Taxation Of Salary Sacrifices

By Dara Burke, ACA and John Ward, FCA

The Revenue Commissioners have always taken a hawkish stance on salary sacrifices, albeit often predicated on rather questionable assumptions. They have recently succeeded in bringing on to the statute book potentially far-reaching provisions designed to reflect their approach in practice. This article analyses these new measures and suggests that their effects do not always coincide with the Revenue's description of them.

Case Law Background

The term 'salary sacrifice', as the name suggests, typically denotes an arrangement under which an employee gives up part, or all, of their future cash remuneration in exchange for an alternative form of reward. Where the salary sacrifice is fiscally motivated, the alternative reward will usually take the form of what is hoped to be a tax-efficient benefit-in-kind. The crucial issue for the Courts has been whether or not the arrangement eliminated the remuneration in question from the general Schedule E charge under TCA 1997 s112 or its equivalent.

Case law establishes that there is a fundamental distinction between the alienation of income and the application of income. Thus, in *Dolan v K* ITR 656, a teaching nun remained liable under the equivalent of TCA 1997 s112 on her earnings, even though she was obliged to hand them over to her order. Similarly, in the earlier UK case of *Mahon v McLoughlin* 11 TC 83, the taxpayer was held to be taxable on that part of his earnings out of which he was obliged to pay the cost of his board and lodgings. Rowlatt J observed pithily:

> *If a person is paid a wage with some advantage thrown in, you cannot add the advantage to the wage for the purpose of taxation unless that advantage can be turned into money. But when you have a person paid a wage with the necessity – the contractual necessity if you like – to expend that wage in a particular way, then he must pay tax upon the gross wage, and no question of alienability or inalienability arises...*

In *Heaton v Bell* 46 TC 211, the taxpayer elected to join a scheme under which employees were provided with a car, in return for what was described as a weekly reduction of their wages. An employee could leave the scheme on giving two weeks' notice, after which the purported reduction would no longer operate. The House of Lords (Lord Reid dissenting) held that the 'reduction' was merely an application of the taxpayer's wages. Accordingly, it had to be added back to ascertain his gross remuneration under the equivalent of TCA 1997 s112. However, the facts in *Heaton v Bell* can be differentiated from the situation where the employer and employee enter into a legally binding variation to the employment contract prior to any changes being implemented. It may be noted that HMRC in the UK accept that such an arrangement represents an effective sacrifice/ alienation of income (see EIM42760).

However, a legally effective salary sacrifice would still not escape TCA 1997 s112 where the benefit concerned was regarded as being convertible into cash, following the principle laid down in the seminal case of *Tennant v Smith* 3 TC 158. In *Heaton v Bell,* a majority of the House of Lords expressed the view that even if the reduction in wages had not been an application of the taxpayer's earnings, the benefit of the car would have been convertible into money, because the taxpayer could have enjoyed additional wages by withdrawing from the scheme. This analysis was followed in the UK case of *Richardson v Worrall*; *Westall v McDonald* [1985] STC 693 where the taxpayer had the choice of having a benefit either

(i) incurred directly by his employer or

(ii) incurred by himself and subsequently reimbursed by his employer.

The Court held that because the taxpayer could have foregone option (i) and instead taken option (ii),

option (i) was thereby convertible into cash and was thus itself a taxable emolument falling within the equivalent of TCA 1997 s112.

The logic behind these decisions is that if the employee could not obtain the right to convert their benefit into cash remuneration at any time during a tax year, then the general charging provisions could not apply in that tax year. This analysis is reflected in the interpretation of the law adopted by HMRC in the UK, although arguably they espouse an even more liberal approach in practice (see www.hmrc.gov.uk/specialist/sal-sac-question-and-answers.htm).

The New Statutory Code in Ireland

TCA 1997 s 118B, inserted by FA 2008 s 21, is designed to provide a statutory basis for the tax treatment of salary sacrifices in Ireland. It takes effect from 31 January 2008, but applies also to salary sacrifice arrangements implemented prior to that date. It would appear highly arguable that its scope does not extend to foreign employments chargeable under Schedule D Case III (see TCA 1997 s 57, which only covers expense payments and benefits taxable under Schedule E).

For these purposes, a salary sacrifice is defined as any arrangement under which an employee forgoes the right to receive any part of the remuneration due under their terms or contract of employment, and in return their employer agrees to provide them with a benefit (TCA 1997 s 118B (1)). The term 'remuneration' is not defined for these purposes, but is clearly wider in scope than simply salary or wages, although inferentially it does not include benefits. In Tax Briefing 70, the Revenue Commissioners rather mysteriously observe:

> *"Remuneration is not restricted solely to cash remuneration, but includes all forms of remuneration arising from the holding of an office or employment. This includes bonus payments and any form of discretionary payment."*

Of course bonuses and other discretionary payments will normally take the form of 'cash remuneration', and it appears that the real point that the Revenue is attempting to make is that remuneration is not confined to regular salaries and wages.

Subject to express exemptions (see below), it is provided that any amount of remuneration foregone under a salary sacrifice is to be treated as taxable emoluments of the employee (TCA 1997, s 118B (2) (b)). Where TCA 1997 s 118B applies, this will of course also entail potential exposure to PRSI, Health Contribution and Income Levies.

The Revenue Commissioners state in Tax Briefing 70 that

> *"The legislation confirms Revenue's view that such arrangements have always given rise to a tax charge."*

However, this is highly tendentious. This article will accordingly proceed on the footing that TCA 1997 s118B supersedes and, in some cases, extends the scope of the previous law in respect of salary sacrifices. The Revenue Commissioners spell out their view of the scope of the new code unequivocally in Tax Briefing 70:

> *"If an employee forgoes any remuneration by way of any arrangement, either by changing the existing terms or contract of employment or creating new terms or [a new] contract of employment …the employee will remain taxable on their 'gross' …This includes bonus payments and any form of discretionary payment."*

It seems to the writers that the Revenue's assertions are almost certainly correct in the relatively straightforward situation where an employee agrees to an alteration to an existing service contract, as a result of which a benefit is provided in exchange for a reduction in salary, etc. Assuming that the sacrifice is legally effective and not reversible during the tax year, a charge would not have arisen under the general Schedule E charging provisions, as discussed above. On the other hand, TCA 1997 s118B will clearly not apply to discretionary payments, since there is no 'right foregone' in such cases.

Where the employee enjoys a so-called Flexible Benefit Package or Flexi-Plan Arrangement which allows them to select from a menu of alternative benefits up to a fixed ceiling based on the aggregate cost to the employer, it seems improbable that TCA 1997 s 118B could apply. This follows from the conclusion above that only sacrifices of 'cash remuneration' are within the scope of the legislation.

Considerable doubt must also attach to the Revenue Commissioner's proposition that the negotiation of entirely new contracts incorporating the provision of benefits rather than salary, etc. is also caught. Firstly, if the old contract is genuinely extinguished, there are by definition no subsisting rights to receive any remuneration under that contract. Secondly, it seems unlikely that the benefits under a new contract could normally be said to have been provided 'in return' for the remuneration received under the previous contract.

Computational Issues

A salient issue is the treatment of benefits which are obtained in return for a salary sacrifice, but which are themselves taxable. There is nothing in TCA 1997 s118B *per se* to exempt such benefits from the imposition of double taxation. TCA 1997 s 118, the general charging provision for benefits in kind, does not apply where the expense of providing the benefit is otherwise chargeable to income tax. However, TCA 1997 s 118B does not render the benefit taxable as such, but instead merely 'adds back' the amount of salary which has been foregone in order to obtain the benefit.

In Tax Briefing 70, the Revenue Commissioners attempt to square this circle by arguing that the effect of TCA 1997 s118B is to establish that the salary sacrifice is a mere application of income. Consequently, the benefit may be reduced by the amount of salary foregone, since this equates to an amount 'made good' by the employee towards the cost of providing the benefit. Again, there is nothing in TCA 1997 s118B itself to support this contention. As demonstrated by the prior case law, it is also inconsistent with general principles in cases where a legally effective salary sacrifice has in fact been entered into. However, since this benevolent analysis will generally remove the threat of double taxation, it is likely to remain uncontested. In effect, the employee will end up paying tax on the higher of the taxable value of the benefit (if any) or the amount of salary treated as sacrificed.

Example 1

An employer agrees with an employee currently earning €100,000 p.a., that it will provide them with non-qualifying childcare facilities in return for their permanently foregoing annual salary of €2,000; the cost to the employer of providing the facilities is €2,500. The employee's taxable emoluments will be computed as follows, adopting the Revenue's analysis:

	€	€
Revised Base Salary	98,000	98,000
TCA 1998 s118B emoluments		2,000
Benefit in Kind	2,500	
Less: TCA 1997 s118B emoluments	(2,000)	
		500
Total taxable emoluments		100,500

Example 2

Alternatively, if it is assumed instead that the cost to the employer of providing the facilities is only €1,800, the employee's taxable emoluments will be computed as follows:

	€	€
Revised Base Salary	98,000	98,000
TCA 1998 s118B emoluments		2,000
Benefit in Kind	1,800	
Less: TCA 1997 s118B emoluments	(2,000)	
		Nil
Total taxable emoluments		100,000

Example 3

Alternatively, if it is assumed instead that the facilities qualify for exemption under TCA 1997 s120A, the employee's taxable emoluments will be computed as follows:

	€	€
Revised Base Salary	98,000	98,000
TCA 1998 s118B emoluments		2,000
Benefit in Kind exempt	Nil	
Less: TCA 1997 s118B emoluments	(2,000)	
		Nil
Total taxable emoluments		100,000

Exempt Arrangements

TCA 1997 s 118B will not apply to salary sacrifice arrangements specifically approved by the Revenue Commissioners in relation to:

(i) travel passes issued by an approved transport provider under TCA 1997 s 118(5A);

(ii) exempt shares appropriated to employees and directors under an approved profit sharing scheme under TCA 1997, Pt 17, Ch 1;

(iii) bicycles and safety equipment within TCA 1997 s118 (5G).

These exceptions will however not apply if there is an arrangement or scheme in place whereby the employee is recompensed, wholly or partly, by the provision of the otherwise relevant benefit together with a compensating payment (TCA 1997 s 118B(4)). Furthermore, the exemptions will also be disapplied where a salary sacrifice agreement is entered into in respect of any right, bonus, commission or any other emolument which arises to an individual after the end of the year of assessment concerned (TCA 1997, s 118B(5)). Finally, the exemptions will not apply where an otherwise relevant benefit is provided to the spouse or dependant of, or a person connected with, the individual who has entered into a salary sacrifice arrangement (TCA 1997, s 118B (3)).

Conclusion

Although TCA 1997 s118B may not be as all-encompassing as the Revenue Commissioners claim, the onus in practice will be on the taxpayer to rebut their contentions. These provisions are therefore liable to inhibit opportunities for effective employee tax planning and, for those not fully alert to their import, could represent a very costly pitfall.

John Ward, FCA, FITI is Professor of Taxation at the University of Ulster. He was formerly a senior tax manager with one of the big four accounting firms in Dublin. He has contributed articles to virtually all of the major professional journals in the UK and Ireland and is the principal author of *Judge: Irish Income Tax*. Email: jd.ward@ulster.ac.uk.

Dara Burke, ACA, AITI is a principal of McAvoy and Associates, a specialist tax consultancy based in Cork. Dara has particular expertise in the areas of estate planning, property transactions, VAT and tax-efficient employment and pension arrangements. She has been a co-author of *Judge: Irish Income Tax* for several years and has contributed articles to both professional journals and the popular press. Email: dara.burke@mcavoy.ie.