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Outsourcing Under the Recent Labor Law Reform—Tax Implications and Concerns

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On November 30, 2012, amendments to the labor law were enacted. These amendments came into effect on December 1, 2012.

The reform includes a number of interesting and important changes to traditional employment terms. This article, however, will concentrate on outsourcing and on a specific employee profit sharing provision in the reform, closely related and with potential serious implications.

Outsourcing

Article 15-A of the labor law reform defines outsourcing (or subcontracting, as it is called in Spanish) as the regime by means of which an employer, called contractor, carries on works or renders services with subordinated workers, to the benefit of an individual or entity, called contractee, who determines the work to be carried on by the contractor and supervises performance of the services or execution of the contracted work.

Outsourcing agreements must be in writing and must comply with the following conditions:

- They cannot cover the entire activity of the contractee
- They must consist in specialized activities
- They cannot include activities identical or similar to those carried on by the other workers of the contractee

Where all of the above conditions are not met, the contractee will be considered employer of the contractor's worker for all labor law purposes, including social security obligations.

The contractee must verify, when entering into the agreement, that the contractor has the documentation and elements of its own sufficient to comply with the obligations resulting from the relations with the contractor's workers.

Further, the contractee must permanently verify that the contractor is complying with all applicable security, health, and environment conditions with respect to the latter's workers. This obligation, however, can be fulfilled by contracting the services of so-called "verification unit" fully chartered and approved.Outsourcing is not allowed when the contractee intentionally transfers employees of its own to the contractor in order to reduce or avoid the former's labor obligations.

Tax Effects

The first tax effect steaming from subcontracting services are the typical effects you will find in basically any third-party supplier transaction.

First, in order for the payment to be deductible for income tax and flat tax purposes, a number of requirements should be met, including:

- Outsourcing must be "strictly indispensable" for the contractee's income-producing activity. This is Mexico's equivalent of the "reasonable" test for deductions in other latitudes.
- Payment is to be made by means of a check or bank transfer if it exceeds $2,000 Mexican pesos (MXN).
- The payment must be properly recorded in the contractee's books of account
- The payor should secure from the payee invoices for each and all payments made. The invoices must meet a number of requirements called for under Mexican law. Among others, the invoice must be numbered, it should show the contractor's taxpayer identification number, date and place of issue, the contractee's taxpayer identification number, itemized description of the goods or services, unitary price, in numbers, total price in numbers or letters, and, where applicable, itemize the corresponding VAT.
- In some instances, an information return regarding payments made to the payee must be filed annually,

generally on February 15.

- In addition, as regards the flat tax, the invoice must have been actually paid.

VAT paid will typically be recoverable. To this end, the VAT must, again, be itemized in the corresponding invoice, must correspond to "strictly indispensable" activities and it must have been actually paid.

The typical VAT rate is 16% but a preferential 11% applies to services and sales by residents of the border zone. Only certain limited types of services qualify for a 0% rate or an exemption.

But if the contractee is, under the Article 15-A rules mentioned above, deemed to be the employer of the contractor's personnel rendering the services or carrying on the work, then it will have greater obligations:

- First, it will be required to request from the workers the Mexican tax identification number (RFC[1]) or, where the number is not provided, it should register the employees in this registry.
- Salaries should be paid in cash, check or deposit into the worker's bank account.
- The contractee will be required to withhold Mexican income tax on the payments to the workers and to issue to the workers certifications to this effect.
- The contractee will be required to file information returns on or before February 15, regarding the individuals to whom salaries were paid.
- In certain instances, for example where the employee makes $400,000 MXN or less in the tax year, the employer must prepare and file the year-end income tax return for the employee.
- The contractee, as employer, will be required to register the employees before the Social Security Institute, if not already registered.
- It must pay in to the Institute social security contributions, for the following coverage:

— Work risks
— Illnesses and maternity
— Disability and life
— Retirement, advanced-age unemployment and old age
— Nurseries and social benefits

The amount of the contributions varies, depending on a number of different calculations and on the employer's history of accidents, but can roughly be estimated to be around 32% of the workers base salary. The base salary is capped at 25% the general minimum wage to compute the contributions for disability and life coverage as well as the retirement, advanced-age unemployment and old age contribution. The present daily minimum wage is $64.76 MXN.

- In addition the employer will be required to withhold from the employee 2.4% of his base salary as contribution to the illnesses and maternity, disability and life and retirement, advanced-age unemployment and old age coverage. Again, the basis for the last two coverages is capped at 25 times the minimum wage.
- The employer must make a 5% contribution to the Mexican Housing Institution (INFONAVIT[2]).
- It must also contribute 2% to the Retirement Savings Account System (SAR[3]).
- Finally, local payroll taxes would also be attracted. The rates vary by State, but they can be estimated to be around 2%.

It is easy to appreciate that compliance with the above tax obligations would be practically impossible for a contractee who has no controls over the activities, employees and cash management of his contractor.

Employee Profit Sharing

All employers are required to share their profits with their employees. This benefit originates from the Mexican Constitution and it is further regulated in the labor law.

Profit sharing is 10% of the company's taxable income.

Taxable income is gross revenues minus allowable deductions, before prior year net operating losses and prior year's employee profit sharing paid. The reason is obvious. Our Constitution and the lawmaker want employees to share in the profits of a company only, and not in its losses. They do not want the basis for employee profit sharing to be reduced with prior year's employee profit sharing paid, as it would make employees bear 10% of the cost of such benefit.

Yet, employee profit sharing is, in fact, deductible. Once the tax profit has been calculated to determine the basis for employee profit sharing, then prior year's net operating losses as well as prior year's employee profit sharing paid, are subtracted to arrive at net taxable income, which is the basis and which the tax rate is applied.

Outsourcing adds a further matter of concern under the labor reform.

The reform added a section IV BIs to article 127 of the law, reading as follows:

Article 127. The right of the workers to share in the profits shall be governed by the following provisions:

(…)

IV Bis. The workers of ***an establishment of an enterprise*** *are a part of the [enterprise] for profit sharing purposes.*

(…)" [Emphasis and brackets supplied.]

Article 16 of the law, in turn, defines enterprise and establishment as follows:

"Article 16. For labor law purposes, enterprise is understood to be the economic unit for the production or distribution of goods or services, and establishment is the technical unit which, as a branch, agency or other similar form is an integral part of and contributes to carry on the purpose of the enterprise."

So far, so good. In reading Article 127 (IV), coupled with Article 16 one would conclude that the workers of the establishments of a company, i.e. the workers of a branch, agency or other similar form, are part of the enterprise and are entitled to the employee profit sharing. No one would argue with that.

The issue arises from a number of decisions by our Circuit Courts, the last one dating back to 2011. Said the courts:

CIVIL CONTRACT FOR THE RENDERING OF PROFESSIONAL SERVICES. IF AS A RESULT OF THEREOF A THIRD PARTY UNDERTAKES TO PROVIDE PERSONNEL TO A REAL EMPLOYER, WITH THE AGREEMENT TO RELEASE IT FROM ANY LABOR OBLIGATION, BOTH ENTERPRISES CONSTITUTE THE ECONOMIC UNIT TO WHICH ARTICLE 16 OF THE FEDERAL LABOR LAW REFERS AND, THEREFORE, BOTH ARE RESPONSIBLE FOR THE LABOR RELATIONS TOWARDS THE WORKER. *Pursuant to Article 3 of the Federal Labor Law, the work is not an item subject to commerce. Also, Article 16 of the Federal Labor Law provides that for purposes of the labor law an enterprise is the economic unit for the production and distribution of goods or services. In this context, when an enterprise intervenes as the provider of the workforce by means of a civil contract for the rendering of professional services, or by any other legal act, and another enterprise contributes the infrastructure and the capital, both enterprises achieving the produced good or service, they comply with the corporate purpose of the economic unit referred to in Article 16; hence, for [labor] purposes they constitute an enterprise and are, therefore, responsible of the labor relations towards the worker.* [Underlining and brackets provided.]

As seen, the court ruled that when one enterprise provides services to another, **BOTH** constitute an economic unit and are, therefore, jointly liable for labor purposes.

This is an unfortunate precedent. Where enforced it would mean that in outsourcing arrangements, among others, the beneficiary of the services is outright liable for all labor benefits of the workers, including, of course, employee profit sharing.

In your writer's opinion, this decision is incorrect and should eventually be reversed.

Based on a literal interpretation of Article 16, the legal conclusion is that the terms "enterprise" and "economic unit" apply to one single entity and that the term "establishment" refers to components of that one entity, its branches, agencies and "other similar forms." Article 16 is nowhere referring to more than one entity constituting an "economic unit."

But further, under a harmonic interpretation of the law we find that the events of joint liability are governed by Articles 13 and 15, and now Article 15-A discussed above. Joint liability is not governed by Article 16.

Articles 13 and 15 read as follows:

"Article 13.There shall not be considered intermediaries but employers, established enterprises who contract works to be carried on with elements of their own sufficient to comply with the obligations that derive from their relationship with their workers. Otherwise they shall be jointly liable with the direct beneficiaries of the works or services regarding the obligations acquired with the workers."

"Article 15. Enterprises that carry on works of services exclusively or mainly for another and who do not have sufficient elements of their own in accordance with article 13, shall be governed by the following rules:

"I. The beneficiary enterprise shall be jointly liable for the obligations with the workers; and …"

The bill submitted to Congress for approval of the Labor Law in 1970 explained the scope of proposed Articles 13 and 15 as follows:

"Articles 12 to 15 consider the problem, that so many difficulties have created in the employer-employee relations, of intermediaries; after the definition in article 12, article 13 provides that there shall be considered intermediaries companies that contract works or services to the benefit of another person if they do not have sufficient elements of their own to comply with the obligations steaming from their relationship with their workers; when this circumstance is present, the beneficiary of the works or services shall be jointly liable with the contractor or the obligations undertaken with the latter's workers.

"The present economy has created as a technical need specialization of enterprises, but it is also often that subsidiary enterprises are organized to execute works or services exclusively or principally for another. Since this circumstance has resulted in detriment to the workers, as their work conditions are less than those of the principal enterprise and because the affiliate enterprise do not always have sufficient elements of their own to comply with the obligations originating from the work relationship, Article 15 establishes the joint liability of the enterprises and provides that the work conditions for the workers that rendered their services in the affiliate entity shall be the same as those of the enterprise that benefit from the activity of the affiliate."

As seen, it is Articles 13 and 15 –and now Article 15-A- that regulate joint liability where services or works are contracted with third parties, and only where the nominal employer has no elements of his own to meet its labor obligations.

This conclusion is confirmed by the report from the House when analyzing the above-mentioned bill:

"A substantial reform to article 15 of the bill is proposed so that it ends with the drafting in the report. The reason for the proposed modification is that demands for the industry make them diversify the works such that it is often the case that enterprises are incorporated specialized in a product that will be used by one or more enterprises. ***When this enterprise has elements of its own sufficient to respond for the obligations incurred with their workers, THERE IS NO REASON TO ESTABLISH A JOINT LIABILITY of the enterprise that***

it incorporated for the production of a given product …" *[Emphasis and capital letters supplied.]*

If, as ruled by the court, joint liability arises any time there is a service agreement, then there would be no need or room for Articles 13, 15 or now for the new Article 15-A.

Let us now turn to the part of the bill proposing enactment of Article 16. Here the reasoning reads as follows:

"The goals of modern industry make a number of enterprises create branches, agencies or other similar units, which are independent one from another but which are all subject to a general administration. This provision has dictated in modern life the need to distinguish between enterprise and establishment. The bill takes on this idea into Article 16: The enterprise is the economic unit for the production of goods or services, the total organization of work and capital under one single direction and in order to achieve one goal, while an establishment is a technical unit, which as a branch, agency or other similar, enjoys technical autonomy, but nonetheless it forms part and contributes to achieve the purposes of the enterprise, which is the superior unit."

The reasoning in the bill introducing the law makes it very clear that all that it is doing is recognizing the fact that enterprises now tend to establish economic units such as branches, agencies and others in order to fulfill their purposes and that, in the end these technical units (branches, agencies and others) do nothing else but contribute to the purposes of the enterprise, with whom they form a whole. No reference is made, not even an insinuation, as to joint liability.

Based on the above analysis, we can reach the following conclusions:

- When defining "enterprise", "economic unit" and "establishment", Article 16 is referring to one and the same entity, not to two or more entities forming and "enterprise" or "economic unit."
- Thus, when the new Article 127 (IV) provides that the employees of the "establishments" are employees of the "enterprise" it means all employees within one single legal entity.
- Article 16 is not creating joint liability between or among two or more entities.

Therefore, other than the express event in Article 15-A discussed above, OUTSOURCING DOES NOT, PER SE, RESULT IN JOINT LABOR LIABILITY BETWEEN THE SUBCONTRACTOR AND THE BENEFICIARY OF THE SERVICES. As a result, the beneficiary of the services is not liable under Article 127 (IV) for employee profit sharing for the subcontractor employees.

Conclusion

Outsourcing is a common contractual arrangement, offering many benefits to contractees, such as transferring certain functions or activities to the contractor generally with efficiencies and savings. However, if not properly structured these arrangements can result in joint or direct labor and tax liability for the contractee. Proper advice from labor and tax professionals is thus imperative in order to document and implement these arrangements.

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1 RFC = *Registro Federal de Contribuyentes*
2 INFONAVIT = *Instituto del Fondo Nacional de la Vivienda para los Trabajadores*
3 SAR = *Sistema de Ahorro para el Retiro*

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