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The Deterrent Effect of the China-Canada Bilateral Tax Treaty on Profit Shifting by Multinational Enterprises

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Abstract: The China-Canada Bilateral Tax Treaty serves both to avoid double taxation and to prevent tax evasion. When multinational enterprises arrange investments, financing, licensing, and service transactions in both countries, the attribution of profits is influenced by residency status, permanent establishment criteria, related-party transaction conditions, and information exchange procedures. This paper identifies the context of the treaty's application, the boundaries of residency and business attribution, adjustments to related-party transactions, and pathways for tax cooperation, and analyzes its deterrent effect on contract splitting, expense misallocation, and transfer pricing deviations. The treaty provides attribution criteria, cooperation procedures, and dispute resolution channels, thereby promoting tax arrangements that are grounded in actual business operations and value creation.

1. Introduction

Profit shifting by multinational enterprises typically results from the selection of residency status, the allocation of functional assets and risks, group financing, and arrangements for licensing and service fees. China and Canada have long-standing trade, investment, and technology ties. Enterprises must both avoid double taxation on the same income and comply with the rules of the source country and the country of residence. Bilateral tax treaties establish criteria for entity status, business presence, adjustments for related-party transactions, and procedures for the exchange of information. These provisions ensure certainty for genuine business operations and limit opportunities for contract fragmentation and expense misallocation, thereby making the boundaries of these rules all the more important.

2. Background on the Application of the China-Canada Bilateral Tax Treaty

2.1 Limitations of anti-tax avoidance rules and pressure on profit transfer

The profit transfer of multinational enterprises comes from the difference between the overall tax burden of the group and the tax liability of the member companies [1]. Purchasing, R & D, financing, brand licensing and sales services can be configured in different jurisdictions, and unilateral domestic laws mainly control the income of domestic resident enterprises and domestic

sources ; when contracts, funds and actual functions are separated, profit attribution must return to value creation judgment. Domestic anti-tax avoidance rules can deal with obviously unreasonable transfer pricing, thin capitalization and controlled foreign enterprise arrangements, but there are still boundaries in the identity of the other party's residents, overseas data acquisition and double taxation relief. The pressure of profit transfer in China-Canada cross-border operations is mainly focused on related purchase and sale, technology licensing, group financing and service fee arrangements. The key lies in whether profits are separated from personnel functions, asset use and risk-taking. If market development, contract negotiation and after-sales support occur on one side, and profits are concentrated on the other side's low-functioning entities for a long time, the risk of tax base erosion will accumulate. Bilateral agreements review these arrangements under common rules, so that enterprises cannot rely solely on formal contracts to choose the most favorable tax results.

2.2 The Need for Tax Coordination in China-Canada Economic and Trade Relations

China-Canada economic and trade relations provide a two-way market and capital allocation space, and the tax treaty has a realistic governance object. The larger the scale of trade and investment, the more frequent the group 's internal procurement, distribution, financing and service settlement, the more enterprises need the agreement rules to confirm the source of income, tax credits and dispute resolution paths. The agreement does not rank the economic status of any party, but serves the tax coordination in the continuing business activities. Macro business indicators do not evaluate the advantages and disadvantages of one party, but only explain the tax coordination scenarios of enterprises in investment, financing, procurement, sales and profit repatriation. The China-Canada tax treaty should play a role in these real links, so that the tax payment place, the tax burden and the adjustment process can be jointly identified by enterprises, tax authorities and dispute resolution agencies. The macro business environment indicators of China and Canada are shown in Table 1.

Table 1: Macroeconomic and Business Environment Indicators for China and Canada

Countries (listed line by line in order from 2022 to 2024)	GDP (in current U.S. dollars)	Exports of Goods and Services (in current U.S. dollars)	Imports of Goods and Services (Current U.S. Dollar Values)	Net Inflows of Foreign Direct Investment (BoP, in current U.S. dollars)	Foreigndirectinvestment, netoutflows (BoP,currentUS$）	Current Account Balance (BoP, in current U.S. dollars)
Canada	2200562785046.32	742056361162.595	731290006744.08	50764048301.0469	88867717364.1574	-9729614620.94181
Canada	2196593836347.42	732380673864.391	729991623300.122	43897082059.7896	91708314847.122	-15238758364.6521
Canada	2270076189683.46	737073649328.937	741233987715.737	63052828220.4018	89434088588.1219	-11074626248.6308
China	18316765021690.2	37050705417 32.88	3166016135468.4	19020378909 2.51	210050160759.03	4041419477 56.878
China	18270356654533.2	35448710836 31.02	3167502597276.28	51338076801.59	225668552811.28	2570293935 81.815
China	18729668435848	38288739719 71.62	3280170243047.19	42646542014.57	192199999993.86	4622830383 3.16

Table 1 shows that both countries have sustained levels of output, imports and exports, direct investment, and current account activity. The differences in these indicators reflect variations in

economic structure, patterns of openness, and capital flows; they do not allow for a judgment on the relative merits of the two systems. The role of the agreement is to translate business relationships into identifiable taxpayers, categories of income, and dispute resolution procedures.

3. Enforcing Mechanisms of the China-Canada Bilateral Tax Treaty

3.1 Tax Jurisdiction Based on Residency Determination

When a multinational enterprise group applies for treaty benefits, residency status first determines which entity is eligible for the provisions on business profits, dividends, interest, or royalties [2]. The China-Canada Tax Treaty applies to residents of one or both Contracting States; income classification can only proceed once the scope of applicable entities is clearly defined. The determination of resident status prevents enterprises from obtaining treaty benefits to which they are not entitled solely based on their place of registration or intermediate holding structures. If an enterprise is registered in one country but has its actual management, board decision-making, financial control, and primary economic interests located elsewhere, the tax authorities must interpret domestic law and the treaty together to determine whether it qualifies as a treaty resident for the purpose of claiming preferential treatment. The restrictive nature of the resident status boundary manifests in two aspects. First, the treaty links the taxpaying entity to the entity eligible for treaty benefits, thereby reducing the feasibility of shell companies obtaining low withholding tax rates or tax-exempt treatment by relying on intermediate residency status. Second, disputes over residency status can be referred to the competent authority consultation procedure, preventing enterprises from selecting only the most favorable interpretation under a unilateral framework. By clearly defining the correspondence between headquarters, capital sources, and income, these boundaries reduce the uncertainty caused by dual residency or non-resident treatment.

3.2 The business ownership formed by the rules of permanent establishments

The permanent establishment rule addresses when the source country can tax the operating profits of non-resident enterprises [3]. Article 7 of the China-Canada Agreement attributes operating profits to the resident country in principle, but when an enterprise relies on a permanent establishment of another contracting state for operation, the other party may tax the profits. The key is to link the taxation right with the actual operation, so that market development and profit attribution cannot be determined only by the internal contract of the group. Permanent establishment rules can inhibit contract splitting and underestimation of functions. If the enterprise allocates personnel, warehousing, negotiation and after-sales functions in the market country for a long time, but records all the contract income in the name of the overseas subject, the source country can examine whether these activities have formed a taxable existence. Article 7 also requires the profits of the permanent establishment to be attributed to the profits that may be obtained under independent and similar conditions, and limits some internal costs charged by the headquarters to the permanent establishment. This arrangement directly points to the channel through which profits are transferred from the place of operation to other nodes within the group. The attribution mechanism of permanent institutions is shown in Figure 1.

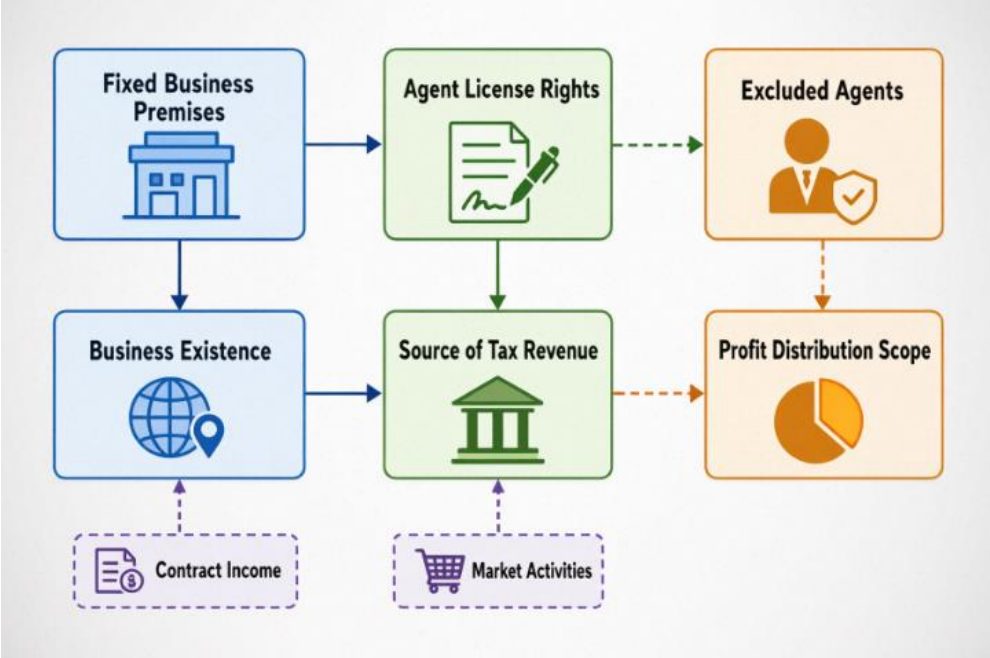


Figure 1: Mechanism for Assigning Permanent Bodies

In Figure 1, the presence of a fixed place of business, the authority to enter into contracts on behalf of the principal, and the independent agent exception collectively define the existence of a business operation, which in turn affects the source country's right to tax and the scope of profit attribution.

3.3 Profit Aggregation Capability in Related Party Transaction Adjustments

The arm's length principle directly corresponds to profit shifting behavior [4]. Article 9 of the China-Canada tax treaty addresses scenarios where a company from one jurisdiction participates in the management, control, or capital of a company from the other jurisdiction, or where the same personnel are involved in the management, control, or capital of both parties. If the commercial or financial conditions between two enterprises differ from those that might arise between independent enterprises, profits not attributable to one enterprise may be included in the profits of the corresponding enterprise and taxed accordingly. The arm's length principle confines the adjustment scope to relationships of affiliation and non-independent conditions, preventing the equating of normal losses or market fluctuations with tax avoidance. The adjustment effect of related-party transactions stems from the comparable uncontrolled price method and profit pooling. If internal group prices for goods, loan interest rates, service fees, and licensing fees deviate from the comparable uncontrolled price, tax authorities may reassess functions, assets, and risks and transfer profits that should have been generated by local enterprises. The treaty also requires both countries to address the issue of double taxation after adjustments, prompting groups to prepare contemporaneous documentation of pricing and contract execution. The adjustment mechanism for related-party transactions is illustrated in Figure 2.

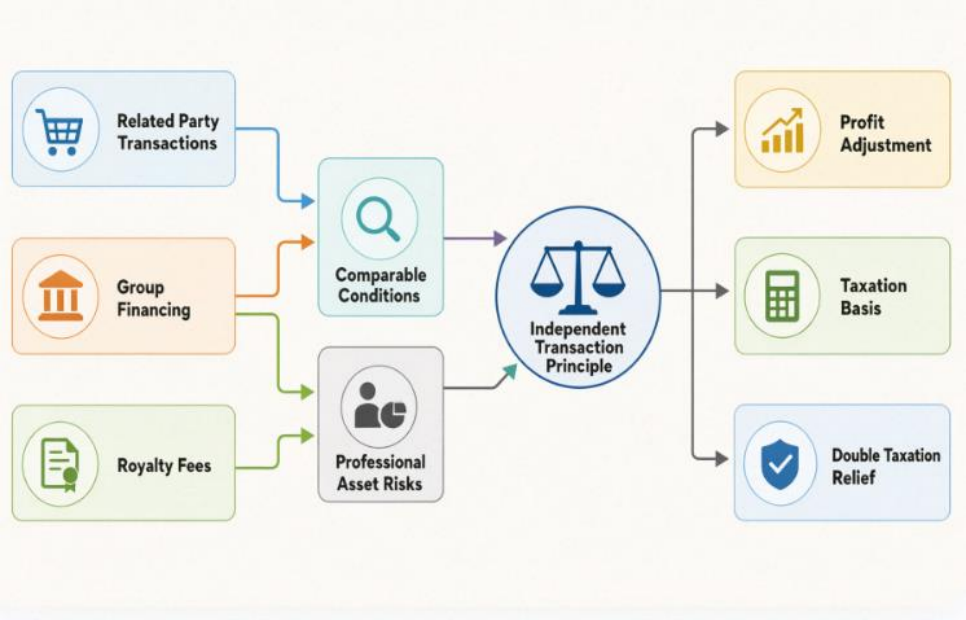


Figure 2: Mechanism for Adjusting Related-Party Transactions

In Figure 2, after related-party sales and purchases, group financing, and licensing fees are subjected to a comparability analysis and a functional asset risk analysis, the arm's-length principle transforms profit adjustments into a tax base and a pathway for relief.

3.4 Tax source identification conditions supported by information exchange clauses

The ultimate controller, source of funds, related party transaction contracts and overseas payment paths of enterprise groups are often located in different countries, and profit transfer governance faces information decentralization constraints. Article 24 of the China-Canada Agreement stipulates that the competent authorities may exchange information necessary for the implementation of the agreement or domestic tax law, and it is clear that such exchanges can be used to prevent fraud or evade relevant taxes. The clause sets both confidentiality obligations and trade secret restrictions, forming a balance between management objectives, availability and confidentiality responsibilities. The inhibition of information exchange on profit transfer does not come directly from the tax rate, but from the increased probability of being verified. If an enterprise relies on overseas related parties to concentrate profits, the tax authorities can request the other party to assist in the confirmation around the beneficiary owner, payment authenticity, related party transaction consideration and actual business functions. The OECD country reporting rules also require large multinational companies to report revenue, profits, taxes and economic activity indicators by tax jurisdiction. After the exchange of agreement information combined with the country report, the abnormal mismatch between profit, personnel, assets and sales is easier to enter the high-level risk identification.

4. The Deterrent Effect of the China-Canada Bilateral Tax Treaty on Profit Shifting

4.1 Agreement terms are the key nodes of profit attribution and risk identification

The primary effect of the terms of the agreement is to extend the judgment of profit attribution from a single transaction price to the dimensions of subject, place, function and information [5]. The permanent establishment confirms when the market country has the right to tax business profits,

the affiliated enterprise clause confirms whether profits can be adjusted under non-independent conditions, and the information exchange clause confirms whether tax authorities can obtain overseas verification data. After the four types of rules are connected, profit transfer must be subject to the cooperation test of the agreement and the competent authority. This node role enhances the pre-positioning of risk identification. When designing the holding structure, purchasing and distribution mode and intangible asset licensing path, enterprises should check the contract signing place, actual management place, market activity place and payment flow in advance. If profits are concentrated in entities with lower tax burdens or less information, and personnel, sales, and assets are mainly distributed within the tax jurisdiction of the other party, the arrangement is more likely to trigger a related party transaction adjustment, a permanent establishment determination, or a beneficial owner review. The agreement shifts the risk of profit transfer to the issue of transaction structure and compliance data preparation.

4.2 Compression of tax base erosion mismatch arrangement space

The erosion of the tax base often occurs based on expense deductions and income attribution. [6] The payment of interest, royalties, service fees or purchase prices by enterprises of market countries to overseas related parties will reduce local taxable profits; overseas entities can obtain income but may lack corresponding personnel, assets or risk-taking. Although the China-Canada Agreement does not directly set all domestic deduction rules, it relies on the terms of operating profit, affiliated enterprises, dividends, interest and royalties, and requires the corresponding taxation rights of income categories, beneficiaries and sources. The more dependent the mismatch arrangement is on the formal contract and the lack of substantive functions, the more difficult it is to maintain under the interpretation of the agreement. The restraining space also comes from the balance between double taxation relief and anti-tax avoidance objectives. The agreement reduces the risk of double taxation for real cross-border operations, which is conducive to the allocation of production, sales and capital between the two countries; nor does the pact protect profit extraction from value creation. Enterprises should use comparable prices, personnel functions and business reasons to explain the profit distribution. Such mechanisms will not negate the market attractiveness of Canada or China, but encourage enterprises to return tax arrangements to the real operating basis.

4.3 Stabilizing tax expectations in cross-border investment

Prior to the establishment of a subsidiary, branch or project company, an enterprise usually estimates the tax burden on dividend repatriation, debt financing, technology licensing and asset withdrawal. [7] The agreement clarifies the treatment of different income categories, which can reduce the concerns of enterprises delaying investment due to repeated taxation, uncertain withholding tax or unclear boundaries of permanent institutions. For enterprises in both countries, certainty itself is a compliance incentive that can promote consistency in contracts, accounting and operating arrangements. Stable expectations do not mean that tax regulation is relaxed, and clear rules make companies identify unacceptable arrangements earlier. The beneficiary owner's review, the business reasons for the group's internal service financing, and the operating existence standards will affect the agreement treatment and profit attribution along different transaction links. Compliance companies get more stable declaration expectations, and arrangements that deviate from substantive operations are more likely to be identified and adjusted.

4.4 Reshaping the profit allocation of intra-group transactions

Intra-group transaction is a common operational level of profit transfer. After the separation of

manufacturing, distribution, R & D, brand, financing and management support, profit allocation should follow functions, assets and risks, rather than only following internal pricing objectives. Article 9 of the China-Canada Agreement provides the basis for the adjustment of non-independent trading conditions, and domestic transfer pricing rules provide comparable analysis, method selection and simultaneous pricing records. After the combination of the two, the enterprise should correspond the internal contract price, execution record, personnel ability and risk control evidence. This reshaping focuses on improving the interpretability of profit allocation. If the Canadian subject undertakes R & D and brand risks, and the Chinese subject undertakes production, distribution or market services, the profit distribution should reflect their respective contributions; the reverse situation should also be dealt with according to the actual functions. For enterprises, the constraints of the agreement have prompted the group to reduce intermediate transactions set up only for tax differences, and to shift post-tax management disputes to pre-pricing, data retention and cross-border communication. Tax authorities can also use the common language of the agreement to reduce the double taxation of the same profit in adjustment and relief.

4.5 To promote tax cooperation between China and Canada and ensure the compliance of enterprises

The long-term effect of the agreement depends on tax cooperation and corporate compliance. Information exchange improves the availability of overseas data, mutual consultation procedures provide communication channels for tax results that do not meet the agreement, and non-discrimination rules require fair treatment for eligible enterprises. The above arrangements form a reciprocal governance structure: the tax authorities of the two countries can share the necessary information within the scope of the law, identify the risk of profit transfer and tax base erosion; enterprises can also rely on complete declaration, simultaneous pricing records and negotiation applications to maintain tax certainty. An objective evaluation of the China-Canada agreement should avoid writing one party's tax system as the opposite of the other. Both China and Canada should balance attracting investment, protecting the tax base and complying with international tax rules. The differences are mainly reflected in the industrial structure, investment direction and collection and management procedures. The value of the agreement is to recognize differences and establish rules that can be communicated. Multinational enterprises ' adherence to compliance management can reduce the cost of internal transaction reconstruction, denial of agreement treatment and cross-border disputes. The profit transfer space is compressed by the three aspects of system, information and commercial essence.

5. Conclusion

The deterrent effect of the China-Canada Bilateral Tax Treaty stems from a combination of rules regarding resident status, permanent establishments, the treatment of associated enterprises, the exchange of information, and mutual agreement procedures. These rules provide the expectation of avoiding double taxation and dispute resolution for real cross-border operations, and also pull the attribution of profits back to personnel functions, asset use, risk-taking and transaction essence. After establishing pre-compliance arrangements around beneficial owner, business presence, associated pricing and record retention, the comprehensive costs of internal transaction reconstruction, agreement treatment denial and cross-border dispute delay are reduced.

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