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To Go or Not to Go? The 30% Rule for Canadian Pension Funds

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Canadian pension funds and their subsidiaries are subject to a rule that prohibits them from investing in shares of a corporation having more than 30% of the votes for the election of directors, except in the case of qualifying real estate, resource and investment subsidiaries (the so-called 30% Rule). The 2015 federal budget announced that the 30% Rule would be reviewed. For this purpose, the Department of Finance issued a consultation paper on June 3 stating that it will be accepting comments from interested parties on whether the 30% Rule should be retained, relaxed or eliminated for federally regulated pension plans. The consultation paper also poses a number of questions related to governance, investment and tax issues related to the 30% Rule.

This consultation follows an announcement in 2015 by the Ontario government to eliminate the 30% Rule for Ontario regulated pension plans.

The original purpose of the 30% Rule was to limit pension plans to making passive investments, rather than active investments for which they would be involved in managing the day-to-day operations of businesses in which they invest. However, partly in response to lower interest rates and volatility in the public equity markets, pension plans have made an increasing number of private equity or similar type of investments for which they are taking on a larger equity stake in business enterprises. Pension plans have implemented a variety of approaches and structures to reduce the impact of the 30% Rule on these investments.

The 30% Rule limits only the percentage of voting shares that may be owned by a pension plan. It does not restrict a pension plan from acquiring more than a 30% equity interest by, for example, investing in non-voting shares in addition to voting shares carrying a 30% voting interest. The consultation paper asks the following questions: whether the original purpose of the 30% Rule remains valid; whether there are additional risks in pension plans taking an active role in the operation of a business; and whether other pension investment rules should be implemented in connection with a relaxation of the 30% rule to address any such risks.

The consultation paper notes that the 30% Rule may affect investment performance and financial market efficiencies by restricting the category of investments that pension plans may make. The paper asks for input on whether the 30% Rule impedes pension plans' investment returns or imposes additional costs on pension plans. It also asks whether the 30% Rule creates an inequity between larger and smaller pension plans or whether its removal would create such an inequity.

Most countries do not have a restriction – like the 30% Rule – that places an ownership limit on pension plans' investments in business assets. However, unlike the tax regimes in many of these other countries, the *Income Tax Act* (Canada) does not contain provisions that limit the tax efficiency of investments in business assets by pension funds. Consequently, Canadian pension plans can structure investments in business entities to reduce or eliminate entity-level taxation by, for example, capitalizing the investment with significant related party debt or structuring the investment through a "flow-through" entity, such as a partnership. In contrast, as an example of a system that does impose tax rules related to such investments, the U.S. Internal Revenue Code contains earnings stripping rules that limit the deductibility of interest payments made to pension plans and certain other investors in specific circumstances. It also imposes an unrelated business income tax on pension plans and other tax-exempt entities that derive certain types of income directly or indirectly through a flow-through entity. The consultation paper asks whether Canada should adopt any new tax rules to preserve the Canadian corporate tax base in connection with the elimination or relaxation of the 30% Rule, similar to tax rules in the United States or other countries.

The consultation paper requires that submissions on the 30% Rule be made by September 16, 2016.

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