

Retail, E-Commerce & Tax Update

Tax Effective Use by Canadian Online Retailers of Bermuda Operations for International Expansion

2011 Canada-Bermuda Tax Information Exchange Agreement

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E-tail Foreign Market Opportunity

The growth of online retail sales has globally outstripped the growth of all other retail channels, including during the last recession. For example, in England during 2012,¹ it has been estimated that online e-tail grew by an average of 17 percent, compared to all other retail growth in England of approximately 2.1 percent during the same period. In 2012, Canadian companies sold \$122 billion of goods and services over the Internet,² and in 2012, 11 percent of Canadian firms sold their goods and services online, compared to only seven percent in 2011.³ In the U.S., there are 263 million Internet users and more than 100 million Americans regularly purchasing goods online.⁴ Forbes estimates that by 2017, U.S. online retail sales will reach \$370 billion.⁵

The increased ability to shop online via mobile devices, combined with the explosion of online shopping apps, the increasing demand for retailers to expand internationally, and the dramatic improvements in the efficiency and dependability of sales fulfillment, are all contributing to the rapidly escalating growth of online retail markets globally.

The Bermuda-Canada Connection

Bermuda has an exceptional international reputation for the sophistication and reliability of its offshore company infrastructure and administration. Only a two-hour flight from New York, Bermuda is one of the leading financial service jurisdictions in the world, including enviable global insurance, re-insurance and banking sectors – all of which depend upon Bermuda's exceptional legal, accounting, communications and advanced IT infrastructure.

There is a long tradition of close political and commercial ties between Canada and Bermuda, including a long history of our common legal framework. Bermuda and Canada also follow the same accounting standards and thousands of Canadian expatriates have lived and worked in Bermuda. Many Bermudians, including many of Bermuda's Cabinet Ministers over the years, including Bermuda's current Minister of Finance, The Hon. Bob Richards, have attended Canadian universities for their undergraduate and graduate education. On July 1, 2011, that relationship between those jurisdictions became much closer when the Tax Information Exchange Agreement that Canada entered into with Bermuda came into force (the Canada-Bermuda TIEA).

Important Tax Benefits

Canadian retailers who sell their goods and services online can now utilize the Canada-Bermuda TIEA to expand their international sales into foreign markets with highly beneficial tax advantages.

Simply stated, as long as certain "foreign affiliate" rules (discussed below) are complied with, active business income accruing to a wholly owned subsidiary that is resident and carrying on an online retail business in Bermuda, as well as any dividends that such Bermudian e-tail subsidiary pays to its Canadian parent, **will be free of Canadian tax.**

In order to secure the exceptional tax advantages of the Canada-Bermuda TIEA, the Bermuda foreign affiliate of the Canadian retailer must carry on its business in Bermuda and have its mind, management and control located in Bermuda. As described in the hypothetical case study below, although much of any online retail business can be automated and operationally

outsourced to others, certain of those activities and operations, together with the management and control of the Bermuda e-tailer by its board of directors, must be conducted in Bermuda.

Yacht Widgets E-tail Case Study

Although each company will have to consider how it will structure its Bermuda e-tail operations in a manner that satisfies Canada's applicable "foreign affiliate" local mind, management and control rules, the following hypothetical⁶ case study of how a Bermuda active business operation may be simply and cost-effectively structured is instructive of the surprising ease with which a Canadian online retailer might secure Canadian tax advantages to pursue its expansion into international markets:⁷

1. Yacht Widgets Canada Corp. (YWC) was a successful Canadian retailer who sold a broad range of boating equipment, accessories and related goods (clothing, small boat parts, books, manuals, etc.) both from their several store locations across Canada and online. Many of its products are made in Canada and the United States, and its online sales to persons in the U.S. began to increase through both word of mouth and recent articles about YWC's products that had appeared in several U.S. boating journals.
2. YWC decided that there were tremendous online sales growth opportunities in the U.S. market, but before they began their advertising campaign into the U.S. market YWC wanted to be sure that it structured its expansion into that much larger and lucrative market to maximize its financial return, including the minimization of its Canadian income tax exposure on those profits.
3. Taking the Canada-Bermuda TIEA into account, YWC incorporated a Bermuda limited liability company, Yacht Widgets Bermuda Corp. (YWB), as its wholly owned subsidiary. Under Bermuda law, that company was exempt from Bermuda's ownership restriction laws because it only sold goods to online buyers who were outside of Bermuda. YWB's e-tail website was set up on a server that was located and operated in Bermuda, and its content intentionally targeted the U.S. market (e.g. prices quoted in U.S. currency, specific U.S. delivery options, links to U.S. boating content like weather reports, journals and U.S. boating news). Any potential sales that it otherwise might receive from Canadian shoppers were seamlessly redirected to YWC's Canadian website.
4. YWC decided that YWB's operation should, for now, focus only on the U.S. market before expanding its market focus to Europe. YWC could have allowed YWB to sell its products to Canadian residents online, but depending on the specific situation, those revenues may not be exempt from Canadian tax and may have to be included directly in YWC's income. The focus forward for YWB was the U.S.
5. YWC and YWB entered into a standard "fair market value" inter-company services agreement⁸ whereby: (1) YWB received a TM (and other IP) license to create, brand and operate YWB's international e-tail business in Bermuda (and via the YWB website); and, (2) YWC was retained to provide YWB with ongoing consulting and advisory services based on YWC's business process knowledge, e-tail know-how, supplier relationships, fulfillment logistics, and general business knowledge to support YWB's business.
6. As the sole shareholder, YWC elected a small number of YWB board directors who were comprised of a lawyer from YWB's local Bermuda law firm, a local business person with e-tail experience and an experienced YWC business manager who was transferred to Bermuda to both Chair YWB's board of directors and to run the day-to-day operations of that e-tail business in Bermuda.
7. As a matter of efficiency and maintaining a cost-effective operation, YWB decided that all other of its technical (IT and server) operations, administration, back-office operations, accounting, local legal/regulatory compliance, fulfillment/logistics management, payment gateway, local banking relationship, and online security monitoring should be locally outsourced to a "turn-key" e-tail management services enterprise in Bermuda with specialized and experienced expertise in operating international e-tail businesses. Pursuant to that Online Retail Support Services Agreement, that local team of outsourced personnel ensured that all of the operations of YWB became as automated as possible and supported in Bermuda.

8. To secure reliable sales fulfillment services in the U.S. market, YWB entered into a services contract with a highly reputable and experienced fulfillment (inventory supply logistics, warehousing, and delivery) service provider in the U.S. (U.S. Logistics Co., based in Bangor, Maine). YWB also separately contracted with the same customer support call centre service provider in India that YWC used for the Canadian market. YWB's aggressive advertising campaign into the U.S. market was directed from Chicago under a contract that YWB entered into with the same Canada-U.S. advertising firm that YWC used out of their Toronto office.
9. YWB's corporate presence in Bermuda also allowed their local Bank in Bermuda to ensure that all of YWB's U.S. customers could use their usual credit cards to purchase YWB's products.⁹
10. Simply stated, YWB was cost-effective and well managed in Bermuda with the support of: a small local board of directors; a dedicated local manager; support from an experienced Bermuda "turn-key" back-office operations services provider that YWB supervises and manages; and, U.S. fulfillment, advertising/marketing and call-centre support services that are provided by experienced providers who are all located outside of Bermuda.
11. YWB's business expanded very rapidly and within the first year YWB's revenues exceeded YWC's revenues by 250 percent, which is still only a small fraction of the potential online market share that YWB could secure in the much larger U.S. market. In a sense, YWB leveraged the business know-how of YWC to rapidly expand its sales through YWB in Bermuda into the highly lucrative U.S. market. YWB's growing profits in Bermuda were not taxed in Bermuda, and they were also not taxed in Canada when they were repatriated to YWC as dividend payments to its parent company.

1. April-July 2012, cited by Portfolio in its article "Growth of E-Commerce Sales Despite The Recession in the UK", <http://www.edirectlink.net/growthofecommercesales>.
2. Statistic Canada, CBC Report, June 12, 2013.
3. *Ibid.*
4. IBISWorld, "Online Retail in the U.S.", <http://www.ibisworld.com>.
5. Forbes, Tech ed. research 3/14/2013, report by Sucharita Mulpara.
6. The case study presented is fictitious, but widely based upon numerous successful retail enterprises in Canada who may wish to rely on the tax advantages of Canada-Bermuda TIEA to enhance their profitability. This hypothetical case is described in the past tense to describe YWC's expansion into global markets on a Canadian tax exempt basis.
7. There are many different and effective corporate and commercial structures that are possible to implement, and this particular case study is provided for illustration purposes only. In our experience, each corporate and commercial structure must be specifically tailored to suit the unique facts of each online retailer and its operations.
8. This agreement would be subject to the transfer pricing rules under Canada's tax laws meaning that some compliance work and documentation would be required to ensure that the "fair market value" reflects arm's length pricing.
9. Acquiring banks' agreements with credit card companies widely stipulate that a bank with an ecommerce acquiring license must only provide credit card services to online merchants that have a corporate presence in the bank's jurisdiction.

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