

Puerto Rico's Taxation of Severance Payments

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Employers considering reductions in force in Puerto Rico should be aware that the rules on the taxation of severance pay in the United States and Puerto Rico are different.

The U.S. rule is straightforward: severance pay is always taxed as wages. Therefore, as the Internal Revenue Service (IRS) instructs in "[IRS Publication 4128, Tax Impact of Job Loss](#)" and "[Publication 525, Taxable and Nontaxable Income](#)," it is included in an employee's Form W-2 and is subject to the withholding of both federal income tax and Federal Insurance Contributions Act (FICA)/Social Security taxes on wages. In Puerto Rico, however, severance pay is largely, and often totally, exempt from the withholding of local income tax, but it is still subject to the withholding of FICA taxes.

Puerto Rico's Tax Rule

Pursuant to Sections 1031.01(b)(15) and 1062.01(a)(1)(G) of the Puerto Rico Internal Revenue Code of 2011, severance pay that a discharged employee receives by reason of his or her dismissal, regardless of whether the dismissal was with just cause, is exempt from the withholding and payment of local income tax up to a maximum amount equal to the compensation the employee would have been entitled to receive under the local unjust dismissal pay law, commonly known as "Act 80," had the dismissal been without just cause. Severance pay in excess of the Act 80 unjust dismissal amount is fully taxable as wages.

As in the United States, severance payments made to Puerto Rico employees are always subject to the withholding and payment of FICA taxes.

Illustration: In connection with a legally compliant dismissal, a Puerto Rico employee receives a severance payment of \$25,000. Assuming that the dismissal was unjust for Act 80 purposes, the employee would have been entitled to an Act 80 amount of \$15,000. Therefore, the first \$15,000 is exempt from the withholding and payment of Puerto Rico income tax, whereas the remaining \$10,000 is taxed as wages. The entire \$25,000 is subject to FICA taxes.

Severance Pay

Severance pay includes any payments that an employer makes to a current or former employee, either voluntarily or in compliance with a court order or settlement agreement, as a direct

consequence of the employee's dismissal or termination of employment, but excluding:

- benefits and compensation for services rendered, such as wages, performance bonuses, and sales commissions;
- liquidation of vacation and sick pay accrued up to the last day of employment;
- pensions and other retirement benefits; and
- distribution of deferred compensation.

Severance pay may be paid in a lump sum, installments, or periodic payments, pursuant to an Employee Retirement Income Security Act-covered severance plan, a payroll program or practice, or an employment contract.

Act 80 Amount

Again, only the portion of severance pay that does not exceed the unjust dismissal amount otherwise payable under Act 80 is exempt from local income taxation. Interestingly, the "Act 80 amount" varies depending on the employee's hire date with the employer, as follows:

Employees hired on or before January 26, 2017:

1. For employees who at termination of employment have less than five years of service with the employer, the Act 80 amount equals two months' salary plus one week's salary per each full year of service.
2. For employees who at termination of employment have between 5 and 15 years of service with the employer, the Act 80 amount equals 3 months' salary plus 2 weeks' salary per each full year of service.
3. For employees who at termination of employment have over 15 years of service with the employer, the Act 80 amount equals 6 months' salary plus 3 weeks' salary per each full year of service. For these employees, "salary" means the highest salary or wages within the three years immediately preceding the date of termination.

For employees hired on or after January 27, 2017, the Act 80 amount equals three months' salary plus two weeks' salary per each full year of service with the employer. For these employees, "salary" means the highest salary or wages during any 30-day period within the immediately preceding year, and their Act 80 amount is subject to a cap equivalent to 9 months' salary.

Puerto Rico Tax Reporting

The portion of severance pay on or below the Act 80 amount is reported as tax-exempt salary pay in Box 16 of the employee's local Form W-2 (officially named "Form 499-2/W-2PR, Withholding Statement") under the compensation code "I," compensation or indemnification paid to an employee due to dismissal under Section 1031.01(b)(15) of the tax code. The taxable portion of severance pay is included as part of the employee's regular wages in Box 7 of the local Form W-2, Wages.

Local Form W-2 must be filed electronically with the Puerto Rico Department of the Treasury (commonly known as “Hacienda”) through its online portal, [*Sistema Unificado de Rentas Internas or SURI*](#), by January 31 of the following year.

Overwithholding Corrections

If an employer inadvertently withholds Puerto Rico income taxes on the portion of severance pay on or below the Act 80 amount, and such taxes cannot be returned to the employee because they have already been deposited with Hacienda, the proper correction procedure is to report the tax-exempt amount in Box 16 of Form 499-2/W-2PR, as described above, and the local taxes withheld in Box 13 of the employee’s Form 499-2/W-2PR. If the local individual income tax return for the year in which the severance payment has been completed, the employee will be able to request a refund of the amount overwithheld.

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