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employee benefits
& wellbeing

Salary exchange

How to get the most from your SMART workplace pension

Tax year 2020/2021

SMART stands for Save More and Reduce Tax and is designed to be a tax-efficient way of making personal contributions into a workplace pension.

Contents

What is SMART?

In the past, the traditional way of making payments was for an employee's net contribution to be taken from their net salary every month or week, after income tax had been deducted.

Under this system, the net contribution was then sent by the employer and 20 per cent basic tax relief added by the pension provider. This meant that paying £100 became £125 in the pension pot. For those paying a higher rate of income tax, additional tax relief was available, but had to be claimed from HMRC by the individual. This would take time to arrange and individuals would need to keep HMRC updated on any contribution changes to ensure the right tax relief was obtained.

With SMART, an employee's salary is reduced by the amount they want to put into their pension each year.

This process is called 'salary sacrifice' or 'salary exchange'. The amount chosen by an employee to save is sent direct to the pension provider by their employer instead. This time no tax relief is needed because no tax has been paid on the contribution. This also means that those paying a higher rate of income tax no longer need to advise HMRC.

An important theme is that the net effect on the tax you pay is the same for both methods. However, because the gross salary has been reduced, less National Insurance is due for both employer and employee. Effectively this means an employee's monthly take-home income will be higher than if they had contributed the traditional way.

So, how would you sum up the benefits of using SMART?

The Pensions Advisory Service lists the following[1]:

- Salary sacrifice is an alternative way of saving into a pension.
- The employee takes a lower salary and the difference is paid into their pension by their employer.
- Both employer and employee pay lower National Insurance Contributions, which makes it a cost-effective way of saving for retirement.
- Higher or additional rate taxpayers no longer have to apply to HMRC for extra tax relief if they enrol in SMART – because no income tax is paid on their contributions.

[1] https://www.pensionsadvisoryservice.org.uk/about-pensions/saving-into-a-pension/salary-sacrifice

Is SMART right for you?

This is an important question because SMART is not a good fit for everyone and is not compulsory.

It is down to the individual to decide whether SMART is beneficial to them.

The key benefits are that it is a tax-efficient way to save for a pension and employees' net monthly income will increase as a result of paying less National Insurance.

However, SMART is unsuitable for the following groups:

- Those who are earning the National Living Wage (NLW) or for those under 25 earning the National Minimum Wage (NMW). In fact, it is not legal to use SMART in those circumstances because it would reduce their salary to below the legal levels.
- Those who work part time and don't earn enough to pay National Insurance would gain no savings benefit from the scheme, either. Or those who are working past state pension age and no longer have to pay National Insurance.
- Those who earn less than £12,500 annually – which means they pay no tax – will find that SMART is not advantageous.

Your SMART savings

Basic-rate taxpayers

The table below provides an example of the savings you could make via SMART if you are a basic-rate taxpayer. A monthly pension contribution made using SMART is compared to the same contribution made in the traditional net-payment-from-net-salary way.

Example
Employee earning £25,000 contributing 5% of salary, employer contribution of 5%.

Period	Gross (reference) salary	Gross pension contribution
Each year	£25,000	£1,250
Each month	£2,083.33	£104.17
Income breakdown	Traditional	SMART
Gross monthly pay	£2,083.33	£1,979.17
Salary given up	—	£104.17
Income tax	£208.33	£187.50
National Insurance	£155.00	£142.50
Net pension contribution	£83.33	—
Basic-rate tax relief added	£20.83	—
Saved in pension	£104.17	£104.17
Take-home pay	£1,636.67	£1,649.17
Employer pension contribution	£104.17	£104.17
Total paid to pension	£208.34	£208.34

These calculations apply to England, Wales and Northern Ireland; the Scottish tax regime differs.

Calculations based on 2020 - 21 tax thresholds and rates.

Higher-rate taxpayers

The table below provides an example of the savings you could make via SMART if you are a higher-rate taxpayer. A monthly pension contribution made using SMART is compared to the same contribution made in the traditional net-payment-from-net-salary way.

Example
Employee earning £60,000 contributing 5% of salary, employer contribution of 5%.

Period	Gross (reference) salary	Gross pension contribution
Each year	£60,000	£3,000
Each month	£5,000	£250.00
Income breakdown	Traditional	SMART
Gross monthly pay	£5,000	£4,750
Salary given up	—	£250.00
Income tax	£958.33	£858.33
National Insurance	£421.67	£416.67
Net pension contribution	£200.00	—
Basic-rate tax relief added	£50.00*	—
Saved in pension	£250.00	£250.00
Take-home pay	£3,420.00	£3,475.00
Employer pension contribution	£250.00	£250.00
Total paid to pension	£500.00	£500.00

*higher rate tax relief can be reclaimed through self-assessment

These calculations apply to England, Wales and Northern Ireland; the Scottish tax regime differs.

Calculations based on 2020 - 21 tax thresholds and rates.

Timeline

Before:

Decide how much you want to save - your pension scheme will have minimum contribution levels you are required to pay. You then agree to give up a certain amount from your salary.

During:

The amount you have given up is sent to your pension provider along with your employer's contribution.

After:

You make a National Insurance contribution saving and your take-home pay is higher.

FAQs

Below are some of the most common questions employees ask. If you have any further queries please refer to HR or your financial advisor.

How much can I invest in a SMART pension and is it always tax-free?

It's up to you to decide how much you want to pay. Personal pension contributions made via SMART are tax-free but for most people there is a limit of 100% of annual earnings (this includes payments made by both you and your employer into the pension pot). If you earn more than £40,000 per year (the annual allowance), then the total contributions will be capped at £40,000 per year.

For administration purposes your employer may have a SMART scheme cap on the amount of salary you sacrifice.

Is everybody's annual allowance the same?

It may be different for higher earners. For people who have an 'adjusted income' from all sources of £240,000 or more the allowance falls by £1 for every £2 of income above the threshold. Additionally, people aged over 55 who have withdrawn pension savings using flexible access rules have a permanently reduced Annual Allowance of £4,000.

Is there a minimum I should pay?

You must pay at least the auto-enrolment or the scheme contractual contributions levels.

How much will I save in National Insurance contributions?

This will depend on individual circumstances, including how much you earn and how much you contribute to your pension. For an employee earning £25,000 a year and paying 5 per cent of their salary into a pension it amounts to £12.50 a month in 2020 - 21.

How much National Insurance do I pay?

The rate is tiered and based on how much you earn:

Weekly earnings of up to £183: 0 per cent

Weekly earnings between £183 and £962: 12 per cent

Weekly earnings over £962: 2 per cent

How much tax do I pay?

Here are the income tax rates and taxable bands for 2020-21*:

Personal Allowance £12,500**

Basic rate tax (20%) up to £37,500

Higher rate tax (40%) £37,501 to £150,000

Additional rate tax (45%) over £150,000

*Different tax rates apply in Scotland.

** Your personal allowance is the amount you can earn before your income is subject to tax. Your personal allowance may be higher or lower depending on your own tax circumstances.

Do I have to commit to SMART long-term?

Because making contributions to a SMART scheme requires the agreement of HMRC, it is part of your contract of employment. Normally this will mean committing to contributing this way for 12-months at a time.

What if I want to leave a SMART scheme mid-year?

Some employers offer a 'change window' which means you can only leave or join the scheme during a specified month each year. However, this may be waived in the case of a 'lifestyle event' which has a significant effect on your finances, for instance marriage, divorce, a new child, serious illness or buying a house. Increasingly, however, employers are being more flexible and allowing employees to join or leave the scheme at any time. It is important to check the details of your employer's SMART scheme.

What if I want to change the amount I pay?

Most employers will allow this, providing it doesn't reduce your income to below NLW or NMW levels, doesn't fall below the auto-enrolment minimum or doesn't raise it above your annual allowance.

Is bonus sacrifice or bonus waiver the same as SMART?

Bonus sacrifice, or waiver, means that bonuses are given up from gross salary (in whole or in part) and paid into your pension in the same tax-efficient way as your regular salary. But there is a difference. SMART is contractual and consists of regular pension contributions over a year. A bonus sacrifice is a one-off event. To comply with HMRC rules it should be formally declared in advance. Once the declaration has been made and agreed it is legally binding and it may not be possible to reverse it. So, it's important to speak to HR and Payroll before making the decision. Not every employer will allow additional payments into the scheme, so check first.

Does SMART have any other advantages I should know about?

Some employees may be able to use SMART to avoid tax traps by reducing their salaries below key thresholds.

For example, people earning more than £100,000 lose £1 of their personal income tax allowance for every further £2 earned. So, their personal allowance of £12,500 could be wiped out entirely when their income reaches £125,000. By using SMART contributions to reduce their salary below the £100,000 threshold their tax liability may be reduced.

Similarly, parents earning between £50,000 and £60,000 gradually lose Child Benefit because of an income tax charge, payable by the higher earner in the household. For every £100 earned in excess of £50,000, 1 per cent of child benefit is removed. Again, these charges can be negated by reducing salary below £50,000.

Does SMART affect my employee benefits?

No, provided your employer has agreed that all your other employee benefits will be linked to your reference (pre-SMART) salary. If available to you, benefits like death in service (salary-related life assurance), income protection, employer pension contributions, percentage-based pay raises and overtime rates will be based on your reference salary too.

Does SMART affect state benefits?

SMART has no impact on your state pension. The government introduced a single-tier flat-rate state pension in 2016, based on qualifying years rather than earnings. This is unaffected by SMART.

Some state benefits could be affected by SMART, although in general benefits that are linked to earnings or National Insurance contributions are based on thresholds and the duration of payments rather than actual figures. Discuss this with HR before you opt into a scheme.

Does SMART affect statutory income declarations?

In some cases, it could. If you are required to provide income declarations for tax credits, child maintenance, student loan repayments or court orders it is important to consider whether you could be better or worse off by using SMART. Speak to HR or seek specialist advice before enrolling.

Could using SMART affect my ability to get a mortgage or other loan?

It shouldn't. Lenders can use your 'reference salary' when applying for a mortgage or financial loan but may need confirmation from your employer. Ask your employer to confirm. Some lenders use an affordability, income and outgoings ratio model to determine how much you can borrow – and this takes pension contributions into account no matter how they are collected.

What happens if I leave my current employer?

Once you cease working for your current employer, your SMART contributions end and you will no longer be part of the scheme. All the payments that have been made into your pension, by you and your employer, will remain invested for your benefit. You can leave them there until retirement or transfer them to another pension scheme.

Key points to remember

1. SMART schemes are designed to make saving for your pension easier and more tax efficient. They result in the employee and employer paying less National Insurance, meaning take-home pay should increase.

2. Remember, they are advantageous for most employees – but not for everybody.

3. It is not a compulsory scheme and you have a choice over whether to be enrolled. Speak to your HR department for more information.

4. SMART schemes are not all the same, they can vary between employers and some businesses will still refer to them as 'salary sacrifice' or 'salary exchange' rather than SMART.

5. Many will allow you to join, leave or change your contribution percentage at any time, but be aware there may be restrictions.

6. Bonus sacrifice and one-off contributions made via SMART could be permissible too, but employers' views on this issue differ.

7. Make sure you understand all the rules and guidelines for your employer's SMART scheme before you join and are happy that it works for you. The HR department should be able to offer guidance.

About us

Howden Employee Benefits & Wellbeing are highly experienced in the sector and we pride ourselves on the expertise and knowledge of our expert team.

Howden Employee Benefits & Wellbeing is part of Howden Broking Group. Our expert team work with clients of all sizes to provide dedicated employee benefits & wellbeing consultancy. We've won many industry awards for our work and are widely recognised for our innovative and creative approach to benefit design. We're proud to be a values led business and put people first.

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