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Get My Money Back: The VAT Distortion and Related-Party Transactions in China

Abstract

This paper examines how capital constraints arising from challenges in the VAT operational system influence firms' tax compliance behavior. Excess input VAT over output VAT was unrefunded in China before 2018, resulting in a significant financial burden for businesses. Utilizing a National Tax Survey Database, we investigate how firms strategically manage their VAT payments to minimize cash lockup. We find that firms with substantial input VAT credit carryovers (IVCC) increase output credits via related-party sales. This effect is more pronounced for financially constrained firms, particularly when the related parties are subsidiaries of listed firms and can effectively absorb the additional output credits generated by increased purchases from listed firms. We further observe that related-party sales induced by IVCC negatively affect the gross margin of transferee parties, suggesting the involvement of inflated transfer pricing. Following China's implementation of partial refund of IVCC in 2018, related-party sales declined notably across the pilot industries. These findings provide empirical evidence of a mechanism for VAT non-compliance and distortion.

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Dr. Tanya Tang is a Full Professor of Accounting at the Goodman School of Business, Brock University. She obtained a Ph.D. in Accounting from the Australian National University. Dr. Tang's research focuses on tax avoidance, corporate political activities, the impact of accounting standard-setting and tax laws on corporate reporting strategies, and the role government plays in curbing management misbehavior. Dr. Tang's research papers have been published in the *Accounting Review, British Accounting Review, European Accounting Review, Journal of Accounting, Auditing and Finance, Journal of International Accounting Research, The International Journal of Accounting, The Journal of the American Taxation Association*, and others. Her research has been supported by SSHRC of Canada, ASAC, the CPA Research Excellence Center, the CPA International Accounting Center, the CPA Ontario Center for Public Policy and Innovation in Accounting, and other international institutions.

Date: 28 August 2026, Friday

Time: 10:00am - 11:30am

Venue: SEK107

Language: English

For enquiries, please contact 2616-8373 or by email (hkibs@ln.edu.hk).
Due date: 29 August 2026

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