

Private Pensions in a Cross-Border Planning Context: AFOREs

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In this article, Callahan and Rodríguez explain the relationship between U.S. and Mexican pensions, tax law, and financial planning as it affects U.S. taxpayers with Mexican pensions or Mexican pensioners who become U.S. taxpayers.

Foreign pensions should be top of mind for any adviser assisting an individual who worked outside of the United States.

For many clients, pensions represent a significant percentage of their retirement savings and future or current income. These plans should be carefully considered in the context of a single country and even more carefully reviewed in an international context. The cross-border tax complications can be significant.

There are two aspects to consider:

- how are these plans treated in their home jurisdiction and
- how would they be treated in the United States if the individual is or should become a U.S. income tax resident (a U.S. person).

Different countries often have different pension and retirement account schemes. Some jurisdictions offer only public benefits. Others may have only private pension schemes. Still others may offer both private and public options that coexist in the same country. The foreign national rules and regulations on how and how much to contribute, who contributes, when you can withdraw, penalties, income taxes, etc., vary widely from country to country and can be

extremely complex. Because of local complexities, it is advisable to understand each country on a stand-alone basis and not rely on broad generalities.

In this article, we look at the history of private pensions, particularly in Latin America, and delve more fully into the private pension system in Mexico and the type of account commonly referred to as *Administradoras de Fondos para el Retiro* (AFORE in Spanish). The article also explores the related U.S. tax and information reporting rules and some planning techniques that may be helpful in certain cases. It is our hope that providing this more in-depth review of one country will provide a framework from which one can approach other private pensions, regardless of their country of origin.

History

Privatization of public pension schemes took off in the 1980s, promoted in large part by the IMF and the World Bank¹ to help address underfunded government pension plans, mostly in developing countries. The idea behind the privatization of pension plans had its genesis a decade earlier in the economic theories of Nobel Prize-winning economist Milton Friedman, who advocated for a bigger role of market forces within national economies, deregularization, and governments returning obligations they had themselves assumed to the private sector.

In addition to advising governments,² Friedman also taught at the University of Chicago, where he had a strong influence on a group of students from Latin America. This group would

¹Peter Heller, "The IMF's Involvement With Pension Issues: 2006-15," Independent Evaluation Office of the International Monetary Fund Background Paper BP/17-01/01, at 3 (July 5, 2017).

²Friedman advised the governments of both Ronald Reagan and Margaret Thatcher.

eventually be known as the “Chicago Boys.” Among them were several Chileans who returned to their country in the 1970s and were appointed to important government posts. Under the influence of the Chicago Boys, free market capitalism and laissez-faire economics were determinant in creating the so-called Miracle of Chile and helped usher in the era of neoliberalism around the world.³ Given this approach, it is no surprise that the first country to privatize their pension scheme was Chile in 1981.

Many countries in Latin America, seeing the economic growth in Chile brought about in large part by the ideas of the Chicago Boys, implemented similar changes over the next decade to address their own woes. One of the reforms that was seen to help perennial government deficits at that time was privatization of the national pension systems. But the Chilean model of pension reform did not stop in Latin America. About a dozen countries in Europe, Asia, and Africa took inspiration from the Chilean model and established their own private pension schemes.

In general, these plans fully or partially transfer the risk of funding retirement programs from the government to the private sector. They often allow for government contributions to some extent, but the burden is largely transferred to employees and the businesses that employ them. An important characteristic of many of these plans is the existence of a master account divided into different “subaccounts.” Some, but not all, of these subaccounts are tied to funding retirement benefits. The different characteristics of the subaccounts in the local environment may lead to different characterizations from a U.S. legal perspective. This adds a unique challenge in understanding the U.S. tax consequences of these plans.

Mexico

Before 1997, Mexico only had traditional pension plans, in which employees in the private sector had amounts withheld from their earnings and deposited with the Mexican Institute for

³Felipe Costa Lima, “Chile and the Overcoming of Neoliberalism: Countering Authoritarianism and the Self-Regulated Market,” *E-International Relations* (July 14, 2021).

Social Security (IMSS in Spanish). In the public sector, employees were covered by a different organization called the Institute for Security and Social Services for State Employees (ISSSTE in Spanish). In the military, personnel were covered by still a different group called the Social Security Institute for the Armed Forces (ISSSFAM in Spanish). After 1997, some employees were allowed to continue to participate in the legacy schemes if they desired.

Private pension plans in Mexico are now administered by AFOREs, which is not part of the government. These independent financial institutions administer individual investment accounts on behalf of plan participants. This article looks at these individual accounts, usually referred to as AFORE accounts.

As of April, there were close to 75 million individual AFORE accounts.⁴ Of the 300 largest pension funds in the world, four are AFOREs.⁵ They had about \$329 billion invested at the beginning of 2024.⁶ The funds invested in AFOREs now represent over 24 percent of Mexican GDP.⁷ As a result of a modification to the social security laws in 2020, required contributions into the AFOREs are set to double over the next few years, with a stated goal of reaching 50 percent of GDP by 2050,⁸ increasing the importance of the accounts for both individuals and the country as a whole. If you have clients that worked or are currently working in Mexico, it is likely you will need to consider these accounts as part of your planning.

How Do AFOREs Work in Mexico?

All employees registered with a Mexican Social Security number must have an AFORE account unless they are eligible and opt to remain covered by a legacy pension plan. Self-employed

⁴Government of Mexico, “Cuentas Administradas por las AFOREs,” *Información Estadística* (last updated July 15) (in Spanish).

⁵Arturo Hanono, “4 AFOREs Are Among the 300 Largest Pension Funds,” *Funds Society* (Sept. 9, 2019).

⁶“Mexico’s AFOREs Gain MX\$21 Billion in January 2024,” *Mexico Business News*, Feb. 19, 2024.

⁷Luz Elena Marcos, “Los Numeros de las AFOREs en Mexico,” *Expansion*, Feb. 26, 2024 (in Spanish).

⁸According to the president of the *Comisión Nacional del Sistema de Ahorro para el Retiro*, Iván Pliego, in a presentation sponsored by the U.S.-Mexico Chamber of Commerce on Aug. 28, 2022.

individuals can open an individual account at one of the AFOREs as well, but the program works differently for the self-employed.

Each employee has a master individual account, which is divided into three subaccounts:

- Retirement, Unemployment, and Old Age;
- Voluntary Savings; and
- Housing.

Retirement, Unemployment, and Old Age Subaccount

Participation in this subaccount is mandatory. The employee contributes 1.125 percent of adjusted salary, the employer contributes 5.33 percent, and the federal government contributes just 0.225 percent, for a total of 6.68 percent. The employee contribution is made before tax, and the employer and government contributions are not taxable to the account holder.

Modifications to the law in 2020 aimed to slowly increase the total percentage that must be paid into these accounts so that by 2030 it will reach a total of 13 percent of adjusted salary. The employee contribution will continue to be 1.125 percent, with the remainder coming, in most cases, from the employer. For employees making very low wages, the federal government will kick in up to an additional 5.5 percent of the adjusted salary.

Employees are not allowed to add additional funds to this subaccount. Funds can be accessed before retirement only in very limited circumstances prescribed by law. “Normal” retirement, as defined in the law, can take place as soon as 60, whereas “old age” retirement takes place at 65. Under certain circumstances, depending on how long they have participated and how much is in the account, some people may qualify for “early retirement” and be able to receive pension payments before age 60. Before age 60, some of the funds in this subaccount can also be accessed in case of unemployment.

Beneficiaries for this subaccount are defined by law and cannot be modified. They are:

- surviving spouse;
- children younger than 16;
- children older than 16 and up to 25, if students;
- children who are “50 percent incapacitated”;

- parents of the decedent;
- live-in, unmarried partner of the decedent, if economically dependent;
- other economic dependents; and
- the IMSS as the beneficiary of last resort.⁹

Depending on various factors, including weeks of participation over an employee’s entire work history and the total amount invested, the account holder may exercise one of the following four options:

- take a lump sum;
- purchase an annuity;
- request periodic and equal payments; or
- exchange the total in the account for a minimum pension paid by the federal government.

Note that a widow or widower with grown children cannot pass on the assets in this subaccount via a beneficiary designation. The heirs would have 10 years to initiate a separate procedure with the Mexican Institute for Social Security or the Institute for Security and Social Services for State Employees to receive these funds.

If there are funds in the voluntary subaccounts (discussed below) at time of retirement, they can be rolled over to the retirement, unemployment, and old age subaccount to increase the pension annuity or periodic payments.

Voluntary Savings Subaccounts

Account holders are allowed and encouraged to invest additional funds into their AFORE voluntary subaccounts with after-tax money. Some of these subaccounts were created to provide a convenient way for people to save and invest additional funds via salary deductions for purposes other than retirement. There are four types of voluntary subaccounts:

- short-term savings;
- medium-term savings;
- long-term savings; and
- complementary savings for retirement.

⁹ Article 510 Ley del Seguro Social.

There is no limit on how much an individual can deposit into the voluntary subaccounts and, unlike the retirement, unemployment, and old age subaccount in which beneficiaries are prescribed by law, the owner of a voluntary savings subaccount is allowed to freely designate beneficiaries without a need to follow the rules related to the so-called legal beneficiaries discussed above. If the account holder fails to designate beneficiaries for the voluntary subaccounts, the legal beneficiary designations will take their place.

Housing Subaccount

Since 1972, Mexico has required employers to contribute 5 percent of each employee's adjusted salary to a fund to help them save to purchase a home. The program is managed by the Institute for the National Fund for Worker's Housing (INFONAVIT in Spanish). To lessen the administrative burden of creating two separate statements, the housing subaccount was created. The INFONAVIT funds and AFORE contributions are reported on one statement. The withholding and reporting of the value in this fund is done by the AFORE. However, INFONAVIT administers the program and invests the money.

How Are AFORE Funds Invested?

Except for the housing subaccount, all funds are invested in a particular type of pooled investment vehicle known as a specialized retirement investment fund (SIEFORE in Spanish). The funds run the gamut from bonds to equities, Mexican to international, and use many different asset classes. SIEFORES can only invest in securities approved by the law. Accountholders are restricted to the investments offered by the company they choose.

The companies provide plan participants model portfolios, like target age funds, although the account beneficiary is not tied to any one model. Account holders can choose between all the different models available, even if a particular model does not meet their age or projected retirement date.

Each AFORE will have its own investment strategies and internal costs. The account owner is not restricted to any one company but can choose

from among ten companies that currently participate in the marketplace. However, they can have only one AFORE account.

Mexican Taxes

For the mandatory retirement, unemployment, and old age subaccount, mandatory employee contributions are deducted pretax from the salary. These funds are added to investments, along with the contributions from the employer and government. Investments in all subaccounts grow tax free.

Upon retirement, if the account holder decides to receive an annuity or periodic payments, about \$32,000 a year could be received tax free in 2024 (at an assumed exchange rate of MXN 18 to the U.S. dollar). Larger amounts are added to regular income and taxed at marginal rates. If the beneficiary chose a lump sum, about \$175,500 could be received tax free in 2024,¹⁰ assuming an exchange rate of MXN 18 to the U.S. dollar. AFORES withhold between 5 percent and 7 percent on amounts that exceed the exemption amount per article 96-bis of the Mexican income tax law.

Voluntary contributions to the short-, medium-, and long-term subaccounts have different tax consequences. For the short-term savings account, contributions are made after tax, and no income tax deduction is allowed on the annual tax return. Short-term funds can be withdrawn after six months, and generally only two withdrawals are permitted per year. Investments are made into any model portfolio the taxpayer picks. Income taxes are due on withdrawals to the extent there were earnings.

Amounts contributed to the other voluntary subaccounts, including the medium-term, long-term, and complementary retirement subaccounts, are made with after-tax money but may be deducted from taxable income on the annual tax return in the year of the contribution, up to a certain amount. In 2024, a deduction equivalent to no more than 10 percent of gross income or \$10,800¹¹ per year (assuming an

¹⁰"El SAT Incrementará el ISR en 2024 para Jubilados que Ahorren," *Tribuna Económica BC*, Nov. 13, 2023 (in Spanish).

¹¹Mexican Income Tax Law, Article 151, V. Note that the 10 percent is for the sum of all allowable deductions.

exchange rate of MXN 18 to the U.S. dollar), whichever is lower, is allowed.

Funds in the medium-term savings subaccount can be accessed at any time. However, if the taxpayer took a tax deduction in prior years and made a withdrawal before the end of five years, the total amount deducted must be added back to taxable income in the year of withdrawal. If the funds are withdrawn after five years, there is no need to add back the amounts taken as a deduction. Regardless, taxes are assessed on any withdrawal to the extent of earnings.

Savings added to the long-term subaccount can be withdrawn only after the amounts in the short-term subaccount have been exhausted. Withdrawals before retirement are subject to 20 percent withholding and are fully taxable.

It is important to note that funds in the short-, medium-, and long-term subaccounts are not defined as pension income. Savings in the complementary retirement subaccount can only be withdrawn at retirement. Unlike the other subaccounts, these withdrawals are considered pension income and may be exempt from regular income tax up to certain limits as explained above.

Mandatory Distributions

There are no mandatory distribution requirements in Mexico. However, there is an incentive to move the funds out of the retirement, unemployment, and old age subaccount. As mentioned, without a lengthy, cumbersome, and at times expensive bureaucratic procedure ancillary to probate, these funds may be lost to nonspouse family members.¹²

On the other hand, for investments in the voluntary subaccounts, the balances are distributed to the named beneficiaries. Funds received by beneficiaries are taxable to them to the extent of earnings.

Creditor Protection

Sums in the retirement, unemployment, and old age subaccount can be split in the event of divorce. Otherwise, they are exempt from creditor attack.

Sums in the other voluntary subaccounts are exempt from creditor attack for a sum of 20 times minimum wage, or about \$99,000 in 2024, depending on exchange rate.

Portability

Account holders can choose their AFORE company and can change companies if they want. If they change jobs, the account follows them. Account holders can roll over their balance to another AFORE once a year.

U.S. Tax and Reporting Framework

Despite the United States and Mexico having an income tax treaty that attempts to provide relief for cross-border pension participants, many U.S. taxpayers are nonetheless subject to U.S. taxation and information reporting with regard to pensions in Mexico. As a result, it is important to understand how U.S. tax and reporting rules may apply to these plans.

The analysis should begin by determining whether the plan will qualify under IRC section 401.¹³ Absent unusual circumstances, foreign pensions generally do not meet the requirements for IRC section 401. If the plan does not qualify, then U.S. tax laws generally treat the plan as a trust. AFOREs are no exception and will generally be treated as a foreign trust for U.S. tax and reporting purposes. Based on this premise, the next step is to evaluate the plan under IRC section 402(b), which is applicable to foreign pensions and deferred compensation plans. Under this framework, the plan may be classified in one of the following manners:

- a grantor trust under sections 671-679;
- a nonexempt employee trust under section 402(b); or
- a bifurcated trust taxable partly as an employee grantor trust under reg. section 1.402(b)-(1)(b)(6) and partly as a nonexempt employees' trust.

The U.S. taxation and information reporting requirements can be substantially different for

¹² Obviously, if annuitized, there is nothing to distribute to nonspouse members and the annuity ends at death of the annuitant.

¹³ IRC section 401(a), Requirements for Qualification: A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section.

each classification. For example, and as discussed below, certain classifications may require annual information return filings (for example, the grantor trust classification may require annual Forms 3520 and 3520-A). Failure to timely file these forms can result in significant penalties. Similarly, all or a portion of the income and growth within the plan may be annually taxed at the participant level, even if the participant has not received a distribution from the plan (for example, if the plan is treated as a grantor trust or discriminatory employee's trust). The failure to properly classify these plans can have very negative results.

In practice, U.S. taxpayers often report an AFORE interest as being an interest in a grantor trust (with the taxpayer as the grantor). This is likely because practitioners are more familiar with the grantor trust rules and believe the IRS may be less inclined to challenge an "IRS friendly" grantor trust reporting position. Contributions to and realized income (for example, dividend and interest income) within grantor trust plans are includible in the taxpayer's U.S. gross income in the year the income is earned by the pension. In contrast, all or a portion of the plan contributions to and earnings within the AFORE may be tax deferred in Mexico. The combination of tax deferral in Mexico and immediate U.S. taxation commonly results in foreign tax credit timing issues, creating an important incentive to seek deferral under U.S. law (if applicable).

To the extent the income earned within a plan treated as a grantor trust is considered passive foreign investment company income (reportable on Form 8621), additional negative tax effects may materially lower the plan's effective return on investment. In addition, the taxpayer would likely be required to file Financial Crimes Enforcement Network Form 114 (foreign bank account report), Forms 3520 and 3520-A,¹⁴ and Form 8938 (Statement of Specified Foreign Financial Assets). Failure to timely file these forms can result in

¹⁴Rev. Proc. 2020-17, 2020-12 IRB 539, exempts some foreign tax-favored retirement trusts from the requirements of section 6048. However, the voluntary subaccounts probably do not meet the definition of a tax-favored retirement account as defined in Rev Proc 2020-17, given that contributions can be made from any source of income and are not limited by a percentage of earned income.

significant penalties.¹⁵ Failure to file the correct forms may also lead to the suspension of the statute of limitations for the taxpayer's entire U.S. tax return,¹⁶ allowing the IRS to go back and question other items on the tax return for years to come. Finally, accounts with practically no value are subject to the reporting requirements and possible penalties.

Classification

To the surprise of many taxpayers, grantor trust status may not be the appropriate classification for many of these AFORE interests. Instead, it may be more accurate to classify the AFORES as an interest in a nonexempt employee trust under section 402(b). As discussed below, this reporting position may greatly benefit the taxpayer.

Please note that if a plan is determined to be classified as a 402(b) trust, then a taxpayer must also determine whether the 402(b) plan is "discriminatory" or "non-discriminatory," which requires another complicated U.S. tax analysis. The outcome of this analysis may have additional effects on the tax treatment of the plan (for example, if the plan is discriminatory, the entirety of the earnings and growth within the plan may be taxable on an annual basis, which may result in more immediate taxation of earnings and growth than in the grantor trust scenario). Therefore, taxpayers should note that if one or more of their AFORE subaccounts is determined to be properly classified as a 402(b) plan, the analysis must not stop there. The taxpayer must evaluate whether the plan is discriminatory or nondiscriminatory to determine the proper tax and reporting obligations and make sure the classification will be beneficial. The determination of whether a

¹⁵Form 8621 — failure to file PFIC form 8621 results in a \$10,000 penalty.

FBAR — failure to file an FBAR on a timely basis is \$10,000. However, a willful violation or misstatement is subject to a penalty of \$100,000 or 50 percent of the balance in the account(s), whichever is greater.

Forms 3520 and 3520A — the IRS may assess an annual penalty equal to 35 percent of the gross value of the trust, or 35 percent of the gross value of the assets transferred to the trust if form 3520 is not filed in a timely manner.

In addition, the IRS may assess annual penalties of \$10,000 or 5 percent of the gross reportable amount, whichever is greater, if form 3520A is not filed in a timely manner.

Form 8938 — failure to file Form 8938 also carries a \$10,000 penalty.

¹⁶IRC section 6501(c)(8)(A).

402(b) is discriminatory or nondiscriminatory is complicated and is not discussed further. If you would like to learn more, please reach out to us to discuss this in further detail.

Depending on the relevant facts, a taxpayer may have significant motivation to determine if the plan should receive 402(b) treatment. A 402(b) plan, particularly one that is not discriminatory, may enable the taxpayer to defer U.S. taxation on a greater portion of the contributions to and earnings within the AFORE (as compared to grantor trust status).

In addition, in certain circumstances, the income that may otherwise be treated as indirect PFIC income to the AFORE participant under grantor trust rules may instead be exempt from PFIC treatment. This can have a significant positive effect on the return on investment within the plan. Moreover, the AFORE participant may not be required to file Forms 3520 and 3520-A annually for a plan or subaccount classified as a nonexempt employee trust under section 402(b). The penalties for failing to timely file forms 3520 and 3520-A can be significant unless the IRS agrees there is reasonable cause for the late filing (or the taxpayer uses an IRS disclosure program to come into compliance with limited or no penalty). Therefore, a U.S. person participating in an AFORE plan may be highly motivated to evaluate whether preferential 402(b) treatment is applicable.

Because the U.S. tax classification of an AFORE plan can have a significant effect on the tax and reporting obligations, the classification analysis should be done separately for each subaccount. Each may be classified separately as a different trust and with a different U.S. tax classification. Therefore, a taxpayer may have certain AFORE subaccounts properly treated as grantor trusts but others treated as 402(b) trusts. For example, a voluntary savings subaccount may properly be reported as a grantor trust, whereas the retirement, unemployment, and old age subaccount may receive the often preferable 402(b) classification.

The process of classifying each subaccount can be daunting and should be performed by experts in the field. With the right facts and guidance, however, a U.S. taxpayer can obtain significant tax savings and diminished reporting

obligations for their AFORE subaccounts. In our experience, the reward of performing this analysis is worth the effort.

Planning Points

It is impossible to take a deep dive into all planning opportunities and challenges. However, here are some possibilities:

- If you are working with a U.S. person that has worked in Mexico, it is important to ask as if they have an AFORE and review the FBAR and separate U.S. tax returns and forms to review if the account has been appropriately considered.
- In view of the mismatch between the tax advantaged nature of AFOREs in Mexico and their taxability in the United States, and especially considering potential PFIC treatment, it may be advisable from a U.S. tax perspective for U.S. persons to refrain from making any voluntary contributions to these accounts.
- A Mexican nonresident alien may be motivated from a U.S. tax perspective to distribute AFORE to the extent permitted by law before becoming a U.S. person.
- In those cases in which a U.S. person has failed, for whatever reason, to file the correct forms with the IRS, it may be advantageous to determine the status of the different subaccounts in the hope of qualifying some or all subaccounts as nondiscriminatory nonexempt employee trusts under section 402(b). This analysis may be worthwhile even if account balances are small, given the severe tax consequences, draconian penalties, and possible loss of the statute of limitation protections that can come from failing to report.
- It is also advisable to get an opinion on possible 402(b) status in those cases in which the U.S. person has been fully compliant with U.S. tax law and regulations, especially if the taxpayer has large balances in an AFORE and reclassification may result in more favorable U.S. tax treatment.
- If a taxpayer has balances in both the mandatory retirement, unemployment, and old age subaccount and voluntary subaccounts, one consideration may be

whether it would make sense to roll the voluntary balances to the mandatory account before starting retirement distributions to allow for a significant tax exemption allowed to Mexican tax residents on pension distributions from the mandatory subaccount.

- For companies operating in Mexico with many U.S. employees or for Mexicans that move to work in the United States, it may be advantageous for the company to seek an opinion on the 402(b) status of employee plans and, where needed, to revise their plans to meet the status.

Conclusion

Employees who have worked in Mexico since 1997 will likely have a private retirement plan known as an AFORE because they are mandatory under Mexican law. Americans working in Mexico as employees and Mexican nationals that later become subject to U.S. taxation also are likely to own these accounts. The ins and outs of these

plans are complex and, like qualified plans in the United States, owners should take into consideration the opportunities and pitfalls that exist.

Complexities for U.S. persons, who often have no choice but to open and fund these accounts, increase exponentially when U.S. tax consequences are considered. These plans and their related subaccounts can and often are treated as foreign grantor trusts. Under some circumstances, however, they may qualify for more favorable U.S. tax treatment under IRC section 402(b).

In our experience, tax professionals don't always give proper consideration to foreign pensions, including private pensions. This could be the result of ignorance or the daunting complexity of these pensions.

Regardless, these assets often are an important component of a client's financial life. Appropriate cross-border planning is vital when considering how to best manage these assets. ■