

**PUERTO RICO SUPREME COURT ISSUES OPINION ON TAXATION
OF SEVERANCE PAYMENTS – TREASURY ISSUES RELATED
GUIDANCE**

COMMENT

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ON DECEMBER 18, 2009, THE PUERTO RICO SUPREME COURT ISSUED A 57-page opinion (excluding two concurring opinions) in the case of *Orsini García v. Secretario de Hacienda*.¹ In *Orsini*, the Supreme Court held, that severance payments made to discharged employees pursuant to Puerto Rico’s Unjust Dismissal Act (Act No. 80)² are not subject to Puerto Rico income tax, and as such, not subject to Puerto Rico income tax withholding.

I. THE FACTS

After several years of employment, in 2003, Orsini was discharged by his Employer and was offered an amount in exchange for signing a release agreement, which Orsini accepted. Following applicable guidance from the Puerto Rico Treasury Department (PR Treasury), the Employer withheld Puerto Rico income tax from the payment and reported the payment and tax withheld to the PR Treasury.

Orsini originally included the payment in his Puerto Rico income tax return as taxable wages. He subsequently filed an amended tax return to exclude said amount from income and to request a refund of the tax withheld, on the basis that the severance payment did not constitute taxable income. The PR Treasury denied the refund request

Orsini filed a claim against the PR Treasury before the Puerto Rico Court of First Instance alleging that the amount received did not constitute taxable in-

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1 *Orsini García v. Secretario de Hacienda*, 2009 TSPR 190, 177 DPR ___ (2009).

2 Puerto Rico Unjust Dismissal Act, Act No. 80 of May 30, 1976, 29 L.P.R.A. §§ 185a-185m (2009).

come, as it was not remuneration for work performed or services rendered, nor was it a substitute for his salary. Orsini argued that the payment was for damages, and as such, it is excluded from the definition of gross income under Section 1022(b)(5) of the Puerto Rico Internal Revenue Code (PR Code).³ At the time of the dismissal, this section excluded from its definition of gross income, payments made on account of damages, including mental anguishes. On the other hand, the PR Treasury alleged that the payment was not made under Act No. 80, but instead, as a separation or severance payment and, as such, it was a payment of wages subject to Puerto Rico income tax.

Eventually, the matter reached the Supreme Court. The Supreme Court concluded that the separation payment received by an employee as a result of a dismissal is not subject to Puerto Rico income tax because the purpose of said payment is to compensate for the damages caused to the employee by the loss of employment. Specifically, the Court determined that payments received under a separation agreement that provides a release of unjust dismissal claims under Act No. 80 are to be presumed, despite express contractual language to the contrary, a payment for unjust dismissal under Act No. 80. Further, the Court held that payments made on account of unjust dismissal, under Act No. 80, are intended to compensate for the emotional and physical damages caused by the loss of employment. Lastly, the Court concluded that payments for emotional and physical damages are excludable from gross income, pursuant to Section 1022(b)(5) of the PR Code,⁴ and thus, exempt from Puerto Rico income taxation. The Supreme Court took into account the fact that the amount received by Orsini was the same amount as the severance payment he would have received had there been a wrongful discharge under Act No. 80.

With this opinion, the Supreme Court appears to be reversing PR Treasury's Administrative Determinations 05-02⁵ and 07-01⁶ which provide guidance regarding the specific content of settlement agreements and the various Puerto

³ Internal Revenue Code of Puerto Rico, Act No. 120 of October 31, 1994, 13 L.P.R.A. § 8001 *et seq.* (2009).

⁴ It is worth mentioning that the severance payment in *Orsini* was made prior to the amendment of the PR Code Section 1022(b)(5), which, effective on July 4, 2006, included the word "physical" in the exclusion from gross-income for amounts received on account of physical injury or physical illness.

⁵ PR Treasury, Administrative Determination No. 05-02 (2005) available at <http://www.hacienda.gobierno.pr/> (follow "Publicaciones" hyperlink; then follow "Determinaciones Administrativas" hyperlink; then follow "05-02" hyperlink) (on the tax treatment of payments made pursuant to an extrajudicial settlements).

⁶ PR Treasury, Administrative Determination No. 07-01 (2007), available at <http://www.hacienda.gobierno.pr/> (follow "Publicaciones" hyperlink; then follow "Determinaciones Administrativas" hyperlink; then follow "07-01" hyperlink) (on the Tax Treatment of Income Pursuant to the Award of an Action for an Employment-Related Damage or an Unjust Employment Termination).

Rico income tax consequences of severance and settlement payments, respectively.

II. AND NOW, WHAT?

On March 8, 2010, the PR Treasury issued Informative Bulletin 10-08 providing that *Orsini* does affect PR Treasury's Administrative Determinations 07-01, 08-04 and 08-13, regarding the taxability of Act No. 80 severance payments, the tax exemption of payments for emotional damages resulting from a physical injury, and the tax exempt treatment for certain voluntary special payments for discharge with just cause under Act No. 80, as amended by Act No. 278,⁷ respectively.⁸ The PR Treasury concludes that after amendments to PR Code Section 1022(b)(5), effective July 4, 2006, only severance payments made on account of a *physical injury or physical illness* are exempt from Puerto Rico income taxes (*i.e.*, that PR Code Section 1022(b)(5), as amended, includes non-physical damages). In light of the foregoing, and assuming that a severance payment is not made on account of physical injury, it might be advisable for employers to report payments for unjust dismissal, under Act No. 80, as taxable wages in a form 499R-2/W-2PR for Puerto Rico income tax purposes; although no Puerto Rico income tax withholding would be made.⁹

On the other hand, Informative Bulletin 10-08 does not address the Supreme Court's position that payments made pursuant to separation or settlement agreements, which mention Act No. 80 within their general release provisions, even if expressly rejecting the commission of any actions covered under Act No. 80, will be presumed to be payments covered under Act No. 80. Thus, PR Treasury Administrative Determination 05-02 seems to have been rendered inapplicable in such situations.

⁷ See 19 L.P.R.A. §§ 185b(d)-(f), as amended by Act No. 278 of August 15, 2008. (which provides tax-free treatment for Puerto Rico income tax purposes to certain payments made to discharged employees to the extent the discharge is due to, among others, full, temporary or partial closing of operations of the establishment, changes in the design or nature of the product or in the services rendered by the employer, or a reduction of volume of production, sales or profits).

⁸ See PR Treasury, Informative Bulletin No. 10-08 (March 8, 2010), available at <http://www.hacienda.gobierno.pr/> (follow "Publicaciones" hyperlink; then follow "Boletines Informativos" hyperlink; then follow "10-08" hyperlink).

⁹ It remains unclear if the same treatment applies to a payment under a separation or settlement agreement which includes a payment in lieu of a payment for unjust dismissal under Act No. 80.

III. WHAT ABOUT FICA?

Although *Orsini* cited the Supreme Court's decision in *Alvira v. SK & F Laboratories*,¹⁰ it did not specifically address whether the payment is subject to withholding of the Social Security and Medicare tax (collectively, FICA). At least two decisions have been issued by the U.S. District Court for Puerto Rico (District Court) after *Alvira* holding that payments under Act No. 80 are wages for FICA tax purposes.¹¹ Absent clear and binding guidance as to FICA tax, it is advisable to report a payment under Act No. 80 (or a waiver or settlement payment for such claim) (including, if applicable, a *gross-up* of the employee portion of the FICA tax) as taxable wages in a form 499R-2/W-2PR for FICA tax purposes. The employer will have to decide whether to *gross-up* the FICA tax withholdings on a payment under Act No. 80. The decision to *gross-up* the special payment is a determination that should be based on the employer's position regarding the need to pay the total Act No. 80 payment for unjust dismissal with no withholdings, after *Orsini*, and not on the taxable or tax-free nature of the payment.¹²

IV. REDUCTION IN FORCE PROGRAMS AFTER *ORSINI*

Generally, payments made under a reduction in force program (RIF) are within the scope of severance payments for dismissals with just cause.¹³ Special Payments are, by law, and irrespective of the decision in *Orsini*, not subject to Puerto Rico income tax, and must be reported in a form 480.6D for Puerto Rico income tax purposes. Such severance payments are subject to FICA tax withholdings and must be reported in a form 499R-2/W-2PR for FICA tax purposes.

If, for labor and employment law reasons, it is decided that the amount of the Special Payment to be made under a RIF will be equivalent to, and should be treated as, the amount payable for unjust dismissal under Act No. 80 (*mesada* payment), then the employer will have to decide whether to *gross-up* the FICA tax withholdings. Whether the employee must receive the total Act No. 80 payment for unjust dismissal with no withholdings in order to comply with Act No. 80 seems an issue still subject to debate after *Orsini*. The decision to *gross-up*

¹⁰ *Alvira v. SK & F Laboratories*, 142 D.P.R. 803 (1997) (concluding that payments for unjust dismissal under Act No. 80 constitute payments for damages which may not be subject to any withholdings).

¹¹ See *Cancio de Jesus v. Phillips Puerto Rico*, Civil No. 98-1147; see also *Rivera v. Baxter*, Civil No. 02-228; see also IRS Regulation on Employment Taxes and Collection of Income Tax at Source, 26 C.F.R. 31.3401(a)-1 (b)(4) (2010).

¹² It is noteworthy that the U.S. District Court for the Western District of Michigan recently concluded that severance payments "made because of the employees' involuntary separation from employment which resulted directly from a reduction in force or the discontinuance of a plant or operation" are not taxable for purposes of FICA taxes. See *In re Quality Stores, Inc., et al.*, 105 A.F.T.R. 2d 2010-1110 (W.D. Mich. 2010).

¹³ See Puerto Rico Unjust Dismissal Act, 29 L.P.R.A. § 185b(d)-(f) (2009).

the special payment is a determination that should be made by the employer on the basis of that need.

V. CONCLUSION

Orsini and Informative Bulletin 10-08 may seriously impact the negotiation and management of separation payments, severance programs, settlement agreements, and the withholding and reporting obligations under various statutes. Employers should revise all severance, separation, and settlement agreements to include specific language as to the nature of the payment(s) being made, the applicable tax withholdings and reporting requirements, and include a *hold-harmless* provision in favor of the employer regarding these matters.