

April 8, 2011

Office of the Auditor General of Canada

240 Sparks Street
Ottawa, Ontario
K1A 0G6 Canada

Dear Auditor General Sheila Fraser:

The 2010 Fall Report of the Auditor General of Canada dealt with the Canada Revenue Agency's processes for compliance with the Income Tax Act of Registered Charities. **I am writing today to request that the Office of the Auditor General of Canada conduct an audit of the Canada Revenue Agency's processes for compliance with the Income Tax Act and CRA's administrative rules for Health and Welfare Trusts, and the new Employee Life and Health Trusts.**

Joan Williams, a senior actuary of Welton Parent Inc. in Ottawa, and myself, an independent financial expert, have been communicating with the Minister of the Canada Revenue Agency and senior officials at the CRA about our concerns regarding the CRA not enforcing the Income Tax Act and CRA administrative rules for HWTs, and for Nortel's HWT in particular. Please see Joann William's correspondence with the CRA during March and April 2011.

There are 1.1 million Canadian employees who are covered by disability insurance provided by employers, primarily through Health and Welfare Trusts (HWT). The HWT is a creation of the CRA to enable employers to achieve certain tax advantages for the deduction of employer contributions and for tax exemption or deferral on employee benefits. The Government of Canada has also introduced by Income Tax Act amendment in 2010, new Employee Life and Health Trusts (ELHT), which have additional tax advantages for employers. The ELHT is a new tax vehicle created to enable the Health Care Trusts formed in the bailouts of General Motors Canada and Chrysler Canada during 2008. The ELHTs have the same need for effective CRA compliance procedures as the HWTs.

Employers are getting large tax deductions for disability insurance plans within HWTs, that are not properly disclosed to employees, that do not provide the income security promised to disabled employees, and that do not comply with the Income Tax Act and CRA rules for disability wage loss replacement plans. And now, we also see that employers are taking employer contribution deductions for future life insurance premiums and death benefits that are specifically denied within HWTs by the Income Tax Act. **The CRA is simply not doing enough to enforce the integrity of the Income Tax Act and its CRA Rules for HWTs and disabled Canadians are suffering catastrophic financial loss as a consequence.**

I have learned about weaknesses in CRA compliance and enforcement procedures from my detailed analysis of the Nortel Health and Welfare Trust, and related research on disability insurance provided by other employers in the country. I am a member of the team of legal, actuarial and financial professionals working on unpaid retainer for the dissenting Nortel disabled. The Nortel disabled, but for those whose partners have income, are now living in poverty. \$45 million allocable to the disabled was removed from the Nortel Health and Welfare Trust and another \$30 million allocable to the disabled of the remaining assets in their Health and Welfare Trust is being distributed to pensioners for a life insurance settlement.

Joann Williams and I have concluded that the Nortel Health and Welfare Trust wind-up distribution is not in compliance with the Income Tax Act and CRA Rules for Health and Welfare Trusts. It also appears that Nortel benefitted from deductible employer contributions for future life insurance premiums that were in contravention to the Income Tax Act.

I know that the Auditor General of Canada cannot intervene on specific CRA tax files and receiving a letter from your office to say this is unnecessary. We have already gotten the same type of response from

the CRA itself, despite the Nortel HWT wind-up distribution court decision being in direct conflict with the Income Tax Act and CRA Rules for HWTs. The actuarial, accounting and legal professionals whose practice covers HWTs and ELHTs are left with ambiguity about what to advise employers on the creation and operation of HWTs and ELHTs. Quite frankly, these professionals are now in a deep ethical dilemma in their work with employers who can now legally abuse disabled employees by providing unsafe disability insurance within HWTs and ELHTs, and get a tax incentive to do so.

My request is for the Office of the Auditor General of Canada to examine the CRA processes for compliance with the Income Tax Act and CRA rules for both HWTs and ELHTs.

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April 6, 2011

The Honourable Keith Ashfield
Minister of the Canada Revenue Agency
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Dear Minister:

Re: Nortel Health and Welfare Trust

Thank you for your correspondence of March 15, 2011 concerning payments to be made from the Nortel Health and Welfare Trust (HWT) on wind-up. Your prompt attention to this matter is much appreciated by all of us who are working toward a fair outcome for disabled employees whose disability insurance is provided through HWTs.

I understand that you and your staff are not permitted to comment on the tax issues of a taxpayer without written authorization; however, the actuaries, accountants and lawyers whose practices cover HWTs need clarification of the CRA's rules governing HWTs. The HWT is defined within the CRA administrative regime for interpretation of the ITA sections on employer contributions and employee benefits. At the Society of Trust and Estate Practitioners Roundtable with the CRA on June 8, 2010, the CRA announced it had no plans to withdraw IT-85R2 upon implementation of the ITA amendments for the new Employee Life and Health Trust (ELHT). Furthermore, at this important forum for practitioners, the CRA said it is remaining diligent in ensuring that HWTs fully comply with its administrative regime. I believe that further CRA guidance is not only warranted, but required due to the conflict between the November 9, 2010 decision of Justice Morawetz on the Nortel HWT wind up distribution, and the existing CRA rules for HWTs.

If I compare the HWT to a registered pension plan (RPP) constituted as a trust, there are a great many similarities. The obvious difference is that the law does not require the automatic filing of HWT documentation in order to maintain a tax-preferred status. However, CRA can and does from time to time request justification for the amounts of deductible employer contributions being claimed. CRA may also require even a third party to produce any and all documents related to a particular HWT. Furthermore, the CRA reviews actuarial reports and other material in order to determine the reasonableness of employer contribution levels. Just as in the case of an RPP, CRA may opine on whether or not a particular arrangement qualifies as a bona fide HWT for tax purposes. As you pointed out in your correspondence of March 15, the CRA may take enforcement actions to deny tax deductions for employer contributions. The CRA's

commentary carries a great deal of weight regarding the administration of such vehicles because taxation is the major issue driving the plan design. From your letter:

“The health and welfare trust developed as an industry response to situations in which employers did not want to purchase contracts of insurance, but employees (and/or their union representatives) wanted a somewhat higher degree of assurance than provided under a pay-as-you-go arrangement. The concept of the health and welfare trust was proposed to ensure that interposing a trust did not create any unintended tax results in terms of preserving the non-taxable status of employment benefits and employer deductions for contributions to the trust.”

If one consults the ITA in conjunction with related CRA publications, the HWT's primary function is to execute group life and health insurance contracts, either issued by third party insurers or self-insured by the employer. All benefits may be self-insured by the employer, with the notable exception being life insurance, which may only be provided using group term life insurance policies issued by third party insurers. The Nortel group term life insurance policies issued by Sun Life and held within the Nortel HWT have premiums that are pay-as-you-go expenses annually. These contracts terminate automatically upon Nortel's receivership or bankruptcy. Once insurance contracts lapse, it is well established that there is no further life insurance coverage for anyone. If all the benefits provided within the HWT were similarly insured with third party insurers, all insurance coverage would cease and there would be no further claims admissible of any kind. **The only remaining liability for the third party insurers would be for the future income payable within the disability claims that have already been incurred up to the date of the termination of the insurance policies. In accordance with the various publications of the CRA, it is clear that the situation on wind-up of the Nortel HWT should be no different.**

For example, the following excerpt from IT-428 dictates that Wage Loss Replacement Plans, such as disability income plans provided through HWTs, must be administered as true insurance plans:

“7. A plan for purposes of paragraph 6(1)(f) of the Act and section 19 of the ITAR must be an "insurance" plan. Those provisions are not applicable, therefore, to uninsured employee benefits such as continuing wage or salary payments based on sick leave debits, which payments are included in income under paragraph 6(1)(a). It is to be noted that, while a plan must involve insurance, it is not necessary that there be a contract of insurance with an insurance company. If, however, insurance is not provided by an insurance company, the plan must be one that is based on insurance principles, i.e., funds must be accumulated, normally in the hands of trustees or in a trust account, that are calculated to be sufficient to meet anticipated claims. If the arrangement merely consists of an unfunded contingency reserve on the part of the employer, it would not be an insurance plan.”



It is clear from the Nortel HWT wind-up reports that assets have been allocated to future life insurance considerations (for the benefit of pensioners and the disabled) for which the HWT has no further liability. Such assets should not have been accumulated using legally deductible employer contributions. At the same time, insufficient assets have been allocated to the liability for incurred disability claims, which is required to be funded under a bona fide HWT. These HWT issues are the jurisdiction of CRA and I suggest it is within the CRA's mandate to review a publicly available HWT wind-up report.

I believe you will find that Nortel should properly incur a tax liability for prior period employer contributions accumulated to fund the proposed distribution for future life insurance considerations. The ITA S. 18 (9) (iii) and CRA's Interpretation and Ruling Documents state that employer contributions in consideration for insurance in respect of a period after the end of the year are not tax deductible. Nortel should not be able to contravene the ITA and CRA administrative regime for HWTs over many years without consequences.

With the advent of the new legislation for ELHTs, there will be no new HWTs established; however wind-up issues pertaining to existing HWTs must still be addressed. Your intervention in the Nortel matter would provide the opportunity for CRA to present its interpretation, but your interpretation is required in any case. As a practitioner, I assure you that your guidance on these issues is essential, and I hope it will be forthcoming while the Nortel HWT is still in existence. Thank you again for your consideration.

Sincerely,



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CC:

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From: MinMail - CourrierMin [<mailto:MinMail.CourrierMin@cra-arc.gc.ca>]
Sent: Tuesday, March 15, 2011 1:02 PM
To: Williams, Joann
Subject: concerning payments to be made from the Nortel Health and Welfare Trust
Importance: High
Sensitivity: Private

Ms. Joann Williams, BSc., FSA, FCIA
jwilliams@wpi.ca

Dear Ms. Williams

PRIVATE COMMUNICATION

PRIVATE COMMUNICATIONN

Yours sincerely,

Keith Ashfield
Minister of National Revenue

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I am an actuarial advisor to a group of disabled former Nortel employees who were, until recently, receiving their monthly income payments from Nortel's Health and Welfare Trust (the Nortel HWT). As far as we know, Nortel has always intended the Nortel HWT to comply with the *Income Tax Act (Canada)* (the ITA) and the published interpretations of the ITA by the Canada Revenue Agency (CRA). From the disclosed Nortel HWT tax filings for 2005 to 2009 and what we are told by the Nortel long term disability income recipients, it appears that benefits and investment income have been taxed in accordance with applicable CRA policy. We presume, but are unable to confirm, that Nortel has deducted all of its contributions to the Nortel HWT for tax purposes, as business expenses in the same year as they were paid into the fund.

As you may know, the Nortel HWT will be wound up in a deficit position and therefore the proper distribution of assets has become an issue. It is proposed to disburse assets in proportion to liabilities in respect of certain "participating" benefits. The liabilities being used for this purpose **include provision for future life insurance payments to pensioners**. That is, living pensioners are being allocated monies from the HWT to satisfy Nortel's promise to pay death benefits to employees who are said to have vested claims. It is our understanding, however, that HWTs may only consist of group term life insurance policies. This accords with Interpretation Bulletin IT-85R2, titled *Health and Welfare Trusts for Employees*, which provides that **HWTs are not permitted to comprise of permanent life insurance policies**. **In addition**, Nortel's Ruling Request Letter dated December 16, 1979 and the Revenue Canada Ruling dated December 28, 1979 specifically provided that the funding arrangement for the Group Life Insurance Plan (Part I – Basic)¹ would be for Nortel to make contributions to the HWT sufficient to pay **premiums**. The 1979 tax ruling makes clear that **only premiums** would be paid

¹ The Pensioners and Active Employees were both covered by one Umbrella Group Term Life Insurance Policy, referred to as Group Life Insurance Plan – Part I.

from the HWT. Despite this, money is being allocated from the HWT to pay death benefits to living pensioners.

The now approved allocation is diverting a significant proportion of HWT assets away from benefits related to previously incurred disability claims to pay for benefits that have not as yet been incurred and which cannot comprise valid HWTs. It is our contention that only previously incurred claims for benefit plans permitted within HWTs should be considered liabilities on wind up of the Nortel HWT, as only these may be funded on a tax-deductible basis. In accordance with subparagraph 18(9)(a)(iii) of the ITA, **consideration for insurance in respect of a period after the end of a year is generally not deductible as a business expense for that year.**

Notwithstanding this prohibition, Nortel has historically kept a notional account for these future life insurance premiums, known as the Pensioners' Insurance Fund (PIF), within the Nortel HWT. We believe that this accounting should not be relevant on wind up of the Nortel HWT, because it is not possible for a valid HWT to hold assets for this purpose. In any event, Nortel was **required** pursuant to the Nortel HWT Trust Agreement and CRA Information Bulletin IT-428 (*Wage Loss Replacement Plans*) to accumulate funds in respect of incurred disability claims. **Nortel was the insurer with respect to these disability income claims and provision should have been made for the orderly funding of disabled life reserves.** Despite the requirement for sound actuarial funding, the value of assets allocated to this purpose is woefully deficient.

We believe that the actual distribution of assets to the pensioners for death benefits may disqualify the Nortel HWT as a *bona fide* Health and Welfare Trust for tax purposes. The proposed HWT payments to pensioners as settlement for future death benefits represent neither legitimate HWT benefit payments, nor surplus. Clearly tax will have been improperly deferred on any lump sum distributions to pensioners at the HWT's wind-up.

As you may know, the Ontario Superior Court has not supported our interpretation that the pensioners are not appropriate beneficiaries of the Nortel HWT in respect of life insurance benefits or future life insurance premiums. Our group has also been denied leave to appeal to the Court of Appeal of Ontario. However, it would be appropriate, in my opinion, for the CRA to issue an opinion or ruling addressing the status of the proposed payments to pensioners and the consequences of making such payments.

I cannot stress enough the importance of this issue to the Nortel disabled group. The HWT distribution that the court has now condoned is not compliant with the ITA or CRA's interpretations thereof and it will needlessly leave these people in poverty.

Beyond the significance to the Nortel disabled, I believe clarity is required for the benefit of actuaries, tax advisors and other relevant professionals at large.

I have enclosed copies of the following documents:

1. [Request for Advanced Income Tax Rulings – Northern Telecom Benefit Plans
December 16, 1979](#)
2. [Reply to Request for Advanced Income Tax Rulings from Revenue Canada
December 28, 1979](#)
3. [Income Tax Act Amendment S. 18 \(9\) \(a\) \(iii\) Dec. 11, 1979](#)
4. [Trust Agreement as at January 1, 1980 between Northern Telecom Limited
and Montreal Trust Company](#)
5. [Affidavit of Joann Williams – August 9, 2010](#)
6. [Affidavit of Joann Williams – September 24, 2010](#)
7. [Affidavit of Jeremy Bell – September 23, 2010](#)
8. [Valuation of Non-Pension Benefit Obligations at December 31, 2010 \(Mercer\)](#)
9. [Appendix UU - Mercers Analysis of the Funding Status of the Pensioners
Life Insurance Fund as of Jan. 1, 2002](#)
10. [Supplement to Fifty-first Report of the Monitor dated September 17, 2010](#)
11. [HWT Allocation Order dated November 9, 2010](#)

The above documents and many more are available at monitor's website:
<http://documentcentre.eycan.com/Pages/Overview.aspx?SID=89>

Please let me know if you require anything further. We appreciate your attention to this urgent matter.

Sincerely

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