

TAX and LABOR&EMPLOYMENT LAWALERT
March 22, 2010

**PUERTO RICO TREASURY DEPARTMENT ISSUES GUIDANCE ON TAX
TREATMENT OF SEVERANCE PAYMENTS UNDER ACT NO.
80AFTERPUERTO RICOSUPREME COURT DECISION IN ORSINI**

As discussed in our Tax and Labor & Employment Law Alert of February 4, 2010, on December 18, 2009, the Puerto Rico Supreme Court (the "Court") issued its decision in the case of Orsini García v. Secretario de Hacienda, 2009 T.S.P.R. 191. The Court held that a severance payment made to Orsini, an employee discharged in 2003 pursuant to the provisions of a separation agreement was, in fact, made: (a) pursuant to Act No. 80 of May 30, 1976 ("Act No. 80"), and (b) as such, in payment on account of personal damages and mental anguish; thus, not subject to Puerto Rico income tax.

Recently, the Puerto Rico Treasury Department ("PR Treasury") issued Informative Bulletin Determination 10-08 ("IB 10-08") to clarify the PR Treasury's position after Orsini. The PR Treasury concludes in IB 10-08 that severance payments made on or after July 4, 2006 are not automatically exempt from Puerto Rico income taxes. Only severance payments made on account of a physical injury or physical illness are exempt from Puerto Rico income taxes. Therefore, the decision in Orsini does not 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 278 of August 15, 2008, respectively.

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

Although Orsini cited the Court's decision in Alvira v. SK&F Laboratories, 142 D.P.R. 803 (1997), it did not specifically address whether the payment is subject to withholding of the Social Security and Medicare tax (collectively, "FICA"). On this matter, 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 Stroes, Inc., et al.*, 2010 WL 679136(W.D. Mich.).)

Orsini and IB10-08 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, or 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. We strongly recommend employers to discuss this matter further on a case by case basis with labor and tax counsel.

If you have any questions regarding the employment law implications of this case, or wish additional information regarding this matter, please contact any of the following attorneys of our **Labor&Employment Law Practice Group**:

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