

**DISMISSAL /SEVERANCE PAYMENT HELD INCOME TAX FREE**

The Puerto Rico Supreme Court recently held that an employee does not have to pay income tax for any amount she/he receives as part of a termination agreement that includes a release for wrongful discharge claims. *Orsini-Garcia v. Puerto Rico Treasury*, 2009 TSPR 190 (December 18, 2009). In doing so, the Court overturned the Puerto Rico Treasury Department's administrative determinations on this subject. The decision also contains expressions that may increase the cost of future employment releases, and creates uncertainty as to FICA and Medicare taxation of such payments.

**Case Facts**

After 18 years of service Orsini-Garcia was terminated from his employment with Pfizer on October 20, 2003. Upon termination, he received a payment of \$163,323.66 (less amounts withheld for Puerto Rico income taxes), in return for his signing a full release. Pursuant to the release, the employee waived all employment related claims against his former employer, including those for wrongful discharge under Puerto Rico's Law No. 80 of May 30, 1976, as amended.

Orsini-García subsequently requested a refund from the Puerto Rico Treasury, alleging the dismissal/severance payment was non-taxable income under Puerto Rico law. As expected the Treasury Department denied his request. The trial court agreed with the Treasury Department, finding the payment was taxable income for several reasons. First, it held the payment was not actually a Law No. 80 payment, but rather a payment made pursuant to a settlement agreement or contractual release. Second, it concluded the payment was not one for personal damages or sickness, which, at the time of the dismissal would be treated as a source of non-taxable income.

Orsini-García appealed the trial court's decision. The appellate court reversed. The Treasury Department then appealed to the Puerto Rico Supreme Court.

**Tax Free Reasoning**

The Supreme Court commenced by recognizing the payment in question was not expressly excluded from the definition of taxable income under the Puerto Rico Tax Code of 1994. The Court then surveyed the history of Puerto Rico's wrongful discharge legislation and found it reflected a concern in protecting employees from wrongful dismissals by progressively increasing the monetary indemnity available to dismissed employees under Law No. 80.

The Court also referred to its prior case-law which viewed a Law No. 80 discharge payment as an indemnification for the *damages* suffered by the employee due to a wrongful discharge. The Court then held that the nature of the indemnification does not change by making the payment pursuant to a release or settlement agreement. Moreover, that the dismissal payment in this case was not necessarily limited to the Law No. 80 amount would not alter this characterization.

Examining Puerto Rico's Internal Revenue Code (§ 1022), the Court found that a dismissal or severance payment (irrespective of whether paid pursuant to the terms of a release) could not be deemed taxable gross income as "salaries, wages, or compensation for personal services" nor "gains or profits and income derived from any source" for two reasons: (1) the amendments to both Law No. 80 and the Puerto Rico Internal Revenue Code which excluded wrongful discharge payments from deductions or withholdings *implied* that such payments were not taxable income, and (2) they must be treated as tax exempt compensation for a personal injury or sickness. Although the Court recognized that *after* Orsini-Garcia's dismissal the local Internal Revenue Code was amended to limit the income tax exclusion to *physical* injuries or sicknesses, the Court inexplicably maintained that its finding on the nontaxable nature of the dismissal payments will continue to apply (footnote 96).

## Other Court's Expressions

Also noteworthy are other Court expressions regarding several other matters that were not germane to the specific question presented on appeal. First, the Opinion seems to imply that the Law No. 80 indemnity payment cannot be validly "settled" for less than the full amount of the statutory indemnity (p.25-28). The Court stated, however, that in this case no issue related to the sufficiency of the payment had been raised.

An unexpected consequence of these expressions is that they open to challenge post employment termination waivers for less than the Law No. 80 indemnity. Further, if the employer only pays the amount required under Law No. 80, can the waiver be valid for other employment claims when no additional compensation is granted for such waivers? These questions will need to be answered in the future.

The Court also opened the door for future controversies by reiterating its prior statement that Law No. 80 payments are not subject to FICA taxation (p.39). In the context of this case, given the absence of information as to whether the dismissal payment exceeded the Law No. 80 indemnity, the Court's holding that the total amount paid cannot be deemed "wages" or "salaries" for Puerto Rico income tax purposes arguably can be carried over to FICA/Medicare tax obligations. In doing so, the Supreme Court places itself in conflict with the federal Internal Revenue Service's regulations that provide any payments made by an employer to an employee on account of the employee's dismissal constitute FICA/Medicare taxable wages, regardless of whether the employer is legally bound to make the payments. Treas. Reg. § 31.3401(a)-1(b)(4).

## Conclusion

In sum, the *Orsini-Garcia* decision has the following consequences:

- All dismissal, severance or discharge payments made to an employee pursuant to a release that includes a waiver of wrongful discharge claims under Law No. 80 are treated as non-taxable income for Puerto Rico income taxes purposes, irrespective of the *reason* for the employment termination or the *amount* of the payment.

- In the absence of a release, any dismissal or discharge payment made expressly to cover the Law No. 80 indemnity will similarly be treated as non-taxable income for Puerto Rico income taxes purposes. Whether a severance payment that is not tied to a release of Law No. 80 rights will receive the same tax treatment, is uncertain.

- Employers will need to examine with their legal counsel the potential exposure of not withholding FICA/Medicare taxes on such dismissal, discharge or severance payments.

- The Puerto Rico Treasury, as well as the IRS may now have to address the fiscal consequences of refund requests by taxpayers who have paid their income and FICA/Medicare taxes based on the prior understanding that similar dismissal or severance payments were taxable income or wages.

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**Note:** *Because of the general nature of this Labor Newsletter, nothing herein should be considered as legal advice or a legal opinion. For further information, please contact our labor and employment lawyers.*

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