September 15, 2016

Finance Canada
90 Elgin Street
Ottawa, Ontario
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Via email: FIN.Pensions-Pensions.FIN@canada.ca

Re: Pension Plan Investment in Canada: The 30 Per Cent Rule

The purpose of this letter is to provide comments from the Pension Investment Association of Canada ("PIAC") on the Consultations on Federally Regulated Pension Plans ("Consultation Document") released on June 3, 2016. We wish to thank the Department of Finance Canada for including PIAC in the consultation process.

PIAC has been the national voice for Canadian private and public pension funds since 1977 in matters related to pension investment and governance. Senior investment professionals employed by PIAC’s member funds are responsible for the oversight and management of over $1.5 trillion in assets on behalf of millions of Canadians. PIAC’s mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries. PIAC’s positions on public policy reflect the fiduciary framework in which member funds operate and its commitment to work in the best interests of plan members.

PIAC believes the government of Canada should, in considering issues related to the 30 per cent rule and tax policy affecting pension plan investments, take into account that pension plans play an important role in Canadian society and the economy. PIAC’s membership invests contributions made by employees and employers to provide secure, stable retirement income for working Canadians.

PIAC has sought the elimination of the 30% rule limit for many years and have considerable experience with the challenges with the limit and its implications for the broader Canadian economy. While PIAC believes that a complete elimination of the 30 per cent rule with no resulting tax changes is the preferred outcome for the pension funds it represents, and is in the best interests of our society and plan beneficiaries, we would accept the status quo as a preferable outcome to the significant tax policy changes that could impact investment returns.
Should the government of Canada choose to eliminate the 30 per cent rule, PIAC, as a representative of small and large pension plans, emphasizes that there would be no disadvantage to small pension plans. This is because large funds already structure their investments to comply with the 30 per cent rule even where they hold an economic interest in excess of 30%. Smaller pension funds do not object to such structures being used, nor do they believe that the elimination of the 30 per cent rule would materially alter the pension investment landscape. Reducing the regulatory burden on larger pension plans that make investments while structuring to comply with the 30 per cent rule would not impact the investment performance of smaller pension funds who do not wish to take more than 30 per cent of the voting shares of a corporation. In short, pension fund investing is not a zero-sum game; enhancing the opportunity for greater investment returns at lower cost for large pension funds does not come at a reduction of returns or increase the costs for smaller pension funds.

PIAC does not support the introduction of significant tax changes for pension fund investments, as the Consultation Document contemplates.

Below, please find detailed commentary on the major themes raised in the consultation paper: Prudential and Investment Considerations; and Tax Policy.

**Prudential and Investment Considerations**

Many large Canadian pension funds have pursued and developed active management strategies as a means to deliver the returns necessary to support pension payments to Canadians.

Pension funds that have embraced active investing strategies have developed sophisticated internal investment teams and strong governance frameworks and have continually demonstrated that they can prudently invest directly, either in Canada or around the world. In fact, Canadian pension fund managers are recognized globally as leaders in active management strategies.

The benefits of active investment strategies delivered by in-house investment professionals are clear: higher returns at lower cost. While individual pension funds may choose different strategies, there is significant evidence that the use of external investment managers is more expensive than internally managed investments. This was confirmed as recently as 2012 in the Report from the Pension Investment Advisor to the Deputy Premier and Minister of Finance, conducted for the Ontario government by William Morneau (“the Morneau Report”).

When contemplating an investment strategy or specific investment decision, pension fund administrators are required to follow the prudent person approach which arises from the administrator’s statutory and common law fiduciary duty. We believe that the prudent person approach is a sufficient governing guideline that ensures adequate balance of the risks that come from any investment decision. If the 30 per cent rule was eliminated, the prudent person approach would continue to guide investment decisions. The strong requirements of the prudent person approach should provide the government of Canada
with comfort that there would continue to be an exceptionally high standard of governance and oversight given to investment decisions.

PIAC would also like to make clear that the 30 per cent rule in its current form does not prevent Canadian pension fund investors from acquiring significant stakes in businesses and projects – it does however impose cost and unnecessary complexity for pension funds to make these types of investments.

The regulatory hurdles associated with the 30 per cent rule should not be overstated nor understated. The issues that emerge in transactions because of the existence of the rule do put Canadian pension fund managers at a disadvantage in some transactions. There are costs associated with complying with the rule for Canadian pension funds. PIAC’s members would, all other things being equal, prefer not incur those costs nor be disadvantaged in the pursuit of investments. However, pension fund managers are able to navigate the rules to make their investments compliant at some cost.

**Tax Policy Considerations**

The Consultation Document considers whether significant new tax rules should be introduced for pension fund investments. The government considers whether it is appropriate to increase the tax burden on Canadian pension fund investments through thin capitalization rules (the “Thin Capital Extension Proposal”) and / or by expanding the entity level SIFT tax regime (the “SIFT Extension Proposal”).

Tax is an investment cost that reduces the overall returns from any investment. It is therefore a factor necessarily evaluated in respect of any investment. PIAC opposes the introduction of new thin capitalization rules and a SIFT tax regime for pension fund investments in Canada and believes those changes will make it more difficult for Canadian pension funds to invest in Canada.

We offer the following comments on the two tax proposals in the consultation paper.

**SIFT Extension Proposal**

Currently the SIFT rules apply to partnership and trust investments which are listed or traded on a stock exchange or other public market (“SIFT Partnerships and Trusts”). Under the SIFT rules, SIFT Partnerships and Trusts are subject to entity level tax to the extent that they earn income from carrying on a business in Canada, receive income (other than dividends) from non-portfolio property or realise a gain on the disposition of non-portfolio property.

One of the impacts of the SIFT Extension Proposals could be adverse tax implications for entities that invest their funds in various asset pools using private flow-through entities such as trusts or partnerships in which various pension plans and other tax exempt government entities invest their funds (“Pooled Investment Vehicles”).

For example, some Canadian pension plans manage trusts or partnerships through which government sponsored pension plans and other tax-exempt government entities
invest their funds. The government of Ontario has (as a result of the Morneau Report) recently announced the creation of the Investment Management Corporation of Ontario (“IMCO”) which is to manage Pooled Investment Vehicles through which Ontario government sponsored pension plans and other tax-exempt government sponsored entities will invest their funds. If the SIFT Extension Proposals are implemented it will subject Pooled Investment Vehicles to entity level tax with respect to all of their Canadian investments thereby putting all of these Pooled Investment Vehicles that invest in Canadian entities at a competitive disadvantage compared to all other Canadian pension plans.

The SIFT Extension Proposal could also be problematic for smaller pension funds and their investment partners because it would introduce pension fund investment partners to new tax burdens. Smaller pension plans, rather than acquiring interests in private equity or infrastructure assets directly, typically make minority investments in funds that are usually organised as limited partnerships, the general partners of which are corporations controlled by the promoter of the relevant fund. The investors in such funds typically include both taxable and tax-exempt investors. In the case of some funds the majority of the investors are taxable and in the case of other funds the majority of the investors are tax-exempt, depending upon the subscriptions received by the promoter of the relevant fund.

If the SIFT Extension Proposal was applied then a large number of private equity funds and venture capital funds, in which smaller plans have a minority interest (less than 50%), would be considered SIFT Partnerships or Trusts. Consequently income (other than dividends) earned on all non-portfolio property and all gains recognised by the fund on a disposition of non-portfolio property will be subject to tax in the fund. This will not only impact the pension fund investors in the fund but also the taxable non-pension plan investors in the fund. The introduction of entity level taxation for pension plans may result in Canadian pension plans becoming unfavourable investment partners to non-pension plans, thereby impeding investment in Canada. This is because in many cases even though investors in such funds are taxable they may not actually pay taxes on all of the income allocated to them by the fund. Such investors could have deductions such as interest expense or non-capital losses which could be used to offset such income, or capital losses that could be utilised to offset any capital gains allocated to them by the fund. In addition, the taxable investors could include mutual fund trusts which hold less than a 10% interest in the fund which could allocate such income or gains to its unit holders without being subject to entity level tax. If the SIFT Extension Proposals are enacted this could well prevent smaller plans from acquiring interests in Canadian private equity and venture capital funds.

Finally, we believe the government of Canada should be aware that the SIFT Extension Proposals are not capital export neutral. Canadian pension plans can invest in private equity funds and infrastructure funds organized in or outside Canada. Such funds are typically organized as limited partnerships and therefore as fiscally transparent entities in their local jurisdiction. Faced with the choice of investing in a private equity or infrastructure fund that is subject to an entity-level tax and one that is not, a pension plan
can be expected all else being equal to choose the tax neutral entity. The effect would be to drive capital outside Canada.

**Thin Capital Extension Proposal**

The existing thin capital rules apply to reduce deductions for interest expense incurred by taxable Canadian corporations with one or more specified non-resident shareholders (generally non-residents which own shares representing more than 25% of votes or value of a corporation) to the extent that the debt to equity ratio exceeds 1.5 to one. If the Thin Capital Extension Proposals are implemented the thin capital rules would also apply in circumstances where a pension plan holds shares entitling it to more than 25% of votes or value.

In the Consultation Document it is stated that absent the Thin Capital Extension Proposal, the concern is that the interest would be deductible to the taxable Canadian corporation but would not be taxable when it is received by the pension plan. In this regard it is noted as follows in the Consultation Document:

> It may be noted with respect to both examples that, while the business earnings are not taxed initially, they will eventually be taxed when the pension plan distributes the earnings to its members as pension income, which is subject to personal level tax. However, the potential policy concern stems from the fact that this taxable distribution may not take place until many years after the income is earned, resulting in a very considerable deferral, not available to taxable businesses.

It should be noted that for certain pension plans when the investment income earned is compared to the pension benefits paid in many cases the deferral is not significant or in fact there is no deferral since the pension benefits paid are equal to or greater than the investment income earned.

It is well understood that capital structure of business is dependent on the industry they operate and the maturity of the businesses. A business with stable earnings can support greater leverage than cyclical businesses. The Thin Capital Extension Proposal is a blunt instrument in that it does not distinguish between the amount of leverage required for different types of investments.

Given that one of the unique and important contributions of pension plans is providing patient capital the 1.5 to 1 debt to equity ratio is likely insufficient when the investor is deploying patient capital with a long-term horizon. Further, since third party debt is not subject to the thin capitalization rules, these businesses may increase third party debt, thereby increasing the financial risks.

Imposing tax on the taxable Canadian corporation has an adverse impact upon both taxable and tax exempt investors in the corporation.
Next Steps

Based on the views PIAC expresses above, we conclude that if the 30% rule is eliminated, tax policy should not be changed to target pension funds with a proposed SIFT tax, Thin Cap rule, or any alternative measures not contemplated in this consultation.

PIAC appreciates the opportunity for ongoing dialogue with the Department of Finance Canada on this matter. As stated earlier, PIAC’s preference is for a complete elimination of the 30 per cent rule with no tax consequences, but is also of the view that the status quo would be a sub-optimal but acceptable outcome for PIAC if pension funds cannot be made exempt from the tax extensions addressed above.

However, because of the potential negative impacts on our members from the potential tax measures included in the Consultation Document, we encourage the Department to continue to be consultative on the issue.

Specifically, we recommend the Department conduct another series of consultations with interested parties on any specific proposals that may be contemplated, so that we can continue to provide feedback and ensure that the government of Canada is aware of all potential consequences of any such changes. Additionally, the Consultation Document is unclear whether the SIFT Extension Proposal would apply to a single pension or an aggregation of pension plans that have a controlling or majority interest.

We believe the role we play as both investors in the Canadian economy and as the providers of retirement income support to Canadians warrants a significant level of transparency and dialogue in advance of any changes being made.

Please do not hesitate to contact Michael Keenan, Chair of the Government Relations Committee (1-514-394-4712 or keenan.m@bimcor.ca), if you wish to discuss any aspect of this letter in further detail.

Yours sincerely,

Lisa Jankov
Chair