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The 30 Percent Limitation for Pension Investment in Companies: Policy Options

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PRÉCIS

La loi actuelle restreint les placements des régimes de retraite dans les sociétés canadiennes en limitant la propriété d'un régime dans une entité à un maximum de 30 pour cent des actions avec droit de vote (« la règle du 30 pour cent »). Quelques caisses de retraite importantes préconisent un assouplissement de cette restriction. Certains ont dit craindre que la règle du 30 pour cent nuise au rendement du portefeuille des régimes de retraite et à l'efficacité du marché financier. Les auteurs examinent ces arguments en détail et se penchent également sur l'incidence fiscale de l'exonération d'impôt des régimes de retraite pour les marchés. Les changements récents apportés à la règle sur les biens immobiliers détenus à l'étranger ont permis aux régimes de retraite canadiens de réaliser une meilleure diversification de portefeuille au niveau mondial, ce qui a atténué certaines des préoccupations au sujet de l'efficacité du marché financier. Les auteurs affirment que les avantages d'une meilleure gouvernance ne sont pas clairs, étant donné le conflit d'intérêts potentiel à l'égard des placements d'un régime dans une société canadienne, entre la maximisation des profits pour les actionnaires et la protection des intérêts des employés. Leur raison d'être sur le marché étant l'acquisition et le contrôle, les caisses de retraite exonérées d'impôt sont privilégiées par rapport aux investisseurs imposables puisque les sociétés contrôlées ont un avantage concurrentiel en raison d'un coût du capital moins élevé. Les auteurs estiment que l'avantage fiscal actuel pour les entreprises et les particuliers est de l'ordre de 600 à 700 M$ annuellement. Ils examinent diverses options de politique concernant la règle du 30 pour cent — y compris son abolition — et diverses politiques fiscales qui créeraient des conditions plus équitables entre les caisses de retraite et les investisseurs imposables.

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ABSTRACT

Current law imposes limits on pension plan investments in Canadian corporations by restricting a plan's ownership in a single entity to a maximum of 30 percent of the voting shares ("the 30 percent rule"). Some large pension funds have advocated for the relaxation of this restriction. Concerns have been raised that the 30 percent rule hurts the portfolio returns of pension plans and capital market efficiency. The authors examine these arguments in detail and also focus on tax impacts on markets arising from the tax-exempt status of pension plans. Recent changes to the foreign property ownership rule have enabled Canadian pension plans to achieve better portfolio diversification at the global level, ameliorating some concerns about capital market efficiency. The authors suggest that the benefits of better governance are unclear, given the potential conflict of interest that may arise in respect of a plan's investment in a Canadian corporation between profit maximization for shareholders and the protection of employee interests. In the market for acquisition and control, tax-exempt pension funds have an advantage over taxable investors that affords controlled companies a competitive advantage through a lower cost of capital. The authors estimate the current corporate and personal tax advantage to be in the range of $600 million to $700 million annually. They examine various policy options with respect to the 30 percent rule, including abolition of the rule and various tax policies that would create a more even playing field between pension funds and taxable investors.

KEYWORDS: PENSION FUNDS ■ ACQUISITIONS ■ CONTROL ■ TAX

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INTRODUCTION

Pension plans provide retirement income to retirees based on, among other factors, the investment performance of the pension fund associated with the plan.[1] While one may argue that, in defined benefit plans, the retirees may be somewhat protected from the impact of investment returns, even in that case employers have been known to change future ad hoc increases in retiree benefits.[2] In Canada, pension plans are regulated under federal and provincial statutes with respect to the obligations of plan sponsors to employees, with Ontario regulating the greatest number of registered pension plans. The regulations are intended, in part, to ensure that plans are funded to provide the promised retirement benefits to employees. The rules spell out the fiduciary responsibilities of pension plan trustees and plan sponsors as well as governance requirements with respect to pension fund investments. Restrictions on the control of companies can be achieved in two ways: explicit quantitative regulations that limit pension fund ownership of voting shares, and/or tax measures that require companies or the pension funds themselves to pay taxes on income earned by controlled companies.

This article analyzes both of these options with a particular focus on the implications of the existing limit on the ownership of voting shares in a single entity by a pension fund ("the 30 percent rule"). More specifically, the 30 percent rule restricts pension funds to holding no more than 30 percent of the voting shares of a corporation under pension standards legislation (although a less restrictive rule applies to public pension funds, notably the Canada Pension Plan Investment Board).[3] Defined real estate corporations, resource corporations, and investment corporations are exempt from the 30 percent rule; however, certain conditions still apply to these entities, particularly with respect to their activities as defined under the Income Tax Act.[4] For example, in the case of real estate corporations, permitted activities include the intent of acquiring, holding, maintaining, improving, leasing, or managing capital property that is real property.[5]

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1 We use the terms "pension plan" and "pension fund" interchangeably in this article.

2 There is also a recent and growing preference for defined contribution rather than defined benefit plans.

3 This does not prevent pension funds from owning non-voting or restricted voting shares of publicly listed companies. A number of large Canadian companies have issued such shares, raising some concerns about governance and performance issues: see Vijay Jog, PengCheng Zhu, and Shantanu Dutta, "Impact of Restricted Voting Share Structure on Firm Value and Performance" (2010) 18:5 *Corporate Governance: An International Review* 415-37, for recent evidence and discussion of these issues. The 30 percent rule is contained in the Pension Benefits Standards Regulations, 1985, SOR/87-19, schedule III, section 12(1) (regulations made pursuant to the Pension Benefits Standards Act, 1985, RSC 1985, c. 32 (2nd Supp.)).

4 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

5 Subparagraph 149(1)(o.2)(ii).

Five issues arising from the 30 percent rule deserve special attention.

1. Some have argued that the 30 percent rule harms the investment performance of pension funds by limiting investment decisions where greater control could lead to better portfolio performance.[6] On the other hand, pension funds employ various techniques to avoid the application of the 30 percent rule and achieve de facto control of companies. Given that the investment rule can often be circumvented, one would query whether it should even be in place.
2. There has been some discussion in the policy realm about the efficacy of this rule. For example, the Ontario government announced in its 2010 budget that the investment rules affecting pension funds would be reviewed; more specifically, it stated:

   > In October 2009, the federal government proposed reforms to update the pension investment rules contained in the federal *Pension Benefits Standards Regulations*, which Ontario adopted by reference in 2000. Once implemented, Ontario will carefully examine the appropriateness of the rules, including the 30 per cent rule, for Ontario-registered plans. The Province will then determine which changes, if any, will be adopted.[7]

   Thus, Ontario could adopt regulations that parallel federal pension rules, but it has the ability to change the rules independently. Given that the number of pension plans in Ontario exceeds the number of plans regulated by other provinces and federally, Ontario's decisions are important to the overall regulatory framework affecting pension funds in Canada.
3. Following the federal government's assessment of the 30 percent rule, the Department of Finance announced in 2010 that the rule would remain unchanged:

   > During public consultations, the Government received many representations from pension plan sponsors and pension service providers indicating that, in a prudent person environment, the quantitative limits were unnecessarily cumbersome and were no longer required. Similar representations were made in respect of the 30% rule, which states that a pension plan may not own more than 30% of the voting shares of a single entity. The Government has examined this rule and has concluded that it remains appropriate at this time for prudential reasons. Specifically, the Government believes that removing the

6 See, for example, Ontario Teachers' Pension Plan, *Response to the Report of the Expert Commission on Pensions* (Toronto: Ontario Teachers' Pension Plan, 2009); and Poonam Puri, *A Matter of Voice: The Case for Abolishing the 30 Percent Rule for Pension Fund Investments*, C.D. Howe Institute Commentary no. 283 (Toronto: C.D. Howe Institute, February 2009), and references therein.

7 Ontario, Ministry of Finance, 2010 Ontario Budget, Budget Papers, March 25, 2010, at 171.

> 30% rule would increase the potential for pension plans to own and operate companies.[8]

The above statement reflects the federal government's concern about the implications of pension plan ownership of corporations in excess of the 30 percent limit and the impact of such ownership on prudent portfolio construction and corporate control.

4. The existence or, alternatively, the relaxation or removal of the 30 percent rule also has implications for overall capital market efficiency and the governance of companies controlled by pension funds—an issue we discuss in this article.
5. Since investment income earned by pension funds is received from the fund's investment in taxable entities, and such income is tax-exempt until it is paid out to pensioners (who pay taxes on the received payout), changes to pension fund regulations also have tax implications.

Although these five issues are clearly interlinked, each has its own complexity. The overall intent of this article is to assess the implications of the 30 percent rule in this broader context and to consider and discuss potential reforms, particularly with respect to the taxation of pension income derived from controlled corporations. The objective is not to recommend any specific policy, but rather to provide an understanding of the benefits and costs of the various options.

The discussion that follows is divided into seven main sections. The first section outlines the contribution made by pension funds to capital market efficiency (a term explained below). The second section provides a theoretical discussion of taxation, corporate control, and governance issues related to pension fund investment in corporations. The third section evaluates tax revenue impacts associated with potential changes to the 30 percent rule. The fourth section provides a review of Canadian and international rules with respect to ownership and control restrictions for pension funds. The fifth section considers whether Canadian capital markets are too small for pension funds to achieve optimal investment performance. The sixth section provides a review of options for policy reform. Finally, the seventh section summarizes our overall conclusions.

From a policy decision perspective, we propose six options:

1. Keep the 30 percent rule unchanged—as advocated by the Department of Finance.
2. Abolish the rule.
3. Toughen the rule.

8 Canada, Department of Finance, "Regulations Amending Certain Regulations Made Under the Pension Benefits Standards Act, 1985: Regulatory Impact Analysis Statement" (2010) 144:19 *Canada Gazette Part I* 1202-10, at 1208.

4. Consider replacing the rule with a tax alternative similar to the US unrelated business income tax (UBIT).
5. Introduce a rule similar to the thin capitalization rules.
6. Limit the deduction of certain payments (such as interest, fees, royalties, and rents) by corporations when such payments are made to related tax-exempt entities.

THE CONTRIBUTION OF PENSION FUNDS TO CAPITAL MARKET EFFICIENCY

It is well accepted that one of the most important roles of financial intermediation is to reduce the risk and information costs to investors in seeking out the best investment opportunities available in the business sector. Investors benefit from risk diversification by pooling investments through financial intermediaries. Intermediaries help to reduce information costs by researching alternatives and monitoring firms that are funded by investor capital. Capital market efficiency is achieved when investors are able to obtain the best possible returns (given the risks involved) and businesses are able to borrow at the lowest possible cost.

Pension funds contribute to the efficient allocation of savings to investment projects by investing funds on behalf of employees in bonds and equities of publicly listed firms, and certain other assets, in the interest of providing adequate retirement income. In this context, we note at least two key beneficial impacts that pension funds have on financial markets in the presence of other institutional investors such as banks, insurance companies, and mutual funds.

The first impact is related to the "patience" of pension funds with respect to investments in capital markets. Given the long-term nature of pension liabilities, pension funds are more willing to invest in assets with a long-term maturity (such as long-term bonds) or with a long-term horizon (for example, buy-and-hold investment in stocks) as compared with banks and mutual funds. This characteristic of pension fund investment is referred to as "patient capital."[9] The long-term horizon of pension funds can be beneficial to capital markets and firms—for example, by reducing volatility in asset prices—given that some other investors, such as hedge funds, are more focused on short-term gains in stock market values. It also reduces

9 Mario Catalan, Gregorio Impavido, and Alberto R. Musalem, *Contractual Savings or Stock Market Development: Which Leads?* (Washington, DC: World Bank, August 2000). An alternative view was provided in Josef Lakonishok, Andrei Shleifer, Richard Thaler, and Robert Vishny, "Window Dressing by Pension Fund Managers" (1991) 81:2 *American Economic Review* 227-31. The importance of pension funds in providing long-term patient capital for Canada's capital markets was also noted by David Dodge when he was the governor of the Bank of Canada: see "A Sound Pension System—Handling Risk Appropriately," speech given at the Conference Board of Canada 2007 Pensions Summit, Toronto, May 10, 2007.

the cost of capital for firms.[10] In addition, Ambachtsheer[11] argues that "model" pension plans that display five attributes—conflict-free, well governed, sensible investment beliefs, sufficiently scaled, and competitively compensated—can enhance returns on employee savings.

The second impact of pension funds is with respect to liquidity. Pension funds channel investment from short-term assets typically held by individuals into long-term assets, thereby increasing liquidity and improving the pricing efficiency of traded assets in both debt and equity markets.[12]

In recent years, the number of pension funds in Canada with assets exceeding $10 billion or more has increased. Owing to economies of scale, these large pension funds are able to hire experienced professional management teams whose active managers are looking to acquire long-term assets that would improve the fund's financial performance, given the level of risk tolerance.[13] It is also possible that the larger the pension fund, the higher are the cost economies associated with managing the fund.[14] To the extent that active management improves pension investment returns, it also contributes to capital market efficiency.

10 Eduardo Walker and Fernando Lefort, *Pension Reform and Capital Markets: Are There Any (Hard) Links?* (Washington, DC: World Bank, February 2002).

11 Keith Ambachtsheer, "Tomorrow's Pension Fund" (2010) *Director* (Institute of Corporate Directors).

12 E. Philip Davis, *Pension Funds: Retirement-Income Security and Capital Markets. An International Perspective* (Oxford: Clarendon Press, 1995). Pension funds invest not only in liquid securities but also in so-called alternative assets (for example, real estate and private equity), which are relatively illiquid. For example, the Ontario Teachers' Pension Fund recently sold its majority illiquid stake in Maple Leaf Sports and Entertainment (MLSE) for $1.3 billion at a cumulative return of almost 500 percent over an 18-year holding period.

13 In a recent paper, Woolley claims that the short-term performance-based incentives for pension fund managers may actually lead them to take a short-term perspective (resulting in higher trading) and investment in non-marketable securities (thereby making performance comparisons difficult, if not impossible): Paul Woolley, "Why Are Financial Markets So Inefficient and Exploitative—And a Suggested Remedy," in Adair Turner et al., *The Future of Finance: The LSE Report* (London: London School of Economics and Political Science, 2010), 121-43. Woolley actually recommends that it may be prudent to cap annual turnover of portfolios at 30 percent per annum, and thereby force fund managers to focus on long-term value, rather than restrict turnover. He also recommends that in order to ensure that proper performance comparisons can be made, pension funds should not be allowed to engage in any form of "alternative investing."

14 See a recent paper by Aleksandar Andonov, Rob M.M.J. Bauer, and K.J. Martijn Cremers, "Can Large Pension Funds Beat the Market? Asset Allocation, Market Timing, Security Selection, and the Limits of Liquidity," January 2012 (http://ssrn.com/abstract=1885536), which claims that large pension funds show, net of costs, better investment performance.

PENSION FUNDS: TAXATION, CONTROL, AND GOVERNANCE

The issues of taxation, control, and governance are interlinked. In this section, we begin with the taxation-related issues arising from the fact that pension funds are tax-exempt entities. This aspect requires special consideration, even if the investment by pension funds in debt and equity securities of publicly listed companies can enhance capital market efficiency. We then discuss corporate governance and potential conflicts of interest that could arise should the 30 percent rule be relaxed or eliminated.

The Income Tax Act plays an important role in determining the policy choices for the regulation of pension investment, since it sets out specific rules for the taxation of pension plan income. To enable employees to accumulate greater wealth for retirement purposes, pension plans pay no tax on investment returns, thereby enabling investors to earn higher returns. The tax exemption is consistent with the expenditure approach to personal taxation,[15] whereby taxes are applied to an expenditure base that is defined as earnings net of savings. Under the expenditure approach, contributions to registered pensions and other retirement assets such as registered retirement saving plans (RRSPs) are deducted from taxable income and the investment income earned by the registered plan is exempt from taxation; however, withdrawals of principal and income from these assets are fully taxed.

Since investment income (interest, dividends, rents, and capital gains) earned on pension fund assets is not taxed when accrued but only when withdrawn to pay benefits, some of the rules under the Act restrict the ability of investors to avoid capital income taxation by shifting assets into tax-exempt entities such as pension and other retirement income plans. These restrictions include limitations on interest deductibility for debt used to fund investments in tax-exempt retirement assets and restrictions on the size of surplus assets that can be carried by occupational pension plans.[16]

Thus, the 30 percent rule has an impact on the tax system, since pension plan managers can engage in corporate tax planning by owning and controlling entities engaged in commercial activities. This can be observed in the tax rules that apply to prescribed real estate, resource, and investment corporations, which, as noted earlier, are exempt from the 30 percent rule. For these cases, the Act imposes certain limitations on the investment activities of pension funds. Also until 2005, pension plan

15 United States, Department of the Treasury, *Blueprints for Basic Tax Reform* (Washington, DC: US Government Printing Office, 1977); and Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade* (London: Allen & Unwin, 1978).

16 Concern about loss of tax revenues from investment income is not new. In 1991, the federal budget proposed a combination of credit and levy to encourage pension funds to reduce their investment in debt and increase their investment in equity. The proposal was withdrawn after considerable opposition by pension funds.

ownership of limited liability partnerships (LLPs) was included in the definition of foreign property and was subject to a limit of 30 percent of total assets. No restrictions apply today to the holding of foreign property.

It is still possible, however, for the 30 percent rule to be avoided by (1) using convertible debt, which can be rolled into voting or non-voting shares; (2) appointing a nominee to vote according to the pension plan's requirements; or (3) making the pension fund the lead partner in an acquisition and the manager of the partnership funds, as is typical in private equity transactions. In each case, the pension fund holds no more than 30 percent of the voting shares but is nonetheless able to control the company.

Two examples can be provided of structures that enable pension funds to reduce the payment of corporate income tax. The first arises when a pension fund fully acquires a corporation and then substitutes equity for debt provided by the pension fund. The corporation can deduct interest expenses and the pension fund does not have to pay tax on the interest income that it receives. Alternatively, a partnership can be established whereby the partnership's income is flowed to the pension plan (as the partner) and is not subject to tax.[17] These structures enable the pension fund to eliminate or substantially reduce corporate tax paid by the operating entity. This tax advantage could enable pension-controlled businesses to operate at a competitive advantage as compared with taxable businesses, since they would have a lower tax cost. Further, this form of tax arbitrage can provide pension funds with an important advantage in acquiring companies since they may be able to outbid taxable investors.

In addition, individual pension funds may avoid corporate tax by acquiring a partial stake in a corporation through co-ownership with other investors. In most private equity deals, the lead investor organizes the acquisition and serves as a general manager of the investment vehicle, thereby earning a management fee (such as 2 percent of the total investment plus 20 percent of gains). The lead investor could be the pension fund or another entity such as a sovereign wealth fund,[18] a foreign pension fund,[19] a non-profit investment fund,[20] or a taxable entity. Thus, not all private equity transactions are organized by pension funds. With respect to non-controlling degrees of ownership, pension funds are only passive owners and therefore have less

17 It should be noted that the private equity partnership substitution avoids "specified investment flow-through" (SIFT) partnership status and corporate treatment because the partnership is not publicly traded.

18 For example, the Abu Dhabi Investment Authority or the Alberta Investment Management Corporation.

19 Such as Singapore's Central Provident Fund.

20 Several rules restrict business ownership by non-profit investment funds. Private foundations are not permitted to carry on business, while public foundations and charitable organizations face restrictions on their ability to carry on a business unrelated to the charitable activity. Under excess corporate holdings rules introduced in 2007, private foundations are also required to limit their concentration of shareholdings in a particular corporation. See Canada Revenue Agency guide T2082, "Excess Corporate Holdings Regime for Private Foundations."

influence over financial decisions, which are left to those who control management (although the pension fund can still influence governance of the corporation).

Given that there are several types of tax-exempt investors, tax distortions need to be evaluated in a broader context, since the 30 percent rule applies only to Canadian pension funds that are subject to schedule III of the Pension Benefits Standards Regulations, 1985.[21] The application of quantitative rules to only one type of entity (pension funds) still enables some investors (such as sovereign wealth funds) to engage in corporate tax avoidance.

Another key aspect of the tax advantage enjoyed by pension funds could also have a significant impact on competition in the takeover market, since pension funds may be able to acquire companies by outbidding others trying to buy target corporations. More specifically, the market price of an entity is determined by the present value of after-tax corporate cash flows that are to be earned from the acquisition discounted by the cost of financing capital. If all investors were subject to the same level of taxation, investments and corporate acquisitions would be based solely on economic criteria such as managerial expertise, synergies, and other factors.[22] To the extent that the 30 percent rule is effective, it could curtail the advantage enjoyed by tax-exempt pension funds in acquiring taxable entities.

Overall, one can conclude that although there are ways for pension funds to circumvent the 30 percent rule, the implicit and explicit costs of circumvention may prevent them from doing so. In addition, the rule may deny pension funds a competitive advantage over taxable entities in the market for corporate control.

We next turn to the issue of governance. Pension fund investment can have important implications for corporate governance and thus the performance of companies. Vast amounts of literature claim that good corporate governance leads to improved performance. This, in turn, reduces risk and thus can lower the cost of capital, thereby leading to an overall increase in the efficiency of capital allocation and capital markets.[23] Large institutional shareholders that own 10 percent or more of a company's shares or that work with other shareholders through a coalition can enforce

21 Supra note 3. As discussed below under the heading "Observations and Policy Options," Canada's thin capitalization rules limit corporate deductions of interest expense on debt in excess of a specified debt-equity ratio for related non-residents (see infra note 87 and the related text). The rules apply not only to foreign corporations but also to partnerships and trusts, including foreign pension funds.

22 Taxation also affects the choice between greenfield investments and mergers and acquisitions. See Johannes Becker and Clemens Fuest, *Tax Competition—Greenfield Investments Versus Mergers and Acquisitions*, CESifo Working Paper no. 2247 (Munich: Center for Economic Studies and Ifo Institute for Economic Research, March 2008).

23 See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Investor Protection and Corporate Governance" (2000) 58:1-2 *Journal of Financial Economics* 3-27; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Investor Protection and Corporate Valuation" (2002) 57:3 *Journal of Finance* 1147-70; and Craig Doidge, G. Andrew Karolyi, and René M. Stulz, "Why Are Foreign Firms Listed in the U.S. Worth More?" (2004) 71:2 *Journal of Financial Economics* 205-38.

better governance by playing an active (or at least an advisory) role in management. Such a coalition, if practised formally and regularly, may have securities-law implications in respect of liquidity and reporting requirements that may discourage such a strategy; however, these restrictions and requirements can be avoided by institutional investors that undertake not to use their controlling position to influence the governance of the corporation in a formal manner.

In a controlling position, so it is claimed, pension funds can enforce better governance to improve the operating performance of the company. However, studies have shown that manager-controlled public companies perform less well than family-owned or privately controlled businesses.[24] The argument is based on informational asymmetries in markets whereby management may have other interests besides maximizing shareholder wealth, such as consuming excessive perquisites. While performance-based executive compensation aligns managerial interests with shareholder wealth maximization, these contracts result in the best managers enjoying some of the economic rents (income above opportunity costs of providing management).[25] Thus, it can be argued that when pension funds or other owners have only a minority stake in a company, they may not be able to fully secure optimum performance; however, with a controlling interest, they can exert greater influence over management, improve managerial incentives, and thereby improve performance.

There are studies that show that pension funds can influence governance practices of firms even if, alone or collectively, they own a substantial yet minority stake. Even the mere presence of institutional ownership improves corporate governance and allows managers to take a longer-term view, and thus make better decisions to maximize shareholder wealth.[26]

However, some earlier authors have questioned whether pension funds can effectively discipline managers, including circumstances where managers take politically popular positions that actually hurt firm performance.[27] Others suggest that managers, especially of public sector pension funds, do not seem to have the right incentives

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24 See the review by E. Philip Davis and Yu-Wei Hu, *Are Canadian Pension Plans Disadvantaged by the Current Structure of Portfolio Regulation?* Brunel University Economics and Finance Working Paper no. 08-13, commissioned by OMERS Canada (London: Brunel University, March 2008).

25 These implications are well-articulated in principal-agent models. See Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Model* (Princeton: Princeton University Press, 2001).

26 See Brian J. Bushee, "The Influence of Institutional Investors on Myopic R&D Investment Behavior" (1998) 73:3 *The Accounting Review* 305-33; Diane Del Guercio and Jennifer Hawkins, "The Motivation and Impact of Pension Fund Activism" (1999) 52:3 *Journal of Financial Economics* 293-340; and Gregory D. Kane and Uma Velury, "The Role of Institutional Ownership in the Market for Auditing Services: An Empirical Investigation" (2004) 57:9 *Journal of Business Research* 976-83.

27 Roberta Romano, "Public Pension Fund Activism in Corporate Governance Reconsidered" (1993) 93:4 *Columbia Law Review* 795-853, at 822.

to maximize shareholder value (for example, their incentive contracts may not be performance-based); instead, they use their position to generate publicity or to enhance their reputation for their own future employment.[28] However, the empirical question is whether active management has produced any demonstrable results, and whether these results have been positive or negative.

The evidence regarding the effectiveness of pension funds in influencing company management through persuasion and thereby improving company performance is not clear. The term "pension fund activism" is often used to describe public intervention by pension funds where a fund provides directives to company management to take specific actions when it is not satisfied with the performance of the company in which the fund, alone or collectively, holds a significant proportion of voting shares.

Pension fund activism has its origin in the late 1980s when CalPERS (the California Public Employees' Retirement System), the largest public pension fund in the United States, started active monitoring of companies in its portfolio. This was followed by other large funds, either on an individual level or through a coalition with other pension funds. It should be noted that stock holdings by pension funds are largely dispersed. Therefore, any intervention by pension funds in corporate governance typically requires the formation of a coalition of pension funds. The realization of a coordinated intervention, in turn, is subject to the problems related to the provision of public goods, such as free-riding. In addition, as noted above, regulations under securities law may impose requirements relating to the reporting of the formation of such a coalition.

A number of empirical studies have attempted to document the effectiveness of these interventions by pension funds. Typically, these studies identify the date on which a pension fund (or a coalition of funds) publicly intervened in a corporation and then compare the performance during the post-intervention period with that in the pre-intervention period. However, since the targeted firms were generally poor performers, and poor performers are more likely to experience turnover in top management, performance would improve with a takeover regardless of pension plan involvement. Hence, it is necessary to use a control group of equally poor performers in the same industry to isolate the impact of pension fund interventions. If the researchers use a less sophisticated matching sample method to select the control group than institutions use to target firms, then these studies could produce a spurious correlation between activism and the governance event.

In addition, one may need to consider the costs of acquiring and divesting large stakes (for example, 50 percent) in one firm. Existing empirical evidence from many merger and acquisition studies indicates that acquiring firms (in this case, pension funds) pay a 30 to 40 percent premium for controlling ownership of acquired companies. While acquiring firms may be able to justify these premiums on the basis of

28 Kevin Murphy and Karen Van Nuys, "State Pension Funds and Shareholder Inactivism" (Harvard Business School, 1994).

potential operating synergies, pension funds cannot resort to this argument, and there will be no operating synergies when a firm is acquired by a pension fund; instead, the major gains will be through financial re-engineering—mostly through additional tax benefits (as discussed in the next section). Alternatively, the costs of divesting large stakes in one firm can also be significant and may require the pension fund to sell its stake at a discount. This two-edged sword of large stakes is a non-trivial cost that makes mutual funds shy away from holding large positions in a single entity.

In any event, the conclusion that emerges from the review of the empirical literature is that, although some studies have found a positive relationship between pension fund activism and firm performance, the results are still far from robust.[29] No positive effect could be proved for either the operating performance or the stock market performance of targeted firms.[30] Perhaps this should be expected given that funds

- may intervene in a private manner (which is not amenable to empirical analysis),
- do not spend very much effort on this activity,
- do not act jointly,
- are not capable of detecting the underlying reasons for bad performance, or
- are simply not very effective in changing corporate behaviour or decision making.

Moreover, the pension plan itself may have governance challenges, and it may not be clear whose interest it may be serving by undertaking activism.

Overall, it is not clear that pension fund managers can be effective managers of active business entities, especially large publicly listed corporations. In terms of voicing their opinions and attempting to make changes to the governance structure of

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29 Andrew K. Prevost and Ramesh P. Rao, "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?" (2000) 73:2 *Journal of Business* 177-204.

30 Faccio and Lasfer analyze the monitoring role of occupational pension funds in the United Kingdom and conclude that these funds are not effective monitors: Mara Faccio and M. Ameziane Lasfer, "Do Occupational Pension Funds Monitor Companies in Which They Hold Large Stakes?" (2000) 6:1 *Journal of Corporate Finance* 71-110. However, in a recent study using confidential data, Becht et al. show that the Hermes U.K. Focus Fund (HUKFF) owned by the British Telecom Pension Scheme substantially outperformed benchmarks owing to its engagement with company management rather than its stock-picking abilities: Marco Becht, Julian Franks, Colin Mayer, and Stefano Rossi, *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*, London Business School Finance Working Paper Series no. FIN 462 (London: London Business School, December 2006) (http://ssrn.com/abstract=934712). Becht et al. found that HUKFF frequently sought and achieved significant changes in the company's strategy, including refocusing on the core business and returning cash to shareholders, as well as changes in the executive management, including the replacement of the chief executive officer or the chair of the board.

the corporations in which they hold significant shares, pension funds seem to have been able to do so without having to own a significantly larger percentage of voting control. So the argument that the relaxation or removal of the 30 percent rule may be the only way to improve corporate performance may be hard to justify.

A further issue that relates to pension fund involvement in controlling firms is with respect to conflicts of interest. In part, conflicts arise between pension plans and other shareholders as a result of the long-term view of pension plans in making investment decisions, as discussed above. Other conflicts arise from pension plans having interests besides shareholder maximization, thereby affecting management incentives.

Conflicts among shareholders are not unique to pension fund ownership of companies—they can (and do) also arise between majority and minority shareholders, employee stockowners and other shareholders, and government and private owners of mixed enterprises. Without effective limitations on control, a pension fund could become the majority owner of a company, and the board of directors may then find it difficult to act in the interests of all shareholders and resolve conflicts among them. Alternatively, control limitations on pension funds would require that their minority ownership rights be protected by corporate law and regulations similar to other situations, such as protection for minority shareholders in the case of an acquisition or in a going-private transaction. Corporate law does offer minority shareholder protection in its oppression remedy, but that protection is limited to the interests of the minority as securityholders and is not extended to any other interest that those shareholders may have. However, if this is indeed a concern, we are of the view that limitations on pension fund control cannot resolve conflict-related issues among owners with different objectives. Instead, corporate-law mechanisms should be used to sort these out.

Further concern would arise if pension plans tended to concentrate their investments in companies for reasons of control rather than improved risk-return tradeoff and diversification. Some of the quantitative restrictions that have applied on the share of pension assets invested in a single company (or sector) have been prompted by concerns that pension funds should be invested widely for risk-diversification reasons. As a guiding principle, however, prudent investors would not put all their eggs in one basket, and quantitative rules are useful only if they reduce any temptations by pension fund managers to make excessive investments in specific securities or asset classes. So it is not clear to us that the 30 percent rule is required to reinforce the prudent portfolio rule that pension funds have to follow in executing their fiduciary duties.

One should also keep in mind that pension funds themselves are operated by managers who may have their own interests at stake. These managers are expected to maximize the value of the investment portfolio for a given risk tolerance, and their performance is often assessed against passive comparable benchmarks (such as a stock market index). When pension funds invest in tradable marketable securities, their performance can be measured against such benchmarks and this comparison can be used to identify underperforming managers of pension assets. One way for pension fund managers to potentially circumvent this scrutiny would be to invest in non-benchmarked, non-traded assets whose actual performance may be revealed long after the departure of the manager who undertook the original investment. This may suggest that policies that promote investment in marketable (tradable) securities rather than private non-traded securities may be prudent.

Another conflict of interest arises when corporate entities held by pension funds make decisions that are in conflict with the interests of the employees who own the fund. For example, the Ohio and California public employees' retirement systems (OPERS and CalPERS) joined together to oppose decisions made by a UK private equity firm regarding a planned closure of a Hugo Boss factory in Brooklyn, Ohio, which would have affected 300 union jobs.[31] This example illustrates that pension fund trustees can be caught between investment decisions and employee interests. Restrictions on pension funds in shares issued by the employer's company reduce but do not eliminate all forms of conflict.

Additional conflicts of interest may arise where pension funds control corporate entities. It is conceivable that a pension fund of a sponsoring company may acquire a large controlling position in a competitor company. In this case, the pension fund may wish to limit any actions of the competitor that would adversely affect the plan sponsor. On the other hand—for example, the purchase by the General Motors Pension Fund of a controlling interest in Ford or a supplier of steel—might raise some concerns about conflicts for trustees of the pension fund between investment performance objectives and the protection of employees' interests.

This is not to say that a conflict of interest will arise in each and every case where a pension fund gains significant control of an operating company. Some pension funds may actually use their superior abilities and world-class governance to improve performance.

Thus, one could consider the limitation on corporate control by pension funds as a broad approach to reduce potential conflicts, since pension funds are restricted to being passive investors. However, an alternative approach may be to permit control but deal directly with any potential conflicts that arise through greater transparency and regulatory oversight by governments.

IMPLICATIONS FOR TAX REVENUES

The control of a taxable firm by a pension fund raises interesting taxation issues that go beyond capital market efficiency, corporate governance, and conflicts of interest. In this section, we focus on the potential impact of control of a firm by a pension fund on tax benefits to investors and, consequently, on government tax revenues.

While Canadian tax laws exempt the investment income of pension plans to encourage the accumulation of wealth for retirement purposes, they do not exempt

31 See Peter Lattman and Gina Chon, "Big Guns of Finance Gather To Talk Terms," *Wall Street Journal*, March 30, 2010.

pension plans from indirectly paying corporate tax. To the extent that pension funds are subject to such tax, the dividends and capital gains earned on their equity investments are reduced. As a result, if pension funds are able to control operating companies, potentially they could engage in tax planning to avoid or reduce corporate taxes that would otherwise be paid by those companies. In light of this concern, we now turn our attention to the possible effect on federal-provincial tax revenues when pension funds are able to gain control of companies.

This issue has received little attention in the literature, perhaps because analyzing tax revenue loss on an annualized basis is a complicated task—a lesson learned from previous studies of income trusts and corporate tax avoidance.[32]

To begin an analysis of pension fund control of corporations and other business entities under the existing regime, we consider a pension fund takeover of a taxable company where equity is replaced by internal debt (raised from the controlling pension fund), thereby eliminating corporate tax. The corporate tax savings would result in either a lower cost of capital (leading to more investment) for the operating company or an increase in the rate of return on investment for the pension fund.[33] Given that Canadian equity markets are not fully integrated with global markets and there is a "home bias,"[34] one would expect that some of benefits of the corporate tax savings would accrue to the corporation (with a lower cost of capital) and some to the pension fund through a higher return on investment.

If a firm benefits from a lower cost of capital, the rate of return on pension fund investments will not necessarily increase since the company will likely expand its investments in economic projects that were previously unprofitable owing to corporate taxation. Nonetheless, pension-controlled operating companies benefiting from a lower cost of capital will have a cost advantage relative to competing taxable companies, which may lose market share to the pension-controlled companies. This could lead to a decrease in tax revenues.

If, on the other hand, the returns on pension investments increase as a result of eliminating the corporate tax paid by pension-controlled companies, the tax revenue impacts will depend on several factors:

32 Lalit Aggarwal and Jack Mintz, "Income Trusts and Shareholder Taxation: Getting It Right" (2004) 52:3 *Canadian Tax Journal* 792-818; and Jack M. Mintz, "Policy Forum: Income Trust Conversions—Estimated Federal and Provincial Revenue Effects" (2006) 54:3 *Canadian Tax Journal* 687-90.

33 Given that the pension fund owns the corporation, the probability of bankruptcy as a result of non-payment of interest is eliminated, since the fund can simply agree to defer these payments or restructure the debt so that the corporation can continue to operate. This will maximize the benefits of the tax deductibility of interest at the corporate level.

34 "Home bias" refers to the situation where an investor invests a higher percentage of her portfolio in her home country than the proportion that an optimally structured global portfolio would indicate.

1. Higher returns on pension investments could increase pension payouts. Since pension payments are subject to personal income tax, increased future payouts would lead to higher personal tax collections. On a discounted basis, the annualized value of personal taxes paid on higher pension payouts is equal to the average marginal personal tax rate on pension income multiplied by the corporate tax savings.[35]
2. If the corporate tax savings enable the pension plan to reduce annual contributions by employers and employees (assuming that pension benefits remain unchanged), employers and employees will claim lower tax deductions with respect to their contributions. The additional tax paid will be equal to the average of the employer's and the employees' marginal tax rates multiplied by the reduction in contribution rates. For employees who deduct contribution costs from personal income, the calculation is similar to the revenue impact discussed in point 1 above. For public pension plans that are non-taxable, lower contribution costs are not a deductible expense for the employer, so no employer-paid taxes are affected. Thus, about half of the personal tax rate would be applied with respect to the tax-back of corporate tax savings.[36]
3. With greater pension fund ownership, dividend and capital gains taxes on equity investment paid by resident and non-resident owners of the target company would be reduced. The tax savings would depend on the investors' respective tax rates: the dividend tax rate and the accrual-equivalent capital gains tax rate[37] for taxable residents, and withholding tax rates on dividends for foreign investors (capital gains taxes would be levied by treaty partners). In cases where other non-taxable entities were owners of the target company prior to the acquisition, a pension fund acquisition of a company would not affect tax revenues.
4. A further revenue adjustment would occur for the value of capital gains taxes paid by owners on shares sold to the pension fund upon a takeover. (This is a one-time tax gain that would need to be annualized as well.) The capital gain depends on the degree to which the tax savings are capitalized in the premium on shares sold by existing shareholders to the pension fund. The

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35 Algebraically, let u represent the corporate income tax rate and t the personal income tax rate. Annual corporate tax savings are equal to uy where y represents profits. The annualized personal tax on pension payments is equal to tuy. Therefore, the total tax savings are $uy(1 - t)$.

36 The tax savings for public pension funds is $uy(1 - t/2)$.

37 The accrual-equivalent capital gains tax rate is the rate of tax that would be applied to capital gains if the investor were taxable on an accrual rather than on a realized basis. A simple formula to calculate the accrual capital gains tax rate is $c = ta/(a + i)$ where a is the average disposition rate of shares on a geometric basis and i is the discount rate of the shareholder. For example, a holding period of five years implies an average disposition rate of 40 percent. With a discount rate of 10 percent and a personal tax rate of 20 percent (since only one-half of capital gains are taxable), the accrual-equivalent capital gains tax rate is 16 percent.

annualized value would be calculated as the one-time impact on the capital gains tax rate multiplied by the discount rate.

Thus, estimating the revenue impact arising from corporate tax avoidance when pension funds gain control of taxable entities requires several assumptions and calculations. As an illustration, we will look at the case in which the corporate tax savings attributable to pension fund ownership result only in a higher return on investment for the pension fund without any increase in investments taken on by the pension-controlled company. (The latter would be difficult to estimate owing to a lack of data.)

To estimate revenue effects, we use 2004 data published by the Department of Finance,[38] which would be roughly representative of the mid-point of the business cycle during the past decade and a good proxy for today. Although these data are not current, they can be used to estimate the impact on tax revenue of corporate tax savings arising from pension control of companies. (All data referred to below are based on Finance estimates unless otherwise indicated.)

1. The loss in corporate tax would be equal to the corporate income tax rate multiplied by corporate taxable income. The average corporate tax rate is assumed to be 25 percent (the combined federal-Ontario corporate income tax rate by 2013). Finance reported that corporate taxes as a share of earnings before interest, tax, depreciation, and amortization (EBITDA) were 9.6 percent in 2004, when the federal-provincial corporate income tax rate was about 35 percent. Given that the corporate income tax rate will be 10 points lower by 2013, corporate taxes as a share of EBITDA would be 6.9 percent.
2. Dividend payments as reported by Finance are 15 percent of EBITDA. About 35 percent of EBITDA represents profits that have been reinvested, resulting in capital gains accruing to owners. Third-party interest payments are 21 percent of EBITDA, and depreciation and amortization are 29 percent of EBITDA.
3. Canadian taxable residents pay 20 percent in tax on dividends and capital gain realizations. The accrual-equivalent capital gains tax rate is 16 percent, as discussed above. Non-resident owners pay 15 percent withholding taxes on dividends (and capital gains taxes to their own jurisdiction).
4. Tax-exempt investors hold 40 percent of total corporate assets, Canadian taxable investors hold 20 percent, and the remainder are held by non-residents.
5. The average personal income tax rate on pension payouts is equal to 33 percent.[39]

38 Canada, Department of Finance, *Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)* (Ottawa: Department of Finance, September 2005).

39 Aggarwal and Mintz, supra note 32.

Next, we need to estimate the assets of pension funds that may be able to take controlling positions. As noted earlier, pension funds are not restricted in their ownership or control of real estate companies (the 30 percent rule does not apply), and in many private equity situations, they are able to gain sufficient control of companies with other tax-exempt partners to avoid corporate tax payments. Currently, large pension funds have invested approximately 7 percent of pension assets in private equity and roughly 12 to 15 percent in real estate.[40] A significant portion of these assets may be held passively, having no impact on income taxes paid by the corporations. Assuming that larger public sector pension funds would be the ones most interested in control, we estimate that one-half[41] of real estate and private equity assets, or 10 percent of pension assets, would be "controlled" equity. This represents $60 billion in assets (based on 10 percent of assets being held by public pension funds). Taking EBITDA as a share of capital equal to 15 percent[42] on assets, the loss in corporate tax would be 1.04 percent of each newly controlled asset (using the rate assumed in 1 above). The potential loss in corporate tax would be roughly $600 million.

If corporate tax savings increase the return on assets, the amount of additional personal taxes raised will depend on whether pension payouts increase or plan contributions decrease. If the corporate tax savings result in increased pension payouts, at a 33 percent personal tax rate on payouts, federal and provincial taxes would increase by $200 million on an annualized basis (one-third of $600 million in corporate tax savings). On a net basis, federal and provincial corporate and personal taxes would be reduced by $400 million annually.

On the other hand, if contributions to public pension plans are reduced, the personal tax revenue gain (since employers are non-taxable) would be only half of the above amount, or $100 million. On a net basis, federal-provincial corporate and personal taxes would be reduced by $500 million.

Further, there is a loss in revenues from dividend and capital gains taxes on shares held by pension funds rather than by taxable investors. In the case of taxable residents (holding 20 percent of equity), the loss in dividend taxes is the tax rate of 20 percent multiplied by dividends (15 percent of EBITDA at 15 percent of assets), which is equal to $50 million. The loss in accrual-equivalent capital gains taxes (capital gains being 35 percent of EBITDA) is equal to $100 million. For non-resident investors, who hold 40 percent of total corporate assets in Canada, the loss in dividend withholding taxes is equal to $75 million.

40 Pension funds are allowed to own 100 percent of real estate companies. Data obtained from CEM Benchmarking Inc., Toronto (www.cembenchmarking.com).

41 We do not have information on the amount of corporate assets controlled by pension funds (as opposed to passive ownership). However, in the face of unknown distributions, one-half minimizes the potential error arising from lack of information.

42 This is roughly based on a pre-tax return on capital of 10 percent and augmented depreciation and amortization equal to 5 percent of capital.

Finally, the one-time increase in capital gains taxes, on an annualized basis, arising from taxable resident shareholders selling their shares to pension funds is equal to the taxable residents' share of corporate tax savings.[43] With a capital gains tax rate on realizations equal to 20 percent, the annualized increase in capital gains taxes is equal to $25 million.

The combined tax effects for the federal and Ontario governments are summarized in table 1.

If the 30 percent rule were eliminated completely, the estimated tax losses would be larger than those shown in table 1. Whether the tax revenue losses resulting from the complete elimination of the 30 percent rule would be significant is not known, since no study to date has assessed this issue.

INTERNATIONAL EXPERIENCE

To provide some additional context for the consideration of policy options, we next turn our attention to international experience as it relates to quantitative rules governing pension fund investments.

A recent survey carried out by the Organisation for Economic Co-operation and Development (OECD)[44] allows us to compare practices in other countries with respect to the taxation and regulation of pension fund investments. Our focus is explicitly on regulations and tax measures that would have an impact on pension fund ownership and control of business entities. Many countries also have other regulations, such as quantitative restrictions on the size of a single investment relative to assets, that could affect pension plan control; however, these are not discussed here. For the sake of brevity, we compare quantitative restrictions and tax rules in Canada, the United States, the United Kingdom, and Australia, and only briefly review quantitative restrictions in other countries. As will be seen, the evidence is mixed. While 10 countries (including the United States, the United Kingdom, and Australia) do not use regulations to limit pension ownership in a single business entity but do use tax rules, 12 (including Canada) limit ownership according to some threshold (in some cases, as low as 5 or 10 percent).[45]

43 The annualized value of increased capital gains taxes paid by target company shareholders is fairly simple to calculate. Assuming that a dollar of corporate tax savings increases shareholder valuation by a dollar, the present value increase in equity is equal to the corporate tax savings discounted by the after-tax shareholder's discount rate: $\Delta V = uy/\rho$ where ρ represents the after-tax shareholder's discount rate, u represents the effective corporate income tax rate on profits eliminated upon pension control, and y represents corporate income. (Note that the premium is $\Delta V/V = \{uy/\rho\}/\{y(1 - u)/\rho\} = u/(1 - u)$, implying a 25 percent premium at an effective corporate income tax rate equal to 20 percent.) Shareholders of the target company pay tax equal to $c\Delta V$. The annual cost of the capital gains taxes is the loss in returns earned on alternative investments ($\rho c\Delta V$), implying that the annualized value of additional capital gains taxes is simply cuy (derived from ($\rho c\Delta V = \rho c(uy/\rho)$).

44 Organisation for Economic Co-operation and Development, *Survey of Investment Regulation of Pension Funds* (Paris: OECD, February 2010) (herein referred to as "the OECD survey").

45 Ibid.

TABLE 1 Estimated Impact of Corporate Tax Savings Through Pension Fund Control of Taxable Companies, Federal and Ontario Tax Revenues Combined

	Increased pension payouts	Reduced pension contributions
Loss in corporate taxes	−$600 million	−$600 million
Loss in dividend and capital gains taxes paid by taxable residents	−$150 million	−$150 million
Loss in withholding taxes	−$75 million	−$75 million
Annualized increase in capital gains taxes paid by taxable residents previously holding shares in target companies	+$25 million	+$25 million
Increased personal taxes arising from higher pension returns	+$200 million	+$100 million
Total net loss	−$600 million	−$700 million

Canada

The starting point is Canada's 30 percent rule. As discussed earlier, this rule expressly prohibits pension funds from owning more than 30 percent of the voting shares of any one company, subject to some well-defined exemptions.[46] The Act includes provisions applicable to income from unrelated businesses, but these appear to apply specifically to charities and public foundations. Moreover, the penalty for non-compliance is revocation of charitable status rather than simply payment of tax.[47]

United States

The United States does not impose quantitative limits on pension plan control of business entities. However, it does apply an "unrelated business income tax" under the Internal Revenue Code.[48] The US UBIT applies to tax-exempt organizations in respect of income from controlled businesses that are not sufficiently related to the tax-exempt purpose of the exempt organization.[49] The term "unrelated trade or business" is defined in IRC section 513(a) to mean any trade or business that is not substantially related to the performance by the organization of its exempt purpose or function (aside from the use it makes of the profits derived).

According to IRC section 511, the UBIT applies to all exempt organizations under IRC section 401 (qualified pension, profit-sharing, and stock bonus plans) and IRC section 501 (other exempt organizations).[50] The UBIT does not apply to passive

46 See supra note 3 and the related text.

47 See David M. Sherman, ed., *Practitioner's Income Tax Act*, 41st ed. (Toronto: Carswell, 2012), notes accompanying the term "related business" in subsection 149.1(1).

48 Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

49 Internal Revenue Service, "Unrelated Business Income Tax" (www.irs.gov/charities/article/0,,id=156395,00.html).

50 With a few exceptions, most of which are related to private foundations.

investment income, including income from dividends,[51] interest,[52] annuities,[53] royalties,[54] and most rents from real property.[55] There are a number of notable exceptions:

- Under IRC section 512(b)(4), income from investments financed by debt is taxed. This includes debt incurred to acquire the investment, and debt incurred afterward that would not have been incurred but for the investment, that was foreseeable at the time of the investment.[56] Exceptions (that is, exceptions to the debt exception) apply for certain types of real estate transactions.
- IRC section 512(b)(13) includes special rules for certain amounts received from controlled entities. In essence, if the exempt organization receives from a controlled entity a "specified payment" that is derived from an unrelated trade or business, the exempt organization must report the payment as unrelated business income. Specified payments include interest, annuities, royalties, and rents.[57] It is notable that this list does not include dividends. This is according to the theory that the income from which dividends are paid is taxed in the hands of the controlled entity before being distributed.[58]

  Control is defined as ownership (by vote or value) of more than 50 percent of the stock in a corporation.[59] In the case of a partnership, control means ownership of more than 50 percent of the profit interest or capital interest;[60] in any other case, it means ownership of more than 50 percent of the beneficial interests in the entity.[61]
- There are special rules for S corporations—qualifying small businesses—whose income or losses flow through to the shareholders. Generally, ownership in an S corporation by an exempt organization counts as an interest in an unrelated trade or business, and all of the income and losses from, and gains/losses on disposition of the shares in, the S corporation are taken into account in calculating the unrelated business taxable income of the exempt organization.[62]

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51 IRC section 512(b)(1).

52 Ibid.

53 Ibid.

54 IRC section 512(b)(2).

55 IRC section 512(b)(3).

56 Ibid.

57 IRC section 512(b)(13)(C).

58 David L. Raish and Sharon Remmer, "How the Unrelated Business Taxable Income Rules Apply to Qualified Retirement Plans" (2004) 28 *ALI-ABA Business Law Course Materials Journal* 5-15, at 9.

59 IRC section 512(b)(13)(D)(i)(I).

60 IRC section 512(b)(13)(D)(i)(II).

61 IRC section 512(b)(13)(D)(i)(III).

62 IRC section 512(e).

United Kingdom

The United Kingdom relies solely on certain tax measures that affect pension plan ownership and control of companies. When pension funds invest in equities, the profits are taxed in the hands of the corporation before distribution, and a pension fund cannot claim a credit in respect of those profits. (The latter rule is a change from previous law, which allowed a credit as part of the UK imputation system that integrated corporate and personal income taxes.) However, there does not appear to be any different tax treatment depending on the level of ownership or control.[63] Income derived from investments or deposits held for the purposes of a registered pension scheme is exempt from income tax.[64] Income from a trading activity ("trading income") undertaken by a registered pension scheme is not investment income and so does not qualify for this tax exemption.[65]

Australia

Like the United Kingdom, Australia does not impose any quantitative restriction on control of corporations by pension funds. Australia follows a unique approach to the taxation of pension funds. Individuals pay a preferential tax rate on earnings contributed to plans, and withdrawals of principal and income from plans are not subject to tax. The earnings (including realized capital gains) in Australian pension funds (sometimes also referred to as "superannuation funds") are taxed at a rate of 15 percent as long as the fund complies with the provisions of the Superannuation Industry Supervision Act.[66] The earnings of non-complying superannuation funds are taxed at the highest marginal tax rate (45 percent).[67] As reported by the Australian Treasury, the effective tax rate on earnings for a typical fund is approximately 6.5 percent, taking into account dividend imputation and other factors. "Investment income derived from assets backing pensions (retirement income streams) is said to be

63 See Philip Booth and Deborah Cooper, *Simplifying the Taxation of Pensions*, IEA Current Controversies Paper no. 13 (London: Institute of Economic Affairs, January 2003) (www.iea.org.uk/sites/default/files/publications/files/upldbook328pdf.pdf).

64 There is an exception to this normal rule in relation to income derived from investments or deposits held by a registered pension scheme as a member of a property investment LLP. See United Kingdom, HM Revenue & Customs, "Registered Pension Schemes Manual" (www.hmrc.gov.uk/manuals/rpsmmanual/Index.htm), at RPSM04103010.

65 Ibid. See also ibid., at RPSM04103030.

66 Taxation of superannuation in Australia is quite different. Benefits paid to members are not taxed. For most taxpayers, earnings paid as contributions to plans are taxed a preferential flat rate. Investment income earned by a plan is taxed at the rate as described.

67 National Information Centre for Retirement Investments, "Super and Tax" (http://www.nicri.org.au/?q=node/26).

'exempt' income on which tax is not levied. If these assets are shares, dividend imputation may result in negative tax rates."[68]

Some Other Countries

The OECD survey lists the following quantitative restrictions imposed in other countries:

- *Brazil*. Pension funds in Brazil can hold a maximum of 20 percent of the capital of a single company.
- *Chile*. Chile imposes ownership concentration limits with respect to 15 percent of individual funds belonging to a single group; 35 percent of local investment funds or outstanding shares of local mutual funds; 7 percent of subscribed shares in a public limited local company; and 35 percent of bonds, commercial paper, or securitized loans.
- *Colombia*. A pension fund can hold a maximum of 10 percent of equity and 10 percent of mandatory convertible bonds issued by a single company.
- *Finland*. A maximum of 5 percent of equity or bond securities may be held in a single corporation.[69]
- *Germany*. Ownership is limited to 10 percent of the nominal capital of one and the same company.[70]
- *Israel*. A pension fund can hold a maximum of 10 percent of the controlling interests in a company provided that it does not have control.
- *Italy*. A pension fund's investment must not constitute more than 5 percent of the nominal value of all voting shares of a listed company and not more than 10 percent of a non-listed company.
- *Slovak Republic*. A pension fund management company may not acquire shares with a voting right that would allow it to exercise significant influence over the issuer's management.[71]
- *Sweden*. Until recently, Sweden limited investment in the shares of any one company to 5 percent of the shares. This restriction and several other quantitative restrictions were eliminated in 2006.[72]

As can be seen, there is no dominant mechanism used in all countries. There is a limited set of countries, including Canada, that restrict ownership or control by pension funds in business entities but do not impose any other tax rules on investment

68 George Rothman, *Assessing the Tax Advantages of Investment in Superannuation* (Canberra: Department of the Treasury, Retirement and Income Modelling Unit, July 2000), at 3 (http://rim.treasury.gov.au/content/CP00_4.asp).

69 OECD, supra note 44, at table 3.

70 Ibid.

71 Ibid.

72 Ibid.

income received by pension funds. In other countries, such as the United States and Australia, specific tax rules may apply to the investment income of pension funds, depending on the type of income received.

CANADIAN PENSION FUND INVESTMENT PERFORMANCE AND CANADIAN CAPITAL MARKETS

So far we have described the possible implications arising from the application of the 30 percent rule with regard to capital market efficiency and tax revenues. This section deals with the argument that the 30 percent rule impairs the investment performance of pension funds, given that Canadian markets for publicly traded securities are relatively small and pension funds may want to increase their holdings in high performance firms. Greater control would arguably allow pension funds to expand their investment in Canada and thereby earn better returns, given that they may have more in-depth knowledge of Canadian companies as compared with investments in global markets. In addition, we focus on another important issue, namely, the size of Canadian pension funds relative to the size of Canadian capital markets and the corresponding implications of changes to the 30 percent rule.

We believe that the concern regarding the size of Canadian capital markets first requires a discussion of the elimination of the foreign property rule (FPR) in 2005 since it was based on a somewhat similar argument. The elimination of the FPR followed a gradual relaxation of the limit from 10 percent in the 1990s to 30 percent from 2001. Removing the limit effectively allowed pension funds to make passive non-controlling investments globally in any security. Given the ability to invest globally, the 30 percent rule may not have any adverse impact on pension fund performance.

As is well known, the elimination of the FPR resulted from arguments made by pension funds and others in favour of increased global diversification and better investment performance. It was claimed that if Canadian pension plans were restricted to investing the majority of their funds in the relatively small Canadian capital markets (which represented approximately 4 percent of the world market capitalization around that time), pension fund performance would be adversely affected. The 30 percent limit on foreign property holdings was therefore not consistent with the prudent person rule and would negatively affect the well-being of Canadians by reducing their retirement payouts. In the February 23, 2005 federal budget, then Finance Minister Ralph Goodale stated, "To expand the investing universe for Canadians and offer them the potential to achieve greater diversification and a more secure future, we will remove the foreign property limit—effective immediately."[73] The budget speech stated that this move responded to the growing retirement income needs of an aging population; would improve diversification opportunities for

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73 Canada, Department of Finance, 2005 Budget, Budget Speech, February 23, 2005, at 15.

retirement investments; would increase the international competitive position and foreign investment capabilities of Canada's pension funds and fund management companies; and would create the potential to stimulate venture capital investments by pension funds. Eliminating the FPR also meant that Canadian pension funds would no longer be held captive to satisfying the financing needs of the Canadian corporate sector and government; instead, they were free to invest wherever the best investment opportunities existed. It also meant that the Canadian corporate and government sectors could no longer rely on automatic investment from Canadian pension funds. Borrowers now had to compete for pension fund investments on an equal footing with foreign companies, by demonstrating a superior risk-return tradeoff. The obvious question to ask is whether a similar situation currently exists with regard to the 30 percent rule and whether the rule negatively affects pension fund returns by limiting a fund's ability to invest as it chooses. It is this concern that we turn to next.

It is well known that Canadian pension funds, spanning both the public and the private sectors, are dominated by large funds, and that pension funds as a whole continue to represent one of the fastest-growing pools of institutionalized capital in Canada. Figure 1 shows the overall growth in assets of Canadian pension funds based on both book value and market value. As at the fourth quarter of 2011, the total assets of Canadian pension funds surpassed $1 trillion, with 75 percent of those assets being controlled by public sector plans. Thus, the importance of pension funds to Canada's capital markets and the corporate sector cannot be overstated.

There is also another important observation with respect to the higher concentration of Canadian pension assets in public sector funds. Using the data available from a recent article on Canada's top 100 pension funds,[74] our analysis indicates that the top 100 funds represent approximately 65 percent ($648 billion by market value) of total pension fund assets based on 2010 data. The top 10 funds account for $260 billion, representing 26 percent of the total and more than 40 percent of the top 100. All top 10 funds are public sector funds. In fact, of the top 100, 49 are public sector funds, and together they hold assets of $443 billion. In terms of their relative importance, the assets of public sector pension funds represent approximately 44 percent of the total market value of assets held by the top 100 funds.

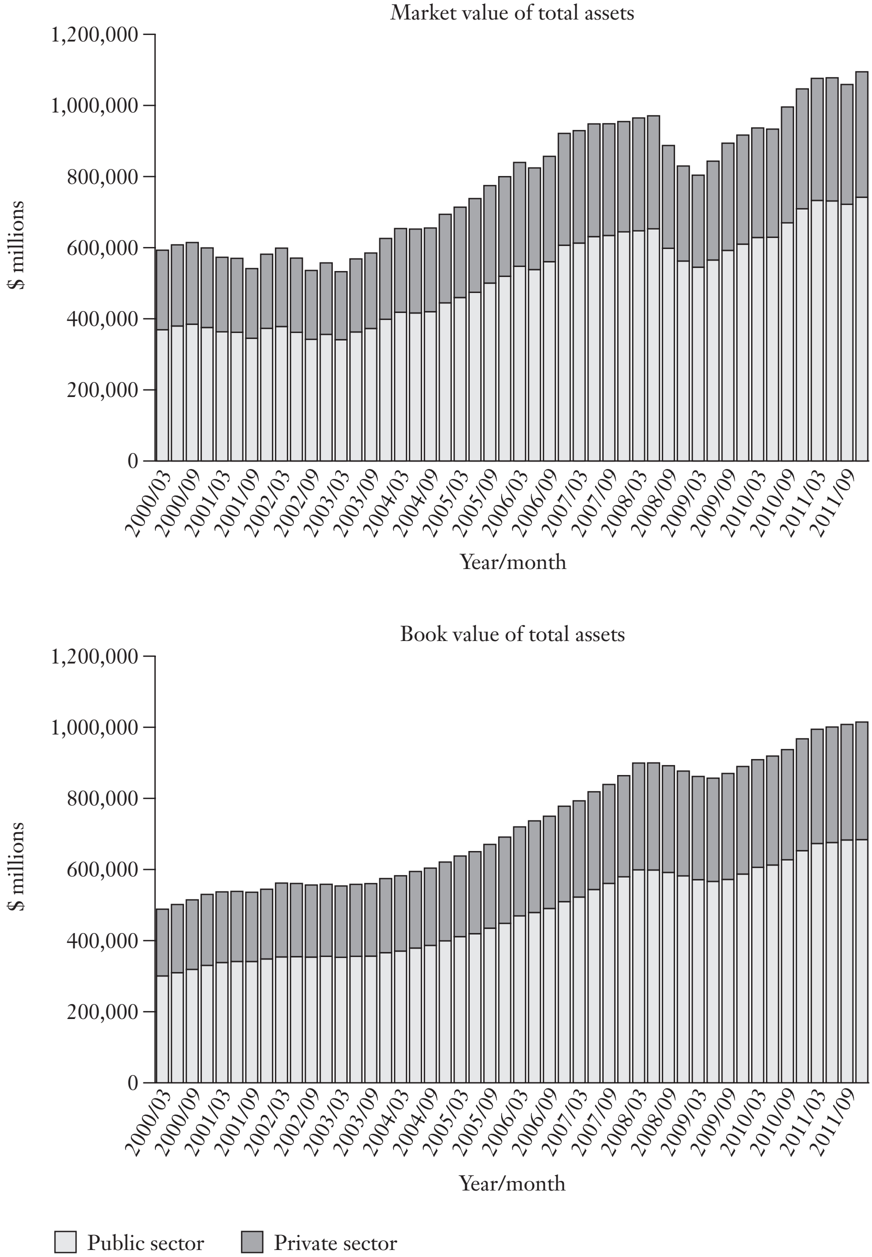
The same article reports that, of the 300 largest pension funds in the world (those with $10 billion or more in assets), as at year-end 2010, 19 were Canadian. Of these 19 funds, 15 are public sector funds, 1 is a Crown corporation (Canada Post), and the other 3 are private sector funds (CN, General Motors, and Air Canada).

These observations imply that large public sector pension funds may be more interested in the relaxation of the 30 percent limit than private sector funds, since the latter may not face a "size of investment" constraint.

Given their size, it is not surprising that these pools of capital and large individual funds have a significant impact on Canada's capital markets in each asset class.

74 Neil Faba, "Top 100 Pension Fund Report: Risking It All," *Benefits Canada*, June 27, 2011, 19-27.

FIGURE 1 Value of Assets Held by Canadian Trusteed Pension Funds, Public and Private Sectors



Source: Statistics Canada, CANSIM database, modified table 280-0003, "Trusteed Pension Funds, Market and Book Value of Assets, by Foreign and Domestic Holdings."

Figure 2 shows the respective investment choices made by public and private funds. As can be seen, the overall asset mix is similar for private and public sector funds: 30 to 35 percent in each of stocks and bonds, with the rest (15 to 20 percent) invested in real estate, mortgages, and other investments. Private sector funds invested a slightly higher percentage in stocks than their public sector counterparts. Of the roughly $1 trillion in assets, pension funds now own $424 billion in bonds and $338 billion in stocks. (More would be held indirectly through pooled funds.) If all these assets were to be confined to Canadian capital markets, arguably this could have important implications for liquidity in capital markets and control of the corporate sector.

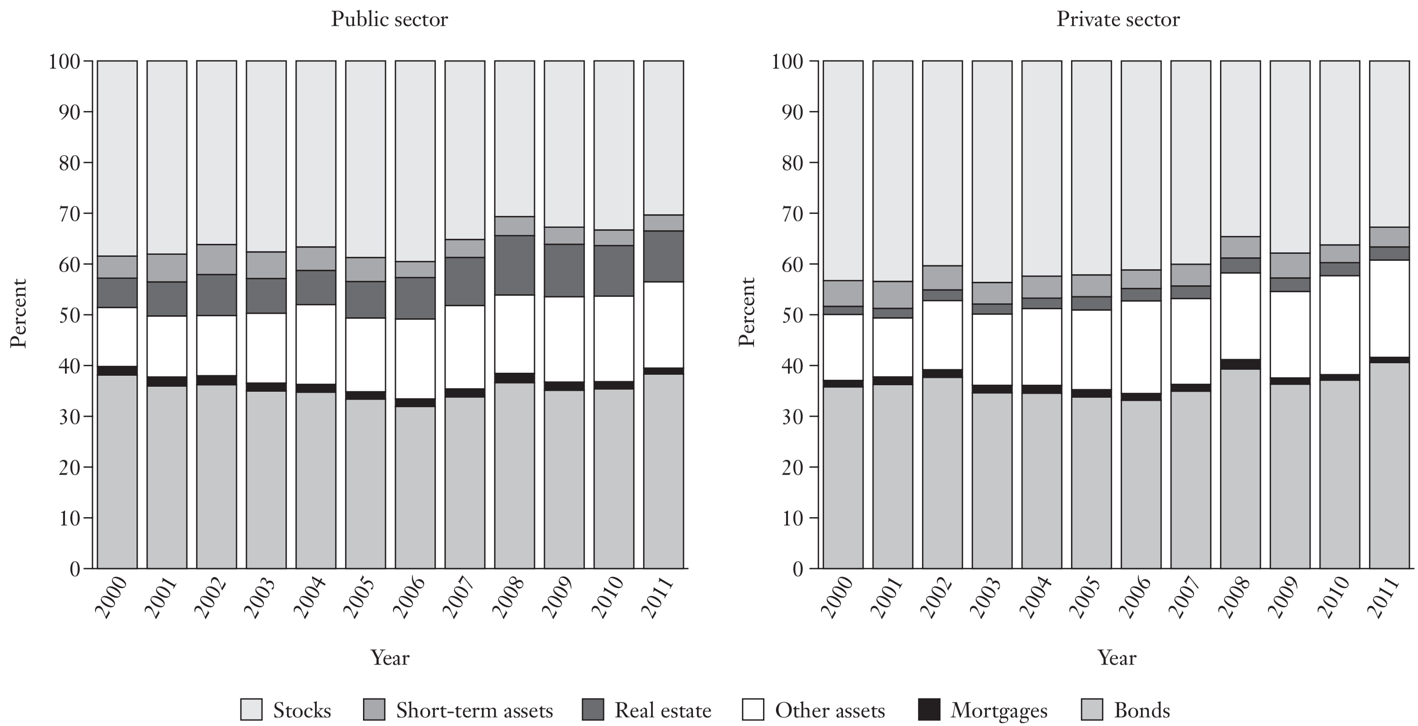
However, as discussed above, since the February 2005 federal budget, pension funds and investors in RRSPs have been permitted to invest in foreign assets. The result of this relaxation of the FPR is reflected in the growth in the percentage of aggregate foreign assets held by pension funds, which rose from 20 percent in 2000 to 25 percent by 2011. Not surprisingly, most of the growth in foreign assets is a result of large investments in foreign (mostly US) stocks rather than foreign bonds.

Figure 3 shows the significant difference in the composition of Canadian assets held by pension funds compared with their foreign asset mix. More specifically, while investments in Canadian bonds constitute approximately 45 percent of Canadian assets, investments in foreign bonds constitute less than 10 percent of foreign assets. Specifically, pension fund investment in foreign assets is dominated by investments in foreign stocks (50 to 55 percent) and other assets (35 to 40 percent), which also include stocks invested through pooled funds.

Since the elimination of the FPR, Canadian pension funds have invested heavily in foreign stocks. This could possibly be to benefit from an improved risk-return potential or for diversification through asset purchases in certain sectors that are not available through Canadian stock markets (high technology, biotechnology, pharmaceuticals, etc.), as well as a desired increased exposure in emerging market equities. The universe of investment opportunities is now so much larger (since Canadian capital markets constitute no more than 4 percent of global markets) that one can easily argue that the 30 percent rule may not hamper the ability of pension funds to seek the best possible returns and thus continue to meet their fiduciary obligations. Of the $338 billion in stocks, foreign stocks (mostly US stocks) now constitute $172 billion, representing 51 percent of the total equity investment—implying that Canadian pension funds have placed more of their equity investments outside Canada.

Next we turn our attention to the size of pension funds relative to the (publicly listed) Canadian corporate sector with a focus on stock market capitalization. To estimate the stock market capitalization of publicly listed Canadian stocks, we use data from S&P Capital IQ that includes all publicly listed Canadian companies on Canadian stock exchanges. Owing to coverage limitations in the Capital IQ database, we limit our analysis to the 2007-2011 period. As at year-end 2011, the total market capitalization of publicly listed firms on the Toronto Stock Exchange (TSX) was $1.8 trillion.

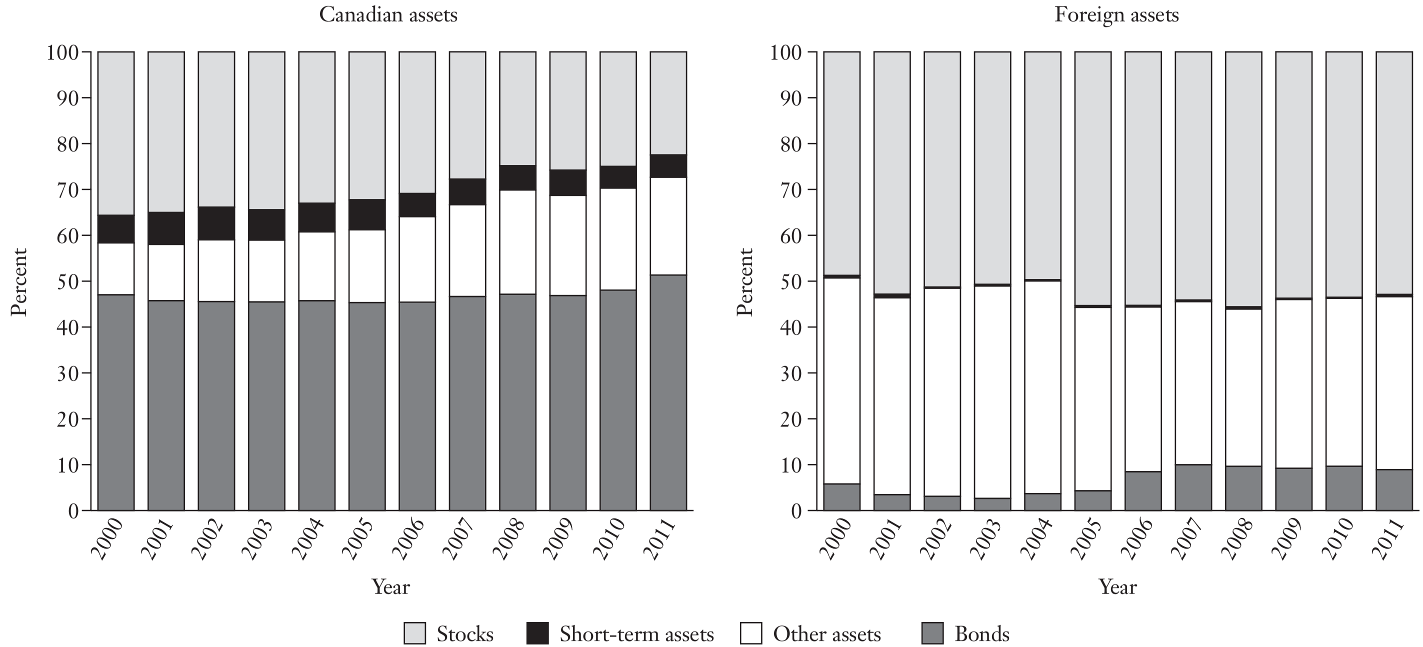
FIGURE 2 Asset Mix of Private and Public Sector Pension Funds, by Market Value



Note: Investments held at year-end.

Source: Statistics Canada, CANSIM database, modified table 280-0003, "Trusteed Pension Funds, Market and Book Value of Assets, by Foreign and Domestic Holdings."

FIGURE 3 Asset Mix of Canadian and Foreign Assets by Canadian Pension Funds



Note: Investments held at year-end. Short-term Canadian assets include cash, deposits, guaranteed investment certificates, and short-term securities; some may mature in more than 12 months. Short-term foreign assets include investments in foreign pooled funds, stocks, bonds, and other short-term securities. Canadian “other assets” include investments in miscellaneous pooled vehicles, mortgages, real estate, and accruals and receivables. All foreign “other assets” are investments in foreign pooled funds.

Source: Statistics Canada, CANSIM database, modified table 280-0003, “Trusteed Pension Funds, Market and Book Value of Assets, by Foreign and Domestic Holdings.”

Table 2 shows the number of firms in our sample segregated on the basis of their equity market capitalization in each year. The table indicates that the distribution across size categories was fairly static over the five-year period: approximately 40 percent of firms had a market capitalization below $100 million, 35 percent were between $100 and $500 million, and 25 percent were what would be considered large firms—those whose market capitalization is higher than $500 million and that may be of interest to large pension funds for liquidity reasons.[75] It is also interesting to note that, as at year-end 2011, there were more than 300 firms whose market capitalization exceeded $500 million. Although not shown in the table, there were 179 firms with market capitalization between $1 billion and $10 billion and 41 firms with market capitalization exceeding $10 billion. The top five banks represented market capitalization of $275 billion, and the top four insurance companies represented another $68 billion. Although the numbers would change with changes in equity prices, these values and the distribution of firms have been fairly similar over the last five years, as shown in table 2.

Tables 3 and 4 show the median and average market capitalization, respectively, represented by the firms in the sample. A large number of Canadian firms are in the greater than $500 million category, with an aggregate median equity value of $1.6 billion at year-end 2011.

The implications of these data can be illustrated by a simple example. Assume that a large pension fund with total assets of $50 billion wished to invest a representative 35 percent, or $17.5 billion, of its total portfolio in Canadian stocks. This fund would have a choice of investing in approximately 1,300 firms. If the fund wanted to invest only in liquid and large firms, it would have a choice of more than 220 firms with a market capitalization over $1 billion each and a total market capitalization of over $1.6 trillion, notwithstanding the investment limits on owning more than 10 percent in certain sectors (such as banks). Given this relative size comparison, coupled with the elimination of the FPR, it is hard to argue that the 30 percent rule is restricting pension funds from achieving optimal investment performance.

However, pension funds could argue that they need to control companies because returns associated with investing in public equities (whether passive or active) do not generate sufficient returns. Thus, they need to privatize, or at least have greater control over companies, and the 30 percent rule may prevent them from taking such action. Since this argument presupposes that pension fund managers (or their agents) have superior ability to select high performance stocks and to run operating companies, we document the performance of Canadian funds, in terms of their return on investment, compared with a passive index such as the TSX/S&P for Canada or the S&P 500 for the United States.[76]

75 Liquidity refers to the ability of an investor to trade a large number of shares (or bonds) without significantly affecting the price or worrying about the availability of demand.

76 These data were obtained from CEM Benchmarking Inc., Toronto, supra note 40, and include a highly representative sample of both public and private sector funds.

TABLE 2 Total Number of Canadian FIrms Listed on the TSX Categorized by Market Value of Equity

Year	Less than $100 million	$100-$500 million	More than $500 million	Total
2007	350	311	276	937
2008	569	238	192	999
2009	508	298	277	1,083
2010	491	375	344	1,210
2011	619	388	332	1,339

Source: S&P Capital IQ (www.capitaliq.com).

TABLE 3 Median Size (Market Capitalization) of Canadian Firms Categorized by Market Value of Equity

Year	Less than $100 million	$100-$500 million	More than $500 million	All firms
2007	42.8	203.6	1,503.2	166.3
2008	23.1	194.7	1,598.9	64.8
2009	33.4	205.8	1,592.6	117.3
2010	33.7	219.3	1,478.0	170.5
2011	29.2	212.4	1,558.0	124.4

Source: S&P Capital IQ (www.capitaliq.com).

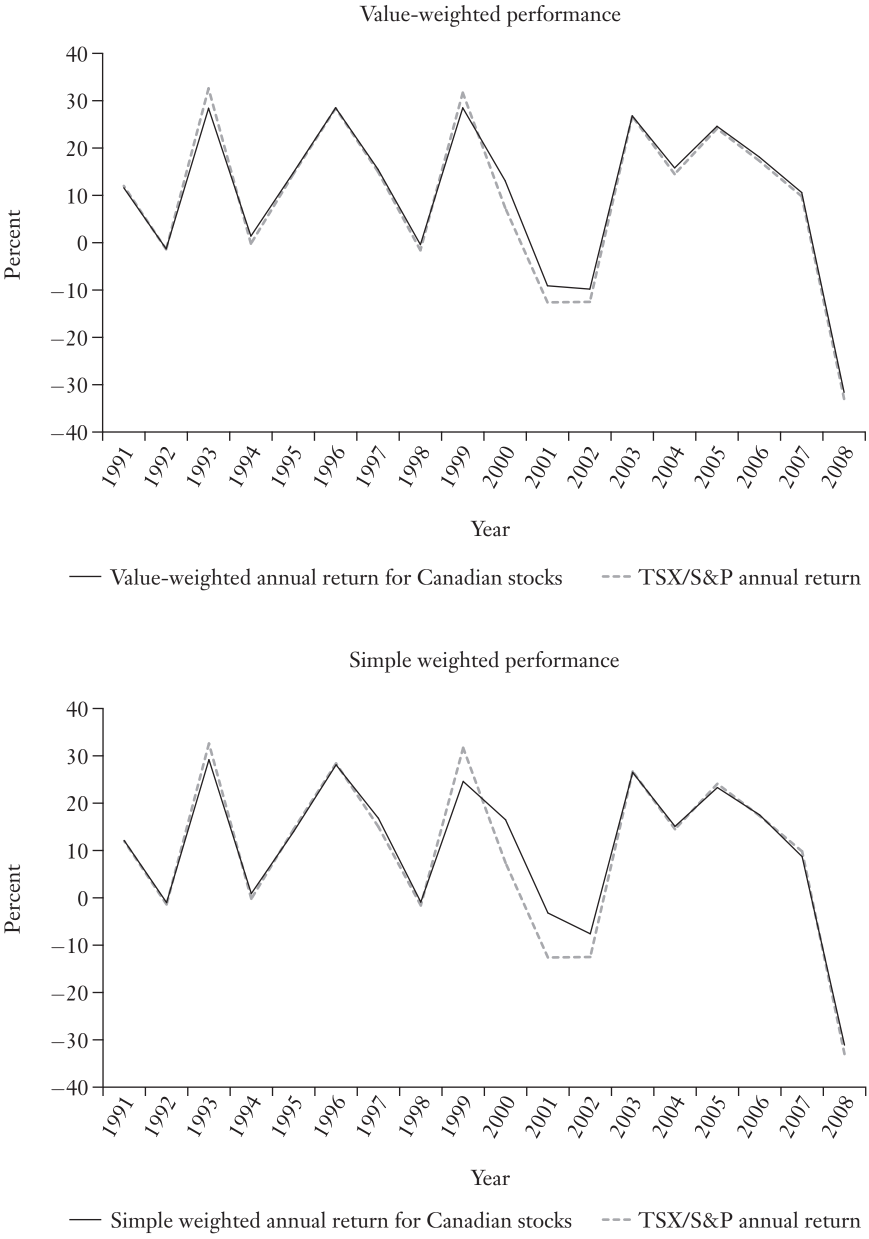
TABLE 4 Average Size (Market Capitalization) of Canadian Firms Categorized by Market Value of Equity

Year	Less than $100 million	$100-$500 million	More than $500 million	All firms
2007	45.0	231.7	5,560.1	1,731.5
2008	31.0	225.3	5,287.2	1,087.5
2009	39.2	235.6	5,376.4	1,458.3
2010	38.6	248.3	5,174.2	1,563.6
2011	36.0	235.6	4,956.4	1,313.8

Source: S&P Capital IQ (www.capitaliq.com).

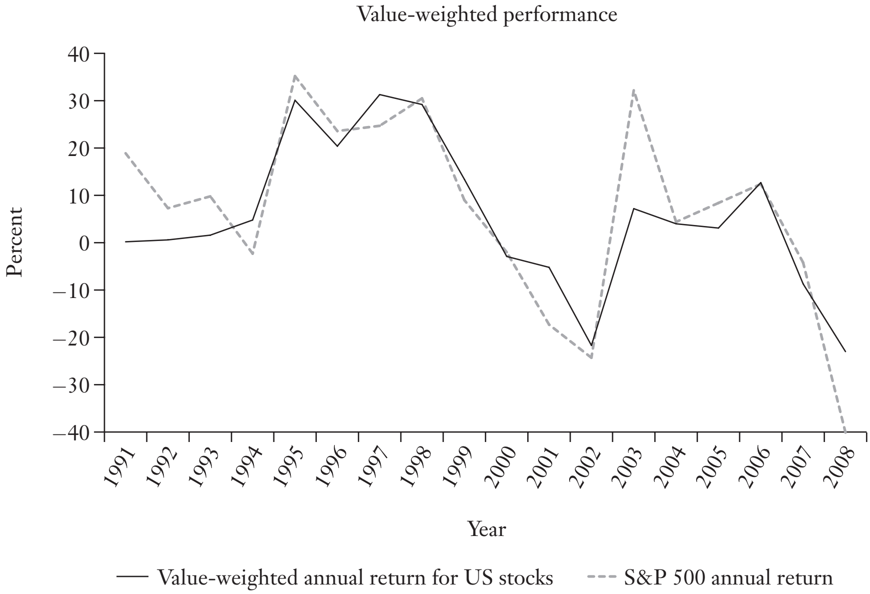
Figures 4 and 5 show both value-weighted and simple average returns for Canadian and US equity investments of Canadian pension funds as compared with the corresponding index. While there would be individual funds whose performance may be above or below the index, it is clear that, on average, pension funds do not display any superior ability to select stocks in aggregate. This is not surprising since there is considerable evidence that professionally managed funds (for example, mutual funds) do not outperform the corresponding benchmark portfolios, net of costs. This evidence indicates that actively managed fee-based portfolios that rely on security selection may not generate higher risk-adjusted returns than passively

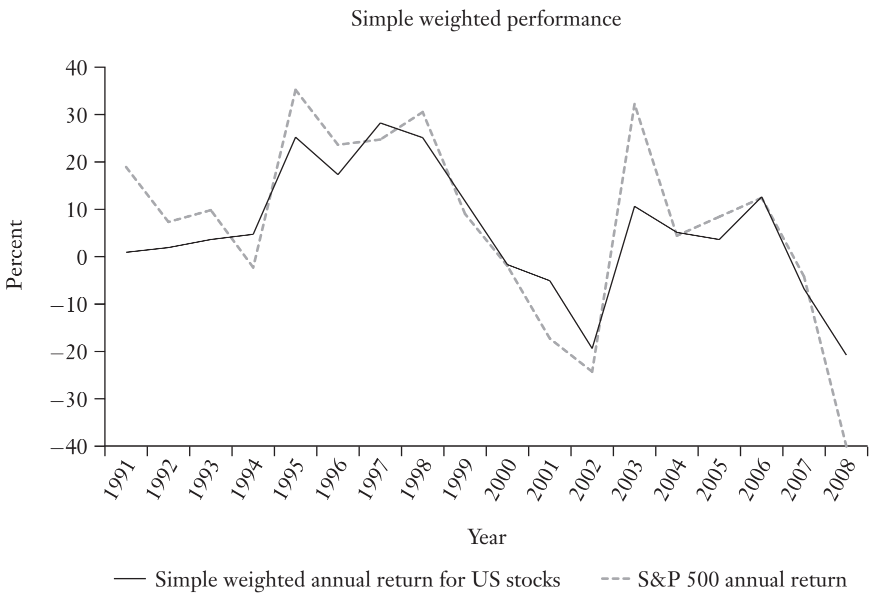
FIGURE 4 Performance of Canadian Pension Funds—Canadian Equity Component



Source: Vijay Jog, *Investment Performance and Costs of Pension and Other Retirement Savings Funds in Canada: Implications on Wealth Accumulation and Retirement*, prepared for the Research Working Group on Retirement Income Adequacy (Ottawa: Department of Finance, 2009) (www.fin.gc.ca/activty/pubs/pension/ref-bib/jog-eng.asp).

FIGURE 5 Performance of Canadian Pension Funds—US Equity Component





Source: Vijay Jog, *Investment Performance and Costs of Pension and Other Retirement Savings Funds in Canada: Implications on Wealth Accumulation and Retirement*, prepared for the Research Working Group on Retirement Income Adequacy (Ottawa: Department of Finance, 2009) (www.fin.gc.ca/activty/pubs/pension/ref-bib/jog-eng.asp).

held, widely diversified portfolios (such as index funds). This does not mean that in a particular year or two, a small percentage of professionally managed portfolios do not outperform the benchmark index; rather, the evidence suggests that the possibility of their doing so in the long term is small.[77]

In a related paper, Jog[78] also shows that there is a remarkable lack of any persistency in individual pension fund performance over the 19-year period in his sample; while he finds that some funds in his sample display some year-to-year quartile 1 persistency, they are unable to maintain their membership in quartile 1 over a longer period. This implies, at the aggregate and at the individual level, that pension funds (in particular, their managers) have not displayed an uncanny ability to find superior investment opportunities compared with benchmarks. Thus, one must now argue that although pension funds have not been able to identify and invest in high performance publicly traded securities, elimination of the 30 percent rule would allow pension funds to identify, acquire, and better manage fully controlled companies and achieve better risk-return tradeoffs. Unfortunately, no evidence exists on the performance of pension-controlled companies since it is difficult, if not impossible, to find the corresponding benchmarks for comparison. Here again, there could be exceptions to the rule. We do not exclude the possibility that one or two pension funds may indeed have an uncanny ability to find superior investment opportunities and significantly improve the performance of companies after they have acquired full control. It is also possible that these pension funds, owing to the long-term nature of their liabilities as well as their size, may provide patient capital to the controlled firm, thereby reducing both its cost of capital and the time that management would otherwise spend on dealing with capital market participants.

Overall, this analysis indicates that relaxation of the 30 percent rule solely on the basis of either the size of Canadian capital markets relative to pension fund assets or the superior investment ability of fund managers cannot be justified. Such a decision could result in a large segment of Canada's publicly traded companies being taken private by Canada's pension plans, without any particular improvement in performance.[79]

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77 The literature in this area is substantial. For some recent evidence, see Rob M.M.J. Bauer, K.J. Martijn Cremers, and Rik G.P. Frehen, "Pension Fund Performance and Costs: Small Is Beautiful," April 2010 (http://ssrn.com/abstract=965388); John C. Bogle, "A Question So Important That It Should be Hard To Think About Anything Else" (2008) 34:2 *Journal of Portfolio Management* 95-102; Kenneth R. French, "The Cost of Active Investing," April 2008 (http://ssrn.com/abstract=1105775); and Rajeeva Sinha and Vijay M. Jog, "Performance of Canadian Mutual Funds and Investors," in Cheng-Few Lee, ed., *Advances in Quantitative Analysis of Finance and Accounting*, vol. 5 (Hackensack, NJ: World Scientific, 2007), 227-59.

78 Vijay Jog, *Investment Performance and Costs of Pension and Other Retirement Savings Funds in Canada: Implications on Wealth Accumulation and Retirement*, prepared for the Research Working Group on Retirement Income Adequacy (Ottawa: Department of Finance, 2009) (www.fin.gc.ca/activty/pubs/pension/ref-bib/jog-eng.asp).

79 This was a noted reason for the federal government's decision not to change the 30 percent rule in its 2010 reforms. See supra note 8 and the related text.

OBSERVATIONS AND POLICY OPTIONS

In this article, we have made several important observations:

- Some large pension funds have argued that they need a relaxation of the 30 percent rule owing to the small size of Canadian capital markets. However, Canadian capital markets are sufficiently large in terms of market capitalization and may therefore not be a limiting factor.
- Removing the restriction on investments in foreign property (the FPR rule) gave pension funds access to global markets, enabling better risk diversification in the purchase of assets. Canadian pension funds have responded by increasing their investment in foreign assets; in fact, the market value of their foreign stocks now exceeds the value of their investment in Canadian stocks. Thus, there seems little to be gained from allowing pension funds to acquire controlling interests in operating companies, given that they can already achieve diversification through participation in global markets.
- Greater voting control of businesses may enable pension funds to have more influence over the choice of corporate directors, providing a closer linkage between ownership and management of the firm. However, it is not clear whether pension fund governance is adequate to give fund managers and trustees an incentive to exercise such influence, nor is it clear how a strengthened pension governance regime would result in better governance of companies if they were controlled by pension funds.
- When pension funds acquire control of companies, potential conflicts of interest could arise for pension fund trustees in relation to the sponsoring firm's management and pension plan members. In some cases, the motives of the pension fund trustees may actually be different from those of the sponsoring firm's management. For example, a labour union pension fund may prefer that the acquired company maintain current employment levels, even if the objective of creating shareholder value calls for a reduction in the number of employees.
- In the market for acquisition and control of businesses, pension funds (being tax-exempt) have an advantage over taxable investors. The advantage arises because a pension fund can restructure a company that it controls so as to eliminate or reduce corporate tax that would otherwise be paid by the company. As a result, capital market inefficiencies may arise since asset purchases and corporate acquisitions are not solely dependent on economic factors, but also take other factors into account, such as superior management skills.
- The effect of the current tax advantage given to pension funds is estimated to reduce annual corporate and personal taxes paid to federal and provincial governments (net of additional personal tax on pension payouts) by a range of $600 million to $700 million annually.

With this overall background and context, we now outline six possible policy options, specifically the following:

1. Keep the rule unchanged.
2. Abolish the rule.
3. Toughen the rule.
4. Consider replacing the rule with a tax alternative similar to the US UBIT.
5. Introduce a rule similar to the thin capitalization rules.
6. Limit the deduction of certain payments (such as interest, fees, royalties, and rents) by corporations when such payments are made to related tax-exempt entities.

Status Quo

In 2010, the federal government announced that it intends to maintain the 30 percent rule for federally regulated pension plans on the basis that the rule prevents some pension funds from owning operating companies, or at least puts sand in the wheels.[80] However, as discussed above, it is still possible for a pension fund to acquire control of a corporation. If the intent of the 30 percent rule is to prevent pension funds from operating as active investors, the rule seems not fully effective. Perhaps it is felt that no other appropriate replacement can be adopted, even if the rule can be circumvented in certain instances.

Abolition of the 30 Percent Rule

The argument in favour of abolition of the 30 percent rule is that, if pension funds were allowed to have a larger ownership share of companies, they could use their influence as controlling shareholders to improve corporate governance and the efficiency of company operations. A pension fund could exert greater control over the company's board and thereby better align management with shareholder interests—although, as discussed earlier, this may not necessarily happen. Further, the absence of the rule would make it easier for pension funds to acquire both domestic and foreign investments—for example, in situations where Canadian funds must compete with foreign pension funds that do not face similar limitations.

However, two important concerns are associated with abolishing the rule. The first is the competitive advantage that pension funds would have in acquiring business entities, relative to taxable investors. As discussed above, this advantage could potentially erode capital market efficiency. In a tax-neutral world, ownership would be determined by management excellence or synergies established among merged companies that increase profits; thus, the target company would go the highest bidder without any concerns about a tax advantage or disadvantage.

While the 30 percent rule is not a direct approach to dealing with non-neutralities in the tax system, it would have some impact in reducing the effect of the tax advantage enjoyed by pension funds in acquiring and managing companies. Nonetheless,

80 Ibid.

the rule applies only to pension funds and not to other tax-exempt investors. Restricting only pension funds in this manner does not eliminate the problem for other tax-exempts. We address this issue below in our discussion of a tax remedy.

The second concern is that the 30 percent rule may be too blunt an approach. The rule does not prevent control in many cases, nor does it resolve conflicts of interest. The abolition of the rule may be appropriate if other regulations can ensure that conflicts of interest will be avoided.

Toughening the 30 Percent Rule

A tougher 30 percent rule could take several forms. For example, it could lower the 30 percent threshold to 10 percent of voting shares, or extend to certain indirect holdings (say, by prohibiting ownership through mutual or segregated funds) to achieve effective (de facto) control. The rule could simply state that pension funds cannot hold voting shares on a related basis, a concept that would be subject to various tests. Or instead, pension funds could be limited to holding passive investments. For example, it has been argued that pension funds should hold only indexed securities (such as those listed on global indexes) in order to achieve maximum risk diversification at very low cost.[81]

Alternatively, a tougher rule could limit a pension fund's ownership of voting shares of companies to a specified maximum percentage of the fund's total investments (such as 5 percent).

The argument in favour of a tougher rule would be that pension plans should not be in the market for corporate acquisitions but instead be passive investors. This view is supported if there is no evidence that active management provides consistent superior risk-adjusted returns net of management costs. Limits to active management would also reduce the ability of pension funds to use their non-taxable status to achieve control of companies, and it would reduce any potential conflicts that could otherwise arise when investing in companies, since control would not be possible. In addition, limiting pension funds strictly (or mostly) to passive investment in business entities would reduce the potential impact of pension fund investment on corporate governance and performance.

However, and most importantly in our view, tougher regulation of pension funds would not curtail the possibility that other tax-exempt entities could purchase companies on a tax-advantaged basis. It could also lead to more foreign ownership of Canadian corporations. Although there are limitations on charities and public foundations with respect to business ownership, other tax-exempts (especially sovereign wealth funds) may face no limitations. Regulatory change has its limitations if the intent is to put all investors on a level playing field; accordingly, if a tougher rule is

81 At a School of Public Policy, University of Calgary conference, on April 13, 2010, Larry Kotlikoff of Boston University argued that Canadians should invest only in securities listed on global indexes, in part to hedge against downturns in the US economy that would affect Canadian asset returns.

applied to pension funds, similar treatment should be extended to other tax-exempt entities.

A Tax on Tax-Exempt Entities

A very different approach is to reduce the tax advantage that pension plans and other tax-exempts enjoy when they acquire control of corporations. This approach is focused on neutrality in taxation rather than concerns about governance.

The tax remedy could be a tax similar to the US UBIT that could be applied to all kinds of tax-exempts. If a tax-exempt entity obtained a certain level of control in a corporation, it would be subject to tax on the income derived from the corporation, other than dividends (which are distributed from profits already subject to corporate tax). The rate of tax could be set at the prevailing federal-provincial corporate rate on such income. Rules would be required to deal with indirect holdings.

Given that most provinces have entered into an income tax collection agreement with the federal government,[82] the federal government would be in the best position to levy such a tax. However, provinces such as Ontario could also administer a separate UBIT that would be imposed in addition to federal taxation.

While an Ontario UBIT could increase provincial revenues, it could motivate tax-exempts to leave the province. Public pension funds and endowment funds of Ontario-legislated bodies would be unable to relocate. Overall, a coordinated approach would be far better.

It should be noted that the US UBIT rule is quite complicated in its effects on non-profit organizations. The UBIT might be used if the aim is to discourage unrelated business activity that could lead to "unfair competition." However, overhead costs for both taxable and non-taxable activities could be more heavily allocated to taxable activities, thereby leading to less taxation of unrelated business activity and therefore an inefficiently high level of such activity.[83] As noted by Hines,[84] non-profit businesses tend to avoid unrelated business activity (which is relatively small in the United States) unless financial pressures push them into it. Hines points out that the UBIT may be an efficient tool to discourage unrelated business activity by non-profits, since it encourages managers to focus their efforts instead on improvements to the conduct of the non-profit business.

Further, rules would need to be developed for related entities such as partnerships and other business organizations to reduce tax avoidance. Canada would need to determine its own control threshold, which would probably be lower than the US threshold of 50 percent. Private plans primarily holding passive investments would

82 Quebec operates its own personal and corporate income tax and Alberta the corporate income tax.

83 Richard Sansing, "The Unrelated Business Income Tax, Cost Allocation, and Productive Efficiency" (1998) 51:2 *National Tax Journal* 291-302.

84 James R. Hines Jr., "Non-Profit Business Activity and the Unrelated Business Income Tax," in James M. Poterba, ed., *Tax Policy and the Economy*, vol. 13 (Cambridge, MA: National Bureau of Economic Research, 1999), 57-84.

likely not be affected by a UBIT. However, the rule could affect passive ownership if it were applied too strictly. Any such tax would require careful consideration before its implementation.

Other issues, related to conflicts of interest, may still need to be addressed through regulations, as discussed above.

Thin Capitalization Rule

Another approach is to limit corporate deductions rather than impose a tax on pension funds and other tax-exempts. Canada already has thin capitalization rules that apply to debt issued by Canadian companies to specified non-resident owners.[85] The rules are applied broadly to foreign related persons, including non-resident corporations, trusts, and pension funds. Thus, foreign pension funds are already at a certain disadvantage with respect to investments in controlled companies in Canada.[86]

A more general thin capitalization rule could apply to non-residents, including sovereign wealth funds and other tax-exempts. The rule could be based on the existing approach of limiting interest deductions when leverage exceeds a defined threshold.[87] Alternatively, the limitation could relate to a share of domestic assets (as in Australia) or a portion of EBITDA (as in Germany and the United States). With respect to the latter approach, a safe-harbour based on a specified debt-equity ratio is typically applied to limit the impact of the rule on low-leveraged companies.

The advantage of a thin capitalization rule is that it could apply to non-residents and all tax-exempts, unlike the regulatory solutions focused on pension funds only or a UBIT that would apply to domestic tax-exempts but not foreign tax-exempts.

However, thin capitalization rules are not easy to apply, and they can produce arbitrary results, for the following reasons:

- Different types of business use different leverage ratios to finance investments. Corporations with stable earnings (such as those in the utilities, real estate, and financial sectors) tend to use more leverage than corporations in more volatile industries. Finding the "right" statutory leverage threshold is not a simple matter.

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85 Canada's thin capitalization rules are contained in subsections 18(4) to (6). A "specified non-resident shareholder" of a corporation is defined to include a "specified shareholder" of the corporation who is, at the particular time, a non-resident person. A "specified shareholder" of a corporation generally captures a person who, either alone or together with persons with whom the person does not deal at arm's length, owns shares representing 25 percent or more of the votes attached to, or the fair market value of, the issued and outstanding shares of the corporation.

86 Similarly, Canadian pension funds are subject to earnings-stripping rules in the United States.

87 The March 2012 federal budget increased the existing threshold—a debt-equity ratio of 2:1—to 1.5:1: Canada, Department of Finance, 2012 Budget, Budget Plan, March 29, 2012, annex 4.

- A thin capitalization rule based on earnings can distort investment decisions since it favours investments in depreciable assets that generate high levels of earnings before the deduction of depreciation and amortization.[88]
- The use of a thin capitalization rule is complex, requiring unused deductions to be carried forward and back.
- Unless corporate group rules are applied, businesses can avoid the application of thin capitalization rules by shifting debt to low-leveraged entities or entities that are exempt from the rule, such as partnerships.

If thin capitalization limitations were to be imposed, clearly changes would be required to both federal and provincial legislation.

Denying Certain Deductions to Related Tax-Exempt Entities

A variant of the thin capitalization rule would be to disallow the deduction of certain payments (such as, interest, fees, royalties, and rents) to related tax-exempt entities. Canada and other countries have applied this rule in certain limited situations (for example, with respect to flowthrough entities and the deduction of distribution payments from corporate income). Under Hong Kong's source-based corporate tax, interest paid to tax-exempt lenders is a non-deductible expense. Rules would be required to determine when companies are "related," although the concept is already used in tax law.[89] Alternatively, a specific voting ownership requirement could be used to determine whether parties are related.

The advantage of this approach is that it could be applied to all tax-exempts. It would be problematic if it were applied more generally to taxable non-residents, since the rule could become a generalized thin capitalization limitation applied not only to interest but also to other forms of payment. Pension funds would be able to control corporations, and the 30 percent rule could be eliminated. Tax-exempts would operate on a level playing field with taxable entities.

The disadvantage of this and other tightening options is that it would have a significant impact on the asset management practices of pension funds.

CONCLUSIONS

It appears that there are three broad approaches with respect to changes to the rules related to pension control of companies. The first is to do nothing, given that the federal government has conducted its own review and chosen not to make any changes to the 30 percent investment rule. The second is to reform regulations by relaxing or abolishing the rule. The third is to introduce limits on the ability of

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88 Duanjie Chen and Jack M. Mintz, *Taxation of Canadian Inbound and Outbound Investment*, research report prepared for the Advisory Panel on Canada's System of International Taxation (Ottawa: Department of Finance, December 2008).

89 For example, it is used in transfer-pricing regulations.

pension funds to control business entities, including maintaining the existing rule parallel to the recent federal position.

A regulatory solution in our view is sensible if it is determined that there are both tax and non-tax reasons to limit pension plan involvement in the management of companies.

The tax solution related to business income earned by tax-exempts is perhaps a better fit if it is agreed that pension plans should operate on a level playing field with other investors with respect to taxation, and that governance issues are better dealt with under securities and other laws. An alternative is to consider a general rule to restrict companies in deducting from corporate taxable income, payments made to tax-exempts more generally. Each approach has its benefits and costs. Whatever choices are made, some clarification of the 30 percent rule seems appropriate.