

October 31, 2008

ADMINISTRATIVE DETERMINATION NO. 08-13

**ATTENTION: EMPLOYERS AND EMPLOYEES OF COMPANIES IN THE
PROCESS OF LIQUIDATION OR CLOSING DOWN OF BUSINESS
AND ADMINISTRATORS OF EMPLOYEE'S TRUSTS**

**SUBJECT: TAX TREATMENT OF CERTAIN PAYMENTS MADE PURSUANT TO
ACT NO. 278 OF AUGUST 15, 2008**

I. Statement of Motives

Act No. 278 of August 15, 2008 (Act No. 278) amended Article 7 of Act No. 80 of May 30, 1976, as amended (Act No. 80), for the purpose of considering as a special compensation, in certain cases of dismissal, any amount of money received by an employee as a product of the liquidation or closing down of business or business programs for sharing profits with employees. Additionally, Act No. 278 amended Article 10 of Act No. 80 and provided that said special compensation shall be exempt from the payment of income taxes.

The Department of the Treasury (Department) has received several inquiries regarding which payments are considered to be special compensation, their application, and how to report them.

This Administrative Determination has the purpose of informing what is considered a special compensation and its tax treatment, clarify its scope, effectiveness, and the manner in which employers or employee's trusts shall report it to their employees or participants. It also reiterates the tax treatment of other payments that are not considered special compensation.

II. Discussion

A. Amendments of Act No. 278 to Act No. 80

Article 7 of Act No. 80, as amended by Act No. 278, provides, as it is relevant in its pertinent part:

“In cases of dismissals based on **reasons (d), (e), and (f)** of Article 2 of Act No. 80 of May 30, 1976, as amended, any amount of money received by workers as a product of the liquidation or closing down of businesses or business programs for sharing profits with their employees shall be considered a **special compensation.**” (Emphasis provided).

Article 2 of Act No. 80 provides several circumstances in which it shall be understood that there was a just cause for the dismissal of an employee. Reasons (d), (e), and (f) of said article (Reasons (d), (e), and (f)) mentioned in Article 7 are:

1. full, temporary or partial closing of the operations of the establishment;
2. technological or reorganization changes as well as changes of style, design or nature of the product made or handled by the establishment, and changes in the services rendered to the public; and
3. reductions in employment made necessary by a reduction in the actual or expected volume of production, sales or profits at the time of the dismissal.

On the other hand, Article 10 of Act No. 80, as amended by Act No. 278, provides, as it is relevant:

“That compensation given to a worker for the liquidation or closing down of businesses or business programs for sharing profits with their employees when his or her dismissal is based on the **reasons stated in subsections (d), (e), and (f)** of Article 2 of Act No. 80 of May 30, 1976, as amended, **shall be exempt from the payment of income taxes**, but may include other deductions agreed to by the employer and the employee.” (Emphasis provided).

Article 3 of Act No. 278 provided that it “shall become effective immediately after its approval,” which was on August 15, 2008.

B. Nature of the Income

Subsection (a) of Section 1022 of the Puerto Rico Internal Revenue Code of 1994, as amended (Code), provides a broad definition of the concept of "gross income" and includes, among other items, gains, benefits, and income derived from salaries, wages, or compensation for personal services of any kind and in paid in any form. It also includes the profits or benefits and income derived from

any source. This concept is broadly and liberally interpreted to implement the intention of the legislator of taxing all profits or benefits, except those specifically designated as exempt in the Code.

Section 1141 of the Code defines the term "wages" as "all remuneration for services rendered by an employee to his or her employer, and all remuneration for the concept of pension for services rendered including the cash value of any remuneration paid by any means other than money". Any remuneration or compensation received for services rendered which is not a compensation for injuries or illness or due to a disability, shall be considered wages.

Among the exemptions from gross income provided in subsection (b) of Section 1022 of the Code, paragraph (5) excludes and exempts from taxation the amount of "...compensation for personal physical injuries or for physical illness, plus the amount of any damages received, in a judicial proceeding or extrajudicial transaction for said injuries or illness... and for occupational and non occupational disability..."

As a general rule, in a dismissal with just cause, such as dismissals for Reasons (d), (e), and (f), the employer is only responsible for paying his or her employees a compensation for services rendered up to the last day of work. This includes certain items that could be accrued up to said date and which the employee would be entitled to receive such as vacations, sick days, commissions, production or sales bonuses, and the Christmas Bonus.

Notwithstanding the aforementioned, it is common for an employer to pay an employee dismissed for Reasons (d), (e), and (f) an additional compensation in exchange for a liability waiver under the different labor laws on which a legal action could be based, including Act No. 80. Some examples of these additional payments are salaries in accordance with years of service or age, special bonuses, and acceleration of terms for the right to acquire stocks or options. These payments are made as a consequence of the dismissal, but not necessarily for the services rendered by the employee.

C. Business Programs for Sharing Profits with Employees

Pursuant to Article 7 of Act No. 80, as amended by Act No. 278, the special compensation includes the amount of money received from an employee profit sharing business program in the case of a dismissal for Reasons (d), (e), and (f). That is, the total distribution made as a result of the dismissal, from a plan established and maintained by the employer, which provides for profit sharing

with the employees. Said plan, whether a profit sharing or stock bonus, must be duly qualified by the Department in accordance with Section 1165 of the Code.

The plan must provide a specifically predetermined formula for prorating profits among its participants and for distributing the funds accrued under the same after a fixed number of years, upon reaching a certain age, or upon the occurrence of an event, such as unemployment, illness, disability, retirement, death, or separation from employment.

III. Determination

A. Exempt Special Compensation

In accordance with the amendments to Act No. 278, the special compensation received by an employee who has been dismissed with just cause for any of the Reasons (d), (e), and (f) due to the liquidation, closing down of business or distribution from an employee profit sharing plan, will be exempt from payment of income taxes and as such, shall not be subject to income tax withholding at source.

This special compensation will only include the additional payments received by the employee as a result of the dismissal for any of the Reasons (d), (e), and (f). The exempt special compensation does not include payments that the employee receives as wages for services rendered that have accrued up to the last day of employment, for example, vacations and Christmas Bonus. These payments are considered taxable wages subject to withholding.

The employer is required to itemize the payments made to the employee and to provide such employee with said information in order to be able to identify the exempt special compensation in case of a future audit.

In addition that the discharge need to be for any of the Reasons (d), (e), and (f), a real separation from employment is necessary. If the employee continues working for the employer with the same responsibilities or different ones, or in another capacity (i.e. professional services), it shall be understood that there was no such dismissal and the special compensation will be taxable.

B. Employee Profit Sharing Plan

In order for the distribution of a plan for any of the Reasons (d), (e), and (f), (whether profit sharing or stock bonus) to be considered as exempt special

compensation, said plan must be duly qualified by the Department in accordance with Section 1165 of the Code.

Additionally, the plan distribution must be as a result of a dismissal for one of the Reasons (d), (e), and (f) and shall be made within the twelve (12) months following the month in which the employee ceased working for the employer.

Distributions of plans other than profit sharing or stock bonus plans shall be taxable in accordance with the provisions of subsection (b) of Section 1165 of the Code. This includes defined benefit plans and plans with a cash or deferred arrangement, commonly known as 401(k) plans.

C. Other Compensation

The compensation received by an employee due to a dismissal without just cause under Act No. 80, better known as the “mesada”, is considered taxable gross income insofar as it is paid in consideration of the years of service rendered to an employer, and it has not been excluded from the definition of gross income by law. However, this severance payment will not be subject to income tax withholding at source in accordance with Article 1141(a)(1)(G)-1 of the Regulation promulgated under the Code and Article 10 of Act No. 80.

Likewise, payments received as economic compensation for damages of any kind or from any source, for reasons other than the exceptions of paragraph (5) of subsection (b) of Section 1022 of the Code, shall be considered taxable gross income; unless said compensation is specifically excepted by law. See Administrative Determinations No. 05-02 of June 10, 2005, No. 07-01 of January 12, 2007, and No. 08-04 of May 22, 2008.

D. Application

The exemption allowed for the special compensation received by an employee by virtue of a dismissal for any of the Reasons (d), (e), and (f) shall be applicable in case of payments made by employers or trusts **on or after August 15, 2008**, regardless of the date of the dismissal.

IV. Informative Statements and Presentation of Income in the Individual Income Tax Return

The special compensation paid by an employer in the cases of dismissals for Reasons (d), (e), and (f) will be informed to the employee and the Department on line 6 of Form 480.6D, Informative Return - Exempt Income.

In the case of profit sharing plans, when the distribution is made due to any of the Reasons (d), (e), and (f), the trust shall inform the distribution to the employee and the Department in Form 480.7C, Informative Return - Retirement Plans and Annuities. The trust will fill out boxes 11, 12, 13 (if applicable), 14, and 15 of the form and will indicate in the Distribution Code, the letter K corresponding to Act No. 80 together with the other applicable Code, whether Plan Termination (Letter E), Retirement (Letter A) or Separation from Service (Letter B). In box 12, Taxable Amount, it will indicate zero.

Any employee who receives the special compensation or distribution from a profit sharing plan for any of the Reasons (d), (e), and (f), shall indicate "Yes" in the question "Other tax exempt income" which appears in Box 1, of both the Short and the Long Form of the Individual Income Tax Return. He or she will include, along with said return, Form 480.6D, which shall be provided by his or her employer or trust.

Any other amounts or severance payments made under Act No. 80, not excepted by the amendments of Act No. 278, will be informed by the payor in the Informative Return - Income Not Subject to Withholding (Form 480.6A).

The employer-payor must also make sure that any payment of wages for services rendered accrued up to the last day of employment, such as vacation leave or of a similar nature, is informed in Form 499R-2/W-2PR, Withholding Statement, and that all the withholdings that are applicable under the Code are made.

This Administrative Determination complements Administrative Determination No. 05-02 of June 10, 2005, regarding tax treatment for payments received as a result of transactional agreements.

V. Effectiveness

The provisions of this Administrative Determination are effective immediately.

Cordially,

Ángel A. Ortiz García
Secretary of the Treasury