Section 118B Taxes Consolidation Act 1997 provides that this is a 'salary sacrifice arrangement' and the contribution paid to the pension scheme is not an employer pension contribution but an application by the employee of their taxable remuneration, i.e. an employee pension contribution.

Revenue in their Tax & Duty Manual 5.3.11, August 2016, states

“The term salary sacrifice is generally understood to mean an arrangement under which an employee agrees with the employer to take a cut in remuneration and in return the employer provides a benefit of a corresponding amount to the employee.

As a general rule Revenue does not regard salary sacrifice arrangements as reducing the employee’s taxable income. If an employee forgoes salary payable under an existing contract of employment in exchange for a benefit, the employee remains taxable on the ‘gross’ income payable.

The salary sacrificed will be considered to be an application of income earned by the employee, not an expense incurred by the employer.”

The employer should therefore, for tax purposes, treat this payment to the pension scheme as a BIK for the employee and not an employer pension contribution; in effect the employee’s taxable remuneration for the year is their [salary + the 40% bonus paid as an employer pension contribution].

- ▶ The employee can then claim income tax relief (but not USC or PRSI) on this contribution as a personal contribution to the scheme, within the usual limits (in this case, based on remuneration of 140% of salary, limited to €115,000 earnings).

The downside of the salary sacrifice treatment where the employer pension contribution is treated as an employee contribution is

- ▶ The employee is liable to USC and PRSI on it, which they wouldn’t be if it were classified as a normal employer pension contribution;
- ▶ Income tax relief, if obtained, may have to be spread out over a number of years, and may not be fully claimed by the time the employee leaves service or retires;
- ▶ It may crowd out the scope for tax relief on ongoing employee and AVC contributions.

Contrary to popular belief, there is no specific exemption in s118B TCA 1997 for the payment of employer pension contributions which fall into the ‘salary sacrifice arrangement’ definition, i.e. where the employee gives up a right to contractual remuneration to fund an equivalent employer pension contribution.

When is an employer pension contribution not deemed to be salary sacrifice?

In broad terms, an employer pension contribution to a pension scheme for that employee is not salary sacrifice if it is **not** funded by the employee foregoing an equivalent amount of remuneration due under their contract of employment.

Example

The employee has a contract of employment which provides for a salary, bonus and the payment of specific level of employer pension contribution, for example, 10% pa of salary.

The employee's remuneration due under the contract of employment is salary + bonus, and as the employer pension contribution is not being funded by the employee giving up part of their contractual remuneration, it isn't treated as a salary sacrifice arrangement.

Instead, it is treated as a normal employer pension contribution, which is exempt from a BIK income tax charge.

Discretionary remuneration

It could be that

- ▶ The employee has no written or verbal contract of employment. For example, a 20% director of their own company; or
- ▶ The employee has a written contract of employment, but it makes no reference to a bonus; it refers only to salary.

In either case, the employee's bonus may be discretionary, as the employee has no legal enforceable 'entitlement' to it. In other words, the employee can not choose or direct the employer each year to get paid a bonus or having a similar amount paid as an employer pension contribution. It's the employer's decision only.

See Revenue Tax & Duty Manual 5.3.11, August 2016, which states in relation to salary sacrifice arrangements and discretionary payments:

"... where remuneration is entirely discretionary and the employee has no prior entitlement to it (e.g. a bonus), the discretionary payment may be made by way of a benefit, and be treated for tax purposes as a benefit, provided such an arrangement precedes any 'entitlement' to the bonus etc. on the part of the employee."

What this means, in relation to an employer opting not to pay a discretionary bonus to the employee but pay an equivalent amount as an employer pension contribution, is

- ▶ The payment of the contribution is a normal benefit in kind provided by the employer and not a 'salary sacrifice arrangement'; but
- ▶ s118(5) & s777(1) TCA 1997 specifically exempts such a BIK from income tax.

So, where the bonus is genuinely discretionary and not part of the employee's contract of employment terms and conditions, the employer can pay a normal pension contribution instead of paying a bonus, provided the decision to do so is the employer's alone and not the employee's.

Renegotiating contract of employment

Where an employee already has a contract of employment with a right to a bonus, it may be possible for that contract to be renegotiated to a new one which contains no right to a bonus, but provides for the employer to pay a variable amount each year to the pension scheme for the employee, which may fall outside the 'salary sacrifice arrangement' tax treatment.

Revenue's view on this in their Tax & Duty Manual 5.3.11, August 2016, states:

"If an employee forgoes salary payable under an existing contract of employment in exchange for a benefit, the employee remains taxable on the "gross" income payable. The salary sacrificed will be considered to be an application of income earned by the employee, not an expense incurred by the employer.

... This is in contrast to the position where an existing contract of employment is bona fide renegotiated so as to provide a mixture of salary and benefits. In those circumstances the employee will be taxed on what he or she gets, i.e. the cash salary plus the taxable value of the benefit-in-kind, **provided the new employment contract involves no right on the employee's part to choose between cash and benefits.**"

Of course, in the case of a normal employer pension contribution, the BIK is exempt from income tax.

So, if the power to choose between bonus and employer pension contribution each year rests solely with the employer, with the employee having no contractual entitlement to a bonus, then the employer opting to pay an employer pension contribution rather than a bonus, should fall outside the salary sacrifice arrangement and be a normal employer pension contribution exempt from income tax, USC and PRSI in the employee's hands.

Foregoing salary

Any foregoing of basic salary in return for an equivalent level of employer pension contribution would be likely to be treated by Revenue as a salary sacrifice arrangement, whether there is a contract of employment or not.

Get professional tax advice

An employee giving up a bonus in return for an equivalent employer pension contribution carries a high risk of being classified by Revenue as a salary sacrifice arrangement and the contribution consequently taxed as an employee pension contribution. This means a USC and PRSI liability on the contribution with income tax relief possibly having to be spread over a number of years, with a risk that all relief will not be claimed by the time the employee leaves or retires.

However the circumstances of each case may differ, and so professional tax advice should always be sought by clients before implementing any proposal to fund an employer pension contribution by way of a reduction or foregoing an employee's remuneration.