MIJARES ANGOITIA CORTES Y FUENTES

Labor outsourcing regime related reforms initiative

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On 12 November 2020, the Federal Executive submitted a Law initiative before the Mexican Congress containing several reforms to the Federal Labor Law ("FLL"), the Social Security Law ("SSL"), the National Housing Fund Institute for Workers Law ("LINFONAVIT"), the Federal Fiscal Code ("FFC"), the Income Tax Law ("ITL") the Value Added Tax Law ("VATL") with aims to regulate the labor outsourcing ("outsourcing") regime in Mexico.

The initiative filed by the Federal Executive must yet to be approved by the Congress. If approved as it is currently being proposed, the initiative would drastically affect the operation of Mexican companies since it would eliminate the possibility of having an "*insourcing*" or a service company within the same group, even though de same had been in due compliance with their tax and social security obligations.

Derived from the foregoing, it is of great importance to analyze in detail the labor and tax effects that would arise in the event that such initiative is approved, in order to be able to timely take the necessary corrective measures.

In this *alert* we will address the main modifications comprising the referred initiative, as well as the practical consequences from a labor and tax perspective within the applicable legal framework.

FLL

Prohibition of certain outsourcing arrangements

The outsourcing arrangement, defined as the arrangement in which an individual or legal entity leaves its employees at the complete disposal and benefit of another individual or legal entity, will be considered illegal.

As a sole exception, the provision of specialized services or the execution of specialized tasks, which are not included within the corporate purpose or the economic activity of the contracting party will not be considered a subcontracting regime, as long as the contractor has been authorized by the Labor and Social Security Ministry for such purposes.

The provision of specialized services must be documented by means of the execution of a written agreement which details the services to be provided or tasks to be conducted and the number of employees that will participate in the execution of such services or tasks.

Authorization of contractor parties

In order to obtain an authorization issued by the Labor and Social Security Ministry to perform their services, contractors rendering specialized services will be required to evidence their compliance with their employer obligations and that the scope of services to be rendered are specialized in their nature.

The aforementioned authorization must be renewed every three years and, if obtained, the contractor will be registered in a specialized services providers database, which will be of public knowledge.

For that matter, the Labor and Social Security Ministry would issue, within 4 months following the date in which the Decree would come into force, the general administrative rules for the procurement of the authorization, and contractors rendering specialized services will be obligated to obtain such authorization within 6 months following the date of publication of the general rules.

Fines

With respect to the administrative sanctions, and regardless of the tax consequences that would arise, any individual or legal entity either continuing to use a subcontracting regime, rendering specialized services without due authorization, or contravening the provision of specialized services or tasks, will be subject to a fine which may range between 2,000 to 50,000 times the current Unit of Measurement and Update. Such fine will also be applicable for individuals or legal entities which are benefited by the subcontracting arrangement.

FFC

Definition of labor outsourcing

It is proposed to define the legal figure of "labor outsourcing" for tax purposes, which would be aligned with the proposed amendments to the FLL in order to avoid unlawful practices destined to tax evasion or elusion, the issuance of tax invoices documenting simulated transactions or hampering labor rights.

Legal effects of tax invoices

It is generally established that tax invoices issued to document labor outsourcing services will not produce any tax effects.

Joint liability

An additional provision would establish the joint liability of the contracting party with respect to employee related withholding taxes to guarantee timely withholding and remittance of such contributions.

Infringements and sanctions

It is proposed to add as an aggravating factor in the imposition of penalties, the crediting for value added tax purposes or the deduction for income tax purposes, of payments made for labor outsourcing services in breach of the requirements set forth in the FLL.

Tax Fraud

It is proposed to establish that the use of schemes involving the simulation of the provision of specialized services or the execution of specialized tasks, as well as the implementation of labor outsourcing schemes, will qualify as tax fraud or a comparable offence.

ITL

Requirements for the deduction of specialized services

In the initiative it is proposed to add as a requirement for the provision of specialized services or the execution of specialized tasks to be deductible, that the contracting party procures from the contractor certain additional information consisting of: i) the valid authorization issued by the Labor and Social Security Ministry pursuant to article 15 of the FLL, ii) tax invoices, iii) withholding income tax returns and iv) evidence of the remittance of employer and employee contributions to the National Housing Fund Institute for Workers (INFONAVIT).

Non-deductibility of labor outsourcing expense

Likewise, in line with the other proposed amendments, it is proposed to establish that expenses derived from labor outsourcing services will be deemed non-deductible for income tax purposes.

VATL

Elimination of withholding obligations with respect to the provision of services

It is established to derogate the obligation to withhold 6% of the consideration paid for the aforementioned services derived from the proposed amendments by which labor outsourcing payments would cease to produce any effects for tax purposes.

Disallowance of a tax credit for labor outsourcing expenses

In addition, through the initiative it is proposed to disallow the crediting of value added tax charged for the provision labor outsourcing services.

Requirements for crediting value added tax resulting from specialized services

For purposes of crediting the value added tax charged for labor outsourcing services qualifying under the requirements set forth in the FLL, additional requirements would need to be met to credit the tax resulting from the provision of specialized services or the execution of specialized tasks, such as i) securing a valid

authorization issued by the Labor and Social Security Ministry pursuant to article 15 of the FLL in force, ii) value added tax returns, and iii) acceptance receipt and proof of payment of value added tax.

SSL

Definition in accordance with the FLL

It is proposed to modify article 15-A of the FLL to align its wording with the modifications proposed for the FLL with respect to the provision of specialized services or the execution of specialized tasks.

Elimination of the administrative simplification related to the employer registry

Likewise, it is established to eliminate the administrative simplification that grants entities rendering labor outsourcing services the possibility to have an employer registry at national level for each class.

In this respect, it is proposed to include a transitory provision applicable to employers which had requested an employer registry for each class prior to the date of entry into force of the Decree, which would require them to cancel such registrations within a term of 120 natural days from the date of entry into force.

Sanctions

Additionally, it is proposed to include a sanction resulting from filing after the expiration of the legal term of the documentation set forth in article 15-A of the FLL, as well as to increase the amounts of the sanctions imposed for non-compliance or extemporary compliance with the obligation to file such information.

It is worth noting that a 6 month term following the date of entry into force of the Decree, is established to begin providing information related to the provision of specialized services or the execution of specialized tasks.

LINFONAVIT

Joint liability

With respect to the LINFONAVIT, it is established that, in the event of an employer substitution, the substituted employer will be jointly liable along with the new employer with respect to the obligations resulting from such law for a term of 6 months.

Likewise, in order to align the modifications proposed in the SSL, it is proposed that individuals or legal entities that hire the provision of specialized services or the execution of specialized tasks from non-compliant entities with respect to their social security obligations, such contracting parties will be jointly liable for the obligations related to the workers engaged in the execution of the services. In this respect, the corresponding administrative rules must be issued within a term of 4 months following the date of entry into force of the Decree.

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For any additional information, do not hesitate to contact our expert team on tax and labor issues, who can be of assistance:

Contact us:

Claudio Jiménez
Partner | jimenezdeleon@macf.com.mx

Nora Morales
Partner | nmorales@macf.com.mx

Enrique Ramírez
Partner | eramirez@macf.com.mx

Manuel Tamez
Partner | mtamez@macf.com.mx

+52 (55) 5201 7400

For more information, visit:

www.macf.com.mx

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