

Vacation Lump Sum Deferral Explanation

Will my lump sum vacation payout be subject to taxes even if I want to have it tax deferred? If so, how much can I defer and what are the tax consequences?

Yes. Under IRS rules, lump sum payments are considered supplemental wages and are subject to Social Security and Medicare taxes even if your maximum contribution limit is greater than your vacation payout. Any federal income tax withheld will be at the IRS supplemental wage tax rate of 25%.

A portion of your pay to cover social security and medicare taxes must be available to withhold and cannot be tax deferred. As such this portion is subject to federal income tax withholding as well, decreasing the amount that can be tax deferred. When Payroll Services calculates the vacation pay for lump sum deferrals, a net pay of \$5.00 is computed to allow for any unforeseen rounding errors

To determine how much can be deferred, Payroll Services uses the following formula:

$$\text{Deferral amount} = [(\text{Vacation Pay} \times 0.6735) - \$5] \div 0.75$$

To illustrate, assume that it is determined your maximum contribution limit for the current tax year is \$20,000. It is further determined your vacation payout will be \$5,000. However, due to taxes, not all can be deferred. In plugging the vacation pay into the formula above, the most that will be deferred will be \$4,483.33.

Vacation Pay	\$5,000.00
Less:	
Social Security tax	(310.00)
Medicare tax	(72.50)
Federal Income tax	(129.17)
Tax Deferred Amount	(4,483.33)
Net Pay	\$5.00

The formula for calculating the federal income tax is:

$$\text{Taxable Wages} = (\text{Vacation Pay} - \text{Tax Deferred Amount})$$

$$\$5,000 - \$4,483.33 = \$516.67,$$

$$\text{Federal Income Tax} = \text{Taxable Wages} \times 25\%$$

$$\$516.67 \times 25\% = \$129.17$$

For W-2 reporting, \$516.67 will be included in Box 1 as taxable wages (total of social security, medicare and federal income tax + \$5). Box 12 will include the tax deferred amount of \$4,483.33.

For more information about tax deferred annuities, please go to the [Retirement Programs](#) webpage.