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SOVEREIGN WEALTH AND PENSION FUNDS CONTROLLING CANADIAN BUSINESSES: TAX-POLICY IMPLICATIONS

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SUMMARY

In a world without taxes, investors that take over companies would do so because they expect to be able to operate the business efficiently and at a high rate of return. But in Canada today, some acquirers enjoy tax advantages over others. And that could mean that certain buyers, who may not be best suited to owning a particular company, are able to outbid those who are better positioned to run that company at optimal efficiency.

That is a problem not just for investors who end up outbid, due to Canada's uneven tax policy, but for the Canadian economy, which suffers from the resulting economic inefficiency.

With respect to registered pension plans, the so-called 30-per-cent rule puts a cap on the amount of voting equity in a company that they are permitted to own. Meanwhile, however, sovereign wealth funds — whether controlled by China or Australia — face no such limit when purchasing stakes in Canadian firms.

The number and size of sovereign wealth funds, globally, is only growing — and rapidly. But as Canada increasingly attracts foreign capital, with foreign-controlled government-affiliated funds seeking out Canadian takeover targets, much of the discussion around public policy has focused primarily on the Investment Canada Act and the "net benefit test" for foreign direct investment. Another component in ensuring that Canadian interests are preserved, however, is the question of whether Canadian institutional investors can operate on a level playing field with foreign sovereign wealth funds. With the 30-per-cent rule limiting equity purchases for one but not the other, it would appear that they are not.

The most appealing remedy to this imbalance is a tax solution: limiting the corporate deductions on interest, fees, royalties, rents, and the like, that so often factor in to the takeover calculation, as part of a tax-minimization strategy.

This would not only put pension funds and sovereign wealth funds on equal footing, but it could also be applied to investors operating from low- or zero-tax jurisdictions, as well. This approach is not without disadvantages. But overall, the neutrality it could achieve among different types of institutional investors, and the potential it has to enable those investors best able to maximize management excellence and synergies, make it the preferable policy direction for ensuring the greatest level of efficiency in the Canadian economy.

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INTRODUCTION

This paper examines the regulatory and tax-policy issues that arise from the role that tax-exempt institutions have in acquiring and controlling Canadian businesses. Particular focus is paid to sovereign wealth funds (SWFs)[1] and pension funds, which are both important institutional investors that can purchase and potentially acquire large controlling interests in both publicly listed and a privately held companies. However, current Canadian law has imposed a voting-share ownership limit on Canadian pension plans, but not sovereign wealth funds. Specifically, pension plans (and the associated pension funds) are subject to a regulation that limits ownership to 30 per cent of voting shares of a single entity by a pension fund (the "30-per-cent rule").[2] This is unlike SWFs that have no similar limitation.

The 30-per-cent rule is related to issues surrounding the ability of Canadian pension plans to engage in corporate tax minimization (tax reduction or deferral) by owning and controlling commercial activities.[3] Section 11 of Schedule Three of the regulations made under the Pension Benefits Standards Act (Canada) provides that pension funds governed by that statute shall not own a corporation's securities that would provide it more than 30 per cent of the votes that may be cast for election of the board of directors of the corporation. This regulatory investment restriction applies under this statute only to federally regulated pension plans in Canada (a small percentage of private pension plans by number, but a disproportionately large representation when measured by assets), and not to other pension plans. However, the regulations made under the Income Tax Act (Canada) provide, in section 8500 and in subsequent sections, that all pension funds that are registered under that act shall not make any investment that could not be made under the rules of the Pension Benefits Standards Act (Canada). This effectively extends the rule to private, provincially regulated pension plans that are registered under the federal income-tax regime in order to obtain deductibility for contributions and tax-exempt status.

There are some additional issues related to the application of this rule. Several important government public-sector pension plans are not subject to the 30-per-cent rule as a result of being Crown agents — for example, the Canadian Pension Plan Investment Board (CPPIB), the Caisse de dépôt et placement du Quebec, and perhaps the Alberta provincial wealth fund (depending on the applicable legal structure). As the rule only applies to voting securities, there is some possibility the limit can be avoided for those investors willing to acquire non-voting shares. The consequence of breaching the rule is potential de-registration of a registered pension plan under the income tax regime.

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[1] Our focus is on SWFs, although our analysis can equally apply to tax-exempt state-owned companies, which we will reference at times below. In Canada, federal and many provincial-municipal Crown corporations are subject to equivalent corporate income taxes. In another paper we specifically focus on pension-plan control of companies. See V. Jog and J. Mintz, "The 30 Percent Limitation for Pension Investment in Companies: Taxation and other Policy Options," *Canadian Tax Journal* 60, 2 (2012): 567-608.

[2] We refer to pension plan and pension funds interchangeably. Since investments are made by a fund associated with a pension plan, the latter term is used most often. A more detailed explanation of the 30–per-cent rule is provided later in this paper.

[3] The 30–per-cent rule does not apply to investments in prescribed real estate, resource, and investment corporations.

Yet, both pension and sovereign wealth funds share a common attribute, albeit different governance regimes: both are generally exempt from paying tax on investment income that they receive. In this paper, we explore the implications of this regulation regime that imposes a limitation on pension-plan control of companies but not sovereign wealth funds, and we explore the appropriate policy options that should be considered to achieve greater neutrality among taxable and these non-taxable investors.

We would also like to note that what is unique about SWFs is not their status as sovereign or state-owned funds per se, but their status as non-residents of Canada combined with their tax exempt status in their home jurisdiction. As non-residents, they are not subject to general income tax under the Canadian income tax system, but only subject to taxation on Canadian source income, which includes tax on a gross withholding basis on investment income paid to them from Canadian residents, such as interest, dividends, rents and royalties.[4] Where direct investment is involved, the rate of such tax is 25 per cent, as reduced by the terms of any applicable tax treaty. For example, the current Canada-U.S. tax treaty reduces the rate on interest payments to zero per cent, the rate on dividends to five per cent, and provides an exemption for certain U.S. pension funds.[5] Thus, in effect, our discussion about the tax treatment of SWFs can be extended to those non-resident entities that operate in zero- or low-tax jurisdictions.

Although only peripherally related to SWFs, we would also like to note that Canada may recognize a non-resident investor in Canadian assets or businesses as immune from Canadian tax — for example, withholding tax on dividends or interest — where the investor is the government of another country, and the following conditions are met:[6] (a) the other country would provide a reciprocal exemption to the Canadian government; (b) the income is derived by the foreign government in the course of exercising a function of a governmental nature and is not income arising in the course of an industrial or commercial activity carried on by it; (c) it is interest on an arm's-length debt, or portfolio dividends on listed company shares. Income such as rentals, royalties or direct dividends from a company in which the foreign government has a substantial or controlling equity interest does not qualify for exemption. Accordingly, this exemption is not likely to play much of a role in the circumstances of major corporate acquisitions.

We believe that this is an important policy issue in light of the increasing attention given to the actual and possible takeover of Canadian companies by SWFs operating from Asia, the Middle East and Russia, where economies are dominated by state-owned entities. So far, Canadian policy-makers have focused on the Investment Canada Act and the "net benefit test" for foreign direct investment. Yet, in our view, in certain situations where a level playing field does not exist among acquirers, it would be appropriate to consider generic remedies, which are better than the ad hoc application of the Investment Canada Act. Specifically, the tax-exempt status for SWFs, pension funds and other government entities should be addressed by regulatory or tax policies that need not be related to restrictions on foreign direct investment.

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[4] These non-residents may also be subject to Canadian taxation on their capital gains upon disposition of their shares in a Canadian resident corporation, subject to limitation in some circumstances by bilateral tax treaties. This is a potentially important difference in favour of domestic non-taxable investors as compared to foreign pension and sovereign wealth funds. See, for example, Article 13 of the Canada-U.K. tax treaty.

[5] Note that such an exemption is not found in most of Canada's other bilateral tax treaties and that considerable amounts of inbound investment are coming into Canada from sources other than U.S. pension funds or U.S. businesses.

[6] See: CRA Information Circular IC77-16R4.

The tax-exempt advantage to these institutions manifests in specific ways. First, these institutions enjoy an advantage in the market for corporate control by being able to outbid for assets, as the tax on the earnings from the acquired companies can be eliminated or deferred in a substantial manner.[7] Second, there is a potential for these institutions to restructure the capital structure of operating companies that they control, and thus lower their cost of capital, providing them a competitive advantage in markets.

With both of these cases, tax exempts gain control of, and manage, companies in order to lever the company with incremental debt so that taxable profits can be reduced by interest paid to them, thus reducing the corporate tax bill of these controlled enterprises. Also, since the SWF or the pension fund pay little or no taxes on the interest received, the total taxes received by governments are reduced. In the case of SWFs, the reduction in corporate tax of the country where the company resides is only offset by some withholding taxes deducted from payments to the SWF. With foreign pension funds, there are no offsetting taxes in Canada (except for withholding taxes which may be exempted as under the Canada-U.S. treaty or levied at a reduced tax rate for tax-treaty countries) while the tax exemption provided for investment income in Canadian pension funds would provide additional benefits or lower contribution costs for employees.[8]

Another advantage for SWFs and, in rare cases, foreign private-sector pension funds, may arise from tax reduction through transfer pricing (transfer pricing rules not withstanding), especially if the product of the SWF-controlled company, domiciled in a foreign country, is required in the SWF's home country. Examples of this advantage are particularly relevant in natural-resource sectors, where there is pricing flexibility through long-term contracts. Given the angst recently over foreign direct investment in Canada, this additional issue of potential tax advantage available to sovereign wealth funds could also be quite important, although difficult to measure precisely. We are not saying that all tax-exempt entities engage in exploiting these advantages, or that taxable foreign multinationals may not also engage in transfer pricing to minimize taxes. We are simply stating that the possibilities do exist.

Some have argued that any limitations on tax-exempt entities, such as SWFs and pension funds, to deal with these issues, reduce economic efficiency, since a controlling ownership could lead to better business performance.[9] On the other hand, it could be argued that the tax exemption provides an unfair advantage to SWFs and pension funds in acquiring and managing companies. The point being that it is not wrong for these investors to control companies, but they should not receive a tax advantage to do so. In a tax-free world, companies would be purchased and controlled in principle by the most able investors who can operate their business at a higher rate of return. However, if some acquirers have a tax advantage, economic efficiency can be impaired if some owners acquire a business because of the tax exemption, rather than due to their better management abilities.

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[7] This argument is similar to the one used in explaining the growth of leveraged buyouts financed by pension funds and insurance companies.

[8] It is also true that private, taxable companies operating from low-tax jurisdictions could also have tax advantages compared to corporate taxes paid on acquisitions in Canada. However, unlike SWFs and pension funds, they are less likely to be tax exempt unless they operate from countries where no corporate tax is levied, such as the United Arab Emirates (Canada may provide reduced withholding taxes when a treaty applies, as in this case).

[9] For arguments associated with controlling ownership by pension funds, see, for example: Ontario Teachers' Pension Plan, "Response to the Report of the Expert Commission on Pensions," Toronto, 2009; 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, February 2009, and references therein.

Accordingly, the intent of this paper is to assess both regulatory and tax policies that would even the playing field among investors in acquiring control of companies in the world of taxable and tax-exempt investors. We consider potential reforms, including: no regulation; regulations to prevent tax exempts from acquiring companies; and tax reforms that would reduce differences between taxable and tax exempts. In our view, the best option is to consider tax reform measures rather than regulatory ownership restrictions, since the main issue is around the tax exemption. We also believe that the rules should apply to all non-taxables, not just pension funds or SWFs. Please note that we do not address another important issue often raised when a SWF (or even an SOE — state-owned enterprise) acquires a domestic firm. In particular, our paper does not deal with the question of whether — merely by virtue of the ownership and control of a domestic enterprise by a foreign government through a sovereign wealth fund — the acquired enterprise would be asked to act, not in its own pure economic interests as if it were privately owned, but rather in the national political interests of the foreign government, to the possible detriment of the domestic economy or other national interests. Our focus is only on issues that are related to tax policy.

Accordingly, the paper is structured as follows. The next section discusses the importance and relative size of SWFs and pension funds. The section after that examines issues related to governance and capital market efficiency; that is followed by a theoretical discussion of taxation and economic efficiency, and a consideration of the implications, for taxable and tax-exempt funds, of taxation on returns for acquired companies. We then provide a review of options for policy reform. The last section summarizes our overall conclusions.

SIZE AND GROWTH OF TAX EXEMPTS

In this section, we provide some evidence on the importance of SWFs in general, and of Canadian pension funds in particular. As we will see, the size of assets under management of these institutions is significant and growing.

A generic definition of a SWF is a fund owned by a state/country, which invests in financial assets such as stocks, bonds, property or other financial instruments. SWFs are entities that manage national savings for the purposes of investment. The accumulated funds may have their origin in, or may represent, foreign currency deposits, gold, SDRs and IMF reserve positions held by central banks and monetary authorities, along with other national assets such as pension investments, oil funds, or other industrial and financial holdings. The names attributed to the management entities may include central banks, official investment companies, state pension funds, or sovereign oil funds, among others.

In general, assets of these sovereign nations, which are typically held in domestic and different reserve currencies, such as the dollar, euro and yen, consist of debt, equity and other types of assets, including infrastructure and real estate. Some SWFs invest only locally (e.g., the Korea Investment Corporation helps the development of the financial sector in South Korea), but most invest in assets outside their own country. Overall, the main source of funds for many of these funds has been wealth obtained from hydrocarbons (54 per cent), followed by non-commodity-related wealth (45 per cent) and wealth accumulated from other commodities (one per cent). East Asian and Middle Eastern funds constitute 76 per cent of the number of funds.[10]

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[10] The evidence on SWFs presented in this paper is based on *The 2011 Preqin Sovereign Wealth Fund Review*, Preqin Ltd., 2011.

In recent years, these funds have grown rapidly, and more often than not, these entities are controlled by the government of their home country. This has resulted is considerable scrutiny about the investment behaviour of these funds and their implications, if any, on the "host" country, especially in the context of its national interests.

As of 2011, there are 58 such funds spanning 36 countries. The oldest SWF, established in 1956, is the Revenue Equalization Reserve Fund of Kiribati, an island nation located in the central tropical Pacific Ocean; the newest is the 1Malaysia Development Berhad fund, established in 2009.

Despite some setbacks in 2008/2009 due to the market crash, SWFs continue to grow at a significant pace. The total assets under management (AUM) of SWFs have grown to US$3.98 trillion, an increase of US$1 trillion over their 2008 asset base. The largest fund (the Abu Dhabi Investment Authority, established in 1976) has AUM of US$625 billion; the smallest is the National Oil Account of Sao Tome and Principe, worth US$12 billion. Of the total AUM, 42 per cent belong to countries in East Asia (China having the largest AUM in the region) and 32 per cent to countries in the Middle East region, followed by Europe (the Norwegian Government Pension Fund being the largest) representing 20 per cent of the aggregate AUM. Ten per cent of the funds have AUMs larger than $250 billion and a majority (40 per cent) of the funds have AUMs that are between $10 and $49 billion. Table 1 shows the top 20 SWFs in terms of their AUMs, comprising 90 per cent of total SWF assets.

Although each sovereign fund has a different investment philosophy, as of 2011, most SWFs have focused their investments on publicly traded equities and debt (of both public and private companies); 80 per cent of SWFs invest in these securities. However, half of them also invest in private equity, real estate and infrastructure. Not all funds disclose their target (or minimum/maximum) asset-mix policies, and even among those who disclose, these policies vary significantly. For example, the largest fund, the Abu Dhabi Investment Authority, has declared that it will only invest in publicly traded equity and debt securities, with its equity percentage limited to no more than 70 per cent, whereas the corresponding limit is 30 per cent for the Heritage and Stabilisation Fund of Trinidad and Tobago. Table 2 shows some notable investments made by sovereign entities in Canadian public securities.

TABLE 1: SOURCE AND ASSETS OF SOVEREIGN FUNDS

Sovereign Wealth Fund	Country	Source of Capital	Year Established	Total Assets ($million) 2011
Abu Dhabi Investment Authority	United Arab Emirates	Hydrocarbon	1976	625,000
Government Pension Fund – Global	Norway	Hydrocarbon	2006	530,598
SAFE Investment Company	China	Non-Commodity	1997	347,100
China Investment Corporation	China	Non-Commodity	2007	332,394
Government of Singapore Investment Corporation (GIC)	Singapore	Non-Commodity	1981	315,000
Hong Kong Monetary Authority	Hong Kong	Non-Commodity	1993	293,201
Kuwait Investment Authority	Kuwait	Hydrocarbon	1982	202,800
Temasek Holdings	Singapore	Non-Commodity	1974	140,943
National Social Security Fund – China	China	Non-Commodity	2000	120,928
Dubai World	United Arab Emirates	Hydrocarbon	2003	100,000
National Wealth Fund	Russia	Hydrocarbon	2008	88,440
Qatar Investment Authority	Qatar	Hydrocarbon	2005	80,000
Future Fund	Australia	Non-Commodity	2006	71,012
Libyan Investment Authority	Libya	Hydrocarbon	2006	70,000
Revenue Regulation Fund	Algeria	Hydrocarbon	2000	61,251
Brunei Investment Agency	Brunei	Hydrocarbon	1983	39,300
Alaska Permanent Fund Corporation	U.S.	Hydrocarbon	1976	39,180
Korea Investment Corporation	South Korea	Non-Commodity	2005	37,000
Khazanah Nasional	Malaysia	Non-Commodity	1993	36,674
Kazakhstan National Fund	Kazakhstan	Hydrocarbon	2000	30,000

Source: The 2011 Preqin Sovereign Wealth Fund Review, *Preqin Ltd., 2011.*

TABLE 2: SOME RECENT NOTABLE CANADIAN INVESTMENTS BY STATE-OWNED ENTITIES

Acquirer Name	Target Name	Investment Date	Value of Investment ($million)
Abu Dhabi Investment Authority	PrimeWest Energy Trust of Canada	September 2007	5,000
International Petroleum Investment Company (CIC)	NOVA Chemicals Corporation	June 2009	2,300
China Investment Corporation	Teck Resources Ltd.	March 2009	1,500
China Investment Corporation[1]	South Gobi Energy Resources Limited	October 2009	500
Australian Future Fund[2]	Brookfield Properties' Global Real Estate Investor Consortium	October 2009	2,500
China State Grid	Quadra Mining MOU	March 2010	1,000
China Investment Corp.	Penn West Energy	May 2010	1,230

[1] *Convertible debentures.*

[2] *Also has participation from China Investment Corp. and Government of Singapore Investment Corp.*

Source: The 2011 Preqin Sovereign Wealth Fund Review, *Preqin Ltd., 2011.*

Overall, it is clear that sovereign-owned investments will continue to grow.[11] One could also speculate that, given the turbulence in the public-equity market and the government debt market, these funds will seek alternative investments or seek full control of public entities to immunize them from public-valuation variations.[12] In that case, the potential for tax-advantage gains will only increase in the coming years.

We now provide some aggregated data on the importance of Canadian pension funds (excluding assets held under Registered Retirement Savings Plans and Tax-Free Saving Accounts) relative to the Canadian capital markets. We do not have any such data on the investments made by foreign pension funds in Canadian companies.

It is well known that Canadian pension funds, spanning both the public and private sectors, as a whole continue to represent one of the fastest growing pools of institutionalized capital in Canada and are dominated by large funds. Chart 1 shows the overall growth in assets of Canadian pension funds based on both a book-value and market-value basis. As of the fourth quarter of 2011 (Q4-2011), the total assets of Canadian pension funds had surpassed $1 trillion; with 75 per cent of the total assets controlled by public-sector plans. Thus, the importance of pension funds to Canada's capital markets and corporate sector cannot be understated.

There is also another important observation with respect to the allocation of Canadian pension assets between public- and private-sector funds. Using the data available from a recent article in *Benefits Canada* magazine on Canada's top 100 funds, our analysis indicates that the top 100 funds represent approximately 65 per cent ($648 billion) of total pension-fund assets (based on market value), based on 2010 data.[13] Of these, the top 10 funds constitute $260 billion — 26 per cent of total assets and more than 40 per cent of the assets held by the top 100. What is also of interest is the fact that all of the top 10 funds are public-sector funds. In fact, 49 of the top 100 are from the public sector, representing $443 billion in assets. In terms of their relative importance, the pension assets of public-sector pension funds represent approximately 44 per cent of total pension-fund assets.

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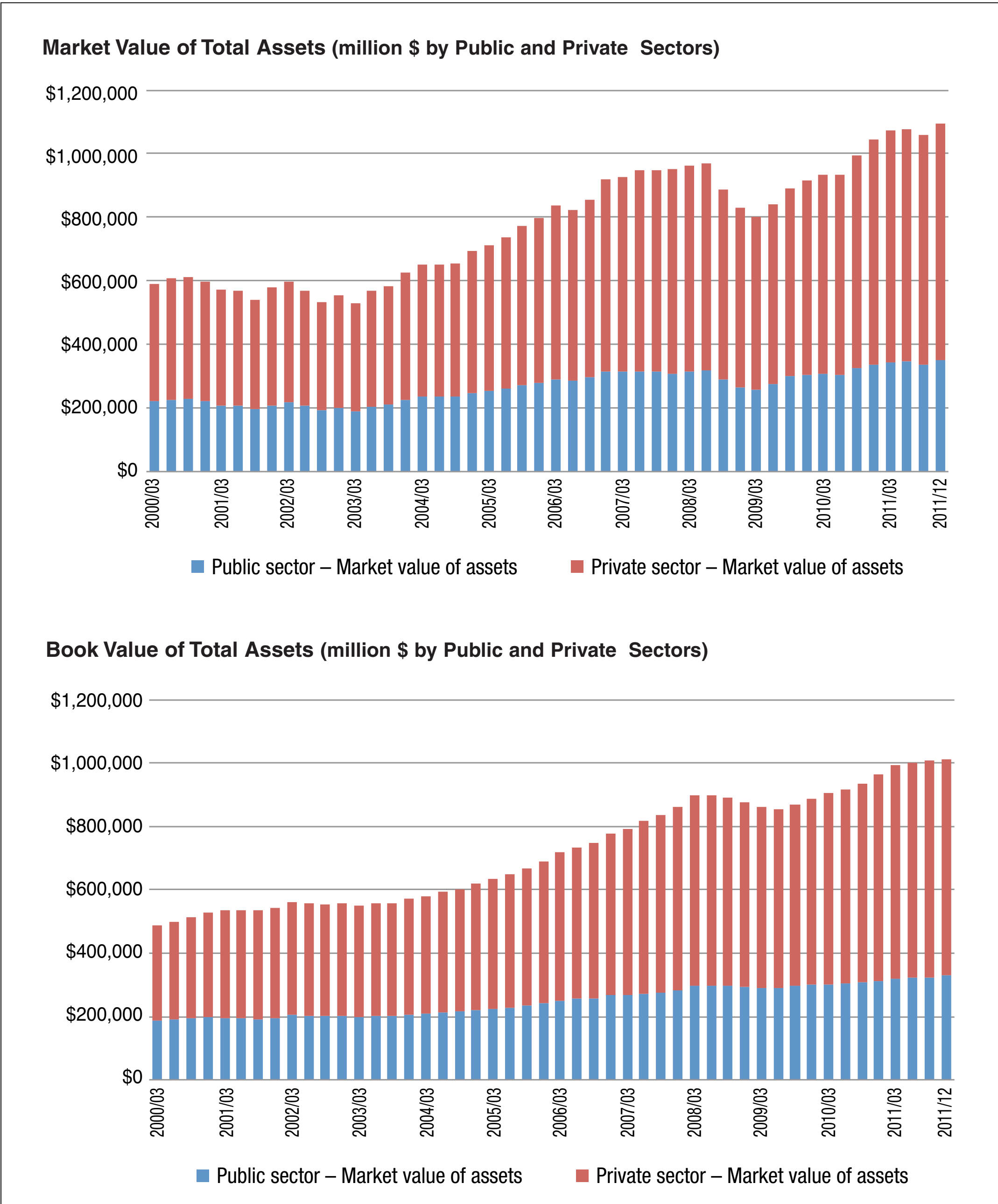
[11] In January 2011, China Investment Corp. (CIC), which has invested billions of dollars in Alberta's oilsands and Canadian resource companies, opened an office in Toronto.

[12] For example, the Canada Pension Plan Investment Board (CPPIB), a Canadian SWF, states that "in recent years, management has elected to pursue value-added returns by expanding the range of investment programs to include private equity, real estate, infrastructure and private debt, achieving greater global diversification and implementing a variety of active investment strategies."

[13] *Benefits Canada*, 35 (June 2011): 19-27.

CHART 1: MARKET AND BOOK VALUE OF CANADIAN TRUSTEED PENSION-FUND ASSETS

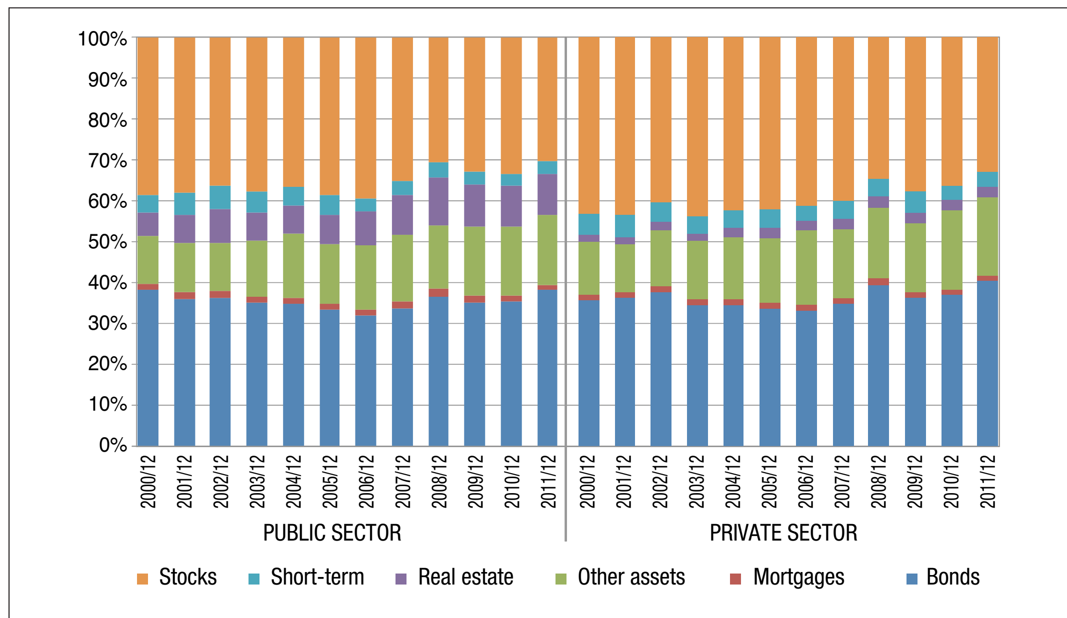


Source: Statistics Canada. Modified Table 280-0003 - Trusteed pension funds, market and book value of assets, by foreign and domestic holdings, quarterly (dollars) (table), CANSIM (database), http://cansim2.statcan.gc.ca/cgi-win/cnsmcgi.exe?Lang=E&CNSM-Fi=CII/CII_1-eng.htm

In addition, as of the end of 2010, 19 of the world's 300 largest pension funds (those with at least $10 billion in assets) are Canadian. Of those 19 funds, 15 are public-sector funds, one is a Crown corporation (Canada Post) and the other three are private-sector funds (CNR, General Motors, and Air Canada). These observations imply that large public-sector pension funds subject to the 30-per-cent limit may be more interested in the relaxation of the rule 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 significant impact on Canada's capital markets in each asset class. Chart 2 shows the investment choices made by both public and private funds, in aggregate. As can be seen, Chart 2 displays a similar overall asset mix for both private and public sector funds: 30 to 35 per cent each in stocks and bonds and the rest 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).

CHART 2: ASSET MIX OF PRIVATE- AND PUBLIC-SECTOR PENSION FUNDS – BY MARKET VALUE

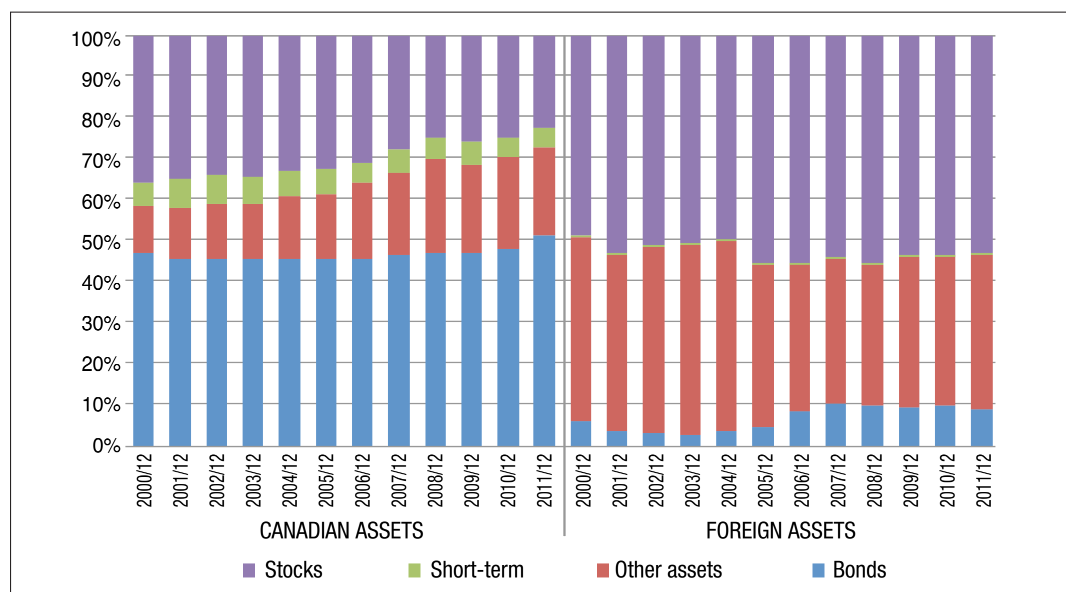


Source: Statistics Canada. Modified Table 280-0003 - Trusteed pension funds, market and book value of assets, by foreign and domestic holdings, quarterly (dollars) (table), CANSIM (database), http://cansim2.statcan.gc.ca/cgi-win/cnsmcgi.exe?Lang=E&CNSM-Fi=CII/CII_1-eng.htm

However, as discussed above, since the February 2005 federal budget, pension funds and investors in RRSPs have been permitted to invest in foreign assets without limitation (since 2001, foreign assets could be no more than 30 per cent of assets, with lower limits in earlier years). The result of the relaxation of this foreign-property rule (FPR) is reflected in the growth in the percentage of aggregate foreign assets held by pension funds, which rose from 20 per cent in 2000 to 25 per cent by 2011. Not surprisingly, most of the growth in foreign assets is a result of large investments in foreign (mostly U.S.) stocks, and not in foreign bonds.

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

CHART 3: ASSET MIX OF CANADIAN AND FOREIGN ASSETS BY CANADIAN PENSION FUNDS



Source: Statistics Canada. Modified Table 280-0003 – Trusteed pension funds, market and book value of assets, by foreign and domestic holdings, quarterly (dollars) (table), CANSIM (database), http://cansim2.statcan.gc.ca/cgi-win/cnsmcgi.exe?Lang=E&CNSM-Fi=CII/CII_1-eng.htm

Short-term assets include cash, deposits, Guaranteed Investment Certificates (GICs) and short-term securities for Canada; some may mature in more than 12 months. Investments in foreign pooled-funds, stocks, bonds and short-term assets are included in short-term foreign assets. Canadian "other" assets include investments in miscellaneous pooled vehicles, mortgages, real estate as well as accruals and receivables. Foreign "other" assets include investments in foreign pooled-funds only.

Since the relaxation of the foreign-property rule, Canadian pension funds have invested heavily in foreign stocks. This is likely the result of an improved risk/return potential, or it is being done for diversification in certain sectors that are not available through the Canadian stock market (high-tech, biotechnology, pharmaceuticals, etc.), as well as a desire to increase exposure in emerging-market equities.

However, pension funds could argue that they still need to be able to control companies because returns associated with investing in public equities (passive or active) do not generate sufficient returns. Thus, they need to privatize, or at least have greater control over companies, and the 30-per-cent rule may prevent them from taking such actions.[14] We do not rule out the possibility that there could be exceptions to the rule and that some pension funds may indeed have an uncanny ability to find superior investment opportunities and significantly improve performance of companies after they acquire total control.

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[14] This assumes that that pension-fund managers (or their agents) have the superior ability to select high-performing stocks and to run the companies. The evidence — as summarized by 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, Finance Canada, 2009 — does not necessarily support this assumption. For some additional recent evidence, see: Rob Bauer and Rik G. P. Frehen, "The Performance of US Pension Funds," Discussion Paper 2007-045 (Netspar, 2008), http://arno.uvt.nl/show.cgi?fid=78520; John C. Bogle, "A Question So Important That It Should Be Hard To Think About Anything Else," *Journal of Portfolio Management* (2008): 95-102; Kenneth R. French, "The Cost of Active Investing," Working Paper (NBER, 2008), http://ssrn.com/abstract=1105775; and Rajeeva Sinha and Vijay M. Jog, "Performance of Canadian Mutual Funds and Investors," *Advances in Investment Analysis and Portfolio Management*, (2007): 227-259.

TAX EXEMPTS AND CAPITAL MARKETS

Given the size and the continued growth of the tax exempts, it is also necessary to review their role in capital markets. It is well-accepted that one of the key roles of financial intermediation is reducing the risk and information costs investors have to bear when seeking out the best investment opportunities among firms in the economy. Investors benefit from risk diversification by pooling investments through financial intermediaries. Intermediaries help reduce information costs by researching alternatives and monitoring firms that are funded by investor capital. Improvement in capital-market efficiency is achieved when investors are able to invest in the best possible opportunities that provide the most optimal risk/return tradeoffs, and businesses are able to raise capital at the lowest cost of finance as possible.

In the discussion below, we do not differentiate between SWFs and Canadian pension funds and thus ignore the reality that, in the case of the former, the benefits may go to investors in a foreign country, whereas in the case of the latter, the benefits may accrue to domestic investors. We refer to both of them as "tax exempts." We note at least three key beneficial impacts that these tax exempts 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" that these tax exempts have when investing in capital markets. Given the long-term nature of their investment horizon, they are willing to invest in assets with a long-term maturity or with a long-term horizon (e.g., buy-and-hold investment policies) compared to banks, and mutual funds.[15] This can be beneficial to capital markets (since other investors can benefit from it as well) and firms, since some other investors, such as hedge funds, are more focused on short-term gains in stock market values. This characteristic is often termed as "patient capital." The long-term horizon, in turn, also reduces the cost of capital for firms.[16]

The second impact is with respect to liquidity. Tax exempts channel investment from short-term assets (e.g., bank deposits) typically held by individuals, into long-term liquid assets, which, in turn, increases liquidity and improves pricing efficiency of traded assets in both debt and equity markets.[17]

The third impact is due to the ability of these tax exempts to hire professional managers to invest their assets. Due to economies of scale, a large tax exempt is able to hire experienced professional management teams whose active managers are looking to acquire long-term assets

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[15] M. Catalan, G. Impavido, and A.R. Musalem, "Contractual Savings or Stock Market Development: Which Leads?", Unpublished Working Paper (World Bank, 2000). The importance of pension funds in providing long-term patient capital for Canada's capital markets was also noted by the then governor of the Bank of Canada: David Dodge, "A Sound Pension System — Handling Risk Appropriately" (speech to the Conference Board of Canada 2007 Pensions Summit Toronto, May 10, 2007).

[16] E. Walker and F. Lefort, "Pension reform and capital markets: are there any (hard) links?", Unpublished Working Paper (World Bank, 2002).

[17] E. P. Davis, "Pension Funds: Retirement-Income Security and Capital Markets. An International Perspective," *Weltwirtschaftliches Archiv* 131, 3 (1995): 602-604. Pension funds invest not only in liquid securities, but also in alternate assets (e.g., real estate and private equity) that are relatively illiquid.

that would improve their investment performance, given the level of risk tolerance.[18] To the extent that active management helps improve investment returns, they also contribute to capital-market efficiency. If tax exempts start investing only in private companies, or in controlled public-traded companies, some of the risk-diversification benefits that they bring to capital markets could presumably disappear.[19]

TAXATION AND ECONOMIC EFFICIENCY

While sovereign wealth and pension funds holding debt and equity securities of publicly listed companies can enhance capital-market efficiency, we now turn our attention to issues related to taxation. Canada's Income Tax Act (the "federal act") plays an important role in spelling out the rules that affect pension plans and sovereign wealth funds operating in Canada. Tax treaties and foreign taxation systems also impact foreign pension funds and sovereign wealth funds. We begin with Canadian pension funds.

Canadian Pension Funds: 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,[20] whereby taxes are applied to a base that is equal to earnings net of savings. Under the expenditure approach, contributions (subject to limits) to registered pensions and other retirement assets, such as registered retirement saving plans (RRSPs), are deducted from taxable income, the investment income is exempt from taxation earned by the registered plan, and withdrawals (dissavings) of principal and income from these assets are fully taxed. In principle, assuming that personal tax rates are the same in years of contributions and withdrawals, the effective tax rate on investment income earned by the plan is zero, since the tax savings for a dollar of contribution is equal to the time value of tax paid on a dollar of withdrawal.[21]

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[18] 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 activity) and invest in non-marketable securities (thereby making performance comparisons difficult, if not impossible). Woolley actually recommends that it may be prudent to cap annual turnover of portfolios at 30 per cent per annum, to force fund managers to focus on long-run value. He also recommends that, to ensure that proper performance comparisons can be made, pension funds not be allowed to engage in any form of "alternative investing." See Paul Woolley, "Why Are Financial Markets So Inefficient and Exploitative — and a Suggested Remedy," in *The Future of Finance: The LSE Report,* Adair Turner et al. (London: London School of Economics and Political Science, 2010).

[19] There is a vast amount of literature on the related issue of corporate governance when tax exempts (especially those managed by professional pension-fund managers, as well as pension funds of public-sector entities) hold controlling positions in companies. For the sake of brevity, we do not review this literature in this paper. For some salient papers, please see: Roberta Romano, "Pension Fund Activism in Corporate Governance Reconsidered," *Columbia Law Review* 93, 4 (1993): 795-853; Andrew K. Prevost and Ramesh P. Rao, "Of What Value Are Shareholder Proposals Sponsored by Public Pension Funds?", *Journal of Business* 73, 2 (2000): 177 – 204; M. Faccio and M. Ameziane Lasfer, "Do Occupational Pension Funds Monitor Companies In Which They Hold Large Stakes?", Journal of Corporate Finance 6, 1 (2000): 71-110; 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," *The Review of Financial Studies* 22, 8 (2009): 3093-3129.

[20] Institute of Fiscal Studies, The Structure and Reform of Direct Taxation (Meade Report), London: Allen and Unwin, 1978; U.S. Treasury, *Blueprints for Basic Tax Reform*, Washington D.C.: Treasury, 1977.

[21] Generally, replacement income at retirement is less than income during a person's working life. See Jack Mintz, "Summary Report on Retirement Income Adequacy Research," Finance Canada, 2009. For many Canadians, effective tax rates on pension earnings are negative, since marginal tax rates during a working life are higher than those during retirement years, although this is not generally the case given the plethora of clawbacks with elderly benefits programs.

Since investment income (interest, dividends, rents and capital gains) earned on pension fund assets are not taxed when accrued, some of the rules under the Income Tax Act have been developed to restrict the ability of investors to avoid capital-income taxation by shifting assets into tax-exempt income earned by pension and other retirement-income plans. These restrictions include limitations on interest deductions 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.

The 30-per-cent rule, as described in the introduction, limits ownership in voting shares of companies in order to reduce the incentive to avoid payment of corporate taxes by operating companies. It should be noted that it is possible for the 30-per-cent rule to be avoided by: (a) using convertible debt, which can be rolled into voting or non-voting shares; (b) the appointment of a nominee to vote according to the pension plan's requirements, or; (c) having the pension fund as lead partner in an acquisition, and as manager of the partnership funds (as is typical in private-equity transactions). In each case, the pension fund holds no more than 30 per cent of the voting shares, but is able to control the company nonetheless.

Two structures enable pension funds to reduce payment of tax. The first arises when a pension fund acquires a corporation and substitutes equity for debt provided by the pension fund. The corporation can deduct interest expenses and the pension fund does not have to pay taxes on the interest income that it receives. Alternatively, a partnership can be established whereby the entity's income is flowed to the pension plan (as the partner) and not subject to tax.[22] Both of these structures enable the pension fund to eliminate or substantially reduce corporate tax paid by the operating company. This tax advantage could enable pension-controlled businesses to operate at a competitive advantage compared to taxable businesses, since they would have a lower tax cost. Further, this form of tax arbitrage provides pension funds with an important advantage in acquiring companies as they can outbid taxable entities.[23]

In addition, individual pension funds may acquire only a partial stake in a corporation by joining 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 1.5 per cent of total investment plus 20 per cent of gains). The lead investor could be a pension fund, sovereign wealth fund, foreign pension fund,[24] non-profit investment fund,[25] or taxable entities. With respect to non-controlling degrees of ownership, pension funds are only passive owners and therefore have less influence on capital decisions, which are left to those who control management.

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[22] Until 2005, pension-plan ownership of limited liability partnerships was included in the definition of foreign property and subject to a limit of 30 per cent of total assets. No restrictions apply today to the holding of foreign property.

[23] This advantage need not be in perpetuity. More specifically, tax exempts can increase leverage for a significant period of time and then bring it back to normal levels of leverage prior to divesting their interest in the firm. This is identical to the practice followed in leveraged-buyout transactions (LBOs) financed by tax-exempt institutions.

[24] Such as Singapore's Central Provident Fund.

[25] Several rules limit non-profit investment funds from owning businesses. Private foundations are not permitted to carry on business. Public foundations and charitable organizations also face restrictions on their ability to carry on a business unrelated to the charitable activity. Lastly, the recently introduced excess corporate-holdings rules (http://www.cra-arc.gc.ca/E/pub/tg/t2082/t2082-10e.pdf) introduced in 2007, require private foundations to limit their concentration of shareholdings in a particular corporation.

Another key aspect of this 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 that are trying to buy target corporations. More specifically, the market price of an entity is determined by the present value of after-corporate-tax 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.[26] However, if one investor has a tax advantage, it can outbid other investors to acquire control of a company since it could reorganize the new company with debt or partnership status, thereby eliminating payment of corporate tax. To the extent that the 30-per-cent rule is effective, it could curtail the ability of tax-exempt pension funds to acquire taxable companies by eliminating corporate taxes.

Foreign Pension Funds: Foreign pension funds also invest in Canadian businesses and are subject to foreign rules that can affect their decisions. Under the Canada-U.S. tax treaty, cross-border income paid to pension funds is exempt from taxation (similarly, Canadian pension funds are exempt from U.S. withholding taxes). Non-U.S. foreign pension funds receiving dividend and other remissions are subject to Canadian withholding tax, which are reduced by treaty.

However, the rules governing foreign pension funds, such as those operating in the United States, will impact on their investment decisions in both domestic and foreign assets. One particular rule that should be noted is the unrelated-business income tax (UBIT) in the United States. This applies to tax-exempt organizations on income from controlled businesses that are not sufficiently related to the tax-exempt purpose of the exempt organization.[27] The term "unrelated trade or business" means any trade or business that is not substantially related to the organization's performance of its exempt purpose or function (aside from the use it makes of the profits it derives). Control is defined as possessing ownership (by vote or value) of more than 50 per cent of the stock in a corporation. In the case of a partnership, control means owning more than 50 per cent of the profit interest or capital interest, and in any other case, ownership of more than 50 per cent of the beneficial interest in the entity.

The UBIT applies to all exempt organizations (qualified pension, profit-sharing, and stock bonus plans) and Section 501 (other exempt organizations).[28] The UBIT does not apply to passive investment income, including income from dividends, interest, annuities, royalties, and most rents from real property. There are a number of notable exceptions. Income from investments financed by debt is taxed, including debt incurred to acquire the investment, and debt incurred afterward that would not have been incurred but for the investment, and which was foreseeable at the time of the investment. 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 it as unrelated business income. Specified payments include interest, annuities, royalties, and rents. It is notable that this list does not include dividends. This is according to the theory that corporate earnings from which dividends are paid are taxed in the hands of the controlled entity before being distributed.[29]

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[26] Taxation also affects the choices between greenfield investments, and mergers and acquisitions. See Johannes Becker and Clemens Fuest, "Tax Competition – Greenfield Investments vs Mergers and Acquisitions," CESifo Working Paper 2247 (CESifo 2008).

[27] Internal Revenue Service, "Tax on Unrelated Business Income of Exempt Organizations," Publication 598 (Rev. March 2012).

[28] With a few exceptions, mostly related to private foundations.

[29] David L. Raish and Sharon Remmer, "How the Unrelated Business Taxable Income Rules Apply To Qualified Retirement Plans," *ALI-ABA Business Law Course Materials Journal* (2008).

Sovereign Wealth Funds: Domestic SWFs do not pay corporate income tax. Therefore, in acquiring businesses, they could finance an acquisition with internal debt (replacing equity) to eliminate most of corporate tax payments in the acquired company, or form a partnership as discussed above. The income accruing to a domestic sovereign wealth fund is untaxed, thereby bypassing the corporate income tax.

With foreign sovereign wealth funds, the income paid to the fund may be subject to Canadian withholding tax as noted above in the introduction. Most sovereign wealth funds that potentially participate in the Canadian market are foreign (including partnerships in private-equity funds). While arm's-length interest and portfolio dividends are tax exempt for foreign SWFs, Canadian withholding tax would apply to income remitted to the foreign sovereign wealth fund that is operating a business on a non-arm's-length basis. Generally, non-treaty interest and dividend payments are subject to 25-per-cent withholding taxes. These rates can be reduced to 10 per cent on non-arm's-length interest (as in the case of internal debt) and five per cent on dividends for direct participation by a parent in a Canadian entity. In the case of the Canada-U.S. treaty, the withholding tax on non-arm's-length interest has been recently eliminated on a bilateral basis.

Canada has an extensive treaty network including those countries where the largest sovereign wealth funds operate (Singapore, Norway, China and Russia). There is no treaty with Hong Kong since it has no withholding taxes with a source-base income tax system (a treaty is now being considered). On the other hand, Canada has a treaty with the United Arab Emirates (U.A.E.) even though U.A.E. countries do not have income taxes.[30]

IMPLICATIONS OF TAXATION ON RETURNS FOR ACQUIRED COMPANIES: TAXABLE VS. TAX EXEMPT

In this section, we compare and contrast the implications of the tax treatment between taxable and tax exempts, especially with respect to the financing of acquisitions. With respect to taxables, Canadian companies generally pay tax on income received (interest, rents, royalties, and capital gains at a half rate) with the exception of dividends from Canadian resident companies, which are exempt (in order to avoid double taxation of inter-corporate dividends). Foreign companies owning subsidiaries in Canada are subject to withholding taxes (on the same basis as foreign sovereign wealth funds). These companies credit Canadian corporate income taxes and withholding taxes against domestic income. Except for the United States, most countries exempt dividends paid by affiliates from corporate income tax and therefore provide no credit for either corporate income or withholding taxes. Some companies might also operate from low-tax jurisdictions (Ireland) or zero-tax jurisdictions (the United Arab Emirates), although for most countries, the parent pays corporate income taxes at rates similar to, or higher, than Canada's.

[30] The treaty was developed so Canadian companies could access the dividend-exemption system for investments in the U.A.E.

Table 5 compares the tax implications of equity- and debt-financed acquisitions by pension plans, foreign sovereign wealth funds and domestic and U.S. taxable companies. We assume a Canadian corporate income tax rate of 25 per cent on taxable profits, and treaty rates for dividends and interest. We also assume that the treaty rates for dividends (five per cent) and non-arm's-length interest (zero per cent in the case of the U.S.) apply.

TABLE 5: AFTER-TAX INCOME ON EQUITY AND INTERNAL DEBT FINANCE FOR VARIOUS CASES OF ACQUISITIONS OF A CANADIAN COMPANY BY INVESTOR TYPE

	Canadian Taxable Equity Finance	Canadian Taxable Debt Finance	U.S. Taxable Equity Finance [2]	U.S. Taxable Debt Finance [2]	Canadian Pension or SWF (Equity Finance)	Canadian Pension or SWF (Debt Finance)	Foreign Pension Fund (Equity Finance) [3]	Foreign Pension Fund (Debt Finance) [3]	Foreign Sovereign Wealth Fund (Equity Finance) [4]	Foreign Sovereign Fund (Debt Finance) [4]
Profit	$100	$100	$100	$100	$100	$100	$100	$100	$100	$100
First-Tier Corporate Tax (25 per cent)	$25	$0	$25	$0	$25	$0	$25	$0	$25	$0
Withholding Tax	n/a	n/a	$3.75	$0	n/a	n/a	$0	$0	$3.75	$10
Profit Net of First-Tier Tax	$75	$100	$71.25	$100	$75	$100	$75	$100	$71.25	$90
Second-Tier Tax [1]	$0	$25	$9.25	$38	$0	$0	$0	$0	$0	$0
After-Tax Profit	$75	$75	$62	$62	$75	$100	$75	$100	$71.25	$90

[1] *Assumes dividend or interest payment.*

[2] *Assumes full crediting of Canadian tax against U.S. corporate tax on dividends and interest equal to 38 per cent for U.S. corporate parent.*

[3] *Assumes U.S. entity.*

[4] *Assumes sovereign wealth fund in U.A.E.*

As can be seen from the table, there are considerable tax advantages given to pension and sovereign wealth funds, compared to taxable Canadian and U.S. companies, when acquisitions are financed by debt; this is especially the case for large pension funds, which have sufficient financial and organizational resources to acquire and reorganize all, or a large portion, of a domestic corporation. This enables a pension plan or sovereign wealth fund to bid higher to acquire control of a Canadian company. There are some exceptions. If cash is not required, Canadian and foreign taxable companies could achieve similar tax advantages if income is routed to tax-exempt conduits (such as those operating in tax havens).[31]

Who benefits from the tax advantages? In general, two potential benefits can arise:

a. The acquiring company is able to get a lower cost of financing and therefore potentially increase its investment.

b. The lender is able to achieve a higher rate of return on investments. For pension funds, this can translate into higher benefits paid to workers or a lower cost of contributions.

[31] However, the foreign accrual property rules in the Income Tax Act (Canada), and regulation 5900 of that act, provide extensive "base erosion rules" to prevent much of this type of activity by Canadian resident corporations. Foreign-based multi-national companies can often obtain similar advantages, subject to Canada's thin-capitalization rules, if they are located or can operate through low-tax or zero-tax jurisdictions.

A few international studies have looked at whether taxes have been capitalized in acquisition prices, resulting in lower costs of capital for the acquired companies.[32] In general, gains are split between new and old shareholders although there is no precise answer given the difficulties of correctly measuring the tax attributes associated with acquisitions.

However, from the standpoint of economic efficiency, even partial capitalization of tax benefits would distort acquisition markets. Without any differences in relative taxation, the winning bid would be associated with managerial expertise, synergies in reducing costs, and potentially increased control of markets. While the latter could have negative consequences on economic efficiency, generally the most efficient companies would improve market performance.

With differences in taxation, however, investing entities such as pension and sovereign wealth funds have advantages over taxable companies, except for those companies operating from low- or zero-tax jurisdictions. Taxation can therefore distort acquisition markets, with control going to those entities with the most favourable tax attributes. Generally, tax policy should be used to level the playing field among different types of investors rather than favour one type over the other. Even if there is some increased control in markets, competition policy, not tax policy, is best able to deal with inefficiencies of this sort.

More complicated is the issue of economic efficiency gains with regard to foreign investment in Canada by sovereign wealth funds and pension funds. Since any income gains to the new investors are payments abroad, the Canadian economic gains arise from increased investment in Canada (due to any improvement in capital-market efficiency) and the taxation of returns. Given that Canada might only tax interest income paid to foreign pension and sovereign wealth funds at a rate of 10 per cent, the economic gains are somewhat blunted. And if the acquisition for control markets is distorted, Canadian economic efficiency is impaired on this basis.

The tax exemption not only leads to a tax advantage for tax exempts but a loss in revenue for governments. In the case of Canadian pension funds, the potential loss in federal and provincial corporate tax and personal tax revenue is in the order of $600 to $700 million in 2011.[33] We are not in position to estimate a similar tax loss for SWFs without further data.

For SWFs, however, the potential tax advantage and tax loss for the Canadian federal and provincial governments is larger for similar-sized transactions. With Canadian tax treaties, withholding taxes on dividends, interest and royalties paid to SWFs are less than personal taxes paid by pension-fund owners. Further, transfer pricing might be used to understate export prices from goods and services sold from the Canadian entity to the foreign entity, resulting in significant revenue losses.

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[32] Recent surveys are provided by D. Shackelford and T. Shevlin, "Empirical Tax Research in Accounting," *Journal of Accounting and Research* 31 (2001): 321-87; and M. Hanlon and S. Heitzman, "A Review of Tax Research," *Journal of Accounting and Economics* 50 (2010): 127-8.

[33] Estimate is provided by V. Jog and J. Mintz, "The 30 Percent Limitation for Pension Investment in Companies: Taxation and other Policy Options," (2012). The estimate takes into account the loss in corporate and personal taxes for taxable investors, but also the gain in personal tax revenues from higher distributions of pension payments to investors or lower contribution costs.

POLICY CONSIDERATIONS

With this overall background and context, in the section below, we now outline three policy options with the intent to improve economic efficiency in capital markets with a more level playing field among taxable and tax-exempt investors. The first is to abolish the existing 30-per-cent rule, so pension plans can operate on the same basis as sovereign wealth funds, as well as those foreign companies that operate from zero-tax jurisdictions. The second is to adopt a regulation on sovereign wealth funds (or for that matter all non-residents operating under zero- or low-tax jurisdictions), similar to that applied to Canadian pension funds. The third is to consider a tax alternative that would limit the deduction of certain payments (e.g., interest, fees, royalties and rents) by corporations, when such payments are made to related tax exempts. The latter, in our view, might be the most promising.

Treating Canadian Pension Funds Similarly to Sovereign Wealth Funds

The argument in favour of abolishing the 30-per-cent rule would be that it would enable pension and sovereign wealth funds to improve economic efficiency by better aligning management interests with shareholder interests, although as discussed above, this need not be the case.

Given these arguments, the abolition (or significant relaxation) of the 30-per-cent rule for pension funds may make sense (many other countries do not have a similar rule[34]). However, two important issues are associated with the abolition option.

The first is that the tax advantage that tax-exempt entities would have in acquiring business entities could 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.

The second concern is that the 30-per-cent rule itself may be too blunt of an approach. The rule does not prevent control in many cases nor does it resolve conflicts of interest. The abolition of the rule could be appropriate so long as other regulations ensure conflicts of interest are avoided.

A Regulatory Option

Another approach is to regulate limits on ownership of Canadian companies by both pension and sovereign wealth funds. An example would be a tougher 30-per-cent rule that would apply to both pension and sovereign wealth funds. For example, the rule could limit ownership to 10 per cent of voting shares, or include certain indirect holdings (excluding ownership, such as through mutual or segregated funds), to achieve effective control (i.e., de facto control) for any single pension fund or sovereign wealth fund. The rule could simply state that pension and sovereign wealth funds cannot control a business on a related basis, a concept that would be

[34] See: V. Jog and J. Mintz, “The 30 Percent Limitation for Pension Investment in Companies: Taxation and other Policy Options,” (2012).

subject to various tests. Alternatively, pension and sovereign wealth funds could be limited to holding only passive investments. For example, it may be argued that pension and SWF funds should only hold indexed funds, such as the global indices, in order to achieve maximum risk diversification at very low cost. This may also assist in dealing with any transfer-pricing issues that may arise with the ownership by a sovereign wealth fund, especially when the controlled company sells its production to a parent company.

The argument in favour of a tougher rule would be that pension and sovereign wealth funds should not be in the market for the control of companies, but instead be passive investors. This view is supported if there is no evidence that active management provides consistently superior risk-adjusted returns, net of management costs. Limits to active managed investment would also reduce the ability of pension and sovereign wealth funds to use their non-taxable status to achieve control of companies. It would also reduce any potential conflicts that would arise when investing in companies since control would not be possible.

Further, and most importantly in our view, tougher regulation of pension and sovereign wealth funds would not curtail the possibility of other entities purchasing companies on a tax-advantaged basis. It could also lead to more foreign ownership of Canadian corporations by state-owned enterprises, and companies operating from low- or zero-tax jurisdictions. Thus, regulatory limits should therefore be extended to other non-tax-exempt entities. This, however, could be in violation of other treaty obligations of the Canadian government.

Limitations on corporate deductions

Another approach is a tax solution, such as limiting corporate deductions.[35] The existing 30-per-cent rule applied to Canadian pension funds could be eliminated. Canada already has a thin-capitalization rule that applies to debt issued by Canadian companies to related non-resident owners. It is applied broadly to foreign related parties, including foreign pension and sovereign wealth funds. Thus, foreign pension funds are already at a certain disadvantage in owning controlled companies in Canada.[36]

A more general thin-capitalization rule could apply to non-residents and all tax exempts. The rule could be based on the existing approach of limiting interest deductions when leverage exceeds a threshold. Alternatively, the limitation could relate to a share of domestic assets (as in Australia) or a portion of earnings before the deduction of interest, taxes, depreciation, and amortization (as in Germany and the United States). With respect to the latter approach, a "safe-harbour," based on a specific debt-equity ratio, is typically applied to limit the impact of the rule on low-leveraged companies.

[35] An alternative is to tax income earned by the pension fund or SWF (as in the case of the U.S. unrelated-business-income tax rule). Obviously, it would not be possible for Canada to impose such a tax on foreign entities.

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

However, thin-capitalization rules are not easy to apply and can result in unintended consequences for the following reasons:

- 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.[37]
- 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-leverage entities or to those exempt from the rule, such as partnerships.
- Businesses may be able to avoid the application of existing thin-capitalization rules in Canada by using guaranteed debt provided by financial institutions, or they may rely on other deductible costs to shift income to tax exempts (e.g., fees, royalty, insurance or leasing payments).[38]

A variant of the thin-capitalization rule would be to disallow the deduction of certain payments (interest, fees, royalties and rents) to related tax-exempt parties. Canada and other countries have applied this rule in certain limited situations (for example, publicly traded flow-through entities and the deduction of distribution payments from corporate income). Under Hong Kong's source-based corporate tax, interest expenses paid to tax-exempt lenders are non-deductible. Rules would be required to determine when companies are "related," although the concept is already used in tax law.[39] Alternatively, a specific voting-ownership requirement could be used to determine whether parties are related.

The advantage of this rule is that it could be applied to all tax exempts and entities operating in low- or zero-tax jurisdictions, thereby potentially creating a more level playing field with taxable companies in markets for corporate control. 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 other forms of deductible payments that might be subject to tax elsewhere.

The disadvantage of this and other tightening options is that it would have a significant impact on the asset and investment management practices of pension and sovereign wealth funds. Moreover, it would be very difficult to administer, as it depends on the tax status of foreign entities in their home jurisdiction and the ability of Canadian tax authorities to obtain the necessary information required to administer it. Thus, there could still be considerable latitude in structuring the position of these investors, or the way they do transactions, to effectively avoid such a rule. Nonetheless, in cases with corporate control, the tax option more directly deals with tax advantages currently available to pension and sovereign wealth funds in control of Canadian companies.

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[37] See D. Chen and J. Mintz, "Taxation of Canadian Inbound and Outbound Investments," Research report, Advisory Panel on Canada's System of International Taxation, 2008.

[38] One may argue that businesses may find it costly to avoid the thin-capitalization rules and thus may not resort to this except under exceptional circumstances.

[39] For example, it is used in transfer-pricing regulations.

CONCLUSIONS

It would seem there are three choices with respect to changes to rules related to pension-fund and sovereign-fund control of Canadian companies.

The first is to abolish the existing 30-per-cent rule so that pension funds can operate on the same basis as sovereign wealth funds.

The second is to introduce limits on the ability of pension and sovereign wealth funds to control Canadian business entities, with a regulation tougher than the 30-per-cent rule currently applied to Canadian pension funds. A regulatory solution 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. However, the regulatory approach may be too blunt of an instrument, since significant efficiency advantages might arise from various owners competing with each other in acquiring corporate control.

The third, which is our preference, is a tax solution that would put pension and sovereign wealth funds on the same footing as taxable companies. A general rule that restricted companies from deducting payments made to tax exempts from their corporate taxable income would be able to accomplish this objective.

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For information about contributing to The School of Public Policy, please contact Courtney Murphy by telephone at 403-210-7201 or by e-mail at cmurphy@ucalgary.ca.

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