

Severance Settlement-related Taxation Issues

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I. Introduction

Unfair dismissals are often resolved through a severance settlement between the company and the dismissed worker, but new conflicts often arise over taxation issues. I recently handled a similar situation. On February 15, 2022, a case for unfair dismissal was filed on behalf of two dismissed employees. In this case, an oral proposal was developed between the company and the dismissed employees as an out-of-court settlement which included a severance payment equivalent to 8 months of salary. In response to this, the company's attorney wrote and sent an agreement which stated that 30% in earned income tax for wages would be deducted from the severance settlement. The employees objected to the company's tax decision and requested that the severance agreement be tax-free as consolation pay for termination of employment. The company asked its certified public accountant about the taxation method for a severance settlement. Accordingly, the certified public accountant contacted the National Tax Service about how to handle taxation on a severance settlement that is relief for unfair dismissal. The National Tax Service responded that if the amount was paid as a condition for withdrawing the lawsuit, it should be regarded as reward money, which would be taxed according to "other income" rules, which would mean it would be taxed at 22%. In response, the dismissed employees argued that the company treated it as "other income" because they wanted to avoid any sort of legal risk despite the fact that it could be non-taxable if the company handled it as compensation for forced termination, and negotiations between the two sides broke down. The company and employees attended a hearing on June 3, 2022 for the Labor Commission's decision. Judges at the Labor Commission understood that both parties, labor and management, had an intention to reach an agreement on this dismissal case, but that they could not reach one due to taxation issues. The judges did not render a decision on the hearing day and gave both parties an additional week to come to an agreement. During this period, the company made a final proposal that included 8.5 months' salary as compensation and

applied for it to be taxed as retirement income. The employees accepted this proposal and an agreement was reached.¹

Here, I would like to examine the taxation methods for earned income, retirement income, other income, and when income related to a severance settlement is untaxable, and then look at related precedents to confirm which taxation method should apply.

II. Types of Taxation for Severance Settlements (Earned Income, Retirement Income, Other Income, Non-taxable)

1. Earned income

“Earned income” refers to salary, money, remuneration, wages, bonuses, allowances, and payments of a similar nature received for providing work (Article 20, Paragraph 1, Item 1 of the Income Tax Act). Unlike business income, earned income is generally generated by those who provide work and receive payment in a subordinate position to others.² Regardless of the name, anything with a “similar nature” is taxed as earned income. The scope of earned income includes not only general wages, but also all income received by workers from employers, except for tax-free items and retirement income on the premise of retirement (Article 38 of the Enforcement Decree to the Income Tax Act).

The tax base, excluding personal exceptions and various income deductions from wage and salary income, is applied as: ▲ 6% for up to KRW 12 million ▲ 15% for more than KRW 12 million and up to KRW 46 million ▲ 24% for more than KRW 46 million and up to KRW 88 million ▲ 35% for more than KRW 88 million and up to KRW 150 million ▲ 38% for more than KRW 150 million and up to KRW 300 million ▲ 40% for more than KRW 300 million and up to KRW 500 million ▲ 42% for more than KRW 500 million and up to KRW 1 billion won ▲ 45% for more than KRW 1 billion.³

For example, if the severance settlement is KRW 120 million, the total amount of tax due would be KRW 52,153,200, with KRW 47,412,000 being earned income tax and KRW 4,741,200 being 10% local income tax. The total tax bill comes to 43.4%

¹ Seoul Labor Commission decision on June 10, 2022, 2022buhae631.

² Lee, Changhee et al., 「Tax Law」, KNOU Press, 2017, p. 162.

³ *The Chosun Ilbo*, “Employee income tax has increased by 39% since the Moon Jae-in administration took office.” Feb. 13, 2022.

of the total amount received, reducing the actual amount received to KRW 67,846,800.⁴

2. Retirement income

“Retirement income” refers to income paid by an employer to a worker due to that worker’s retirement (Article 22, Paragraph 1, Item 2 of the Income Tax Act). This includes severance pay, honorary retirement pay and severance benefits as a result of corporate restructuring.⁵

Retirement income enjoys significant reductions in taxes owed as a way of protecting retirees’ ability to provide for themselves in their old age. Retirement income tax varies depending on the number of years of service, but comes to a maximum of 24%.

		Retirement income				(Number: KRW)	
Years	Severance Settlement	KRW 50 million	Deduction (plus 10% resident tax)	KRW 150 million	Deduction (plus 10% resident tax)	KRW 300 million	Deduction (plus 10% resident tax)
	5 years		2,810,000	6.2%	23,320,000	17%	65,170,000
10 years		1,610,000	3.5%	12,740,000	9%	46,370,000	17%
20 years		650,000	1.4%	6,420,000	5%	24,900,000	9%
30 years		160,000	0.4%	4,030,000	3%	15,190,000	6%

For example, if the retirement allowance for an employee with five years of service is KRW 120 million, the actual tax on that retirement income would be KRW 12,342,500 plus 10% local income tax of KRW 1,234,750, for a total tax bill of KRW 13,576,750. This means that 11.3% of the total amount is deducted as Retirement Income tax, and so the actual amount to be paid is 106,423,250 won.⁶

3. Other Income

“Other income” refers to income other than interest income, dividend income, business income, earned income, pension income, retirement income and capital gains (Article 21, Paragraph 1 of the Income Tax Act). If the employer pays the severance settlement in good faith to end the employment relationship early, it is regarded as reward money belonging to “other income,” and means a 22% tax

⁴ Refer to the KangNam Labor Law Firm app: Automatic calculation of Retirement Income tax: <https://k-labor.co.kr/main/auto4.html>

⁵ Lee, Changhee et al., 「Tax Law」, KNOU Press, 2017, p. 168.

⁶ Refer to the KangNam Labor Law Firm app: Automatic calculation of Retirement Income tax: <https://k-labor.co.kr/main/auto4.html>

bill. However, if the amount is paid as compensation for emotional or status damage, it is not taxed.⁷

For example, if the retirement settlement amount is KRW 120 million, KRW 26,400,000, or 22%, is deducted as tax on other income, with the actual amount received totaling KRW 93,600,000.

4. Non-taxable Income

Compensation received due to a breach or cancellation of a contract is considered “other income” (Article 21, Paragraph 1, Item 10 of the Income Tax Act). However, in relation to a severance settlement, the amount received as compensation for damages or consolation money for damage to the freedom or honor of another person or inflicting mental pain, etc., is not taxable.⁸

III. Major Cases on Taxation of Severance Settlements

One example of a case of unfair dismissal recognized the severance settlement as non-taxable, while another decided a 22% tax rate applied to a severance settlement as “other income.”

Judicial guidelines for the relevant cases:

(1) If a settlement has been reached in a lawsuit, stating that the employer pays a certain amount to the worker, and that the worker gives up the rest of the claim during litigation, the amount paid should be viewed as dispute settlement money agreed to instead of giving up his/her claims. Even if the settlement amount was calculated by the employee's wages, it cannot be regarded as wages or severance pay.⁹

(2) The “reward money” stipulated as “other income” in Article 21 (1) 17 of the Income Tax Act means money and goods paid as a courtesy in relation to handling office work or providing services, etc. The decision must be made after comprehensively considering the motive and purpose for seeking that money, the relationship with the other party, and the amount.¹⁰

⁷ National Tax Service Administrative Guidelines, Income, Income Tax Division-1126, Nov. 8, 2010.

⁸ Song, Gae-dong, “Damage Compensation and Tax Law,” Tax Law Research, Nov. 2004, p. 82.

⁹ Supreme Court ruling on Mar. 31, 2022, 2018da237237.

¹⁰ Supreme Court ruling on Sep. 13, 2013, 2010du27288; Supreme Court ruling on Feb. 9, 2017, 2016du55247.

1. A case in which severance settlement was recognized as non-taxable¹¹

(1) Facts

In December 2015, Director A, who was in charge of public relations for Qualcomm Korea, was fired for disclosing the contents of the Fair Trade Commission investigation into the company to the media without the company's prior approval. Accordingly, in March 2016, Director A filed a lawsuit against the company, claiming the dismissal was invalid. The court recommended that the company reconcile with Director A and pay an additional KRW 500 million to Director A. The company and Director A did not object to this, so reconciliation was finalized in October 2016. At the time of his dismissal, Director A was paid over KRW 200 million a year, and he had about 13 years left until retirement.

The company applied a tax rate of 22% to the reward money as "other income without necessary expenses" under the Income Tax Act. Of the KRW 500 million payment, KRW 110 million was withheld and KRW 390 million paid to Director A. Accordingly, Director A applied for a debt collection order to the court, saying that the collection of income tax and local income tax was unreasonable because the settlement amount was considered non-taxable income. The court accepted his argument.

(2) Understanding the judgment and related criteria

1) "Reward money," defined as "other income," means money and/or valuables paid as a courtesy in connection with handling office work or providing services (Article 21 (1) 17 of the Income Tax Act). Whether this falls under "other income" should be determined after comprehensively considering the motive and purpose for giving and receiving money or valuables, the relationship between the parties, and the amount of money.¹² In addition, even if the money and valuables seem to be paid out as administrative processing, etc., if they contain a nature that cannot be regarded as reward money in reality, none will be regarded as reward money.¹³

2) This judgment maintained the decision of the High Court during the original trial. "The payment of reconciliation money to the plaintiff is only in accordance with the binding force of the decision to recommend reconciliation in this case,

¹¹ Supreme Court ruling on Mar. 31, 2022, 2018da237237.

¹² Supreme Court ruling on Sep. 13, 2013, 2010du27288. Supreme Court ruling on Feb. 9, 2017, 2016du55247.

¹³ Supreme Court ruling on Jan. 15, 2015, 2013du3818.

and it is difficult to see that the plaintiff should be made to express “Thank you for early resolution of this dispute” to the defendant. The lawsuit was filed on March 7, 2016, and the decision to recommend reconciliation was made after the closing of pleadings and was finalized on October 22, 2016, so it is difficult to say that the dispute between the plaintiff and the defendant was resolved early.¹⁴

3) Therefore, the issue is whether or not the legal nature of this severance settlement is as “reward money” equivalent to “other income.” It may be other income if the employee agrees to a severance agreement to end the lawsuit, and the employer pays in return for this. However, in the process of the plaintiff arguing that his dismissal was unfair, the settlement money following the court's recommendation for mediation cannot be considered other income because it cannot be said to be an expression of appreciation by either party. Therefore, this severance settlement is tax-exempt as it is not earned income, retirement income, or other income.

2. A case in which severance settlement was recognized as reward money and other income¹⁵

(1) Facts

1) The worker was hired by STX Engine Co., Ltd. in Changwon on May 10, 2004, and was fired on February 28, 2014. The worker applied for remedy against unfair dismissal with the Labor Commission, but was rejected on April 28, 2014. The employee then appealed to the National Labor Commission, where a mediation by the judgment committee resulted in reconciliation between the worker and employer. “The worker confirms that the employment relationship with the company has been effectively terminated as of February 28, 2014, and the company shall pay the worker KRW 25,302,000 (before tax), which is 6 months’ salary, as a dispute settlement by August 22, 2014. The parties agree not to raise any civil, criminal or administrative claims in the future in relation to this case, and to keep the details of this settlement confidential and never to disclose it to outside parties.”

2) On August 22, 2014, the company regarded the settlement money of KRW 25,302,000 as “reward money” under “other income,” and withheld 20% for income tax (KRW 5,060,400) and 2% for local income tax (KRW 506,040), for a total

¹⁴ Original ruling: Seoul High Court ruling on May 10, 2018, 2017na 2073137.

¹⁵ Supreme Court ruling on July 20, 2018, 2016da17729.

tax withholding of KRW 5,566,440. The balance of KRW 19,735,560 was paid to the worker.

3) The worker filed a lawsuit arguing that the settlement money in this case was not subject to taxation.

(2) Understanding the details of the judgment and the related criteria

1) “In the settlement of this case, it was confirmed that the employment relationship with the company was effectively terminated as of February 28, 2014, the date of dismissal of the employee, and the nature of the settlement money in this case is specified as dispute settlement money and in this case is only received on the premise that the dismissal dispute has been resolved due to mutual agreement, and cannot be said to be earned income paid on the premise that the employment relationship continues. However, the company is paying the settlement money in this case as an example of helping to resolve the dispute regarding unfair dismissal claims quickly and amicably, such as by giving up on reinstatement and salary claims and not raising any objections in the future. So, the settlement money in this case is considered “reward money” under “other income” in Article 21 (1) No. 17 of the Income Tax Act.”

2) The original trial court in this case said, “It cannot be said that the reconciliation money paid by one party while making mutual concessions and compromises in the course of a fierce legal dispute is not a gift to be paid as an expression of gratitude.”¹⁶ However, the Supreme Court regarded the severance settlement in this case as dispute settlement money and determined it as other income. In this case, there is criticism that the Supreme Court did not provide clear criteria for determining the severance settlement amount.¹⁷

IV. Conclusion

In legal disputes, such as relief applications against an employer for unfair dismissal or a lawsuit to confirm the invalidity of a dismissal, the employer pays the employee a severance settlement and the employee withdraws the application for relief in return. If this severance settlement is paid as compensation for emotional damage, it can be regarded as dispute settlement money and excluded from taxation. However, in many cases, the National Tax Service considers

¹⁶ Changwon Regional Court ruling on Mar. 24, 2016, 2015na9657.

¹⁷ Kang, Jihyeon, “Review of the 2018 Framework Act on National Tax and Income Tax Act,” Tax Law Research (25-1), Apr. 2019, p. 258.

severance settlements as “other income” (reward money) under the Income Tax Act when the lawsuit is withdrawn by agreement between the two parties to the dispute.¹⁸

The actual amount a worker receives of a severance settlement depends largely on which taxation method the employer applies. Assuming that an employee with 10 years of service was dismissed and could receive KRW 100 million as a severance settlement, the employee expects that KRW 100 million will be deposited into his or her bank account. However, as a withholding agent, the employer must deduct tax and pay it to the National Tax Service. If the tax item is treated as earned income, the employee will receive only KRW 58,158,200 after KRW 41,841,800, or 42% is deducted for tax. However, if the settlement money is treated as other income, the employee will receive KRW 78 million after KRW 22 million (22%) is deducted for tax. If this part is treated as retirement income, only KRW 5,024,523, or 5%, is deducted for tax, and the employee will receive KRW 94,975,477. If the termination settlement agreement is paid as compensation for emotional damage, it is not taxed. Therefore, even though an agreement is reached in a dispute over dismissal, another potential source of conflict appears regarding what tax is applicable. In this regard, when drafting a settlement agreement, one way of avoiding this potential dispute is for both parties to agree on the actual amount of the settlement money that will be deposited into the employee’s bank account.

¹⁸ National Tax Service Administrative Guidelines, Income, Withholding Tax Division-152, Mar. 26, 2012; Income, Income Tax Division-1126, Nov. 8, 2010; Choi, Jinsoo, Jeon, Youngjun, “HR and TAX”, Labor Law, May 2014, pp. 87-88.