OPB
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SENT BY ELECTRONIC MAIL

Mr. Brian Ernewein
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Dear Brian:

Tax Policy Considerations related to the Relaxation or Elimination of the 30% Rule

Ontario Pension Board ("**OPB**") is the administrator of the Ontario Public Service Pension Plan ("**PSPP**"), a defined benefit pension plan sponsored by the provincial government. Our membership consists of certain employees of the Government of Ontario and its agencies, boards and commissions. With $23 billion in assets, 42,105 members, 36,220 retired members, and 6,037 former (deferred) members, the PSPP is one of Canada's largest pension plans.

I am writing on behalf of the OPB to provide comments with respect to the Consultation Document released by the Department of Finance Canada on June 3, 2016 titled "Pension Plan Investment in Canada: The 30% Rule" (the "**Consultation Document**"). The Consultation Document raises various questions relating to the current operation of the 30% Rule and the impact of relaxation or elimination of the 30% Rule, in terms of fairness and efficiency. One of those questions states as follows:

> Small pension plans, while also tax-exempt, may not have the size, capacity or risk tolerance to be able to acquire controlling stakes in businesses. This raises the issue of whether they would be precluded from undertaking certain tax strategies potentially available to larger pension plans or may have to incur significant transaction costs (e.g., by working collectively through private equity firms) to employ similar strategies.

Although subsidiaries of OPB directly hold certain real estate assets, OPB typically has not acquired controlling stakes in businesses or assets, but rather, would typically invest in private equity, venture capital and infrastructure through investments in funds which are typically organized as limited partnerships or trusts. The Consultation Document puts forward two potential tax measures (the "**Potential Tax Measures**"):

(i) extend the entity level SIFT tax regime (the "**SIFT Extension Proposal**") which currently applies to publicly-traded flow-through entities to private flow-through entities which are controlled by pension plans. (As discussed further below, as a result of certain comments in the Consultation Document, it is not clear whether the SIFT Extension Proposal will only apply in circumstances where a pension plan controls a partnership or trust or whether it would also apply where one or more pension plans have a non-controlling interest); and

(ii) extend the thin capital rules (the "**Thin Capital Extension Proposals**") that currently only apply to debts owing to certain non-residents to apply to debts owing to pension plans.

As will be discussed below, if the potential tax measures are introduced this will adversely affect the ability of OPB to make investments in Canadian private equity, venture capital and infrastructure. Consequently, implementing the Potential Tax Measures will not improve OPB's ability to compete with larger plans that utilize strategies to acquire controlling interests in businesses, but rather will greatly impede OPB's ability to invest in Canadian private equity, venture capital and infrastructure.

The competitive advantage of large plans relative to smaller plans has been considered previously by the Government of Ontario. In 2012 the Ontario Deputy Premier and Minister of Finance engaged a pension investment advisor, William Morneau, to prepare a report (the "**Morneau Report**") dated October 2012 to discuss the competitive advantage experienced by larger plans relative to smaller plans in terms of investment returns and to provide recommendations in that regard. The Morneau Report described the success of AIMCO and bcIMC in terms of being asset managers for a variety of pension plans and other public bodies and enrolment funds. The funds of many Canadian pension plans and other tax exempt government entities are invested in various asset pools structured as private flow-through entities such as trusts or partnerships ("**Pooled Investment Vehicles**") managed by AIMCO or bcIMC. The Morneau Report recommended that Ontario establish its own asset manager to manage similar Pooled Investment Vehicles. As a result of the recommendations in the Morneau Report, on July 6, 2016, the Ontario government announced that the Investment Management Corporation of Ontario ("**IMCO**") was established on July 1, 2016 and is expected to be set up and running by the spring of 2017 with the OPB and the Workplace Safety and Insurance Board being the founding members with combined assets of $50 billion.[1] As discussed below, if the SIFT Extension Proposal is implemented it will cause the Pooled Investment Vehicles to be subject to entity level tax with respect to their Canadian investments thereby causing the Alberta, British Columbia and Ontario pension plans which invest in such Pooled Investment Vehicles to be subject to an additional layer of taxation compared to all other Canadian pension plans.

<u>Impact of Tax Measures</u>

1. SIFT Extension Proposals

Currently the SIFT rules apply to partnerships and trusts, investments in which are listed or traded on a stock exchange or other public markets ("**SIFT Partnerships and Trusts**"). Under the SIFT rules SIFT Partnerships and Trusts are subject to entity level tax to the

[1] See Canadian Press Article dated July 6, 2016.

extent that they earn income from carrying on a business in Canada, receive income (other than dividends) from a non-portfolio property or realise a gain on the disposition of non-portfolio property. Non-portfolio property is defined for this purpose to include:

(i) Securities of a Canadian resident corporation, trust or partnership, (or a non-resident person or partnership the principal source of income of which is Canada) if the fair market value of such securities represent more than 10% of the equity value of the entity;

(ii) Canadian real property or resource property; and

(iii) Property used by the SIFT Partnership or Trust or a person or partnership with which it does not deal at arm's length in carrying on business in Canada.

The Consultation Document is not clear in terms of how the SIFT rules will be extended. The relevant consultation question is whether the SIFT rules should apply to pension controlled trusts and partnerships but the consultation question does not specify what pension controlled means for this purpose in terms of whether a trust or partnership is controlled for this purpose only if a pension plan has actual control of the trust or partnership (the "**Actual Control Test**") or if a trust or partnership is controlled if a single pension plan holds more than a 50% interest in a trust or partnership (the "**Single Plan Holding Test**") or if a trust or partnership will also be controlled if the aggregate of all holdings by pension plans represent more than a 50% interest in a trust or partnership (the "**Aggregate Plan Holdings Test**"). The example relating to Private Flow-Through Entities used in the Consultation Document involved a plan having a 50% interest in a limited partnership of which it was not a general partner. Such a structure would not result in the limited partnership being controlled by a pension plan under either the Actual Control Test or the Single Plan Holding Test. Furthermore, the Consultation Document states that absent the 30% Rule pension plans may be seen to have an unfair advantage over self-directed RRSPs that are generally prohibited from having interests of 10% or higher in any business. This would suggest that it is contemplated that the extended SIFT rules could apply based upon an ownership level of 50% or lower (a "**Specified Limit**"). It is not clear whether such a test would apply based upon holdings by a single plan in the trust or partnership (the "**Single Plan Specified Limit Test**") or based upon the aggregate holdings of all plans in the trust or partnership (the "**Aggregate Holding Specified Limit Test**").

The SIFT Extension Proposals would have adverse tax implications for Pooled Investment Vehicles, investments by smaller pension plans in private equity and venture capital, and investments by smaller pension plans in infrastructure which is discussed below.

(a) Pooled Investment Vehicles

As discussed above, many British Columbia and Alberta government sponsored pension plans and other tax-exempt government entities invest their funds through Pooled Investment Vehicles (trust or partnerships). The government of Ontario has recently announced the creation of IMCO which is to manage Pooled Investment Vehicles through which Ontario government sponsored pension plans and other tax-exempt government sponsored entities will invest their funds. If the SIFT Extension Proposals are implemented it will subject Pooled Investment Vehicles to entity level tax with respect to all of their Canadian investments thereby putting all of the British Columbia, Alberta and Ontario government sponsored pension plans that invest in Pooled Investment Vehicles which invest in Canadian entities at a competitive disadvantage compared to all other Canadian pension plans. If either of the Aggregate Plan Holdings Test, or the Aggregate Holding Specified Limit Test is applied all of the Pooled Investment Vehicles, including those to be managed by IMCO, will be considered SIFT Partnerships or Trusts under the SIFT Extension Proposals. Even if the Single Plan Holding Test or the Single Plan Specified Limit Test are applied certain of the Pooled Investment Vehicles, including certain of those to be managed by IMCO, would be SIFT Partnerships or Trusts. Therefore, all investments by such Pooled Investment Vehicles in non-portfolio property would be subject to entity level tax. The impact of the SIFT Extension Proposals in terms of putting pension plans that invest in Pooled Investment Vehicles at a disadvantage compared to all other Canadian pension plans can best be illustrated through a simple example.

Assume that a Canadian pension plan holds 20% of the debt and equity of a taxable Canadian corporation that directly carries on an active business in Canada ("**ACo**"). The pension plan would not be subject to tax on interest and dividends received from the ACo. The pension plan would also not be subject to tax on any gain realized on a disposition of its interest in ACo. If on the other hand a pension plan invests in a Pooled Investment Vehicle that holds 20% of the debt and equity of ACo the tax results are materially worse. As discussed above, the Pooled Investment Vehicle would be considered a SIFT Partnership or Trust and the Pooled Investment Vehicles interest in ACo would be non-portfolio property since the Pooled Investment Vehicle holds more than 10% of equity in ACo. Consequently the Pooled Investment Vehicle would be subject to entity level tax on the interest it receives from ACo and would be subject to entity level tax on any gain realised on a disposition of its interest in ACo.

Therefore, if the SIFT Extension Proposals are implemented, the pension plans that invest in the Pooled Investment Vehicles, including those to be managed by IMCO, will be subject to an additional level of taxation with respect to their investments in Canadian private equity, venture capital and infrastructure to which no other Canadian pension plans will be subject.

(b) Private Equity and Venture Capital

In the case of OPB, rather than making majority investments in private equity or infrastructure, it typically makes minority investments (less than 50%) in funds that are typically organised as limited partnerships, the general partners of which are corporations controlled by the promoter of the relevant fund. The investors in such funds typically include both taxable and tax-exempt investors. In the case of some funds the majority of the investors are taxable and in the case of other funds the majority of the investors are tax-exempt depending upon the subscriptions received by the promoter of the relevant fund. If either of the Aggregate Plan Holdings Test or the Aggregate Holding Specified Limit Test were applied, then a large number of private equity funds and venture capital funds in which OPB has a minority interest would be considered SIFT Partnerships or Trusts. Consequently income (other than dividends) earned on all the non-portfolio property and all gains recognised by the fund on a disposition of non-portfolio property will be subject to tax in the fund. This will not only impact the tax-exempt investors in the fund such as OPB but also the taxable investors in the fund. In many cases even though investors in such funds are taxable they may not actually pay taxes on all of the income allocated to them by the fund. Those investors could have deductions such as interest expense or non-capital losses which could be used to offset income allocated to them by the fund or capital losses that could be utilised to offset any capital gains allocated to them by the fund. In addition, the taxable investors could include mutual fund trusts which hold less than a 10% interest in the fund which could allocate such income or gains to its unitholders without being subject to entity level tax. If the SIFT Extension Proposals are enacted this could well prevent OPB from acquiring interests in Canadian private equity and venture capital funds. If the SIFT Extension Proposals are implemented and grandfathering rules are not introduced as part of such proposals this could cause OPB and other pension plans to dispose of their existing interests in Canadian private equity and venture capital funds which could result in a downturn in Canadian capital markets.

(c) Infrastructure

If the SIFT Extension Proposals are implemented it will adversely impact upon the ability of OPB to invest in Canadian infrastructure partnerships.

As noted above, if either the Aggregate Plan Holdings Test or the Aggregate Holding Specified Limit Test is applied, Canadian infrastructure partnerships in which OPB has invested will be considered SIFT Partnerships or Trusts. Income earned by the Canadian infrastructure partnerships will be income from a business carried on in Canada and therefore will be non-portfolio earning and subject to entity level tax. Subjecting the Canadian infrastructure partnership to entity level taxation will not only adversely affect OPB and other pension plans that have invested in the partnership but will also adversely affect the infrastructure developers. Even though the infrastructure developers in such partnerships are typically taxable entities, they would typically have deductions in respect of current expenditures, and capital cost allowance on other projects that can be used to offset income allocated to them by the Canadian infrastructure partnership. If the SIFT Extension Proposals are enacted, infrastructure developers may no longer wish to enter into partnerships with pension plans. If the SIFT Extension Proposals are enacted without grandfathering rules this may result in pension plans disposing of their existing interests in Canadian infrastructure investments. Given that infrastructure investments are typically held by institutional investors, if Canadian pension plans are driven out of infrastructure investment this could lead to greater non-resident ownership of Canadian infrastructure.

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2. Thin Capital Extension Proposals

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

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

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

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

The idea of applying the thin capital rules to pension plans was considered in a paper prepared by Vijag Jog and Jack Mintz entitled "*The 30 Percent Limitation for Pension Investments in Companies: Policy Options*" Vol 60, No. 3, Canadian Tax Journal 567-608 (the "**Mintz Paper**"). One of the difficulties in this regard discussed in the Mintz Paper is:

> 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.

Given that one of the unique and important contributions of pension plans is providing patient capital and capital for large scale projects the 1.5 to 1 debt to equity ratio may well be insufficient for such projects.

The Thin Capital Extension Proposal is a blunt instrument in that it does not distinguish between the amount of leverage required for different types of investments and, by imposing on the taxable Canadian corporation, it has an adverse impact upon both taxable and tax exempt investors in the corporation.

If the Potential Tax Measures were implemented, a number of other tax measures need to be implemented in order to attempt to reduce the adverse consequences described above. These measures would include:

(i) A grandfathering rule such that the Potential Tax Measures would not apply to existing investments by pension plans. As noted above, the Potential Tax Measures may affect both majority investments and minority investments. In addition, the Potential Tax Measures will cause partnerships and trusts in which pension plans have invested to be subject to tax. Absent grandfathering, the introduction of the Potential Tax Measures could result in OPB, or partnerships or trusts in which it has invested, being forced to dispose of their investments in Canadian private equity, venture capital and infrastructure;

(ii) If the SIFT Extension Proposal is implemented it should contain an exception for Pooled Investment Vehicles. As discussed below, absent such an exception, pension plans investing in Pooled Investment Vehicles, including those to be managed by IMCO, would be subject to an additional level of tax with respect to their Canadian investments;

(iii) If the SIFT Extension Proposal is implemented, it should contain a safe harbour provision that would prevent it from applying unless a particular pension plan held more than 50% of the partnership or trust. Absent such a safe harbour provision, the SIFT Extension Proposals would prevent smaller pension plans and Pooled Investment Vehicles from investing in venture capital, private equity and infrastructure funds;

(iv) If the SIFT Extension Proposal is implemented, it should contain an exemption for partnerships or trusts that would qualify as real estate investment trusts (as defined in subsection 122.1(1) of the Income Tax Act (Canada) ("**ITA**")) if they were trusts the units of which were listed on a prescribed stock exchange. OPB indirectly holds some of its Canadian real estate investments through private limited partnerships and trusts that hold real estate. Absent such an exemption OPB would be at a disadvantage in terms of investing in Canadian real estate;

(v) If the SIFT Extension Proposals are implemented, the list of permitted activities for tax exempt corporations set out in paragraph 149(1)(o.2) of the ITA should be expanded. Currently paragraph 149(1)(o.2) of the ITA provides exceptions for corporations that qualify as real estate corporations, resource corporations, and investment corporations. This list of qualifying corporations has not been expanded since the early 1980's when subparagraph 149(1)(o.2)(ii.1) was added to provide an exemption from tax for corporations that invest in Canadian resource properties. As discussed above if the SIFT Extension Proposal is implemented it will create a major impediment for Canadian pension plans in terms of investing in Canadian infrastructure projects, clean energy projects, private equity and venture capital. There have been public statements made by various levels of Canadian governments to the effect that they would like Canadian pension plans to invest in Canadian infrastructure and venture capital. If the activities for tax exempt corporations are not expanded an important source of patient capital for large projects that the Canadian government has stated it wants to encourage will disappear. In particular, given that the Potential Tax Measures will not only affect tax-exempt investors in such projects but will also adversely affect taxable investors in such projects pension plans will not be viewed as attractive investors or partners in these projects; and

(vi) If the SIFT Extension Proposals are implemented, an exception should be added for a trust utilized as a special purpose investment vehicle by a pension plan, where the only undertaking of the trust is investing its funds in property. Such trusts, which hold only investments and do not carry on business, are not the type of active business entity to which we understand the SIFT Extension Proposals are intended to apply.

We appreciate the opportunity to provide feedback on the government's proposal. If you would like to discuss anything covered in this letter, please contact me directly at 416-601-3903 or at mark.fuller@opb.ca.

Sincerely,

Mark Fuller
President and CEO