Mexico: It’s Time for Profit Sharing!

Employment and Labor

Under Mexico's law, employees are entitled to a share in the company's profits, currently calculated on the basis of 10 percent of the company's pre-tax income. However, new companies are exempted from this requirement during their first year of operation. In addition, the highest-ranking officer of a company is not entitled to this benefit.

Legal framework

Under Mexican statutory law, profit-sharing programs must be managed by employer-employee committees that are formed in each company operating in Mexico. The Mexican Federal Labor Law ("FLL"), Mexico's primary employment law, requires that each company with operations in Mexico create five employer-employee committees to regulate important aspects of the company's internal day-to-day operations. These committees must consist of an equal number of representatives from the employer side and the employee side to regulate over the following areas:

- Health and safety
- Training and productivity
- Seniority
- Creation of the internal work rules
- Profit sharing

This requirement — that every company must create these five employer-employee committees — is born out of the *“in dubio pro operario”* principle adopted by the FLL. This principle presumes that, within the context of an employment contract, the employee is the weaker party. As such, any dispute as to the terms of such contract must be interpreted in a manner that is favorable to the employee.

Similar to the employment laws in other Latin American countries, the FLL is generally regarded as extremely protective of employees. Therefore, by setting these mandatory employer- employee committees, the FLL ensures that the above-listed areas are managed with the active participation of employees, instead of at the sole discretion of the employer.

A brief history

Mandatory profit-sharing is an interesting concept, rarely found in any country other than Mexico. It finds its origins when the Mexican economy was a “closed economy” in that it had virtually no foreign participation and the political and social circumstances were very different from today. For instance, in 1963 when the first resolution of the National Commission for Profit Sharing (the “Commission”)[1] was issued, Mexico was not a party to any free trade agreements with any other country and devaluations of the Mexican peso were constant.

1 The National Commission is the designated organism in charge of setting the percentage of profit-sharing nationwide every 10 years or when the economic circumstances justify it. It consists of three members, one representing employers, another representing employees, and the third member representing the state.

The first profit-sharing percentage was set in 1963, to be calculated on the following formula: 20 percent of a company’s distributable profit (available for dividend distribution) minus 30 percent of that amount for reinvestment, plus an application of a capital-labor ratio. With a growing economy in 1974, the Commission established that profit-sharing should be calculated on eight percent of the company’s taxable income. The Commission did not meet again until 1985, at which point the profit-sharing percentage was adjusted to 10 percent of a company’s pre-tax earnings.

Mexico’s social and economic realities changed dramatically in 1985. On September 19, 1985, Mexico experienced the worst earthquake in its history, causing devastation on a national level. As a result of this disaster, millions of Mexican families lost their assets and companies sustained huge financial losses. With decreased domestic savings, Mexico’s economic growth temporarily stagnated. The country’s effort to recover from this natural disaster is commonly known as the “reconstruction phase.”

In 1996, the Commission issued its fourth resolution, keeping the profit-sharing percentage at 10 percent. This was a time when the country was experiencing one of the worst — if not the worst — economic meltdown in its modern history. This happened despite Mexico signing, together with the United States and Canada, the North American Free Trade Agreement (“NAFTA”).

In 2009, the Commission issued its fifth resolution. To avoid protests from unions and workers association, the Commission once again kept the profit-sharing percentage at 10 percent to maintain the status quo that has been in place for decades.

Profit-sharing employer-employee committee

Every year, all national and multinational companies with operations in Mexico must create an employer-employee committee in charge of profit-sharing. The duties of the committee include:

- Formulate the allocation of profit for each eligible employee, per the FLL guidelines.
- Post notices in all company locations, announcing profit-sharing payments at least 15 days before payments are made.
- Inform employees of their right to challenge the committee's determinations.
- Resolve challenges within in a 15-days period.
- Monitor that the payment is made, per FLL guidelines.

Moreover, in compliance with the provisions of article 122 of the FLL, profit-sharing among employees must be paid within 60 days following the date in which the employer's tax return is filed with the tax authority, even if an objection or disagreement from employees is pending.

Planning ahead, always the best strategy

The way profit-sharing is structured and regulated is unique to Mexico. Foreign investors typically have difficulties understanding it. Therefore, it is very important for companies with operations in Mexico to annually develop the employer-employee committee in charge of profit-sharing to be fully compliant with the FLL. Failure to comply with this requirement can open the company to risks of fines imposed by the government and potential complaints by employees.

Companies starting operations in Mexico should take profit-sharing into account when implementing their corporate and tax structures. Moreover, all foreign companies with operations in Mexico — whether established recently or years ago — should consider profit-sharing on a yearly basis when drafting their variable compensation plans to ensure that employees working in Mexico are not overcompensated due to profit-sharing in comparison to employees working in other countries who are performing the same type of job but are not eligible to receive this benefit.

The role of productivity

As its name suggests, profit-sharing was created in order to motivate employees to do better and to share in the profits that they helped to achieve. Ironically, however, the FLL structures profit-sharing based only on two variables: wages received and number of days worked by employees during the fiscal year, without consideration of an employee's participation in the actual creation of profits or even the employee's own productivity and performance. This has regenerated substantial criticism in Mexico since profit-sharing has nothing to do with productivity, nor with the current social and economic circumstances of the country and companies operating in Mexico.

Due to the above, during the last few years, employer associations have been lobbying to reform the law by assigning a specific percentage of profit-sharing to productivity indicators and limiting the payment to months of employees' salaries. While most companies have corporate structures that allow a proactive management of profits, other companies distribute up to eight or nine months of salary as profit-sharing. Reducing the distributable percentage for profit-sharing, based on a real analysis by the Commission of the country's current economic situation, could have a positive impact on the economy in that it would simplify companies' operations, increase Mexico competitiveness and attract more foreign investment. It also would reinforce current President Enrique Peña Nieto's focus on productivity. As stated by the International Labor Organization ("ILO") in several occasions, high productivity indicators are absolutely linked to decent wages for a country's population.

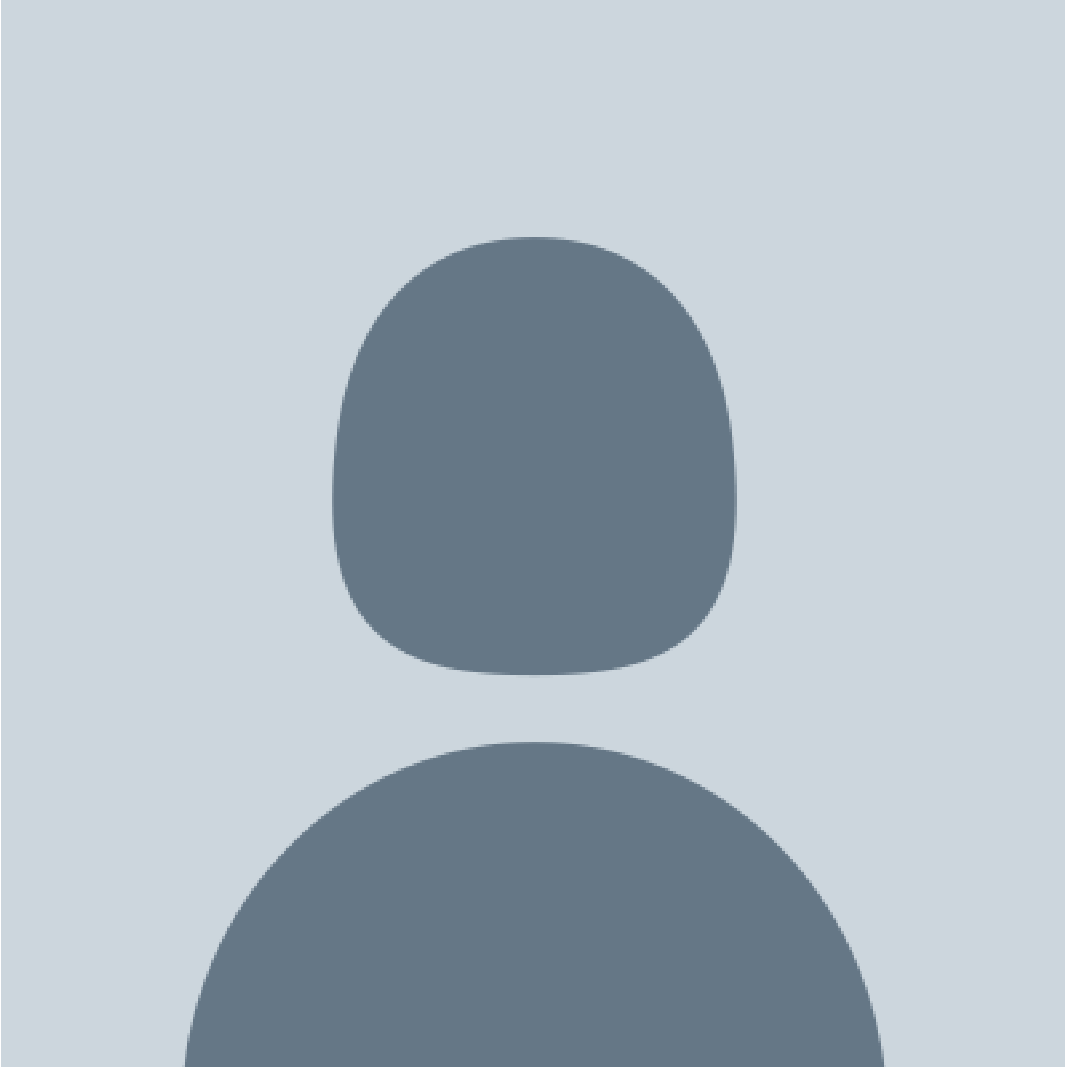
Regrettably, Mexico's productivity performance has been consistently low during the past years, even when comparing it with countries with similar or even smaller economies. For instance, according to the Organisation for Economic Co-operation and Development ("OECD"), between the years 2001 and 2011, annual productivity growth in Mexico was only of 0.81 percent, well below the 1.65 percent average of the OECD countries. This looks particularly discouraging if we compare the Mexican economy with Chile, for example. Between 1997 and 2014, Chile held an annual average in productivity of 2.6 percent and 3.9 percent economic growth. In contrast, during the same period, Mexico had a productivity increase of 1.18 percent and an economic growth of 2.8 percent.[2]

2 OCDE, "Labour Productivity Statistics", OCDE, www.oecd.org.

With this in mind, the reform to the FLL of December of 2012 incorporated a whole chapter dedicated to productivity. It is worth noting that the word "productivity", prior to the labor reform only appeared three times in the FLL. The purpose of some of the new FLL provisions, such as the teaching and training obligations imposed on the employer, is to increase employee productivity. An employer's failure to comply with these obligations can result in penalties imposed on the employer.

Although the Commission is not required to reconvene until 2019, the debate into whether it is time to re-adjust the profit-sharing percentage is starting now. While the FLL requires the Commission to meet every 10 years, the law also allows it to hold extraordinary meetings if the economic circumstances justify it. As such, the goal of the current debate is to open up the dialogue between the government and the employer and employee sectors, to prompt them to bring the necessary adjustment to the profit-sharing percentage.

Mo?nica Schiaffino



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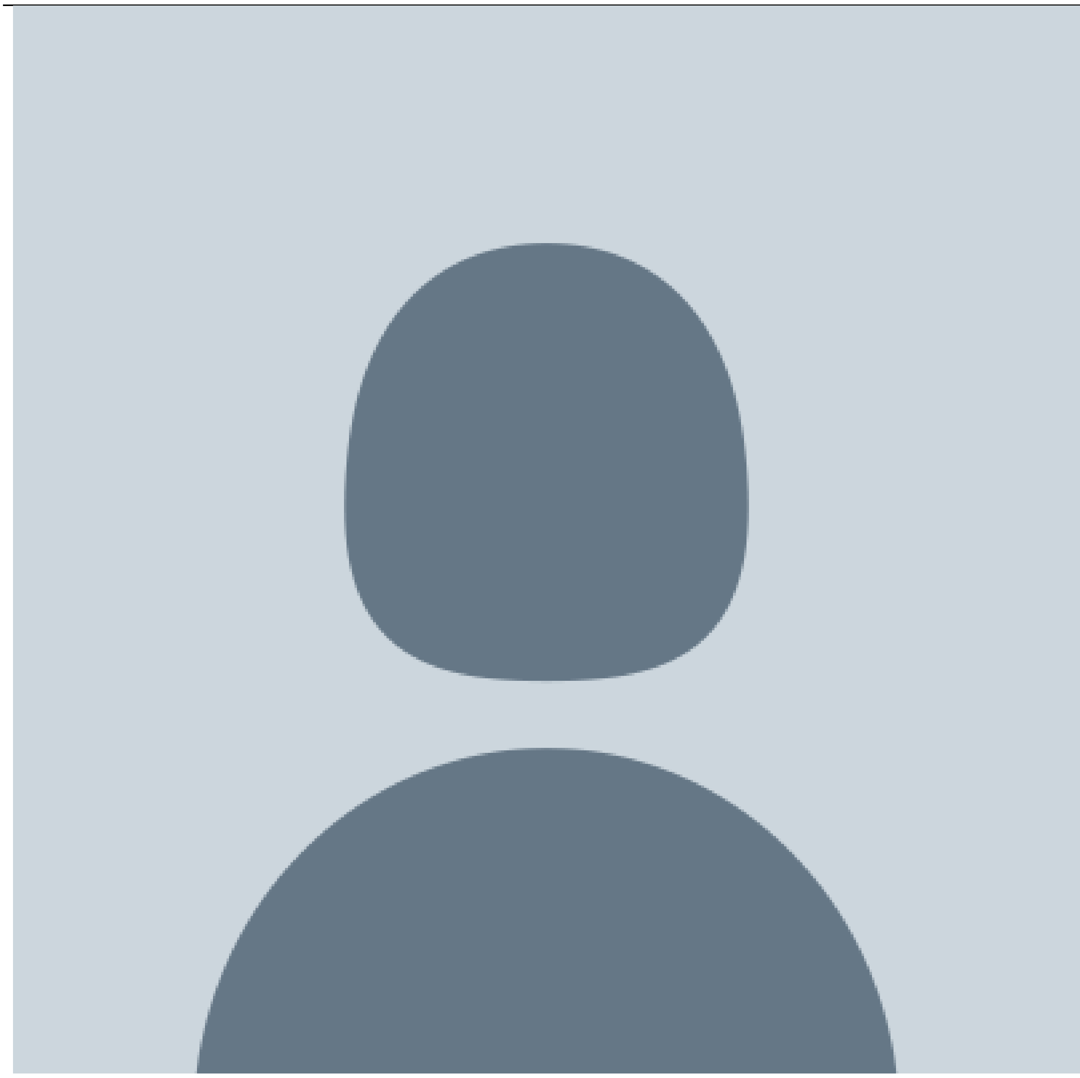

Associate

Littler Mendelson P.C.