

MEXICO

Ritch Mueller



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The transactional impact of Mexico's labour reform

Oscar López Velarde and Ximena García of Ritch Mueller discuss how Mexico's labour reform will substantially alter how corporate groups operate and how foreign investors do business.

According to the Mexican Constitution, domestic employees have the right to receive a profit share from their employers. This share, referred to in Spanish by the acronym PTU, is a percentage of the employer's yearly taxable income, excluding NOLs.

The PTU percentage has been set at 10%, which is extremely high, particularly for capital intensive industries. As such, most companies in Mexico have usually set up dual organisational structures, in order to park their revenues in a company with no employees while hosting employees in another company that offers personnel services to the former.

Over the past two decades, this 'insourcing' structure evolved to 'outsourcing', whereby the company contracts employees from third party services. However, it has become a systemic way to avoid taxes, notably payroll taxes and social security contributions.

Seeking to curb these practices, President Andrés Manuel López Obrador presented a bill to prohibit both the insourcing and outsourcing of personnel. Following intense discussions between the government, unions and the private sector, the labour reform was approved by Congress in April 2020. It includes changes to the Federal Labour Law (FLL), Social Security Law, National Workers Housing Fund Law, Federal Fiscal Code (FFC), Mexican Income Tax Law (MITL) and the Value-Added Tax Law (VATL).

This reform will alter substantially how corporate groups operate and how foreign investors do business in Mexico, by breaking the accepted dichotomy between 'operations' and 'services' companies.

The main changes of the labour reform are the following:

- As a general rule, subcontracting personnel is prohibited, either with third parties or with other entities of a same group;
- Subcontracting personnel is defined as "the act of providing or making available employees for the benefit of another

entity"; therefore, it does not cover all services subcontracted by employers or taxpayers;

- Subcontracting personnel, which in principle is prohibited, is still permitted if related to specialised services or specialised work beyond the corporate purpose or main business activity of the contracting party. Entities rendering such services or work must be registered before the Labour Ministry.

The labour reform has some positive outcomes, especially with regards to the PTU. This will now be capped to the highest between either the sum of three months of the employee's salary or the average of PTU paid to such employee in the last three years.

Additionally, there are a number of fiscal changes, such as:

- The denial of income tax deduction and VAT creditability of subcontracting payments, renders subcontracting prohibitive;
- The application of higher-compliance requirements in connection to personnel services providers; and
- The possibility to equal non-complaints with qualified tax fraud offenders.

Although this is the first time that various tax law bodies include simultaneous changes in connection with illegal personnel subcontracting, the Mexican tax authorities' negative views on outsourcing have been forged over several years. While the provision was repealed, the VATL included a 6% withholding on payments related to personnel that was made available to the contracting party or to its related parties, regardless if under its direction, supervision, coordination or dependency; in opposition to those employees contracted directly which were not subject to withholding.

Subcontracting personnel for specialised services also carry new compliance obligations: services providers will need to register as such before the Labour Ministry by August 21 2021.

Once this registry is completed, the provider will obtain a specific ID for every specialised service rendered, which will have to be included in every agreement signed with their contractual parties. Nevertheless, the greatest challenge of this registry will be the negotiation among parties and the type of indemnities to be included in case of breach, especially considering that the Labour Ministry will be monitoring constantly registered specialised services outside the core business of contracting companies.

It should be noted, though, that not all services are prohibited, only that implying the provision of personnel to render core business services, which fall into the sub-

contracting definition. Consequently, many types of services are not covered by the labour reform. However, any corporation that has been subcontracting personnel services will need to check thoroughly whether their personnel structure complies with the reform's requirements. This could involve registering as an employer, relocating employees among entities and fulfilling labour-tax obligations.

Ignoring this analysis could have serious negative consequences, such as being denied income tax deductions and VAT creditability, as well as damaging relations with providers and other third parties. Worse still, non-compliant entities may be signaled as a tax fraud offender, which entails criminal implications.

Investors looking for opportunities in Mexico will have to set up structures considering that employees need to be hired by the operative entities and all target companies will need to comply with the new legislation.

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