THE EXECUTIVE REMUNERATION REVIEW

Sixth Edition

Editors
Arthur Kohn and Janet Cooper

THE LAWREVIEWS

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SIXTH EDITION

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Arthur Kohn and Janet Cooper

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MEXICO

Alejandro Santoyo and Francisco J Peniche Beguerisse[1]

I INTRODUCTION

The Mexican legal system has been subject to a considerable number of changes. Congress has approved a major reform to the Federal Labour Law, and also recently approved major reforms in the energy, tax, antitrust and bankruptcy sectors.

These reforms have triggered international corporations to look again at Mexico as an investment alternative, which is resulting in the implementation of a more complex structure of compensation for executives in Mexico. Similarly to many countries that have recently been targeted by international investors, there is a trend in Mexico to change the current short-term structure into a medium or long-term structure.

Even though a special set of laws or a special area of law does not apply to the compensation and remuneration of executives in Mexico, special sections within Mexico's laws delimit executive remuneration and the applicable structures. We also believe that new legal precedents will be issued in the short or medium-term that will provide investors and executives with more certainty, especially in the employment and tax fields.

Below, we detail some of the most important changes in the tax and labour laws that have a direct impact on the compensation structures of executives in Mexico.

II TAXATION

i Income tax for employees

There are two scenarios in which individuals could be subject to tax in Mexico for income earned as executive compensation: where individuals are regarded as being resident in Mexico; and where individuals are not Mexican residents, but have earned income considered to have derived from a Mexican source.

Generally speaking, individuals who have established their abode in Mexico should be regarded as Mexican residents (regardless of the number of days they spend in Mexico). In cases where individuals also have abodes in other countries, a tiebreak rule regarding the centre of vital interest of such individuals should be applied.

In the case of international staff who maintain their abode in their home country, a further analysis must be made with respect to any tax treaty provisions, in which case, the tiebreak rules may lead to a different outcome than those under the domestic tax rules to define such staff's tax residency.

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1 Alejandro Santoyo and FranciscoJ Peniche Beguerisse are partners at Creel, García-Cuéllar, Aiza y Enríquez SC.

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Mexican residents are obliged to pay income tax on all the income they earn on a worldwide basis; therefore, compensation earned from both Mexican employers and foreign sources is subject to tax in Mexico.

Employers paying income to executives are obliged to withhold income tax when it is effectively paid. 'Income derived from subordinated personal services rendered' (employment income), which includes salaries, fringe benefits, bonuses, allowances and other concepts deriving from a labour relationship, as well as profit-sharing and termination payments, is subject to taxation.

Taxes withheld by employers are considered as an advanced tax payment that can be credited against the annual tax liability computed through the annual tax return of each individual. If compensation is received from a foreign employer, withholding is not applicable, because Mexican executives are obliged to pay the corresponding tax liability to the tax authorities before the 17th day of the month subsequent to the month when the income was received.

Both the advanced tax payments and annual tax liability are computed by applying a progressive table, under which a maximum rate tax of 35 per cent applies to annual income of 3 million pesos or more.

Employment income paid to non-Mexican resident employees will also be subject to tax when services have been rendered in Mexico. The initial 129,900 pesos is tax-exempt; a subsequent tax rate of 15 per cent applies for income earned up to 1 million pesos; and a maximum rate of 30 per cent for payments above that threshold.

Tax withheld to foreign executives is a final tax payment, and foreign executives do not have any obligation to file tax returns or to comply with any other formality in Mexico.

ii Equity-based employment income

Income derived from equity-based plans such as restricted stock awards, restricted stock units (RSUs) or stock options are not considered as capital gain; therefore, they are subject to taxation as any other ordinary income would be.

In the case of RSU awards where the executive does not receive the stock immediately, but instead receives it according to a vesting plan, the RSUs are assigned at fair market value when they vest. Upon vesting, they are considered taxable income.

Amounts derived as dividend equivalent during the vesting period should be treated as employment income and not as dividend because the employee does not own any stock under RSU programmes.

Under a restricted stock award plan subject to forfeiture during the vesting period, the executive is not taxed at the time of the grant; instead, the employee is taxed at vesting, when the restrictions have lapsed. The amount of income subject to tax is the difference between the fair market value of the grant at the time of vesting minus the amount paid for the grant, if any.

Income earned from stock options granted by the employer or by any of its related parties is also regarded as employment income when the exercise price is zero or when it is lower than the fair market value of the underlying stock. The granting of stock option awards is not subject to taxation.

Once the participant has become the owner of the awarded stock, dividends received should be subject to income tax at two different levels: ordinary income subject to income tax; and dividends subject to an additional 10 per cent tax that is withheld by Mexican issuers, or paid directly by the participant in the case of foreign dividends.

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If the cost of any of these equity-based awards is borne by the foreign related party of the Mexican employer, the employment income would be regarded as received from a foreign employer, and the participant would have to compute and directly pay the tax liability.

If the cost of the award is charged to a Mexican employer, a withholding obligation for the employment income would derive for the employer. Different methods exist for employers to have the funds to pay for the withholding tax. The most common is to have the foreign related party sell enough stock in the market to have the necessary funds to transfer 35 per cent of the tax liability to the Mexican employer.

The executive's tax basis is equal to the amount paid for the stock plus the amount included as employment income. Upon a later sale of the shares, assuming the employee holds the shares as a capital asset, the employee would recognise capital gain income or loss; this may be subject to a reduce rate of 10 per cent if the capital gain is executed through the stock exchanges.

iii Social taxes for employees

Social security taxes (contributions) have to be paid both by employees through withholding, which is achieved by the employer applying an overall rate of 2.38 per cent over the adjusted daily wage, and by the employer, who has to pay up to 9.66 per cent.

The employment income regarded as the basis for computing these contributions is subject to a cap that is determined based on a multiple of the minimum daily wage. The maximum amount of salary that may be used to compute the social security contributions equals 25 times the Value of the Unit for Measurement and Adjustments (UMA).[2]

Currently, the maximum annual social contributions per employee are approximately 60,000 pesos for the employer portion and 15,000 pesos for the individual employee portion.

Mexico has entered into international agreements for social security purposes with Canada and Spain. Under these agreements, employees from these countries may generally work in Mexico and qualify for certain exemptions related to social security taxes. In addition, under such agreements, employees are entitled to preserve their weekly contributions, during the time they work in a different country, for pension matters.

Additionally, employers must contribute 5 per cent of salaries (also limited to 25 times the UMA to Infonavit (the Institute of the national housing fund), which provides funds for the construction of housing for workers.

Employers also make contributions equal to 2 per cent of an employee's compensation (also considering the limit of 25 times the UMA) to the retirement plan, Afore, which is managed by a bank in the employee's name.

Social taxes are substantial in any employment relationship in Mexico and the social security authorities are entitled to audit and determine tax assessments as it so happens with any federal tax.

iv Profit sharing

In accordance with Mexican laws, employees shall participate in the profits of the company at a percentage rate fixed by the National Committee of Profit Sharing. The percentage fixed shall constitute the employees' share in the profits of each company and is computed by applying the rate of 10 per cent to an adjusted net income used for income purposes.

2 The current value of UMA in 2017 is 75.49 Mexican pesos.

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Profits to be distributed shall be divided in two equal parts. The first part shall be shared equally among all the employees, taking into account the number of days worked by each employee during the year, irrespective of the amount of each employee's remuneration. The second amount shall be shared out in proportion to the total sum of the remuneration earned, irrespective of the number of days worked during the year.

For the purposes of the profit sharing distribution, 'wage' shall mean the amount actually received by each employee as a daily rate. It shall not be deemed to include extra payments, payments in kind and other payments referred to as integrated salary.

General managers and general directors of a company are not entitled to participate in the distribution of profits.

v Tax deductibility for employers

Expenses incurred by employers for payments made to employees are generally regarded as deductible for income tax purposes if they were effectively paid in cash, through wire transfers or paid in kind when different from debt securities.

Regardless of whether bonuses were paid in respect of services rendered during the prior tax year, they can only be regarded as deductible during the tax year in which they were effectively received.

Other formal requirements must be complied with, such as taxes being correctly withheld to furnish electronic tax receipts, and the correct registration of employees before the Mexican Social Security Institute.

From 2014, in order to establish a 'tax symmetry' between deductible expenses for employers and taxable income for employees, the deduction of expenses incurred for payments regarded as exempt employment income (such as the savings funds, pension funds, fringe benefits and other benefits) is limited to 47 per cent of the cost of such payments. This deductible percentage can be increased up to 53 per cent in the event that the fringe benefits are not reduced in respect of the prior tax year.

There are additional limitations for specific items of employment expenses incurred. The most relevant are that deductible bonuses cannot be higher than the annual compensation earned by the highest-ranked executive; the total bonuses paid during the year cannot be of a higher amount than the annual salaries during that year; and bonuses cannot exceed 10 per cent of the total employer's deductible expenses.

vi Other special rules

There are no special tax rules that affect compensation or incentive plans applicable in cases of a change in control of a company.

Life and health insurance are regarded as fringe benefits that, in order to be regarded as deductible, must be widely granted to all employees. It is also possible to comply with this requirement if such insurance is granted only to those employees who are part of a union, or if such insurance is exclusively granted to those employees that are not part of such union. One further interpretation is that the 'widely granted' concept could also be accomplished if such insurance is granted to all employees that are at the same level or that have the same characteristics (e.g., executives).

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III TAX PLANNING AND OTHER CONSIDERATIONS

To better administrate the profit amount that has to be distributed (see Section II.iv, *supra*), it is common for Mexican corporations to incorporate a service structure. In this type of structure, one entity within a group will have the sole purpose of acting as the group's business and income centre, while another entity within the same group acts as the exclusive employer of the personnel who render services to the entity acting as the income centre.

These structures have to be carefully formulated; otherwise, both entities could be considered to be responsible for the corporation's employment obligations.

IV EMPLOYMENT LAW

i Labour law overview

Private labour and employment relationships in Mexico are regulated by Article 123, Section A of the Federal Constitution (CPEUM), and by the Federal Labour Law (LFT), which regulates Article 123.

Both the CPEUM and the LFT are the result of the Mexican Revolution, which is why the guidelines established in the LFT are based on the social principle of protecting the working class. This is clearly reflected in Article 18 of the LFT, which stipulates that 'in the case of doubt, the interpretation most favourable to the employee must prevail'.

Under the LFT, employees shall not be discriminated against based on their position within the company. This principle applies not only to lower positions in a company, but also to higher positions. As such, in accordance with the LFT, people in management positions and executives of companies are entitled, just as any other employee, to, *inter alia*, payment of overtime, holidays, Christmas bonuses and rest days.

The following list of special rights and obligations are applicable to trust employees (directors or executives) in Mexico:

a they cannot be members of the same union as the rest of the employees;
b they cannot vote in the event of an inter-union conflict;
c they cannot represent the employees in mandatory joint commissions;
d their employment relationship can be terminated due to a 'loss of confidence';
e employers can legally refuse the reinstate them in the case of litigation;
f administrators, directors and general managers are not entitled to participate in mandatory profit distributions;
g they are considered as *de facto* representatives of the employer;
h a probation period of up to 180 days can be agreed for them; and
i their training and instruction relationship can be agreed for a period of up to six months.

ii Restrictive covenants

Labour overview

From a Mexican labour perspective, non-competition obligations and other restrictive covenants such as non-solicitation are very difficult to enforce. In theory, these types of obligations are likely to be considered contrary to the principle of 'work freedom' embodied in Article 5 of the CPEUM, which establishes that any individual can perform any kind of services or activities, provided such services or activities are not illegal; therefore, any restriction on an individual to engage with a company or to perform specific activities would

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not be valid or enforceable. Furthermore, and different from many jurisdictions, Mexico's labour courts cannot issue injunctions or cease and desist orders that may impede a company from hiring an individual or an individual to accept employment from a company.

Consequently, post-employment non-competition or non-solicitation obligations would be very difficult to enforce in Mexico before the labour courts.

Civil overview

From a Mexican civil law perspective, non-compete obligations are agreements between two parties in which one party accepts the responsibility not to compete in a certain market during a certain period of time in a determined territory. To secure compliance with such obligation, parties will usually agree on the payment of an indemnity that will be triggered in the event of contravention.

Based on the above, the main object of such obligation will be a negative covenant – that is, a covenant to refraining from doing something. It is important to note that, according to Mexico's civil laws, a negative covenant must be possible and lawful; that is, there shall no contradiction of Mexico's public laws or common standards of conduct. A party who fails to comply with the covenant will be subject to the payment of damages.

One of the most important principles in Mexican civil law is that parties are bound by what they expressly agree to, and also by the legal consequences of good faith, common practice and traditions. Based on this principle of contractual freedom, a non-compete agreement will be legal and enforceable under Mexican civil law when non-competition clauses or agreements are entered into to prevent unfair competition. Consequently, as long as a non-compete clause or agreement are intended to offer advance protection and assure strict confidentiality and a high standard of loyalty to prevent future losses or any kind of economic damages, we consider them to be lawful under civil law. Non-compete obligations are limited for a defined term, and to a defined territory, set of clients, and activities, products or services.

Mexican civil law recognises the validity of sanctions or penalties arising from a breach of a non-compete obligation and establishes some limitations: the amount of the penalty cannot be greater than the principal obligation, and a judge can reduce the amount of the penalty when the obligation was 'partially complied with'.

iii Termination of employment

In accordance with the LFT, an employment relationship is deemed as 'the rendering of a personal service by one person to another, under the latter's direction and control, in consideration for the payment of a salary'.

It is very important to note that in Mexico, 'employment at will' is not recognised even for managerial positions or executives. Employment relationships in Mexico are ruled by a 'stability principle' that states that, unless a just cause or a justified ground to terminate a relationship exists, employees cannot be terminated without being entitled to a severance payment.

Termination of an employment relationship

The LFT provides that an employment relationship may be terminated for the following reasons:

a by mutual agreement;
b death of an employee;

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c termination of the specific job or the term of the capital investment;
d the physical or mental incapacity or disability of the employee;
e force majeure or acts of God;
f the self-evident non-profitability of the operation;
g the depletion of the resources of an extractive industry; and
h insolvency or bankruptcy being legally declared.

Termination 'for cause' of an employment relationship

The LFT provides that an employer can only terminate an employment relationship 'for cause' in the event that the employee carries out one or more of the specific causes provided in the LFT.

Severance payment

Employees dismissed without a justified cause (wrongful termination) are entitled to receive the following severance payment:

a three months of compensation at a rate equivalent to an employee's daily salary;
b a total of 20 days of daily compensation for each year of services rendered;
c a seniority premium, equal to 12 days of salary per each year of services rendered, with a salary limitation of up to twice the minimum wage,[3] if an employee's salary exceeds such limitation;
d back salaries from the date of the dismissal throughout the first 12 months of litigation. After the first 12 months of litigation, a monthly interest at a rate of 2 per cent over the amount of 15 months of salary will be generated; and
e the accrued and proportional part of employment benefits.

In accordance with the LFT, an employee has the option in the event of a wrongful termination to receive the above-mentioned severance payment, or to ask for his or her reinstatement to his or her job.

Daily total compensation

Daily total compensation or integrated salary is deemed as the payroll salary, plus any fringe benefits such as commissions, compensations, allowances and other benefits in kind.

The commissions, bonuses or premiums to which an employee may be entitled, derived from his or her activities as a sales employee, are considered to be part of such employee's salary; thus, they should be integrated into his or her salary for purposes of the calculation of the statutory severance. To measure the average salary of a sales employee, the sum of his or her salary and any commission or bonuses achieved during the past year of services should be divided into 365 days.

iv Overview of employment liabilities derived from equity incentive plans

It has become common practice in Mexico for companies to allow their Mexico-based executives to participate in equity incentive plans (options, stock options, restricted units, etc.). It is important to note that participation in equity plans, if not correctly formalised, could trigger the following employment-related risks.

3 In 2017, the minimum wage in Mexico City is 80.04 pesos per day.

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Potential joint liability

In terms of the LFT, the employer is solely responsible for the employment relationship; consequently, only the employer should be obligated to pay salaries and benefits to its employees. In the event that the participation of an executive in an equity plan is not correctly documented or formalised, there is a potential risk that the foreign entity and the Mexican subsidiary will be construed as being jointly liable for all the employment terms and conditions of the participant. This potential liability would arguably derive from the fact that employment with the local entity is a condition to entitlement under the equity plan.

Moreover, a Mexican labour court may potentially establish a link between the foreign entity and the local subsidiary as being jointly responsible for the terms and conditions of the plan, since the income deriving from the awards may be deemed as part of the employees' compensation scheme.

Integration in local compensation

In accordance with the LFT, in the case of termination of employment without a justified cause, employees are entitled to receive a severance payment. Two of the three severance concepts are based upon a 'daily total compensation amount'.

In our experience, whenever executives and those in management positions are terminated, it has become common practice for such terminated employees to request the integration of the daily proportion of the amounts gained in equity awards plans into the daily salary. To date, the labour courts have not ruled on whether benefits gained from equity plans paid by related entities should be considered as part of an employee's compensation for severance purposes.

It is important to note that the LFT specifically provides that in the event of doubt, the interpretation that is most favourable to the employee shall prevail. Accordingly, it is critical to have undisputed evidence to support the argument that the participation of local employees in an equity plan should not be considered as an employment benefit.

It is worth mentioning that on 10 June 2016, the labour courts issued a resolution in which they ruled that the options and benefits derived from a stock option plan are not to be considered part of the employees' compensation unless such grant is included in the individual employment agreement of the employee.[4]

V SECURITIES LAW

The Mexican Banking and Securities Commission has issued General Rules Applicable to Issuers. These Rules establish that amounts of any type paid by Mexican issuers and subsidiaries during the past year to persons making up the board of directors, as well as amounts for relevant executives and individuals having the character of related persons, must be disclosed.

Disclosure should include the total estimated or accrued amounts intended to be paid as pension, retirement or similar plans offered by the Mexican issuer and subsidiaries to the above-mentioned persons.

4 Although we consider that the rationale used by the labour courts is incorrect, this is, to the best of our knowledge, the only employment resolution in this regard.

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In addition, such disclosure must include a description of the type of compensation and benefits that all of the above-mentioned persons received from the Mexican issuer on a group basis; and any agreements or programmes issued for the benefit of the members of the board of directors, relevant executives or employees of the Mexican issuer that allow them to participate in the Mexican issuer's capital, describing the rights and obligations, as well as the mechanism for distributing stock and determining the prices at which shares will be distributed.

VI DISCLOSURE

Mexican companies are not legally obligated to disclose any information regarding executive remuneration. Recently, the Mexican Business Co-ordination Board issued recommendations in its Code of Best Corporate Practices that have been widely adopted by both public and privately companies.

There is a clear recommendation that the board of directors disclose the remuneration policies and a breakdown of the compensation earned by the chief operating officer and relevant executives in the company's annual report to stockholders.

Public companies are obliged to disclose information regarding the annual compensation paid to the chief operation officer and relevant executives. Disclosure must be made on a group basis, and not considering any specific threshold.

VII CORPORATE GOVERNANCE

One of the most frequently adopted recommendations contained in the Code of Best Corporate Practices is for the board of directors to have the capacity to approve recommendations made by the management regarding the chief executive officer's compensation and performance, as well as regarding other highest-ranking officers. Additionally, it is recommended that termination payments for these officers are approved by the board of directors. The performance and compensation programme should be disclosed in the company's annual report to enable investors to have comfort in this respect.

The board of directors must carry out these activities through a compensation committee, which should be composed of at least three, and not more than seven, independent board members who do not have any conflict of interest.

Clawback or recoupment of remuneration provisions agreed with employees in Mexico (including executives) are not enforceable, since such provisions are contrary to the payment obligations contained in the LFT.

VIII SPECIALISED REGULATORY REGIMES

Regulated financial institutions such as banks, broker dealers and insurance companies are subject to specific rules provided by the regulatory authorities; however, these rules do not include any limitation on the amounts or kind of compensation that must be paid to executives. These rules are established so that entities can establish remuneration policies that take into consideration not only the financial results of the current year, but also the associated risks that result and are incurred by the entity during a reasonable period of time.

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IX DEVELOPMENTS AND CONCLUSIONS

There are currently a number of hot topics regarding executives in Mexico including, importantly, the pending resolution of several litigation cases to verify whether all executives will be considered not entitled to the profit-sharing obligation. Likewise, special attention will have to be paid to verifying how the labour courts issue legal precedents related to executive terminations and the manner used to calculate the daily total compensation concept.

After the filing of the 2014 annual corporate income tax return in March 2015, many employers filed constitutional claims (*amparo* proceedings) to challenge, among other matters, the deductibility limitation of 47 per cent of compensation paid to employees, which is considered exempt employment income for the latter. Newly incorporated companies also filed constitutional claims upon the filing of their 2015 tax returns, and this happened again upon the filing of the 2016 tax returns.

During the proceedings of the constitutional claim, employers were required to apply the 47 per cent limit, as the filing of the claim did not limit, suspend or stay the application of the partial deduction. Therefore, as employers were required to partially deduct exempt compensation, such limit had a significant impact on the structure of the compensation to be paid to executives going forward.

The Mexican Supreme Court solved such *amparo* claims and issued case law, stating that the deductibility limitation of 47 per cent of compensation paid to employees is constitutional. Hence, employers are required to apply such deductibility limitation of compensation paid to employees.

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Appendix 1

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