

Legal 500

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Mexico

Employee Incentives

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This country-specific Q&A provides an overview of employee incentives laws and regulations applicable in Mexico.

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Mexico: Employee Incentives

1. What kinds of incentive plan are most commonly offered and to whom?

The Federal Labour Law ("FLL") provides all employees with minimum mandatory benefits (Christmas bonus, vacation premium, vacations, profit sharing). In addition to the minimum rights provided by FLL, and based on the principle of contractual freedom, it is common practice that companies offer to certain executives or key employees members of the management, different fringe benefits or incentives. These incentives could be designed for short, medium or long-term purposes, hence they can comprehend different types of awards, entitlements or instruments.

The most common incentive plans offered by Companies in Mexico to their executives are:

- i. Salary-based commissions for sales;
- ii. Performance bonuses which depend on the achievement of specific objective;
- iii. Share purchase plans or equity based incentives (i.e. Stock options, Restricted Stock units, among others);
- iv. Retention awards
- v. Deferred compensation
- vi. Hybrid plans containing a combination between cash and equity.
- vii. Private retirement or pension plans.

2. What kinds of share option plan can be offered?

Employers can offer their employees participation in different types of share/stock option plans, so long the plans comply with the Mexican law (i.e. restricted stock options, performance based stock options, among others). In other words, there are no specific limitations on the grant or offering of share or equity-based plans to employees or executives other than those provided by applicable law like securities or banking / financial regulation for specific public companies or regulated entities.

3. What kinds of share acquisition/share purchase plan can be offered?

Employers can offer to their employees all type of share acquisition / purchase plans (i.e. direct purchase, stock

options with vesting periods, discounted shares price or free of charge and units convertible into stock, among others). The most common share plans used in Mexico are option plans that give the Employees the right to buy a certain number of shares or stock of their Employer Company, a Subsidiary of it, or from the Holding Company. Employees can generally exercise their share options and acquire the underlying stock after a specified period (vesting period).

4. What other forms of long-term incentives (including cash plans) can be offered?

Common long-term incentives (cash or equity based) in Mexico are:

- i. Retention awards;
- ii. Deferred cash compensation awards;
- iii. Private, pension plans;
- iv. Stock Options
- v. Stock Appreciation Rights
- vi. Phantom Stock
- vii. Performance Shares
- viii. Performance Share Units
- ix. Restricted Stock Units
- x. Early retirement awards or plans
- xi. Seniority awards or bonuses

5. Are there any limits on who can participate in an incentive plan and the extent to which they can participate?

There are no limits in general and employers can set the parameters and scope. Therefore, employers can decide which employees can be part of a given incentive plan. Normally, share or equity-based plans as well as retention and special cash awards are offered only to high ranked executives or key positions. Tax considerations must be reviewed, however, for certain types of incentives and personnel.

6. Can awards be made subject to performance criteria, vesting schedules and forfeiture?

Yes, plans can be structured and offered subject to performance, vesting schedules, and forfeiture. However, for evidentiary and enforceable purposes, the awards and

conditions must be set forth in writing. Also, there are specific awards that could be linked to performance of the company or the individuals and be tailored according to the needs of the company or employer.

On the forfeiture aspects, such plans should be crystal clear on the forfeiture causes or circumstances and on any clawback provisions because the Mexican labour law tends to protect employee's rights and recognize payment of awards once they accrue in favour of the employees. Clawback or payback by the employees can find certain limitations on the Federal Labour Law and release employees from certain payment obligations towards their employers.

7. Can awards be made subject to post-vesting and/or post-employment holding periods. If so, how prevalent are these provisions both generally and by reference to specific sectors?

Yes, awards can be subject to post-vesting and/or post-employment holding periods. However, for prevalence and enforcement purposes, the conditions must be set forth in writing. Such post-vesting and/or post-employment holding periods should be carefully drafted within the plans because they can trigger certain tax and labour liabilities (i.e. construal that any post-employment award payment could renew the labour relationship or not be counted for tax deduction where not properly justified).

8. How prevalent malus and clawback provisions are and both generally and by reference to specific sectors?

Malus provisions may be set for performance and target bonuses. To legally justify refusal of payment of the award, employers shall meticulously design their incentive plans in order to adequately cover when the award can be granted and when could be cancelled or forfeited, where performance results are below the expected target or where certain no payment circumstances take place.

Clawback provisions are more commonly used for employees whose compensation includes a base salary and variable compensation as well as in retention awards paid in advance to the retention periods. Since the amount of the award usually depends on the employee's achievements on sales or fulfillment of retention periods, it is common practice that in these positions companies often allow the employee to participate in an incentive plan to acquaint themselves with the assigned market

and region or for not quitting the position before the estimated time. As in malus provisions, employers shall meticulously design their incentive plans to adequately determine when payments might claw backed or paid back by the employee which usually takes place where their performance results are below the expected target or where retention periods are not met. The employee shall expressly authorize any withholding or retention for re-payment of any award or amount due to the employer with the limits set forth in the FLL. According to FLL, employers shall make deductions from an employee's salary only in certain cases. Discounts to salary can be applied to payments that have been made in advance, with the following restrictions: (i) the amount to be discounted must be no more than the equivalent of one month's salary (ii) the deductions must not exceed 30% of the difference between the salary and the minimum daily wage.

9. What are the tax and social security consequences for participants in an incentive plan including: (i) on grant; (ii) on vesting; (iii) on exercise; (iv) on the acquisition, holding and/or disposal of any underlying shares or securities; and (v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

Generally, compensation to employees becomes taxable for federal income tax upon actual payment, therefore the mere granting of a certain incentive will not trigger income tax consequences.

Upon actual payment of compensation, the employer must withhold and pay the applicable income tax (at a progressive rate up to 35%) as an advance payment on behalf of employees, and these must, generally, include such compensation and the advance payments as part of their yearly tax return.

Certain concepts of compensation mainly comprised by fringe benefits that are not regularly part of an incentive plan (health insurance, savings fund and others) may be eligible for income tax exemption up to a rather limited amount.

In the case of employee stock option plans, a particular rule included in the Mexican Income Tax Law ("MITL") states that income will be deemed perceived upon actual exercise of the option, per the difference between the shares' market value and the option's strike price. The

eventual sale by the employee of the corresponding shares would trigger income tax due on the capital gain derived thereof, which may be taxable at a 10% special rate for publicly traded entities or the general rates applicable to individuals (progressive rate up to 35%).

With regards to loans offered to employees, there are no rules or regulations stating whether these would constitute taxable income or any specifics thereon.

Loans, however, may fall under the broad conception of "benefits" referred to in the MITL, for which a case-by-case analysis would be recommendable.

For social security purposes, certain awards can be considered as part of the base salary of contribution before the Social Security Institute, hence each award or incentive plan must be reviewed for purposes thereof.

10. What are the tax and social security consequences for companies operating an incentive plan? (i) on grant; (ii) on vesting; (iii) on exercise; (iv) on the acquisition, holding and/or disposal of any underlying shares or securities; (v) in connection with any loans offered to participants (either by the company operating the incentive plan, the employer of the participant (if different) or a third party) as part of the incentive plan.

Companies will be able to take the corresponding income tax deduction for any payments made to employees upon actual payment, and subject to the company complying with the applicable withholding and reporting obligations. Particular consideration on the specific deductibility limitations for certain types of employees or benefits is advisable (e.g. high ranking officers, profit based incentives, etc.).

Companies shall issue electronic tax invoices for any employee compensation paid, including information on the concepts and amounts comprising such compensation. These invoices must be delivered to the employees (while they are also automatically remitted to tax authorities).

Withholding and reporting on stock options plans will depend on the specifics of the plan. As an overall rule, companies will have to report on a yearly basis the information on employees who exercised the option for purchasing stock.

Any benefits that are deemed exempt income for

employees will be partially deductible for the company, at a 47% or 53% rate, in this latter case subject to the company not having reduced its exempt compensation from the previous year.

As for local (state) payroll tax, incentives will regularly be deemed part of the taxable base depending on the state where tax is due and will trigger a 2-4% tax due on the company upon actual payment. Stock option plans may eventually fall outside the scope of local payroll taxes, subject to analyzing the corresponding plan and the state in which it would be taxed.

An eventual sale of shares acquired as part of a compensation plan will trigger a taxable gain to the employee. However, withholding on such sale will be due on the buyer and not on the company.

With regards to loans offered to employees, there are no specific rules or regulations stating whether these would constitute taxable income or any specifics thereon.

Loans, however, may fall under the broad conception of "benefits" referred to in the MITL, for which a case-by-case analysis would be recommendable.

For social security purposes, certain awards can be considered as part of the base salary of contribution before the Social Security Institute, hence each award or incentive plan must be reviewed for purposes thereof.

11. What are the reporting/notification/filing requirements applicable to an incentive plan?

From a securities law and financial regulation standpoint, incentive plans are not subject to registration with the regulators or securities authorities, provided these comply with the registration exemption set forth thereof.

There are specific rules for public companies or listed companies and their affiliated entities for reporting compensation payments of members of the boards of directors, as well as compensation paid to relevant executives (including amounts paid under any specific compensation or incentive plan).

Such filing or report shall comprehend a thorough description of any compensation and benefits that the board members and relevant executives received from the Mexican public company or issuer of securities through an authorized exchange; and details of any plans or arrangements relating to the directors or relevant executives.

From a tax perspective, there are no requirements on the

plan itself. Compensation, however, must be duly included and outlined (concept and amount) as part of the corresponding electronic invoices and certain informative returns. Particularly concerning the exercise of stock options, companies will have to report on a yearly basis the information on employees who exercised the option for purchasing stock.

12. Do participants in incentive plans have a right to compensation for loss of their awards when their employment terminates? Does the reason for the termination matter?

Upon termination, employees shall receive any accrued benefit up to the date and any other fringe benefit up to the date of termination as profit sharing, Christmas bonus, vacation, vacation premium, salary, and any other that followed up to the date of termination.

Now, regarding incentive plans that are beyond these minimum benefits, employers can regulate the terms of conditions of such plans and any payment applicable upon employment termination. It is a common practice to establish that employees will lose their awards upon termination if they have not been vested or exercised by the employee, regardless of the termination cause.

Nonetheless, this matter can always be subject of interpretation by the Labour Courts because any termination unilaterally provoked or conducted by the company or issuer of the plan could lead to an interpretation by the Labour Courts that the pending awards or stock to be granted or vested in favour of the employee should be paid out or compensated under a wrongful termination scenario.

13. Do any data protection requirements apply to the operation of an incentive plan?

Not necessarily for the operation of the incentive plan per se or particularly, however, in general employers shall treat employees' data in compliance with the Federal Law on the Protection of Personal Data Held by Individuals ("Ley Federal de Protección de Datos Personales en Posesión de los Particulares") whenever they collect data from the employees (including collection of data for participation in any incentive plan implemented or issued by the company or employer).

14. Are there any corporate governance guidelines that apply to the operation of incentive

plans?

There are no specific legal guidelines for the operation for incentive plans.

Nevertheless, there is a set of recommendations contained in what is known as the Code of Best Corporate Practices for Boards of Directors issued by a reputed chamber of commerce in Mexico and which among other matters addresses the suggestion for Board of Directors to analyse and approve compensation structures and plans for high level or key executives, along with special awards, termination payments and performance indicators. It is also suggested that companies incorporate a compensation committee composed by certain board members or independent directors free of conflict with the relevant officers of the company.

15. Are there any prospectus or securities law requirements that apply to the operation of incentive plans?

There are no specific prospectus or securities law that apply for the operation in specific for incentive plans provided that these plans comply and fall within the registration exemption under Mexican securities regulation.

16. Do any specialist regulatory regimes apply to incentive plans?

Certain financial entities deemed regulated entities under the oversight of financial or insurance regulators (i.e. banks, broker dealers, non-bank banks, bond and/or insurance companies) may be subject to set up specific remuneration policies aimed to avoid financial pitfalls or conflicts of interest within their operation.

17. Are there any exchange control restrictions that affect the operation of incentive plans?

There are no specific exchange control restrictions that affect the operation of incentive plans in Mexico.

18. What is the formal process for granting awards under an incentive plan?

There is no formal process set forth by law for granting or offering awards under a given incentive plan. However, employers shall document and follow the form or protocol set up in the relevant plan. Most of the awards

are granted through joinder agreements to the specific plans or award letters where the conditions of the award are stated. Reference to specific plans or terms and conditions are also included in the granting documents. These plans require the consent of the employee, thus any agreement or document evidencing such consent by the employee could be sufficient.

19. Can an overseas corporation operate an incentive plan?

Yes, there are no restrictions for such, bearing in mind that tax obligations regarding the income for such awards would still apply for the employee's tax residents in Mexico. In this regard it is important for the overseas corporation to understand the labour liability it could acquire in Mexico for offering incentives to Mexican employees, since any award granted by an overseas or foreign entity could trigger tax (permanent establishment) and labour liabilities in Mexico. Normally, the laws from the jurisdiction of the issuer or grantor of the award would apply; however, employees who receive an award for work rendered in Mexico shall find protection of the Mexican labour laws regarding such benefit and a potential labour responsibility on the side of the overseas company.

20. Can an overseas employee participate in an incentive plan?

Yes, there are no restrictions in such regard, although such overseas employee could be considered a de-facto employee of the company granting the award if such company is located and legally established in Mexico.

Such would trigger Mexican employer obligations by the issuer towards the overseas employee.

21. How are share options or awards held by an internationally mobile employee taxed?

Taxation in Mexico for the employees will depend on their tax residence, which is determined by (a) the location of their home or (b) when having a home both in Mexico and abroad, the location of its center of vital interests (personal and economic relations.) Mexican national individuals are presumed to be tax residents in Mexico.

Taxation for Mexican residents will apply as mentioned in the answer to question 9. Overall, for foreign residents, stock options and the eventual sale of shares will be taxed in Mexico when (a) they are granted per services

rendered in Mexico, except when compensation is paid by a foreign resident and the employee does not spend more than 183 days, consecutive or not, within a 12-month period or (b) the issuing entity is a Mexican resident, upon the eventual sale of the corresponding shares.

As with Mexican residents, income from a stock option plan for foreign residents will be deemed perceived upon exercising the option. Income tax would be triggered at a progressive rate up to 30%.

There could be specific cases when the share option or awards are subject to taxation in more than one jurisdiction, in which case the employee could eventually apply the benefits of Double Taxation Treaties.

Tax obligations for companies granting stock option plans will be applicable to the extent they are Mexican resident entities.

22. How are cash-based incentives held by an internationally mobile employee taxed?

Taxation on cash-based incentives will be subject to the rules set forth in Q21, with income deemed perceived upon payment.

23. What trends in incentive plan design have you observed over the last 12 months?

No particular trends have been observed in the last 12 months, although ultimately, we have seen companies rely more on Stock Option and Restricted Stock Units for equity-based plans and less on Phantom Stock or direct purchase or stock assignment plans. In general, long term incentive plans are not commonly used in Mexico and most of the plans we come across are imported by subsidiaries from US or Multinational Corporations.

Nonetheless, executive compensation and incentive plans are becoming more common in Mexico derived from changes to profit sharing and outsourcing regulations where companies are working on finding new compensation structures for employees and executives amid the new reality.

24. What are the current developments and proposals for reform that will affect the operation of incentive plans over the next 12 months?

Currently, there are no developments or proposals for reform regarding incentive plans. However, various reform initiatives to the FLL could have significant

implications and operational-administrative costs for companies in Mexico. Among these initiatives are: (i) the reduction of the work-shift and the increase of resting days, and (iii) the increase in Christmas bonus days.

Nevertheless, we emphasize that these topics are only proposals at this stage, which must undergo the legislative process before being incorporated into the FLL

and becoming mandatory for employers in Mexico.

In the event that these proposals or any other initiative of a similar nature are approved, it is important to consider that they may represent administrative and operational costs for the employer, which could affect the budget for new compensation structures, incentive plans, or long-term awards.

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