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What the Budget could mean for salary exchange and pensions?

As the autumn Budget approaches, there remains speculation that salary exchange (or salary sacrifice) may be *on the chopping block*. However, the employer National Insurance contribution (NIC) increase earlier this year may preclude any major changes at this stage.

This briefing shines a spotlight on salary exchange and the impact any potential changes could have.

Background

The Government's recent research into salary exchange for workplace pensions – commissioned by HMRC – tested three hypothetical scenarios, involving the removal of the NIC exemption for both employers and employees, alongside the increases in employer NICs which started in April 2025.

Salary exchange has historically provided a tax-efficient method for both employers and employees to contribute to pensions, delivering savings on both sides through NICs.

Some employers have chosen to *recycle* this saving – back into the employee's pension – giving them a *bonus* contribution.

Salary exchange has become more popular among employers following last year's Budget and the employer NIC increase from 13.8% to 15% together with the annual threshold change from £9,100 to £5,000.

This increased cost to the employer understandably prompted many companies that had yet to implement salary exchange to review how this could benefit them.

What is salary exchange?

Salary exchange refers to a mutual agreement between an employee and employer. The employee relinquishes a portion of their salary in return for alternative, non-cash benefits, in this instance, pension contributions.

Employees may not like the idea of a lower salary, but it's a highly tax-efficient strategy that saves them money. This is because by decreasing their gross (pre-tax) salary, they pay lower income tax and NICs on their earnings.

In turn, employers benefit from NIC savings. They may opt to return this saving to the employee, increasing their overall pension contribution further.

As with many things, there are upsides and downsides to this arrangement.

Advantages:

- Boosting employees' pension pots every month
- Making savings on both income tax and NICs
- Gaining the full higher rate or additional rate benefit of tax relief without having to claim it back
- Giving employers the option of channelling the NIC savings back into the business
- Offering employers the opportunity to use the NIC savings to attract new employees and retain valued staff.

Disadvantages:

- Potentially limiting the amount an employee can borrow (e.g. for a mortgage), although the employer can provide a letter stating a *notional/reference salary* instead
- Potentially impacting other earnings-related benefits.

As long as an employee's salary isn't reduced below National Minimum Wage or National Living Wage levels, salary exchange can be an efficient way of saving into a pension scheme.

On the other hand, employees do need to be mindful of the annual allowances for pension contributions.

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They need to make sure they don't exceed the current level of £60,000 for the current tax year (2025/26) unless there is sufficient *carry forward* allowance available.

It's also worth noting that an employee's State Pension is determined by their NIC history.

Participating in a salary exchange scheme results in lower NIC payments, which could affect State Pension entitlement. This is a particular risk for lower-income earners – if salary exchange takes their earnings below the NIC payment threshold (£242 per week for the 2025/26 tax year).

What's happened?

Research conducted by HMRC and through government consultations (across 51 firms, 41 of which offered salary exchange) has examined potential modifications or restrictions to salary exchange, by testing three potential reforms:

1. NIC charges on the salary the employee exchanged
2. Removal of the income tax exemption for employees on salary exchange
3. Removal of the exemption on salary exchange above a £2,000 threshold.

Other proposals, such as a universal NIC cap on all salary-exchange benefits, a minor levy on pension funds, and standardised tax relief may also be evaluated.

The research aimed to:

1. Assess the effectiveness of salary exchange schemes
2. Review the potential impact of changes to tax and NIC regulations that could affect these schemes
3. Provide valuable insights for informed decision-making by policymakers and stakeholders.

The research found that motivations for employers when offering salary exchange included:

- Generating NIC savings for both employers and employees
- Benefiting from the flexibility of salary exchange, including the ability to vary pension contribution levels.

Those offering the benefit found it easy to administer. There was no real difference in terms of the *admin burden* and the majority did not *recycle* the NIC savings. Among those not offering the benefit, most had a basic understanding of how salary exchange works but were not always aware of the financial benefits.

All three scenarios tested received unanimous disapproval from employers. The second option was perceived as the most unfavourable, whereas the third option received some support from employers but for smaller amounts of exchanged salary.

The employer's perspective – having already seen NIC rises earlier this year – was that it would increase their costs. The ability to recycle NIC savings was viewed positively. Employers perceived that changes to salary exchange may reduce the future retirement savings of their people and was likely to affect employee morale.

Many see offering salary exchange as a valuable and appreciated arrangement. In some cases, staff had asked for it to be implemented.

Implications of any changes

Should the Government target salary exchange, the consequences could involve increased costs for employers, diminished take-home pay and contributions for employees, a heightened administrative burden, and possible effects on staff retention.

Any limitations or alterations to salary exchange in the forthcoming Budget are likely to have a direct impact on pension arrangements, potentially reducing tax efficiency and affecting both contribution levels and long-term retirement savings.

What should employers do at this stage?

Employers may want to:

- Review their existing scheme
- Conduct scenario testing on potential changes
- Communicate clearly with employees
- Reassess their benefit packages
- Review how the employer's NIC savings are currently used, and the impact if salary exchange were removed or savings reduced
- Seek expert guidance if necessary.

Get in touch with our experts

For further information, **contact the Employee Benefits consulting team** or your usual First Actuarial consultant.