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Recent Changes in Labor Laws May Require Immediate Action for Companies with Operations in Mexico

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EXECUTIVE SUMMARY

Businesses that maintain operations in Mexico may need to take immediate action with respect to their workforce as Mexico accelerates implementation of its new labor law. On April 23, 2021, a decree that reforms labor outsourcing in Mexico was published in the Official Journal of the Federation (Mexico), the official governmental publication of Mexico. The new language of the law **expressly prohibits subcontracting**, defined as *the practice of providing or making available workers for the benefit of another person or legal entity*. This decree may require certain businesses with operations in Mexico to significantly and quickly change their workforce structure if they are using outsourced labor in Mexico.

1. BACKGROUND

Under Mexican Law, companies doing business in Mexico are required to distribute 10% of their pretax earnings among their employees in Mexico. This obligation is commonly referred to as "Profit Sharing" or "PTU."

To avoid these Profit Sharing issues, many domestic and foreign investors doing business in Mexico have chosen to outsource their employees (through outsourcing companies such as Manpower) or establish their own "internal" outsourcing structures (in these cases, this outsourcing or personnel subcontracting is commonly referred to as "insourcing"). Insourcing is accomplished by establishing two separate entities: (1) an Operating Company; and (2) a Service Company. The Operating Company would not have any employees and would be operated for purposes of carrying out all intended business transactions, including the collection of proceeds. The second company, the Service Company, would hire all appropriate personnel and would provide personnel, administrative and other related services to the Operating Company for a fee, which would generally be calculated based upon such Service Company's total costs and expenses (including those incurred in connection with the hiring of the employees) plus an appropriate mark-up. The yearly profits of the Service Company could thus be managed and any Profit Sharing contributions to the Mexican employees could be significantly reduced.

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While a source of great debate for many years, this “dual company” mechanism was considered legal and valid in Mexico. However, in recent years, this outsourcing structure has become overly abused and used as a mechanism to defraud employees and the tax and social security authorities.

2. WHAT ARE THE CHANGES

This “Labor Reform” prohibits personnel outsourcing, defined as any transaction where a company (or individual) would make its own workers available to and for the benefit of another company (or individual). This reform would also include the prohibition of companies known as “pagadoras” in Mexico. Outsourcing for specialized work or services will still be permitted provided such work or services are not within the beneficiaries’ corporate purpose or main economic activity and provided that several other requirements are met (including registration and licensing requirements for the contractor). The Labor Reform also restricts the provision of services and work between companies that form part of the same corporate group.

The Labor Reform is essentially intended to end the current personnel outsourcing mechanism used in Mexico. The Labor Reform provides for certain mechanisms and guidelines for the termination of existing outsourcing and “insourcing” operations that are now considered illegal, provides for several social security related adjustments, and provides for fines, sanctions and adverse tax and social security consequences (that could reach criminal prosecution) in the case of non-compliant outsourcing transactions. For example, if it is found that a company is subcontracting personnel, both the contractor and the beneficiary (customer) could be subject to fines ranging from $179,240 to $4,481,000 pesos (or US$8,962 to US$224,050).

To address the opposition and concerns that arose in connection to the Profit Sharing concept, the Labor Reform set forth a limit to the Profit Sharing that Mexican employees can receive individually, equivalent to the higher of such employee’s three months of salary or the average of the Profit Sharing amounts that such employee received within the last three years.

3. CRITICAL DATES

The outsourcing prohibitions and restrictions became effective on April 24, 2021 (some components of the Labor Reform, such as the tax provisions, will become effective through August 2021). Although this reform is being referred to as a Labor Reform, it also has several tax and social security components as well.

4. WHAT STEPS SHOULD BE TAKEN

The Labor Reform will require all companies doing business in Mexico to review their internal structure (including for purposes of reviewing their bylaws in connection with their stated “corporate purpose” and their tax register and other registers and licenses in connection with their declared primary economic activity) and their business relationships and contracts with services suppliers and clients, including with related parties. This review will need to be multidisciplinary, as many elements of the Labor Reform seem to be inconsistent with other existing Mexican laws, regulations and requirements. Companies with operations in Mexico that use outsourcing or insourcing personnel should immediately evaluate the labor and tax implications the Labor Reform could have on their operations and implement an action plan to comply.

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