THE EXECUTIVE REMUNERATION REVIEW

EIGHTH EDITION

Editors
Arthur Kohn and Janet Cooper

THE LAWREVIEWS

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PREFACE

Executive remuneration encompasses a diverse range of practices and is consequently influenced by many different areas of the law, including tax, employment, securities and other aspects of corporate law. We have structured this book with the intention of providing readers with an overview of these areas of law as they relate to the field of executive remuneration. The intended readership of this book includes both in-house and outside counsel who are involved in either the structuring of employment and compensation arrangements, or more general corporate governance matters. We hope this book will be particularly useful in circumstances where a corporation is considering establishing a presence in a new jurisdiction, and is seeking to understand the various rules and regulations that may govern executive employment (or the corporate governance rules relating thereto) with regard to newly hired (or transferring) executives in that jurisdiction.

The most fundamental considerations relating to executive remuneration are often tax-related. Executives will often request that compensation arrangements be structured in a manner that is most tax-efficient for them, and employers will frequently attempt to accommodate these requests. To do so, of course, it is critical that employers understand the tax rules that apply in a particular situation. To that end, this book attempts to highlight differences in taxation (both in terms of the taxes owed by employees, as well as the taxes owed – or tax deductions taken – by employers), which can be the result of:

a the nationality or residency status of executives;
b the jurisdiction in which executives render their services;
c the form in which executives are paid (e.g., cash, equity (whether vested or unvested) or equity-based awards);
d the time at which executives are paid, particularly if they are not paid until after they have 'earned' the remuneration; and
e the mechanisms by which executives are paid (e.g., outright payment, through funding of trusts or other similar vehicles, or personal services corporations).

In addition to matters relating to the taxation of executive remuneration, employment law frequently plays a critical role in governing executives' employment relationships with their employers. There are a number of key employment law-related aspects that employers should consider in this context, including:

a the legal enforceability of restrictive covenants;
b the legal parameters relating to wrongful termination, constructive dismissal or other similar concepts affecting an employee's entitlement to severance on termination of employment;

c any special employment laws that apply in connection with a change in control or other type of corporate transaction (e.g., an executive's entitlement to severance or the mechanism by which an executive's employment may transfer to a corporate acquirer); and

d other labour-related laws (such as laws related to unions or works councils) that may affect the employment relationship in a particular jurisdiction.

The contours of these types of employment laws tend to be highly jurisdiction-specific, and therefore it is particularly important that corporations have a good understanding of these issues before entering into any employment relationships with executives in any particular country.

Beyond tax and employment-related laws, there are a number of other legal considerations that corporations should take into account when structuring employment and executive remuneration arrangements. Frequently, these additional considerations will relate to the tax or employment law issues already mentioned, but it is important they are still borne in mind. For example, when equity compensation is used, many jurisdictions require that the equity awards be registered (or qualify for certain registration exemptions) under applicable securities laws. These rules tend to apply regardless of whether a company is publicly or privately held. In addition to registration requirements, it is critical for both employers and employees to understand any legal requirements that apply in respect of executives' holding, selling or buying equity in their employers.

Given the heightened focus in many jurisdictions on executive remuneration practices in recent decades – both in terms of public policy and public perception – the application of corporate governance principles to executive compensation decisions is crucial to many companies. Decisions about conforming to best practices in the field of executive remuneration may have substantial economic consequences for companies and their shareholders and executives. Corporate governance rules principally fall into two categories. The first concerns the approvals required for compensatory arrangements: a particular remuneration arrangement may require the approval of the company's board of directors (or a committee thereof). Many jurisdictions have adopted either mandatory or advisory say on pay regimes, in which shareholders are asked for their view on executive remuneration. The second concerns the public disclosure requirements applicable to executive remuneration arrangements: companies should be aware of any disclosure requirements that may become applicable as a result of establishing a new business within a particular jurisdiction, and in fact may wish to structure new remuneration arrangements with these disclosure regimes in mind. In recent years, there has also been increased legislative and shareholder focus in many jurisdictions on environmental and social governance issues, such as the gender pay gap, tying executive compensation to environmental and social goals and diversity initiatives.

We hope that readers find the following discussion of the various tax, statutory, regulatory and supervisory rules and authorities instructive.

Arthur Kohn
Cleary Gottlieb Steen & Hamilton LLP
New York
August 2019

Chapter 13

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. Along with 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 their tax residency.

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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 1259,900 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 is not considered a capital gain; therefore, it is subject to taxation as any other ordinary income would be.

In the case of RSU awards where an 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 concerned employee does not own any stock under RSU programmes.

Under restricted stock award plans subject to forfeiture during the vesting period, executives are not taxed at the time of the grant; instead, the employees are 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 an 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 participants in the case of foreign dividends.

If the cost of any of these equity-based awards is borne by a foreign related party of an 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 an 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 value of the unit for measurement and adjustments (UMA). The maximum amount of salary that may be used to compute the social security contributions equals 25 times the 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 a rate of 10 per cent to an adjusted net income used for income purposes.

2 The value of the UMA in 2019 is 84.49 Mexican pesos.

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, paid 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 by the employee.

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, 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 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.[3]

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, 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 a union.

3 The Mexican Supreme Court solved *amparo* claims in this regard 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.

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).

III TAX PLANNING AND OTHER CONSIDERATIONS

To better administrate the profit amount that has to be distributed (see Section II.iv), 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 a 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 because of a loss of confidence;
e employers can legally refuse to 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 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 an 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 the 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 be 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 is 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 it 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;
c termination of a specific job or the term of a capital investment;
d the physical or mental incapacity or disability of an employee;
e force majeure or acts of God;
f the self-evident non-profitability of an 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 a 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,[4] if an employee's salary exceeds that 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 the employee's salary; thus, they should be integrated into his or her salary for purposes of the calculation of

4 In 2019, the minimum wage in Mexico is 102.68 pesos per day.

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.

Potential joint liability

In terms of the LFT, employers are solely responsible for the employment relationship; consequently, only an 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 a foreign entity and its Mexican subsidiary will be construed as being jointly liable for all the employment terms and conditions of a 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, as 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 employees 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.

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 an employee.[5]

5 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.

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 their boards 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.

In addition, the 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 Coordination Board issued recommendations in its Code of Best Corporate Practices that have been widely adopted by both public and privately owned companies.

There is a clear recommendation that boards of directors disclose the remuneration policies and a breakdown of the compensation earned by their chief operating officers and relevant executives in their companies' annual reports to stockholders.

Public companies are obliged to disclose information regarding the annual compensation paid to chief operation officers 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 boards of directors to have the capacity to approve recommendations made by management regarding chief executive officers' compensation and performance, as well as regarding other highest-ranking officers. Additionally, it is recommended that termination payments for these officers are approved by boards of directors. The performance and compensation programme should be disclosed in a company's annual report to enable investors to have comfort in this respect.

A 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, as 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. The rules were drawn up 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.

Appendix 1

ABOUT THE AUTHORS

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Alejandro Santoyo is a partner at Creel, García-Cuéllar, Aiza y Enríquez SC, where he is part of the tax practice. His practice comprises tax advisory services for M&A, capital markets, structured finance, estate planning and private equity. He is a leading adviser for financing transactions and international taxation for cross-border business activities.

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