Salary exchange

DAM Community Hub

What is salary exchange?

Salary Exchange is an agreement between an employee and their employer. If you're saving into a workplace pension scheme, some of your salary will automatically be paid into your pension. However, you can save tax and increase the money that's paid into your pension by giving up some of your salary or bonus before tax.

How it works

You exchange part of your salary for a non-cash benefit, such as additional pension contributions.
If you're paid a bonus, you can also exchange some or all of your bonus for extra pension contributions.
The advantage of salary exchange is that you'll save on tax and national insurance, and your employer will save on national insurance as well. The saving comes because you exchange some of your salary for pension contributions before you're taxed on it.

Your saving can then be used to increase your take home pay or increase your pension contributions. Your employer will make the decision on this as it has to be the same for all pension scheme members.

To see how salary exchange might affect your salary and pension payments, we will look to an example case of John Smith. John is paid an annual salary of £40,000. He pays £2000 (gross) into his pension each year, these are matched by his employer, taking his total annual pension contribution to £4000.

- With salary exchange, John could stop making pension contributions and 'exchange' £2000 of his salary for a pension payment, paid by his employer.
- John's employer would reduce his salary to £38,000 and pay the 'exchanged' amount (£2000) into his pension plan, along with the £2000 they paid already on his behalf.

	Before Salary Exchange	After Salary Exchange
Salary	£40,000	£38,000
John's pension payment	£2000	£0
Employer pension payment	£2000	£4000
Total pension payment	£4000	£4000

As a result of his lower salary, John will pay less National Insurance (NICs) which will increase his take home pay in this example.

The main advantage of salary exchange is that you'll save NI, but there are a range of potential implications (see below), so it's important to weigh these up before you go ahead.

Be aware that not everyone can qualify for salary exchange. The rules say that you can't do salary exchange if it would mean that your salary would fall below the National Minimum Wage or National Living Wage levels.

Is Salary Exchange suitable for everyone?

Not necessarily - salary exchange reduces an individual's gross salary and can affect certain state and other benefits. For example, it may have an impact on the following:

- Mortgages and other borrowing - Lenders may base the amount that they are willing to lend on either a multiple of a salary or affordability. Whilst the employer can provide a pre-exchanged salary reference, this may not be accepted by some lenders.
- Other employer related benefits - Although it is a reduction in gross salary, a notional salary can be used for the purpose of things such as Death in Service and other flexible benefits. This notional salary will also be used when calculating pay rises and bonuses.
- Statutory maternity/ adoption pay - SMP/SAP are based on gross earnings that are subject to NIC's and tax. As these earnings will reduce as a result of salary exchange, there may be an impact on SMP/SAP entitlement.
- Student loans - Repayments of student loans are triggered where earnings reach a certain limit. If salary exchange reduced earnings to below this limit, then repayments may reduce or stop. This may mean that it will take longer to repay student loan.
- State Pension - Salary exchange should not affect the State Pension as it is dependent on the number of National Insurance Contributions made as opposed to the amount paid.
- National minimum wage - You cannot participate in salary exchange if it results in your salary falling below the national minimum wage or national living wage.

Salary exchange and the Child Benefit High Income Tax Charge

If you claim Child Benefit and earn more than £60,000 a year, you may be able to save tax through salary exchange. Under the current rules, if you claim Child Benefit, and you earn more than £60,000 a year, you'll incur a tax charge (called the Child Benefit High Income Tax Charge).

The tax charge also applies if you live with your partner, where one of you claims Child Benefit and one of you earns more than £60,000 a year (it doesn't have to be the person who claims Child Benefit). Once you, or your partner, earn £80,000 or more a year, the tax charge wipes out the Child Benefit. However, you can effectively 'reduce' your salary for Child Benefit purposes, by making additional workplace pension contributions. The additional pension contributions don't have to be paid through salary sacrifice, but it's an option.

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