PES
viewpoint

# How are employee benefits funded?


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Happy people. Happy business

# How are employee benefits funded?

## And what's changed following the 2017 Finance Bill?

Employee benefits are a great way to make people feel valued, engaged and happy. And the good news is that they don't have to cost the earth. There are three main funding options (with a few variations), each of which we present here. You can choose whichever approach works best for your business, or offer a combination of two or three.

- Benefit fund
- Core benefits
- Salary exchange (or sacrifice)

Of these, salary exchange has seen the biggest changes recently.

This is where employees 'buy' benefits in exchange for a reduction (or 'sacrifice') in their gross salary. Salary exchange can attract tax and National Insurance (NI) advantages, but since the Finance Bill 2017, the chancellor has reduced the number of benefits eligible for this type of tax treatment.

We'll say more about this later. For now though, do bear in mind that tax relief shouldn't be your first consideration when it comes to offering employee benefits. There are so many other advantages, from increasing employee motivation and loyalty, to offering a more competitive recruitment package and enjoying greater staff retention. In short, it makes business sense to invest in your employees.

Before we look at the implications of changes to salary exchange, let's take a look at the other ways in which you could fund your benefit scheme.

Employee benefits aren't primarily about tax relief. They offer a host of advantages including:

- increased employee motivation
- more competitive recruitment
- better employee retention

# A benefit fund (sometimes called a 'flex pot')

A benefit fund is a sum of money which you give to each member of staff specifically to pay for employee benefits. They can spend it however they like on a range of products, selected from a list determined by you. If you offer these benefits via an online platform, you'll make it really easy for employees to see at a glance what's on offer and how much they have to spend. You'll also be able to communicate with them quickly and easily, and measure accurately just how well people are engaging with your scheme.

A benefit fund has a host of advantages.

- You can give your employees a great selection of benefits to choose from – to boost their health, save money efficiently, look after their loved ones, or simply enjoy life more.
- Benefit funds are totally flexible, allowing employees to choose benefits that suit their lifestyle and interests.
- Take-up and engagement with the scheme are likely to be high.
- You can set the fund to match your budget (although make sure it has enough for staff to buy at least one or two benefits).
- The fund is quite separate from salary, so you have the flexibility to increase it (or not) at different rates to your normal pay review – which can be a handy way to help soften the blow when pay rises are low or non-existent. And benefit funds don't need to be included in pensionable pay, so you're not obliged to make employer pension contributions on any increase.
- Offering every employee the same fund levels the playing field, creating parity and leaving salary to reflect differences in seniority (although you can use different value funds for different levels of the organisation if you want something extra for senior staff).
- You can offer the fund on a 'use it or lose it' basis so that it's divided into a monthly spend which disappears if not used. This also encourages people to get involved with the scheme (although of course if they don't, you'll also save money).
- If you include your pension scheme in the fund, employees can use it to increase their contributions (subject to automatic enrolment rules and restrictions).
- Increases in provider premiums and/or Insurance Premium Tax (IPT) will need to be paid for out of the employee's benefit fund rather than directly by you, helping you to manage/fix budgets.
- A benefit fund that can't be exchanged for cash offers some tax advantages with certain benefits – read on to find out more.

Not all benefit funds are the same - some employers allow them to be redeemed for cash. We don't think this is a great idea because:

1. It deflects interest away from the benefits themselves. Whatever your reasons for investing in them, the object is defeated if people don't engage with the scheme.

2. Benefits create enthusiasm, loyalty and motivation among employees. They can also improve health and wellbeing (think about gym membership, for example, or health cash plans). This in turn could reduce absenteeism, a big cost for business owners and possibly one of the reasons for introducing the scheme in the first place.  All these advantages may be lost if you offer a straight swap for cash.

3. Employees may also miss out on tax efficiencies. Despite moves by HMRC to restrict tax advantages associated with some benefits through salary exchange, the rules don't apply to benefit funds, provided they can't be exchanged for cash.  Read on to find out more.

## Core employee benefits

Core benefits are paid for by the employer as part of the employee total reward package. Typically they include products like life assurance or private medical insurance. They are a straightforward cost to the business, but with a good return when well communicated. You can provide these benefits for all of your employees, or just for a selected group. Often they are perceived as important additions to salary, and in some sectors they make the difference between attracting the top talent or losing star players to the competition.

The best way to think of core benefits is as an investment in your company and its' people. You'll win hearts and minds by providing them. You may also save money by giving your employees faster access to high quality healthcare so they return to work quicker after an illness or accident.

For some smaller businesses, certain benefits may need to be core (rather than voluntary). With Private Medical Insurance, for example, the provider may require a minimum number of scheme participants in order to minimise risk.

Choosing a broker who's focused on giving you a high quality, personalised service will give you competitive group rates for products that are a good fit for your organisation.

Few businesses have the time to search the market for competitive pricing, product suitability and appeal to their workforce. The best brokers will make sure your investment works as hard as your employees.

## When core benefits don't pay

In the interests of balance, we should point out that there are some downsides to offering core benefits. Employees may value them less than benefits that they choose themselves. In fact, sometimes they don't even know they have them! Some may not need the core benefits you offer, but don't get around to opting out (Private Medical Insurance, for example, where they may already be covered by their partner's scheme). In all of these cases, you could be wasting money. What's more, if your employees have a contractual right to the benefit, then you're stuck with price increases that can be substantial.

So if you do offer core benefits, make sure your employees know about them so they can make informed choices. You can maximise their value and appeal by offering them via an online platform and encouraging employees to upgrade or add their partners (at their own cost or from their benefits fund).

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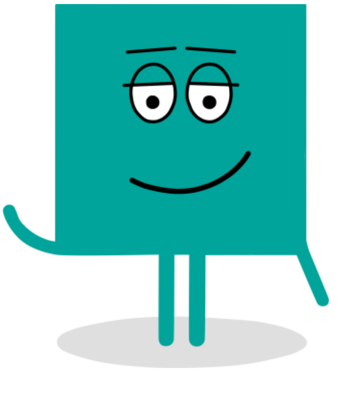


# Salary exchange, or salary sacrifice

And so to salary exchange. As we've already mentioned, this is a voluntary arrangement that allows employees to pay for the benefits they choose directly out of their salary, usually over a 12-month period. With some benefits, the reduction to gross salary after the benefit payment is taken means that the employee will pay less tax and NI (see cycle to work example below).

With salary exchange, you need to pay for the cost of the benefit initially, while your employee pays you back gradually over the repayment period. So you'll need to factor in the upfront cost of some benefits for cashflow purposes. Let's take a bike, for instance.

**Example**

You provide a cycle to work scheme which allows your staff to buy a new bike and accessories. The cost of the bike is £600. You pay for the bike upfront, while your employee pays the money back at the rate of £50 per month (with a 12-month agreement), which is covered by a reduction in their salary. During this period, the bike is effectively 'leased' from you.

Your employee pays tax and NI on their salary minus the £50 per month. You also pay less employer NI, based on the reduction in gross salary.

In this case, the benefit is like an interest-free loan for your employee. But it offers tax advantages for both of you.

Salary sacrifice works like this for other benefits too, although not all attract the same tax advantages. But the principle remains the same – you cover the initial cost of the benefit, which you reclaim directly from payroll over a longer period.

| | |
|---|---|
| Employee salary | £24,000 |
| Monthly gross salary | £2,000 |
| Value of bike | £600 |
| Monthly payment | £50 |
| Monthly gross (taxable) salary | £1,950 |
| Tax saving: £50 @ basic rate tax 20% | £10 pcm |
| NI saving: £50 @ 12% | £6 pcm |
| Employer NI saving: £50 @ 13.8% | £6.90 pcm |

## Mixing and matching

There's nothing to stop you funding your benefits with a mix of approaches. For example:

- two or three core benefits plus a benefit fund
- a benefit fund only
- voluntary benefits only (where they are all paid for by employees via salary exchange)
- core and voluntary benefits.

A benefit fund will always give employees the option to pay for extra benefits voluntarily. An example where all three options work together could be:

- You offer a health cash plan as a core benefit up to a certain level of cover.
- You also provide a benefit fund of £120 per year or £10 per month.
- An employee chooses to use their £10 to top up the health cash plan to the next level of cover.
- They also choose to buy a bike under a cycle to work scheme, which they pay for via salary exchange.

# What about the Finance Bill 2017?

Some benefits are not quite as tax-efficient as they once were, but we never advocate setting up a benefit scheme just to save tax. As we've been at pains to point out, employee benefits are primarily about keeping your employees happy, productive and engaged.

That said, good value for money is important, and there are tax advantages associated with certain benefits. The way you offer them also makes a difference. Let's take a closer look.

## 1. Core benefits / benefit funds with no cash exchange option

If you provide taxable benefits directly as core benefits, or if they are taken up via a benefit fund where no cash exchange is offered, there is no change to the way they are treated for tax purposes post-April 2017. Where there were tax advantages before, they still exist.

This increases the value of a benefit fund and makes popular, valuable benefits like health screening or parking eligible for further tax and NI savings – provided there is no cash option instead of the fund.

## 2. Salary exchange (or as HMRC now calls it 'Optional Remuneration Arrangements')

Salary exchange has long been viewed as a tax-efficient way of offering certain benefits. A reduction in gross salary, with its commensurate reduction in tax and NI for both employer and employee (depending on the benefit), has tempted many employers to take the leap.

However, the Finance Bill 2017 has changed this, stipulating that from April 2017, only some of these benefits will be eligible for this treatment (let's not forget, however, that a whole range of benefits have never been tax exempt, so in fact the new regulations have not had as dramatic effect as many have suggested).

## Benefits still eligible for tax relief

- Pension contributions
- Pension's advice
- Employer supported childcare vouchers
- Cycle to work schemes
- Ultra-low emission cars
- Registered group life schemes (considered to be a registered pension scheme)

## Benefits no longer eligible for tax relief

- Health screening
- Company cars (other than low-emission cars)
- Car parking at or near a place of work
- Mobile phones, computers and other technical equipment (where ownership remains with the employer)
- On-site Gyms
- Living accommodation
- Certain school fees
- Any group life cover provided outside a registered arrangement
- Group income protection

## Optional remuneration arrangements

HMRC now describes a taxable benefit paid for via a reduction in salary as an 'optional remuneration arrangement'. Tax will be payable on 'the amount foregone', which in layman's terms usually means the cost of the benefit (the insurance premium, for example, or the cost of gym membership), or the cash equivalent, if this is higher.

Benefits that are taxable can still be an attractive option for employees paying via their salary. Here are a couple of reasons why.

1. If you pay for the benefit upfront while your employee repays the cost over a period of time, it's equivalent to an interest-free loan (for a gym membership, for example).
2. If you're offering a life or health insurance product, you're likely to have group rates that are preferential compared to individual rates, making the premium lower for employees.
3. Employees can still save on some NI contributions when paying via their salary for non-exempt benefits.
4. Employees can access benefits easily.
5. By doing so, they can develop positive behaviours such as saving for the future and leading healthier lifestyles.

You can read more about this in our accompanying paper: 'Optional Remuneration Arrangements'.

# What does it all mean for you?

Choosing how to fund your benefits isn't overly complicated, but it still needs careful thought. The type of benefits you offer, and the way you offer them, will affect what they cost you, and may change the way you and your employees are taxed. So you need to consider what you want to achieve with your benefit scheme, and what kind of investment you're prepared to make.

Talking to experts is a good place to start. At PES, we know each business is unique and we assess each client's requirements carefully. We also stand by some clear principles.

Benefits are a great way to attract the best employees, keep them motivated and demonstrate how much you value them. They aren't primarily about making savings, although they need to represent good value for money, and some may give tax advantages. You may also save on recruitment costs by improving retention rates, and reduce sickness absence by providing good healthcare options.

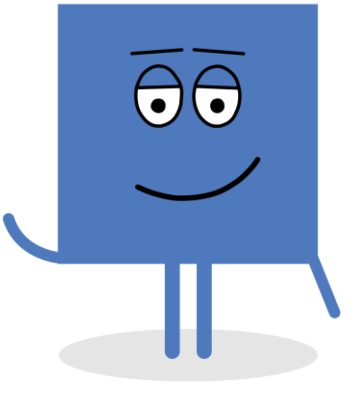
## Benefits and reward

But the important thing to remember is that benefits form an intrinsic part of your overall reward package. They help you to stand out as an employer of choice. They also encourage positive behaviours among your employees – such as staying healthy, keeping fit and saving sensibly for the future.

If you value these outcomes, then there are various ways of offering benefits cost-effectively. You can choose a method that suits your budget. Or if you already offer benefits, then you may feel it's time to review your scheme and how you fund it.

We make sure that employers have the right benefits scheme for their business and optimal funding arrangements. Taxation isn't our primary focus, so many of our clients have been unaffected by changes in legislation. Our main goal is to create the right conditions for a positive, engaged workforce –

because we know that happy people mean happy businesses.



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