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IMPROVING THE DESTINATION-BASED CASH-FLOW TAX: COMBINING A VALUE-ADDED TAX WITH A WORKER CREDIT

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Abstract

Replacing business income taxes with a destination-based cash-flow tax (DBCFT) would remove existing distortions and profit-shifting incentives. The border adjustments would raise the price of imports and reduce the price of exports, creating trade disequilibrium at existing prices and exchange rates. Under the DBCFT, the natural way to restore equilibrium would be for the dollar to appreciate. This would, however, induce a wealth transfer of about $11 trillion to foreigners who hold dollar-denominated assets. Our proposal would replace the corporate income tax with a border-adjusted value-added tax that applies to all businesses, coupled with credits to workers and to owners of pass-through businesses. This would replicate the benefits of the DBCFT while reducing the transfers to foreigners by roughly $4 trillion. It does so by restoring trade equilibrium through higher nominal prices and wages rather than an appreciated dollar. Relative to the DBCFT and the current system, our proposal would also raise revenue and reduce the ratio of the federal debt to GDP. To reduce foreign wealth transfers further, we describe additional rules that could be implemented at the time of reform. The success of all these tax changes would depend on the extent to which the Federal Reserve Board accommodates the price increase.

I. Introduction

The United States is on an unsustainable fiscal course. After the One Big Beautiful Bill Act of 2025 (OBBBA), which cut federal taxes substantially and permanently, federal debt is projected to rise from about 100% of gross domestic product (GDP) today to 183% by 2054 under current law, and to 233% by 2054 if Congress makes OBBBA's temporary provisions permanent and the effect of higher debt on interest rates is taken into account (Auerbach and Gale 2026). Under either scenario, the ratio continues to rise thereafter, with no natural end in sight. Closing that gap will require both spending restraint and additional revenue.

This paper proposes a business tax reform that reduces deficits and addresses long-standing structural problems in the taxation of business income. The current system distorts the choice between the organizational form of the business, business investment, and the use of debt or equity finance. It taxes income based on where business produce their output rather than where their output is purchased and consumed , which invites firms to shift production and profits to lower-tax countries. Tax preferences and separate rules for different types of businesses narrow the tax base, add complexity, and make tax administration difficult.

The leading proposed solution is the destination-based cash-flow tax (DBCFT) (Auerbach et al. 2017), which shifts the tax base from where a company produces goods to where consumers ultimately buy them. It taxes a firm's sales less its purchases from other businesses, its wages, and its investment, expensed in full. In this system, interest is not deductible. As a result, firm-level taxes no longer distort the decision of whether or how much to invest or how to finance investments. In a destination-based system, the tax applies to imports but not exports, which means that income is taxed where goods are

consumed, removing the incentive to shift production or profits abroad.[1] Finally, if applied to both corporations and pass-through businesses, the DBCFT reduces tax-motivated reasons for preferring one business form to another.

Under the DBCFT, the border adjustment is widely expected to cause the dollar to appreciate in proportion to the tax rate. At the exchange rate that existed before the tax was implemented, imposing a tax on imports and exempting exports would make U.S. goods cheaper relative to foreign goods, raising exports and reducing imports. The natural response would be for the dollar to appreciate to restore the original pattern of trade, which could happen quickly.

But trade neutrality does not imply wealth neutrality. Notably, the dollar's appreciation would raise the value of foreigners' dollar-denominated claims. Foreigners' fixed-dollar claims (for example, Treasury debt or corporate bonds) and their real claims (such as corporate equity and real estate) grow in value when the dollar appreciates.

Accounting for these considerations, we estimate that a conventional DBCFT would give foreign holders of U.S. claims a one-time gain of roughly $11 trillion, about 37% of annual GDP.[2] This is not a tax or a trade adjustment, and it is not recoverable by later policy. A transfer of this magnitude could outweigh the various benefits of a DBCFT, which makes understanding and addressing the transfer a central design question for any destination-based business tax in the United States. Wealth transfer concerns have been noted elsewhere (Bradford 2004; Costinot and Werning 2019; Gale, Looney, and Patel 2026; Joint Economic Committee 2026), but generally as an unavoidable cost of taxing business in this way.

In contrast, our proposal aims to reduce the transfer to foreigners, while still preserving the benefits of the DBCFT. It replaces the corporate income tax with a subtraction-method, border-adjusted value-added tax (VAT) at a baseline rate of 25%, and gives each worker a fully refundable credit equal to the VAT rate times their taxable compensation.[3] Because the DBCFT is identical to a subtraction-method VAT except that it also includes a wage deduction, the principal structural difference between our proposal and the DBCFT is where the wage relief occurs. The DBCFT gives it to firms as a deduction. Our proposal gives it to workers as a credit.

That seemingly small difference has important implications for the wealth transfer to foreigners. The existing corporate tax allows deductions for wages at the firm level, so conversion to a DBCFT, which has the same treatment of wages, need not cause a rise in consumer prices. Instead, the natural result is that the exchange rate appreciates, as noted above. Our goal, however, is to avoid that exchange rate appreciation, and our proposal aims to do that by encouraging a price-level adjustment instead. Generally, a VAT does not allow deductions for wages, so the natural outcome upon conversion to a VAT would be for

[1] For further description of the DBCFT, see https://bipartisanpolicy.org/explainer/what-is-a-border-adjustment-tax-what-is-a-destination-based-cash-flow-tax/.
[2] GDP is measured over the four quarters ending in 2025:Q2 ($29.97 trillion), the date of the foreign-claims data used throughout this analysis.
[3] A subtraction-method VAT imposes burdens on the difference between a firm's total sales over a given period less its purchases from other businesses.

the consumer price level to rise (Freund and Gagnon 2017). The worker credit would then boost workers' wages (or taxable compensation) by the same percentage as the price level rose, giving workers the resources needed to afford the higher prices without changing their consumption.[4]

Unlike the DBCFT, our proposal applies to all businesses, not just corporations. Workers at pass-through businesses receive the same credit, and owners receive a credit for VAT paid on their share of profits, which they continue to report on their individual returns. Pass-through income therefore remains subject to the progressive individual income tax schedule.

These changes reduce but do not eliminate the transfer to foreigners. They would eliminate the transfer for fixed-dollar (that is, nominal) foreign claims. A foreign bondholder would be paid the same dollars and face the same prices at home, so the value of the claim would not change. We estimate that roughly $4 trillion of the $11 trillion total transfer under a DBCFT reflects fixed-dollar claims and can be avoided by creating a price-level adjustment instead of an exchange rate adjustment.

A claim on real U.S. cash flows is different. Repealing the corporate tax raises after-tax profits and share values for all shareholders. For U.S. shareholders, that gain is offset by the new tax burden. For foreign shareholders, who consume outside the VAT base, the increase in share value is a windfall. The same holds for real assets outside the VAT base, such as real property, whose value rises with the price level. Foreign owners of such assets consuming abroad keep that gain. Because real claims gain under either adjustment channel, the remaining $7 trillion transfer arises under both the DBCFT and our proposal.

To reduce the transfer further would require targeted transition rules imposed at the same time as the reform. One example would be to impose a one-time tax on all firms and give a rebate to domestic shareholders of those firms.

Our proposal is therefore a package: a destination-based reform that leads to changes in the price level rather than the exchange rate; a set of transition rules designed to recapture the transfers to foreigners created by repealing the corporate tax; and an application of the reform to all businesses, with owner-level credits that retain the existing progressive individual income tax schedule.

In summary, like the DBCFT, our proposal has several advantages relative to the current system. It would eliminate firm-level tax distortions to the choice of business form, investment, and financing, and to the location of profits and production. It would simplify business taxes. By taxing excess profits rather than the normal return, and by taxing pass-through owners at their individual rates, it would be more progressive.

The proposal also has advantages relative to the DBCFT. First, by facilitating a price-level adjustment rather than an exchange-rate adjustment, it would reduce—and, with appropriate transition rules, shrink more substantially—the transfer of wealth from Americans to foreigners that the DBCFT would create. Second, it would help address the

[4] A 25% tax-exclusive VAT raises the prices of covered goods and services by 25% (if the tax is passed on to consumers, as the evidence suggests), and we assume that the prices of items outside the base, chiefly housing services and most financial services, rise in the same proportion, so that the price level rises by 25%.

U.S. long-term fiscal position, to the extent that the VAT base is broader than the DBCFT's, the one-time price-level increase reduces the real value of outstanding federal debt, and any transition rules would raise additional receipts on a one-time basis.

We offer two caveats. First, our proposal is a tax reform intended to produce a particular nominal transition, not a guarantee about exchange rates or foreign wealth transfers. The success of our proposal in achieving a price-level adjustment and reducing foreign wealth transfers depends crucially on an accommodative monetary policy. The price-level adjustment will only hold if the Federal Reserve (the Fed) allows the one-time increase in the price level to endure. If the Fed instead acts to prevent it, the adjustment would revert toward the exchange rate channel, reviving the transfer of fixed-dollar claims to foreigners that our proposal is designed to avoid. Such an action by the Fed would likely also cause a recession.

Second, under our proposal, there would still be redistribution of wealth, but the transition would occur to a greater extent among domestic agents and would reduce the transfer to foreigners. For example, for fixed-dollar claims—like a fixed-rate mortgage—an increase in the domestic price level erodes the real value of the debt—so creditors are made worse off and debtors are made better off by the same amount.

Section II makes the case for reform. Section III sets out the mechanics of the proposal in a simplified setting in which all firms are corporations. Section IV contrasts the exchange-rate and price-level adjustments. Section V values foreign investors' claims under the old and new bases, compares our proposal with a DBCFT, and sets out the transition rules that would be required to recapture the residual $7 trillion transfer. Section VI applies the proposal to pass-through businesses. Section VII discusses the potential revenue effects. Section VIII concludes, and four appendices follow: background on the inefficiencies of the current system, technical details supporting the construction of the wealth-transfer estimate, a comparison of alternative tax systems, and additional details on the mechanics of the proposal.

II. The case for reform

The current system is inefficient, facilitates avoidance, and is needlessly complex. The DBCFT would address many of these failures. However, the transition to a DBCFT results in a large and costly transfer of wealth from the United States to foreign owners of U.S. assets.

A. Problems with the current system

The current tax system distorts business's choice of organizational form. C corporations are subject to the corporate income tax, while the income of pass-through businesses (sole proprietorships, partnerships, S corporations, and most limited liability companies) is taxed only at the individual level. The two regimes produce different burdens on the same dollar of income. Accounting for all levels of taxation in 2024, Pomerleau (2024) estimates average effective tax rates of 29.3% on C corporation income against 23.7% on pass-

through income that qualifies for the Section 199A deduction[5].

A second issue is that the treatment of investment and financing is inconsistent. Most investment, other than structures, is expensed immediately, which removes tax on the normal return to capital. Interest is also deductible (with some limits), which exempts the return to debt-financed investment a second time. The combination drives effective tax rates on debt-financed equipment well below zero (Gravelle and Keightley 2025).

For multinational firms, the system also facilitates tax avoidance because it taxes business income according to where it is earned rather than where it is consumed. This allows firms to book profits in low-tax jurisdictions through transfer pricing and the manipulation of the location of intangible assets. The resulting revenue losses were about $100 billion a year before 2017, and the research consensus is that the 2017 Tax Cuts and Jobs Act (TCJA) did little to change them (Clausing 2020, 2024; Dharmapala 2024). Tax avoidance has contributed to a long decline in U.S. corporate tax receipts as a share of the economy even as corporate profits have increased.

Finally, the system is needlessly complex, and the tax base is narrowed by numerous tax preferences. Credits, deductions, exclusions, and preferential rates function as spending routed through the tax code. These tax expenditures reduce corporate receipts by roughly 60% of what the tax system collects (PGPF 2026), so that the statutory rate applies to a far smaller base. The Section 199A deduction for pass-through income is a leading example. It is projected to cost $851 billion over the coming decade (OTA 2026a). It is extremely regressive, directing 44% of its benefit to taxpayers earning more than $1 million (JCT 2018). The evidence suggests that it has not raised investment, hiring, or wages. The primary effect, instead, is that firms relabel income to qualify (Goodman et al. 2025). Partnership taxation rules compound these problems. Partnership laws have not been comprehensively reformed since 1954, and the flexibility they allow has made large partnerships opaque enough that even tax administrators struggle to determine who ultimately earns the income (Cooper et al. 2016; Johnson et al. 2024).

B. The destination-based cash-flow tax

The leading proposal to replace the current system is the DBCFT (Auerbach et al. 2017). The DBCFT differs from the corporate income tax along two important dimensions. First, it taxes cash flow rather than income. The tax base is revenues minus purchases from other businesses, wages, and investment. In contrast to a pure income tax, in which long-lived investments are deducted gradually, through depreciation, in a cash-flow tax, investments are deducted in full in the year made. Interest, however, is not deductible. This treatment means the tax falls only on supernormal returns to capital (rents), and not on the normal return itself. An investment that just breaks even bears no net tax burden in present value.

Second, the DBCFT features a border adjustment, which makes the tax "destination-based." This adjustment applies the tax to imports but exempts exports, so that a good is

[5] Section 199A, enacted in the TCJA and made permanent by OBBBA, allows owners of pass-through businesses to deduct up to 20% of their qualified business income, subject to limits for higher-income owners. See Appendix A.6.

taxed according to where it is sold rather than where it is produced. As a result, a good produced in the United States and sold abroad would bear no U.S. business tax, while a good produced abroad and sold in the United States is subject to tax. The border adjustment is what converts the current tax on domestic production into a tax on domestic consumption.

Together, these features address the problems described in the current system. A uniform cash-flow base treats every firm the same regardless of organizational form, and every investment the same regardless of its useful life or how it is financed, which removes the distortions to organizational form, investment, and financing. Because the tax depends on where goods are sold rather than where they are produced, a firm cannot lower its U.S. tax by shifting profits or production abroad, eliminating the incentive behind profit shifting. The DBCFT is also simpler and more progressive than current law.

In practice, the U.S. corporate tax exists as an uneasy hybrid between an income tax and a cash-flow tax. It began as an income tax and has been moved partway toward a cash-flow tax through a series of incremental changes, most recently the 2025 tax law (Gale, Looney, and Patel 2026). Investment is now largely expensed (other than for structures). Interest remains largely deductible. The current tax base is source-based rather than border-adjusted. Recent efforts to reduce business tax expenditures have only been partially successful, and recent legislation increased business tax expenditures and added new ones. A natural next step in the reform of business taxation is to complete the shift to a cash-flow tax.

C. A transfer of wealth abroad

If a DBCFT replaced existing business taxes, and exchange rates initially remained unchanged, goods produced in the United States would become cheaper relative to foreign goods, because exports are exempt and imports would become more expensive. The natural, and quick, response to this disequilibrium would be for the dollar to rise in value, in proportion to the tax rate, until the original pattern of trade is restored. The appreciation is a necessary and expected equilibrium outcome, and most analyses of border-adjusted taxes assume it will occur (Auerbach 2010; Driessen and Keightley 2017; Freund and Gagnon 2017).

That appreciation transfers wealth from the United States to the rest of the world. The United States is the world's largest debtor, and it owes that debt almost entirely in dollars, including Treasury securities and corporate bonds. Likewise, foreign investors own large dollar-denominated claims in equities, real estate, and other U.S. assets. When the dollar appreciates, the value of those claims rises. The United States still owes the same number of dollars, but those dollars now buy more goods and currencies for its international creditors (and, likewise, our dollars purchase fewer foreign goods). The result is a one-time transfer of wealth to foreign investors, set when the reform takes effect, and proportional to the tax rate times the net dollar position of foreign investors. Because foreign investors own trillions of dollars, the magnitude of the transfer is very large. Moreover, unlike purely domestic wealth effects typically considered in the transition to a consumption tax, such as between domestic creditors and borrowers, this wealth transfer makes foreign investors better off at the expense of Americans.

Part of the revaluation accrues to foreigners who hold nominal dollar debt claims. The larger part, however, arises from the equity that foreigners hold in U.S. companies, other direct investments, and real estate. All of these rise in value in the holder's own currency when the dollar appreciates. For corporate equity, the new tax takes about as much of the firm's cash flow as the corporate tax did, so the firm's stock price in dollars is little changed and U.S. owners are largely unaffected. A foreign owner, however, converts the same dollars at stronger exchange rates and gains. For real estate and other assets outside the new tax base, there is no new tax, and the foreign owner keeps the full gain.

The higher the tax rate in a DBCFT, the more the dollar appreciates, and the larger the transfer on fixed-dollar claims and on assets outside the tax base. At a tax rate of 25%, the one-time transfer would be about $11 trillion, or roughly 37% of a year's national output. A cost of this size could easily exceed the efficiency gains of the reform. Whether and how this cost could be reduced is therefore a first-order concern that determines the viability of such a plan. In this paper, we propose an alternative approach to achieving the gains of the DBCFT that reduces the magnitude of the cost. But eliminating the cost would require new and robust transition rules.

III. The proposal in a simplified corporate-only setting

In this section, we describe the basic features of our proposal in a simplified setting. We assume initially that all firms are corporations. We defer issues like individual income taxes on dividends, capital gains, and pass-through businesses until Section VI.

To begin, we define a tax-exclusive rate as the tax divided by the pre-tax price. For example, a 25-cent tax on an item that costs $1 before the tax is a 25% tax-exclusive tax (it is calculated as 25/100, and the denominator excludes the tax). A tax-inclusive tax is defined as the total tax divided by the total cost to the consumer (and so would be calculated as 25/125, with the tax included in the denominator). Note that a 25% tax-exclusive tax corresponds to a 20% tax-inclusive tax. For comparison, though, the current corporate income tax is a 21% tax-inclusive rate, so our corporate rate is slightly lower than the existing corporate rate when both are reported in tax-inclusive forms. Section VII discusses rate issues further.

The proposal has two main components. First, every corporation files a subtraction-method VAT, at a baseline tax-exclusive rate of 25%, in place of the corporate income tax. The VAT raises prices by 25%. Second, each worker receives a fully refundable credit equal to the VAT rate times their taxable compensation, τW. The credit protects workers from the price increase. (Appendix C compares the resulting system with the income tax, the DBCFT, and a standard VAT.)

A. A subtraction-method VAT

As in standard VATs, wages are not deductible, investment is fully expensed in the year it is made, interest (paid or received) is not in the base, imports are taxable, and exports are not. Each C corporation computes its VAT liability as the standard rate times the difference between taxable sales and deductible purchases, with imports taxed and exports excluded. Letting R denote total sales receipts (including exports), P purchases from other

businesses, I real investment, M the imported component embedded in P or I, and X exports, the firm's VAT liability is:

$$T = \tau\,[(R - P - I) + M - X].$$

The mechanics are clearest for a single firm, shown in Table 1. Consider a corporation that produces using only labor, paying $100 in wages and earning no profit. Because wages are not deductible, its VAT base is sales net of purchases and investment, here $100; at τ = 25%, its VAT liability is $25. The firm adds the $25 tax to its price, so output that previously cost $100 now sells for $125 at the register. Of that $125 collected by the firm, $100 is paid in wages, $25 in VAT to the government, and profit is again zero. The tax is paid by the consumer via the price increase.

TABLE 1

One firm, one worker, no profit

Pre-tax value of output (equal to wages)	$100
VAT at 25% (wages not deductible)	$25
Register price paid by the consumer	$125
Less: wages paid to the worker	−$100
Less: VAT remitted to the government	−$25
Firm's net	$0

The $25 the firm remits is τ times the wage bill. Under our proposal that amount is returned to the worker as a credit. Unlike in the current system or the DBCFT, there is no deduction for wages. This treatment of wages is a central design choice in the proposal.

B. A worker credit

Each worker receives a credit equal to τ times their taxable compensation W. The simplest formulation of the credit is that it is paid to workers every payday on top of their paycheck. (This credit could also be administered in different ways as described in Appendix D.) At τ = 25%, a worker earning $100 in wages receives a credit of $25, the same $25 the firm remitted on those wages. The credit is included in the worker's taxable compensation, alongside the wage itself, and applied dollar for dollar against the worker's tax liability, which is otherwise reconciled at tax time through individual filing.

Pre-reform, the worker at that firm earned $100 and faced an average individual tax rate of 20%, leaving $80 to consume. After the VAT, prices rise by 25%. The $25 credit brings the worker's taxable income to $125. Taxed at the same 20% individual rate, the worker owes $25 and is left with $100. At the new, 25% higher price level, the $100 buys exactly the same amount that $80 did before the reform, so worker consumption is unchanged.

C. Revenue relative to a destination-based cash-flow tax

In the simplest setting, where both taxes cover the same businesses and the same base

except for wages, our proposal raises the same revenue as the DBCFT. The only difference is where the wage relief occurs: the DBCFT gives the wage relief to the firm as a deduction, and our proposal gives it to the worker as a credit. Under a DBCFT, the firm deducts wages and remits τ times profit. Under our proposal, the firm remits τ times value added, which equals wages plus profits, and the worker credit returns the tax on wages to workers. In this case, the taxes would raise the same amount of revenue, net of government spending on the wage credit.[6]

In practice, our proposal has a broader base than the DBCFT because the worker credit covers wages and salaries but not fringe benefits, which therefore bear the VAT (Section VI). As a result, it would raise more revenue than a DBCFT, as discussed in Section VII.

IV. The price-level channel versus the exchange-rate channel

Under both our proposal and the DBCFT, international transactions are border-adjusted. Imports are taxed, so that goods consumed in the United States are taxed at the same rate whether they are produced at home or abroad, and exports are exempt from the tax. At the exchange rate and price level existing before the new tax is imposed, border adjustment makes imported goods more expensive relative to domestic consumption and U.S. exports more profitable relative to domestic production. As a result, trade cannot remain in balance at the old prices.

Balance can be restored through one of two nominal adjustments (or a combination of the two). In the *exchange-rate channel*, the dollar appreciates by about the tax rate while the U.S. price level is unchanged. In the *price-level channel*, the U.S. price level rises by about the tax rate while the value of the dollar is unchanged. Both paths restore real trade flows to their pre-reform levels. Their consequences for U.S. wealth are different, however.

For claims fixed in dollars—like a Treasury bond—dollar appreciation raises the value of foreign creditors' holdings, so there is a transfer of wealth out of the country. In contrast, increases in the domestic price level do not generate a transfer out of the country. Instead, they create offsetting domestic effects: reducing the value of claims held by domestic creditors and benefiting U.S. debtors.

For claims on U.S. real cash flows, the price-level and exchange-rate channels have similar wealth effects. Under either channel, foreign owners escape the new tax, because it falls only on consumption in the United States. For domestic owners, the burden of the new tax roughly offsets the gain from repealing the old one.

Under a DBCFT, U.S. prices do not change. If the effective tax rate is unchanged, a firm's after-tax cash flows and share price in dollars are also roughly unchanged, leaving

[6] The same holds once the firm earns a profit. Suppose it buys $50 of inputs from other firms, pays $100 in wages, and earns $50 of profit, so its output sells for $200 before tax. Its VAT base, sales net of the $50 of purchases, is $150, and the tax is $37.50. The worker's credit is unchanged at $25, a quarter of the $100 wage, because the credit tracks wages, not the firm's profit. The government keeps the difference, $12.50, a quarter of the firm's $50 profit, and exactly what a DBCFT would collect by taxing that profit directly.

domestic shareholders unaffected. A foreign shareholder receives the same dollars but converts them to foreign consumption at a more favorable exchange rate. The dollar's appreciation is thus a windfall—and not only to foreign *shareholders*, but to foreign holders of all U.S. dollar assets.

Under our proposal, the exchange rate does not change, but U.S. prices rise, and with them firms' nominal cash flows and share prices. For domestic shareholders, this gain is exactly offset by the new burden of the consumption tax. The tax is collected at the register when spent rather than at the firm when earned. A foreign shareholder, however, gains from the higher nominal cash flows and higher share values, but that gain escapes tax when spent abroad.

The same logic applies to real assets that lie outside the new tax base, such as real property. Under either adjustment channel, foreign owners of those assets benefit, either through the exchange rate appreciation under a DBCFT or the increase in the U.S. price level, which increases their home-country purchasing power. Section IV.A provides examples that work through the arithmetic.

While the intent of our proposal is to allow policymakers to select the price-level adjustment, which adjustment actually occurs also depends on whether the Federal Reserve allows a one-time rise in the price level. Section IV.A shows how either channel restores trade, and how that affects the inherited stock of assets. Section IV.B argues that our implementation makes the price-level channel the path of least resistance, but describes how the Federal Reserve's response affects that outcome.

A. The two channels

Consider two countries, the United States and France, trading a single good, a widget, in dollars and euros. Before the reform a widget sells for one euro abroad and one dollar at home, at a 1:1 exchange rate, with no taxes. A U.S. importer buys a widget in France for one euro, sells the widget at home for one dollar, and breaks even; a U.S. exporter buys a widget from a U.S. producer for one dollar, sells it abroad for one euro, and breaks even.

Now impose a border adjustment—exempting exports and taxing imports. Hold the exchange rate and the price level fixed for a moment, and recall that a 25% tax-exclusive rate is equivalent to a 20% tax-inclusive rate. The importer still pays $1 to buy a widget abroad and still sells it at home for $1 but now owes $0.20 of tax on that sale; the tax leaves it $0.20 short. The exporter is the mirror image: It still buys the widget at home for $1 and sells it abroad for €1. Its export sale is exempt, but it can still deduct the $1 purchase, which already bore VAT, so it receives a $0.20 refund, leaving it $0.20 ahead. Imports fall, exports rise, and trade flows are out of balance. Something must give.

One way to restore balance is for the dollar to appreciate by the same percentage as the tax rate, so that €1 comes to be worth $0.80 rather than $1. At the new rate the importer's input cost falls to $0.80, which with the $0.20 tax brings it back to break-even, and the exporter's euro revenue is now worth $0.80 in dollars, which with the $0.20 refund covers its $1 cost. Both firms break even and trade returns to equilibrium volumes (Table 2). The consumer still pays $1.

TABLE 2

The exchange-rate channel, 20% tax-inclusive VAT (cash flows per widget)

	Unchanged FX (€1 = $1)	Appreciated FX (€1 = $0.80)
Importer		
Import cost	−$1.00	−$0.80
Sale revenue	+$1.00	+$1.00
Tax	−$0.20	−$0.20
Net	**−$0.20 (loss)**	**$0.00 (break-even)**
Exporter		
Domestic purchase cost	−$1.00	−$1.00
Sale revenue	+$1.00	+$0.80
Refund	+$0.20	+$0.20
Net	**+$0.20 (profit)**	**$0.00 (break-even)**

The appreciation, though, is also what transfers wealth abroad. Take a foreigner holding $100 of U.S. Treasury bonds. Before the reform, at €1 = $1, that $100 is worth €100 of French goods. After the dollar appreciates to €1 = $0.80, the same $100 converts to €125. The nominal claim is unchanged, but it now purchases more real resources abroad. Intuitively, in switching to a destination-based system, the United States exempts from tax income earned in the United States and consumed abroad. Foreign owners benefit from that change. The exchange rate appreciation is simply the mechanism that accomplishes that relief.

In the DBCFT, the dollar appreciation applies to all dollar-denominated assets. If, instead, market equilibrium is restored through a change in domestic U.S. prices, that portion of the wealth transfer associated with nominal dollar claims can be avoided.

In particular, the other way for trade flows to balance is for the U.S. price level to rise by the same percentage as the tax rate, with the exchange rate unchanged. In this one-good example the widget is the whole of covered consumption, so its price and the U.S. price level move together. In other words, a widget that sold for $1 now sells for $1.25, the pre-tax base is $1, and the tax is $0.25. The importer's cost is still $1 because the exchange rate has not moved. Its revenue is now $1.25, and the $0.25 tax restores it to $1. Likewise, the exporter's purchase price at home has risen to $1.25, its euro revenue is unchanged at $1, and the $0.25 refund restores it to $1. Again, both firms break even, trade returns to its pre-reform volumes (Table 3), and the exchange rate is unchanged.

TABLE 3

The price-level channel, 25% tax-exclusive VAT (cash flows per widget)

	Unchanged price (P = $1)	Adjusted price (P = $1.25)
Importer		
Import cost	−$1.00	−$1.00
Sale revenue	+$1.00	+$1.25
Tax	−$0.20	−$0.25
Net	**−$0.20 (loss)**	**$0.00 (break-even)**
Exporter		
Domestic purchase cost	−$1.00	−$1.25
Sale revenue	+$1.00	+$1.00
Refund	+$0.20	+$0.25
Net	**+$0.20 (profit)**	**$0.00 (break-even)**

Because the exchange rate has not moved, the value of foreign-held fixed-dollar claims is also unchanged. A foreign owner of a $100 bond still purchases the same quantity of foreign goods in the foreign country as before the reform. In contrast, domestic-owned fixed-dollar claims fall in value. Take an American holding $100 in a bank deposit or a Treasury bond. Before the reform, $100 buys $100 of goods. After domestic prices rise 25%, the same $100 buys only $80 of (pre-reform) goods. However, the creditor's loss is a debtor's gain. Whoever owes that $100 gives up only $80 of goods and services to repay it—the debt has been eroded by the price increase. The largest such debtor of fixed-dollar claims is, of course, the federal government, whose debt (or debt to nominal GDP) would similarly be reduced by the reform.

Foreign-held equity or real assets are different, however, and foreign owners of these assets continue to benefit from the reform whether exchange rates or prices adjust. Consider a U.S. firm owned by a French shareholder. Before the reform, the firm earns $100 of pre-tax profit and pays corporate tax at the current 21% statutory rate, leaving $79.[7] At €1 = $1, the shareholder receives €79.

Now impose a VAT and leave the corporate tax in place. Domestic prices rise 25%. The firm's nominal pre-tax profit rises to $125. The firm pays $25 in VAT, leaving $100, and the corporate tax takes another $21, leaving $79 in post-tax profit. The shareholder again receives €79, since the exchange rate has not moved. In other words, imposing a VAT in isolation does not affect the foreign shareholder.

Now repeal the corporate tax. The $21 previously paid to the government instead accrues to shareholders, who now retain all $100 in income. The value of shares rises proportionately. This gain was not due to the price-level adjustment, but to the repeal of the corporate tax.

Under the exchange rate channel, the outcome for domestic firms is identical. Domestic prices do not move, so pre-tax profit stays at $100. The VAT takes $20, since a 25% tax-exclusive rate is a 20% tax-inclusive rate, leaving $80, and the corporate tax is gone.

[7] The example uses the current statutory rate. Appendix B varies the share of the tax capitalized into share prices, which determines the size of the transfer.

Because the dollar has appreciated by a quarter, $80 converts to €100.

The shareholder ends with €100 worth of consumption either way, increased from €79 in the pre-reform state of the world. The nominal payouts differ: $100 under the domestic price channel and $80 under the exchange rate channel, but the shareholder's purchasing power does not. In other words, the windfall on these corporate claims does not depend on the adjustment channel; it comes from repealing the corporate tax that foreign shareholders had been paying and replacing it with a U.S. consumption tax, which they largely escape by consuming abroad.

B. The role of the Federal Reserve in determining the adjustment channel

The Federal Reserve ultimately decides which adjustment occurs. But what it is actually deciding differs under our implementation as compared to a conventional DBCFT, and the difference relates to where each proposal places the wage subsidy.

Under our implementation, the natural result would be that the price level rises, because firms pass the VAT to consumers. Evidence from countries that have adopted or changed their VAT suggests that the tax passes through to consumer prices almost one-for-one (Freund and Gagnon 2017; Benedek et al. 2020). Firms raise the prices of covered sales by the amount of the tax, and they do so the day the tax takes effect.

The question for the Federal Reserve is whether to look through the increase, letting the one-time price-level rise occur. Looking through such a rise is standard central-bank practice, and it is how the central banks of the United Kingdom, Canada, New Zealand, and Australia have treated the introduction of, or increases in, the national VAT (Nelson 2025). Were the Federal Reserve to tighten instead, the adjustment would have to come through nominal wages rather than prices, which could result in a long, painful recession.

A conventional DBCFT produces no domestic price change. Because it lets firms deduct wages (as do existing taxes on corporations and other businesses), no price-level adjustment would naturally occur when it takes effect. If prices do not move, the trade imbalance created by the border adjustment can equilibrate only through a stronger dollar, which is what creates the transfer of wealth.

Whether the Federal Reserve looks through the price change is a policy choice to be managed. A Treasury and Federal Reserve announcement, made in advance, that the day-one rise will be treated as a one-time increase, with the inflation target applying only to ongoing inflation afterward, would coordinate expectations, preserve the credibility of the Fed, and make the one-time pass-through of the tax the expected outcome. If, instead, the Federal Reserve resists the price increase and some of the adjustment falls on the exchange rate, the wealth transfer on fixed-dollar claims comes back proportionally.

V. Wealth transfers

There are several wealth transfers to consider. If the dollar appreciates, foreign holders of nominal claims gain. If the price level adjusts, U.S. creditors lose in real terms while U.S. debtors gain; foreign holders of nominal claims are unaffected. Under either approach,

foreign owners of real U.S. assets gain, because they escape the new tax, which falls only on consumption in the United States. For owners of corporate equity, the gain is the repealed corporate tax. For real assets outside the new base, such as real estate, the gain arises from the stronger dollar or the higher price level, which escapes tax when consumed in the foreign country.

The magnitudes of these wealth effects make the design question central. Under a conventional DBCFT, the total gain to foreign holders is about $11 trillion. Our proposal, by shifting to a price-level adjustment, reduces the transfers to foreign investors by roughly $4 trillion. Reducing the remaining $7 trillion foreign windfall associated with real claims would require additional transition rules.

This section describes these magnitudes using data from the U.S. balance sheet, estimates their values under the old and the new tax base, and describes potential transition rules that might reduce the transfers further.

A. What foreign owners actually hold, and in what form

Foreign claims on the United States totaled roughly $61 trillion, according to the Bureau of Economic Analysis's (BEA's) International Investment Position (IIP).[8] Roughly half of that is contractual dollar debt in the form of U.S. Treasury securities other than Treasury inflation-protected securities (TIPS), corporate and agency bonds, bank deposits, loans, and holdings of money-market and bond funds. Most of the rest is equity and direct investment (BEA records foreign-owned real estate held for profit direct investment). These are also real claims on U.S. cash flows.

Sorting claims into these two groups is challenging because the IIP groups foreign holdings by the form the investment takes: direct investment, where a foreign owner holds at least a 10% stake in a U.S. business; portfolio investment, meaning holdings of U.S. stocks and bonds; and other investment, which is mostly bank deposits, loans, and trade credit. In some cases, those categories mix fixed-dollar claims and equity claims. Moreover, some claims would not be affected by the reform at all, including foreign-currency debt of U.S. issuers, the foreign operating value of U.S. equity, and financial derivatives.

Of the $61 trillion in total foreign claims, we estimate that roughly $6.6 trillion would not be revalued by the reform because it is composed of foreign-currency debt of U.S. issuers and the part of U.S. multinationals' equity value that comes from their foreign operations. Another $2.2 trillion is financial derivatives, whose revaluation we do not estimate because BEA reports them at gross market value without describing their currency or underlying exposure. An additional $800 billion is indexed to the price level and so gains under either channel. The remaining $51 trillion is split roughly evenly between fixed-dollar exposure (roughly $25 trillion) and real claims on U.S. cash flows (roughly $27 trillion). This breakdown is reported in Table 4, with a more detailed crosswalk from the IIP tables shown in Appendix B.

[8] All figures in this section are drawn from the BEA International Investment Position in Q2 of 2025, the most recent Treasury International Capital benchmark date. Treasury International Capital benchmark surveys are what BEA uses to establish who actually holds U.S. securities; positions in intervening quarters are extrapolated from them. Figures reflect BEA's annual revision of June 24, 2026.

TABLE 4

Foreign claims on the United States, by exposure to the reform, 2025:Q2

	$ trillions
Fixed-dollar exposure	24.8
Real U.S. exposure	26.6
Indexed claims, which gain under either channel	0.8
No U.S. exposure	6.6
Financial derivatives	2.2
Total foreign claims on the United States	**61.0**

Notes: Fixed-dollar claims gain to a foreign holder only under exchange-rate appreciation; real claims gain under either channel. Indexed claims are TIPS, whose principal follows the consumer price index. Claims with no U.S. exposure are foreign-currency debt of U.S. issuers and the foreign operating value of U.S. equity. We exclude financial derivatives from our analysis because BEA reports them at gross market value without specifying their currency denomination or underlying exposure. Appendix Table B1 provides additional detail on how these categories are constructed.
Source: BEA International Investment Position, release of June 24, 2026.

With regard to the estimates in Table 4, two additional caveats should be kept in mind. The first relates to debt owed by U.S. firms themselves. What matters for the wealth transfer involving fixed-dollar claims is the foreign owner's *net* level of fixed-dollar claims, not the gross level. To see why, note that a foreign shareholder in a leveraged U.S. company gains when increases in domestic prices erode the real value of that company's borrowing, even though a U.S. creditor may hold the bond.

The second relates to ownership itself. BEA records the immediate counterparty rather than the ultimate owner. Our estimates treat every claim that BEA records as foreign-held as belonging to a foreigner. However, some offshore claims, like assets held in tax havens, are ultimately owned by U.S. residents (Zucman 2013; Coppola, Maggiori, Neiman, and Schreger 2021). For those claims, the gains accrue to Americans, so our figures overstate the transfer abroad.

B. The transfer under each adjustment channel

A foreign holder of a claim fixed in dollars gains 25% when the dollar appreciates, and nothing when domestic prices rise instead. Applied to the $24.8 trillion of fixed-dollar exposure, that implies a $6.2 trillion wealth transfer under the DBCFT.

That figure, however, is based on gross claims. Americans also hold $9.2 trillion of dollar-denominated claims on foreigners, and appreciation works in their favor: The foreign debtor now owes more in real terms. That is a $2.3 trillion gain to U.S. holders, offsetting part of the loss. Netting the two, the choice of adjustment channel implies roughly $15.6 trillion of net fixed-dollar exposure, and a wealth transfer of $3.9 trillion that can be avoided under our proposal.

Claims on U.S. cash flows work differently. It helps to think of the reform in two steps. Step one: Impose the new tax. Under a DBCFT, the tax lowers the firm's after-tax cash flows and

share price in dollars, burdening both domestic and foreign owners. But the dollar appreciates by exactly enough to restore the purchasing power of foreign owners consuming abroad. Under our proposal, the tax raises U.S. prices, the firm's nominal cash flows rise with them, but its after-tax cash flows and share price in dollars are unchanged. U.S. consumers are burdened by the tax, but foreign owners are not. Hence, either way, a domestic shareholder bears the tax through a lower share price under a DBCFT, or through higher prices under our proposal. A foreign shareholder consuming abroad, however, bears neither and is no better or worse off.

Step two: Repeal the corporate tax. The repeal raises after-tax cash flows and share values for all shareholders. For a domestic shareholder, the gain offsets the burden of the new tax (exactly when the rates are the same). However, foreign shareholders avoid the new tax, and the gain is a pure windfall.

Note that for real assets outside the new base, the first step alone also produces a gain. Both a stronger dollar and a higher price level raise the value of those assets to a foreign owner in their home currency, and there is no new tax to offset it. Both gains occur whether the adjustment runs through the exchange rate or through prices.

TABLE 5

One-time gain to foreign holders under each channel, 2025:Q2

	Exposure ($T)	DBCFT ($T)	Our proposal ($T)
Claims fixed in dollars, foreign-held	24.8	6.2	—
less U.S.-held dollar claims abroad	-9.2	-2.3	—
Net fixed-dollar position	**15.6**	**3.9**	—
Real claims on U.S. cash flows	26.6	7.1	7.1
Indexed claims	0.8	0.2	0.2
Total	**43.1**	**11.2**	**7.3**
Difference		**3.9**	

Notes: Exposure is from Table 4; claims with no U.S. exposure are excluded. U.S.-held dollar claims abroad are BEA Table 4.1 line 2; they gain when the dollar appreciates, so they offset part of the loss to foreign holders. Real claims are assigned the forgiven corporate tax, t/(1-t) at a 21% rate, whichever price adjusts. For corporate equity, the revaluation of the firm's cash flows offsets the new levy under either channel, leaving the forgiven tax; real assets outside the new base retain the revaluation instead. Some further adjustments cannot be read off the balance sheet and are not shown. Two addjustments narrow the difference: leverage inside U.S. firms, which raises the transfer under our proposal, and claims recorded as foreign that are economically U.S.-owned, which lower the transfer under both our proposal and the DBCFT. One adjustment widens the difference: The comparison assumes both taxes cover the same assets. Foreign owners of assets that our VAT taxes but a corporate DBCFT does not, such as noncorporate businesses, would gain under a DBCFT but not under our proposal. Additional details are provided in Appendix B.

Table 5 compares the wealth transfer to foreign holders under a DBCFT and our proposal. The $26.6 trillion of real claims gain under both proposals; for corporate equity, the gain is the forgiven corporate tax. For a corporate tax rate τ_c, that forgiveness is measured as $\tau_c/(1-\tau_c)$ under the assumption that the corporate tax is fully capitalized into existing

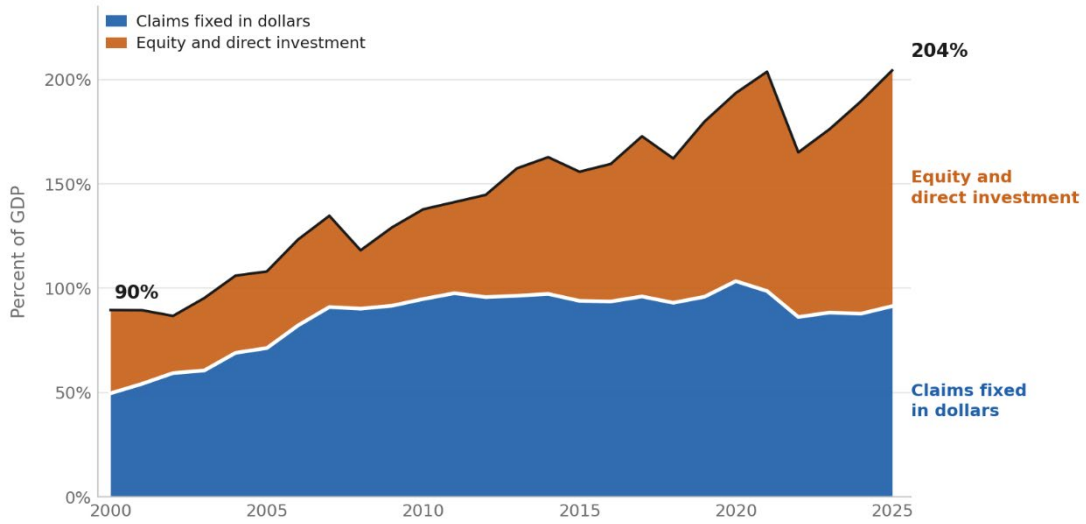
share values. The current 21% corporate rate, therefore, implies gains of 26.6% that cannot be avoided, or $7.1 trillion in wealth transfer.[9] The remaining $800 billion in indexed claims implies a $200 billion gain, for a total wealth transfer under our proposal of $7.3 trillion compared with $11.2 trillion under a DBCFT.

Across roughly 135 million U.S. households, that amounts to roughly $83,000 each under a DBCFT and about $54,000 under ours. As a share of the economy, the two are 37% and 24% of annual GDP.

Over the past quarter century, foreign claims have grown substantially relative to the U.S. economy, rising from 90% of annual GDP to just over 200%. Claims in fixed dollars have been roughly flat as a share of the economy since 2011; equity and direct investment have more than doubled and are now the larger of the two. This underscores the importance of robust transition rules to recapture this wealth transfer back into the base.

FIGURE 1

Foreign claims on the United States by type, as a share of GDP, 2000–2025



Notes: Claims fixed in dollars are direct-investment debt, portfolio debt securities, and other investment; equity and direct investment are direct-investment equity plus portfolio equity and fund shares. Financial derivatives are excluded. Categories are as reported and are not adjusted to the exposure classes in Table 4. The final observation reflects year-end 2025, two quarters beyond the IIP statistics reported in Tables 4 and 5. Source: BEA International Investment Position (IIP) Table 1.2 and National Income and Product Accounts (NIPA) Table 1.1.5.

C. Recapturing the wealth transfer through transition rules

Rules to recapture the equity-based wealth transfer have to be enacted with the reform rather than added later. To be effective, there would need to be a one-time charge on the inherited stock of foreign claims. Once the reform is announced, share values will adjust to account for the wealth transfer, and foreign holders can sell at the higher prices. A rule that

[9] The 26.6% figure assumes the corporate tax is fully capitalized into existing share values, and is therefore an upper bound. If, for example, 60% were capitalized, the transfer on real claims would be $3.8 trillion rather than $7.1 trillion, and the total wealth transfer under our proposal would be $4 trillion rather than $7.3 trillion.

is enacted or implemented after the fact will instead apply to whoever happens to own the asset at that time, who would not be the actual beneficiary of the windfall.

One rule that could recapture the wealth transfer would be a one-time tax on the firm, paired with a refundable credit for resident shareholders. The base of the tax could be accumulated earnings as of the announcement date, which corporations already compute. U.S. shareholders would recover their share of the tax through a tax credit, whereas foreign shareholders would not. This aligns the tax with the windfall gain that would otherwise accrue to foreign shareholders. A tax applied to the firm may also be more consistent with existing treaties, which typically limit what the U.S. may withhold from a foreign investor but impose fewer constraints on how the U.S. may tax a U.S. corporation.

Raising withholding on dividends and buybacks paid to foreign shareholders by 5 to 10 percentage points could also collect additional revenue using systems that already exist. A limitation is that such withholding taxes only profits that are distributed to shareholders; retained earnings and capital gains would still escape tax. Foreign-owned real property could be taxed by assigning liability at the reform date and collecting the tax when the property is sold. Existing law already does something similar by requiring the buyer to withhold a share of the price at closing when the seller is foreign.

In addition, what's included in the tax base is a matter of policy design, and policymakers have more direct control over this portion of the wealth transfer. Take a foreign-owned apartment building. If the rents are outside the VAT base, the reform that raises the price level, including rents, increases the value of the building. A U.S. owner surrenders that gain through the VAT when the proceeds are spent on taxable consumption, but a foreign owner does not. Standard VATs exclude residential rent, the imputed services of owner-occupied housing, and financial services. Each exclusion creates a one-time wealth transfer to owners of those assets at the time a VAT is created (or increased), and part of each transfer goes to foreign owners. Policymakers can shrink this portion of the transfer by bringing these items into the base or by applying a transition rule, such as the one for real property described above, to foreign-owned assets whose returns the base excludes.

Exclusions that result in windfalls to foreign owners are a national loss, which makes the stakes different from the usual transition debate, which focuses on reallocation among domestic agents. Recapturing or reducing these windfalls is thus a first-order problem. No single instrument or transition rule can recapture all of the foreign wealth transfer that would otherwise occur in a significant reform like this. While many of the administrative pieces exist separately under current law, including the 2017 transition tax, which assessed a one-time entity-level charge on the stock of unrepatriated earnings, the widespread application of such rules is likely without precedent. With trillions of dollars at stake, however, the transition rules would need to be an essential pillar of the reform.

D. The domestic revaluation of nominal claims

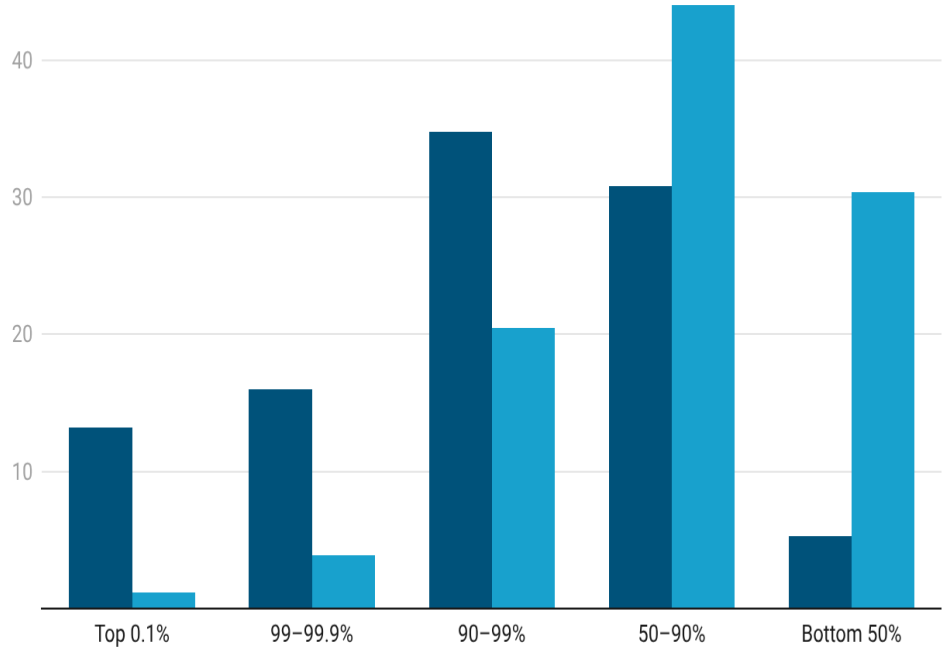
Under our implementation the price level rises. Covered goods and services rise by 25%. To maintain equilibrium, the prices of items outside the tax base, such as rents, must rise as well. We assume that all consumer prices rise by 25%.

This causes wealth transfers within the U.S. that are a familiar consequence of

consumption taxes. U.S. Treasury and corporate bonds, bank deposits, certificates of deposit, and cash savings all fall in real terms. Correspondingly, mortgages, auto loans, credit-card balances, and student loans are easier for borrowers to repay. This is a transfer of wealth, but among Americans. Every dollar of real wealth lost by a creditor is a gain to a debtor. The incidence of this transfer is broadly progressive. Nominal financial wealth is concentrated at the top of the distribution. Nominal debt is concentrated in the middle, where households are more often net nominal debtors because they owe mortgages and other household debt (Figure 2). The price-level rise therefore moves wealth from the top of the distribution toward the middle.

FIGURE 2

Shares of total assets and liabilities by wealth percentile



Source: Federal Reserve, Distributional Financial Accounts, 2025:Q4.

Certain groups, like retirees living on fixed nominal pensions without cost-of-living adjustments, would bear the burden of the tax, and thus would be a salient group who would otherwise lose from the reform.

One important beneficiary would be the federal fiscal position. The federal government is among the largest dollar debtors. Debt held by the public stands near 101% of GDP. This debt is overwhelmingly nominal and dollar-denominated (other than TIPS). A 20% real erosion in its value is a one-time improvement in the federal fiscal position of roughly 20% of GDP, or about $6 trillion at current GDP. This erosion does not appear in conventional revenue scoring. However, it would result in a real reduction in the accumulated debt burden as a share of nominal GDP, making it easier to finance that debt for the same reasons that households would have an easier time paying their mortgages with higher nominal incomes.

This is the efficiency case that consumption-tax transition theory has made for three decades. A one-time revaluation of existing nominal wealth is a lump-sum tax on wealth already accumulated. It cannot distort behavior, because the behavior that produced the wealth has already happened (Auerbach 1996; Bradford 1996).

In the DBCFT, exchange-rate adjustment sidesteps any changes in domestic prices, and therefore forgoes this levy on domestic nominal claims. Instead of a domestic transfer of wealth, the transfer is from U.S. to foreign creditors. Implementing the reform via the price-level channel avoids that transfer and distributes it progressively. Which of the two occurs is ultimately set by the implementation of the reform by the Federal Reserve rather than by the underlying tax design.

VI. Completing the proposal: Pass-through businesses and shareholder taxes

The analysis above focused on corporations. Pass-through income, however, is taxed on the owner's individual return, where tax liability is determined by the progressive rate schedule. This section describes how pass-through business income, capital gains, and dividends remain subject to individual-level taxes.

A. Crediting the owner's share of a pass-through

For a pass-through business, the 25% VAT on the owner's share of income is similar to withholding and is passed on as a credit (alongside the reported income) to the owner's individual return at filing. To make this operational, we would extend a refundable credit for the owner's share of value added that is analogous to the worker's credit for wages.

Step 1: Decompose the base. A firm's VAT base splits into three parts,

$$B = W + F + \Pi,$$

where W is workers' creditable compensation, F is non-creditable compensation (such as excluded fringe benefits), and Π is the owner's share of value added. Section III did not need this split because tax was collected entirely at the firm. Pass-through income is instead allocated to owners and taxed on their individual income tax returns, so we must identify Π and route it back out as an owner-level credit.[10]

Leaving F outside the worker credit is a deliberate choice that expands the tax base relative to current law and proposed DBCFTs. The worker credit covers wages and salaries, not fringe benefits, so employer-provided health insurance and retirement contributions bear the VAT. Those benefits are excluded from the corporate income tax today, so taxing them under the VAT broadens the base.

Step 2: Define the credit. The firm remits τB in taxes in the usual way. Its employees

[10] Π here is the expanded business base, which differs from current-law K-1 or Schedule C/F net income, because the base denies interest deductions and eliminates most current-law preferences.

receive wage credits of τW. Its owners receive deemed business-withholding credits of $\tau\Pi$, allocated through K-1 reporting for partnerships and S corporations and reported directly for sole proprietorships. At filing, each owner includes their share of Π as income and claims a credit equal to τ times that share. Owners whose liability exceeds the credit pay the difference. Those whose credit exceeds their liability receive a refund.

The result of this reform is a tax very similar to the DBCFT, with progressive treatment of the owner's income. The difference in our proposal is the expansion of the base to include fringe benefits. Net of both credits, the firm-level tax is

$$\tau B - \tau W - \tau\Pi = \tau F.$$

The firm remits τ on its entire base, but the credit returns the tax on wages and on the owner's share, so only the tax on fringe benefits F , stays at the flat τ . Wages and owner's share are instead taxed on individual returns, at each person's own rate under the progressive schedule. That is how the reform preserves the progressivity of current law while broadening the base to include fringe benefits.

B. An example

An example shows why the $\tau\Pi$ credit matters (Table 6). Consider an owner with $1 million of pass-through business income, and enough other income to face the top 37% tax rate on all of their pass-through income. Pre-reform, the owner reports the $1 million and pays $370,000 in federal income tax. The effective rate on Π is 37%.

Apply the Section III proposal without the $\tau\Pi$ credit, and the firm remits $250,000 on the $1 million of value added, with no individual reconciliation—the owner does not report the income on their individual income tax return. The effective rate on Π falls to 25%, 12 percentage points below the pre-reform rate.

Add the $\tau\Pi$ credit, and the firm still remits $250,000, but the owner now reports the $1 million, owes $370,000 for taxes on pass-through income under the individual income tax schedule, and credits the $250,000 against it, leaving $120,000 due at the individual level. Firm and owner together pay $370,000—an effective rate of 37%, matching the pre-reform amount.

TABLE 6

Federal tax on $1 million of pass-through business income under three regimes: The pre-reform baseline, the reform without the τΠ credit, and the reform with it

	Pre-reform baseline	Reform without τΠ	Reform with τΠ
Firm-level federal tax	$0	$250,000	$250,000
Individual-level taxable base	$1,000,000	—	$1,000,000
Federal income tax (37%)	$370,000	$0	$370,000
Less: τΠ credit	—	—	–$250,000
Net individual-level tax	$370,000	$0	$120,000
Total firm + owner	**$370,000**	**$250,000**	**$370,000**
Effective rate on Π	**37.0%**	**25.0%**	**37.0%**

Notes: The owner is in the top federal bracket. State taxes, payroll details, and the Section 199A deduction are set aside; the proposal eliminates Section 199A as part of firm-level equalization. The middle column shows the accidental rate cut the unreconciled mechanism would deliver; the right column shows the progressive rate preserved.

C. Effective tax rates and the dividend question

Every business would file the same VAT on the same base, reducing one source of complexity. The Section 199A deduction would serve no purpose and would be repealed. Firm-level tax reasons for choosing one entity form over another would be reduced. Remaining partnership and S corporation rules, such as for allocation, basis, loss limitation, and K-1 reporting, would be simplified. However, different business forms would still be treated differently at the shareholder level.

For pass-throughs, the owner credit integrates the firm-level VAT with the owner's individual income tax rate schedule. For C corporations, distributions are still subject to the dividend tax, and gains on stock are still subject to the capital gains tax.

That means that the firm-level rate is zero on normal returns, for both business forms. In a subtraction-method VAT with full expensing, no interest deduction, and symmetric loss treatment, the deduction for investment offsets the tax on the returns in present value. The marginal effective rate at the firm level on a normal-return investment is therefore zero, both for C corporations and pass-throughs. Excess returns still bear tax.

For pass-throughs, the combined firm-plus-owner rate is also zero for investments that earn the normal return.

For C corporations, the shareholder taxes remain. At the firm level, the effective marginal tax rate on normal returns is zero, but distributions are still taxed. Dividends and capital gains are taxed at a top federal rate of 20%, plus the 3.8% net investment income tax, for a top rate of 23.8%. Other things equal, retaining this system would impose higher shareholder-level taxes on C corporations than pass-throughs.

There are three basic options for how to treat this tax difference arising from differential treatment of dividends and capital gains. Our treatment is to leave the dividend and capital-gains taxes as they are and accept the gap. Equalizing firm-level treatment of investment, debt, and international transactions is a substantial improvement on its own. The incremental shareholder-level tax applies mainly on inframarginal returns and on equity-financed marginal investment, so its distortion is at least limited. An alternative reform would require far more individual-side changes that are beyond the scope of our analysis.

An alternative proposal is to extend equalization to shareholders. Eliminating this gap would require dividend imputation, pro-rata shareholder allocation, or a comprehensive business income tax. These ideas are well developed in the tax reform literature. However, these additional reforms would require coordinated changes to capital-gains rules, stock basis, and the treatment of foreign shareholders.

Another alternative is to extend C corporation treatment to all businesses and all business distributions. This approach would also rationalize and equalize the treatment of business income, but would also involve important tradeoffs. As long as people earn business income without incorporating, the system would still need rules for unincorporated income.

VII. Revenue

The reform replaces the corporate income tax with a broad-based VAT plus worker and owner credits; pass-through owners continue to pay individual income tax on their business income. This section estimates the revenue effects of the reform. The estimate is static and for a single year, and is meant to establish the magnitude of revenue in play. The estimate uses 2024 data and the broad consumption base from which VAT estimates conventionally start.[11] We approximate 10-year effects by applying the 2024 estimate, as a share of GDP, to CBO's projected GDP for 2027 through 2036.

A. The core swap: A VAT for the corporate income tax

The intended tax base is aggregate personal consumption, less the items a VAT cannot practically tax, such as imputed housing services and government health spending.[12] For 2024 the proposed tax base is about $15 trillion or roughly half of GDP. At the 25% rate, the gross VAT on that base is about $3.8 trillion.

In our proposal, the firm-level VAT is an up-front collection device. Most of the revenue is routed back to workers and firm owners through credits. About $2.4 trillion goes to workers as a worker credit (τW) and about $700 billion to pass-through owners through the deemed business-withholding credit ($\tau \Pi$). Each of these credits is then reconciled at tax time on

[11] The base is defined following Gale (2020) without the small-business carve-out, updated to the 2024 NIPA data.

[12] Most VATs exempt financial services because their value added is hard to measure. Our estimates include financial services for simplicity. An alternative tax base could exclude financial services from the VAT but continue taxing them under a corporate tax. Removing financial services from the VAT base would lower revenue, but that revenue would be mostly offset because financial-sector wages would be removed from the worker credit and the corporate income tax would remain in place on financial firms. On net, these changes would reduce net revenue only modestly (Gale, Looney, and Patel 2026).

individual tax returns using the unchanged progressive income tax schedule. Federal income tax paid on the tax credits themselves raises roughly $300 billion in additional revenue. On net, total federal revenue increases by about $1 trillion.

The reform replaces the corporate income tax, which raised about $540 billion in 2024. Net of repeal, the VAT reform raises about $470 billion a year, about 1.6% of GDP, or about $6.4 trillion over 2027-2036, on a static basis (Table 7).

TABLE 7

Illustrative single-year revenue from replacing the corporate income tax with the VAT, 2024, at a 25% tax-exclusive rate

Item	$B (2024)	% GDP
VAT base (broad consumption base)	15,039	51.3%
Gross VAT (τ = 0.25 × base)	3,760	12.8%
Less: worker credit (τW)	−2,369	−8.1%
Less: deemed credit to pass-through owners (τΠ)	−685	−2.3%
Plus: income tax on the taxable credits	+299	1.0%
Net federal collections	**1,005**	**3.4%**
Less: corporate income tax replaced	−536	−1.8%
Net new revenue (VAT less corporate tax)	**+469**	**+1.6%**

Notes: The base follows the consumption-side construction of Gale (2020), updated to the 2024 vintage. Credits are netted at the aggregate. Shares of GDP use 2024 GDP of $29.3 trillion (BEA NIPA Table 1.1.5)

B. Smaller offsetting items

Our reform also makes several other small, offsetting changes. We eliminate about $80 billion in tariff revenue, which the border adjustment makes redundant. We repeal the Section 199A pass-through deduction, saving about $75 billion. We cut several other narrow business tax expenditures, raising $20 billion a year. These changes roughly cancel.

C. The price-level offset

A VAT raises consumer prices by 25%. Federal programs indexed to consumer prices, including Social Security, Supplemental Security Income, the Supplemental Nutrition Assistance Program, and federal civilian pensions, will automatically pay out more. That increase in outlays offsets part of the gross revenue gain. Following Gale (2020), we estimate that the increase in outlays equals about 14% of the gross VAT, or roughly $525 billion a year.

It is traditional to include this offset in the official scoring of consumption taxes. However, the price-level rise that increases indexed spending also cuts the real value of the federal debt by roughly $6 trillion. Typically, this effect is not incorporated into revenue estimates of tax proposals. Our approach is simply to report each of the components separately.

VIII. Conclusion

The current business income tax distorts firms' organization, investment, and financing. Moreover, because it taxes income where firms produce rather than where they sell, it

invites multinationals to shift profits abroad. A DBCFT would address these problems. Taxing cash flow reduces the distortions across form, asset, and financing. The border adjustment turns a tax on production into a tax on consumption that removes the incentive to shift profits. The one serious drawback is that, implemented the usual way, the border adjustment would likely result in exchange rate appreciation, resulting in a large one-time transfer to foreign holders of dollar claims.

This paper proposes a plan to achieve the tax base and economic benefits of the DBCFT that reduces the transfer to foreign asset owners. We replace all income taxes on corporations with a single border-adjusted, subtraction-method VAT, paired with credits that return to workers and pass-through owners the tax on their portion of value added. The proposal is a DBCFT with some important twists. First, the subsidy to wages is delivered directly to workers via a credit in our proposal, rather than provided to the firm as a deduction, as in the DBCFT. Second, pass-through owners receive a refundable credit for their share of value added and continue to be taxed under the individual income tax. Third, the proposal expands the tax base to include fringe benefits, raising revenue. Transition rules enacted with the reform could further reduce foreign wealth transfers.

Changing the tax system from a source-based tax to a destination-based tax—going from taxing where income is earned to where it is consumed—would necessitate significant changes to the relative prices of domestic versus foreign goods. Under a DBCFT that adjustment is expected to occur through the exchange rate. The dollar appreciates by the tax rate. In doing so, however, the dollar claims foreigners hold become more valuable, producing a one-time transfer abroad about $11 trillion. In our proposal, the intent is to achieve the necessary relative price adjustment through an increase in the domestic price level. A direct benefit of that change would be to limit the wealth transfer to real claims and to avoid the roughly $3.9 trillion transfer associated with fixed-dollar claims that would otherwise occur. That outcome depends on the Federal Reserve allowing a one-time rise in the price level; if it resists, the adjustment shifts back toward the exchange rate.

To an extent, some portion of the remaining windfall could be recouped with transition rules. In our proposal, repealing the corporate tax raises after-tax profits and share values for all shareholders. For U.S. shareholders, that gain exactly offsets the new tax burden. For foreign shareholders, who consume outside the VAT base, the increase in share value is a windfall. Likewise, the value of real assets outside the VAT base, such as real property, would rise with the price level. Rules that recapture these windfall gains from foreign shareholders could limit that transfer. Whether the reform is worth adopting likely depends on whether these rules can be made to work.

Beyond the direct improvements to the tax system, the domestic revaluation created by price-level adjustments has its own merits. A one-time revaluation of existing nominal wealth is a lump-sum tax on wealth already accumulated. It cannot distort behavior, because the behavior that produced the wealth has already occurred (Auerbach 1996; Bradford 1996). Moreover, the change moves real wealth from creditors at the top of the distribution toward debtors in the middle. And it erodes roughly $6 trillion of the real value of the federal debt. Finally, we estimate that the proposal could collect about $470 billion a year more than the corporate income tax it replaces.

Appendix A: Issues in the current taxation of business income

The ideal business tax would raise substantial amounts of revenue, in a progressive and simple manner, without distorting economic choices (except in the presence of externalities like the economy-wide benefit of a firm's innovative investments). The current system of U.S. business taxation falls short on all scores.

1. Background

The U.S. business sector is characterized by a fundamental distinction between C corporations, which are subject to the corporate income tax, and pass-through entities, whose income is taxed only at the individual level. Pass-through businesses include sole proprietorships, partnerships, S corporations, and most limited liability companies (LLCs).

Krupkin and Looney (2017) and Kopczuk and Zwick (2020) provide data on U.S. businesses. Pass-throughs dominate the U.S. business landscape in terms of the number of firms. Roughly 95% of U.S. businesses are organized as pass-through entities. Within the pass-through category, sole proprietorships are the most numerous, accounting for a large share of all businesses, followed by partnerships and S corporations. Sole proprietorships tend to be small. Partnerships and S corporations, in contrast, include many large and complex firms. Legal form is therefore not a reliable proxy for firm size.

Pass-through entities now generate more than half of total U.S. business income, a dramatic increase from roughly 20% to 25% in 1980. This shift reflects a long-running trend driven in part by tax reforms (notably the Tax Reform Act of 1986) and the relative tax advantages of pass-through form. Within pass-throughs, there has also been a shift in the composition of income away from sole proprietorships and toward partnerships and S corporations. Partnerships, in particular, now play an outsized role in sectors such as finance and real estate.

Finally, an important feature of the U.S. business sector is the concentration of pass-through income among higher-income households. A large majority of pass-through income accrues to taxpayers in the upper part of the income distribution, with 62% going to those with incomes greater than $250,000 and 32% to those with income greater than $1 million as of 2011 (Keightley 2017).[13] This concentration reflects both the role of pass-through entities in professional services and investment activities and the increasing importance of large, high-income partnerships and S corporations. For more information, see Smith et al. (2019).

2. Parallel tax systems and effects on organizational form

As noted, there are two separate regimes for business taxation in the United States. The income of pass-through businesses is attributed to the individual owners and taxed under the individual income tax. The income of corporations is taxed under a separate corporate income tax, with any payments of dividends or sales of stocks with capital gains taxed

[13] Consumer prices have risen by about 43% from 2011 to 2025 (U.S. Bureau of Labor Statistics n.d.).

under the individual income tax as well.

As a result, taxes can play an important role in a firm's choice between organizing as a pass-through entity or as a C corporation. Empirical research shows that changes in relative tax rates lead to small but measurable changes in organizational form, with firms reclassifying into pass-through form in response to reforms that reduced taxes on pass-throughs relative to corporations (Gordon and MacKie-Mason 1994, 1997; Goolsbee 1998; Tazhitdinova 2020).

Pomerleau (2024) estimates that the average effective tax rate is approximately 29.3% on C corporation income but only 23.7% on pass-through income benefiting from the Section 199A deduction—a 5.6 percentage-point advantage for pass-throughs. Differences in the marginal effective tax rate on new investment run the same way: 22.1% for C corporations versus 17.7% for pass-throughs that qualify for the Section 199A deduction, which is described below.

Thus, even if firms' choice of organizational form were not affected at all by taxes, there is still a resulting inefficiency, with different types of firms facing different marginal tax rates. Of course, non-tax considerations—such as legal liability, access to capital markets, and governance structures—also influence organizational choice.

3. Investment and financing distortions

Tax rules for both pass-throughs and corporations treat investment and financing inconsistently. This in turn leads to overly generous treatment of some investments and misallocation of investment across types of assets and financing choices.

Under an ideal income tax, businesses pay tax on their revenue less their costs of production. Because many investments are long-lived, their costs are deducted gradually through the depreciation deduction, rather than in full when the investment is made. When these depreciation deductions match the asset's true economic decline in value over time (economic depreciation), the effective tax rate on new investment is positive and equal to the statutory rate. This positive tax rate raises the return a project must earn to be profitable.

Under the current system, however, firms are allowed to expense investment costs immediately, rather than deducting costs over time. Economically, this up-front deduction is equivalent to eliminating tax on a "normal" return to the investment, and so the effective tax rate on the normal return to new investment is zero. The tax instead falls only on returns greater than the normal level—economic rents, sometimes called "excess returns."

However, business interest payments remain largely deductible, as would generally be the case under an income tax.[14] Coupling expensing with interest deductibility leads to effective tax rates less than zero for some investments and overinvestment in assets that are amenable to debt financing. That is because businesses deduct the value of the

[14] The TCJA limited interest deductions to 30% of earnings, initially measured using Earnings Before Income Taxes, Depreciation, and Amortization (EBITDA) (a broader measure that permits larger deductions). Starting in 2022, the limit tightened by switching to EBIT (excluding depreciation and amortization). The OBBBA reversed this change, returning to an EBITDA-based measure.

investment up front, effectively exempting the normal returns from tax. They then also deduct the interest payments on the investment, effectively exempting the returns from tax again. The Congressional Research Service has estimated that effective tax rates on debt-financed investment in equipment are substantially negative under current law (Gravelle and Keightley 2025).

4. Profit shifting

Profit shifting, or the practice by which multinational firms book profits in low-tax jurisdictions rather than in the country where the economic activity actually occurs, has been a central feature of the U.S. tax system for decades. Although it is mainly an issue with corporations rather than pass-throughs, profit shifting nevertheless reduces U.S. revenues and complicates the tax system significantly.

Profit shifting arises because the U.S. business taxes are fundamentally production-based. They tax business income based on where firms are located and where production is deemed to occur, rather than where goods and services are consumed. This requires firms to allocate profits to particular jurisdictions. Those allocations are difficult to measure and, in practice, can be influenced by the location of intangible assets, transfer pricing, and the placement of real activity. As a result, firms can reduce their tax burden by shifting profits, intangible assets, or real activity to lower-tax jurisdictions.

The incentive to shift profits creates pressure for countries to compete by lowering corporate tax rates in a global race to the bottom. This incentive in the U.S. tax code has contributed to a long-run decline in U.S. corporate tax revenues relative to the size of the economy and is one of the most significant sources of corporate tax base erosion (Clausing 2020; Clausing 2024). The three panels of Appendix Figure A1 show that U.S. multinationals continue to report a disproportionate share of profits in low-tax jurisdictions, even as their overall profitability has increased. At the same time, corporate tax receipts have failed to rise with profits and have remained relatively flat as a share of the economy; this pattern predates the 2017 TCJA rate cut.

Rather than undertaking fundamental reforms to the structure of corporate taxes, U.S. policymakers have so far responded to international tax competition by reducing rates and creating a growing set of layered rules. In 2017, the TCJA introduced a series of provisions designed to limit the most aggressive forms of profit shifting while preserving the underlying source-based framework. The Inflation Reduction Act of 2022 re-introduced a Corporate Alternative Minimum Tax (Patel 2024), which extended this approach by imposing minimum effective tax rates on certain income. In 2025, the OBBBA took some measures to adjust the international provisions of tax law.[15]

[15] TCJA lowered the U.S. statutory rate and introduced new international provisions, including the Global Intangible Low-Taxed Income (GILTI) minimum tax, the Foreign-Derived Intangible Income (FDII) deduction, and the Base Erosion and Anti-Abuse Tax (BEAT) (Gravelle and Marples 2022). OBBBA restructured both regimes. GILTI became a tax on net controlled foreign corporation tested income (NCTI), which no longer exempts a deemed 10% return on a firm's foreign tangible assets, and FDII became a deduction for foreign-derived deduction-eligible income (FDDEI), which likewise dropped the carve-out for tangible assets (Gale, Looney, Patel 2026). Although these changes broaden the scope of the minimum tax, they do not eliminate the underlying incentives created by differential taxation of domestic and foreign income. Firms continue to have incentives to locate profits and investment abroad.

But these changes appear to have had little effect on profit shifting. Prior to the TCJA, estimates suggested that the United States was losing about $100 billion annually in corporate tax revenue due to profit shifting (Clausing 2020). The empirical research consensus is that the decline in profit shifting since 2017 has been relatively modest (Clausing 2024; Dharmapala 2024; Garcia-Bernardo, Janský, and Zucman 2022).

As long as corporate income is taxed based on where firms produce rather than where they sell, international competition is likely to translate into continued pressure on rates, ongoing profit shifting, and a further layering of complex policy responses.

5. Business-related tax expenditures

Business income tax expenditures are provisions like credits, deductions, exclusions, and preferential rates that reduce corporate tax liability relative to a normal tax base. They are often described as "spending through the tax code" because they function similarly to direct government outlays by subsidizing specific activities or industries (Sammartino and Toder 2020; PGPF 2025; GAO 2016). There are dozens of such provisions, spanning a wide range of policy areas, from research and development to housing, energy, and international taxation.

Taken together, these provisions substantially narrow the tax base. Their fiscal cost is large, hundreds of billions of dollars per year and reaching into the trillions over the next decade (OTA 2024b). Estimates indicate that corporate income tax expenditures alone can amount to roughly 60% of corporate income tax receipts (PGPF 2026). As a result, the statutory corporate income tax rate is applied to a much smaller tax base, reducing revenue and increasing pressure to rely on a higher rate or new taxes to meet revenue goals. Meanwhile, the tax expenditure associated with the Section 199A deduction is projected to be $851 billion for the 2026–2035 period (OMB 2026a).

Well-designed business taxes should instead rely on a broad and neutral tax base. A small number of corporate income tax expenditures are widely used, relatively effective, and serve clear economic purposes, including certain clean energy and research and experimentation credits. But most are narrow, targeted incentives that largely serve special interests, are of questionable effectiveness, and often significantly complicate taxes through eligibility rules, phase-outs, and interactions with other provisions (Sammartino and Toder 2020; Keightley and Marples 2023; GAO 2016). Substantially limiting tax expenditures is therefore central to restoring a broader tax base, improving neutrality, and supporting a more efficient and sustainable business tax.

6. The Section 199A deduction

The Section 199A deduction, created in the TCJA, originally provided a 20% deduction through 2025 for qualified business income (QBI) earned in pass-through businesses.[16] The

[16] QBI is essentially the net domestic business income from a qualified trade or business, excluding certain specified categories of income and adjustments. It includes ordinary business income and the taxpayer's allocable share of income, deductions, and losses from those entities. QBI specifically excludes capital gains and losses, dividends, interest income (unless allocable to the business), reasonable compensation paid to the taxpayer by an S corporation, guaranteed payments to partners, foreign-sourced income, and certain other investment-related items.

deduction was intended as a political and policy response to the reduction in the corporate tax rate from 35% to 21%, which lawmakers worried would otherwise create a substantial tax advantage for C corporations relative to pass-through businesses. In 2025, the OBBBA made the provision permanent and expanded its scope. Among other changes, the OBBBA established an inflation-adjusted minimum deduction of $400 for taxpayers with at least $1,000 of qualified business income.

The deduction has proven to be expensive, regressive, complicated, and unable to boost pass-through investment or employment. JCT (2025) estimates that the Section 199A deduction will reduce revenues by $737 billion from 2025–2034. This compares to the OMB (2026) tax expenditure estimate of $851 billion over the 2026-2035 period. JCT (2018) finds that 44% of the tax savings from the deduction goes to those earning more than $1 million.

Section 199A's rules are complex and arbitrary. They impose income thresholds, phase-ins, wage and capital limitations, and special exclusions for specified service trades or businesses (SSTBs) such as law, accounting, and consulting. Taxpayers have responded by restructuring activities, such as splitting firms, reclassifying income, or altering compensation, to qualify for the deduction. This complexity undermines tax neutrality and generates planning incentives and costs that disproportionately benefit sophisticated, high-income filers.

Goodman et al. (2025) find little evidence that the deduction increased investment, hiring, or wages. Instead, the primary responses appear to be tax-motivated reclassification of activities and income shifting, such as converting wages into business income to qualify for the deduction. This aligns with a broader empirical literature finding that targeted tax preferences often induce relabeling rather than new economic activity (Slemrod and Yitzhaki 2002).

Finally, while the Section 199A deduction reduces differences between corporate and pass-through income, it increases differences between pass-through and wage income, and even among different kinds of pass-through businesses (Guenther 2024). For example, owners of SSTBs face different treatment than other businesses above certain income thresholds, encouraging inefficient reorganization or fragmentation of firms.

7. The taxation of partnerships

Partnerships are now a dominant organizational form, accounting for roughly 30% of business income, yet the governing rules have not been comprehensively reformed since 1954 (Johnson et al. 2024). The modern U.S. system of partnership taxation, codified in Subchapter K, was designed to provide flexibility and avoid the double taxation imposed on C corporations. But that same flexibility has become a central source of complexity and difficulty in administration.

Partnership tax rules allow substantial flexibility. Partners may allocate income, deductions, and credits in ways that need only loosely correspond to underlying economic arrangements, creating planning and avoidance opportunities. Large partnerships, especially in finance and real estate, often involve multitiered ownership structures that are difficult for outsiders to understand and can be engineered to minimize taxes or even

facilitate evasion. Cooper et al. (2016) describe partnership ownership as "opaque," with about 20% of income going to unclassifiable partners and substantial income flowing through circular ownership chains. Empirical estimates suggest large potential revenue effects: Applying corporate-style taxation to pass-through income would have raised tens of billions annually.

Moreover, the opacity makes it difficult even for tax administrators to identify who ultimately earns partnership income. The combination of tiered entities and limited third-party reporting makes it difficult for the IRS to audit large partnerships and significantly impairs enforcement.

These factors combine to imply that current partnership taxation rules create avoidance opportunities that result in revenue loss, cause compliance and enforcement problems, and reduce both vertical equity (since partnership income is concentrated among high earners) and horizontal equity (since similar income can be taxed differently depending on organizational form).

8. Revenue

It is difficult to obtain data on tax revenues collected from pass-through businesses because their taxation is built into the individual income tax. What is clear is that U.S. corporate tax revenues have declined substantially as a share of the economy over the past half century, even as corporate profits have risen. Corporate income tax receipts fell from roughly 3% to 4% of GDP in the late 1940s to approximately 1% to 1.8% of GDP in recent years (OMB 2026b; CBO 2026), and CBO projects they will average about 1.3% of GDP over the next decade.

Several factors have contributed to the reduction in corporate tax revenues. First, starting with the Tax Reform Act of 1986, which lowered the top rate on individual income less than the top rate for corporations, there has been a large and enduring shift toward pass-through businesses and away from corporations. Although the owners of pass-throughs pay income tax on their earnings, the effective tax rate on pass-throughs has been lower than the rate on corporations. Federal revenues were about $100 billion (0.6% of GDP) lower in 2011 than they would have been if the pass-through share of business income had stayed constant over the preceding 30 years (Cooper et al. 2016).

Second, corporate tax receipts have also fallen sharply as a share of C corporation economic profits (Appendix Figure A1; Aron-Dine 2026). Likewise, U.S. corporate tax receipts are low as a share of GDP compared to other developed countries, even though corporate profits, accounting only for C corporations, are high (Clausing 2026).

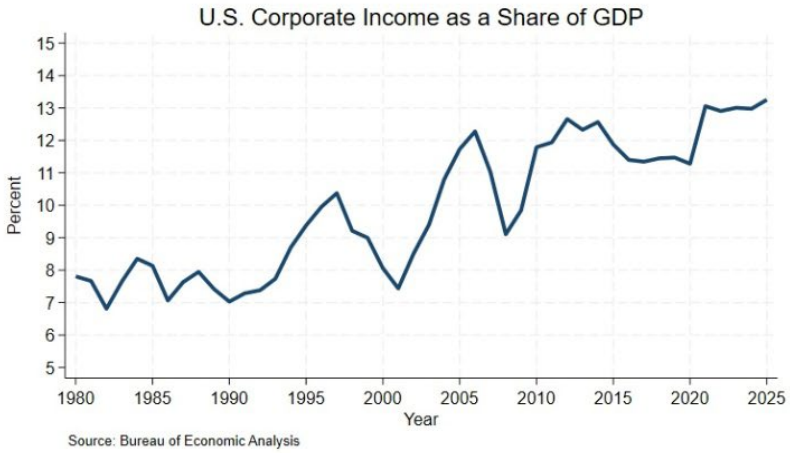
One reason is that tax avoidance through international profit shifting has proliferated. U.S. multinationals have reported increasing proportions of their foreign earnings in key low-tax countries over the past 30 years. The TCJA aimed to reduce such shifting, but did not seem to have such an effect. Clausing (2020) estimates that profit shifting cost the United States $100 billion in corporate tax revenue in 2017, or about 0.5% of GDP).

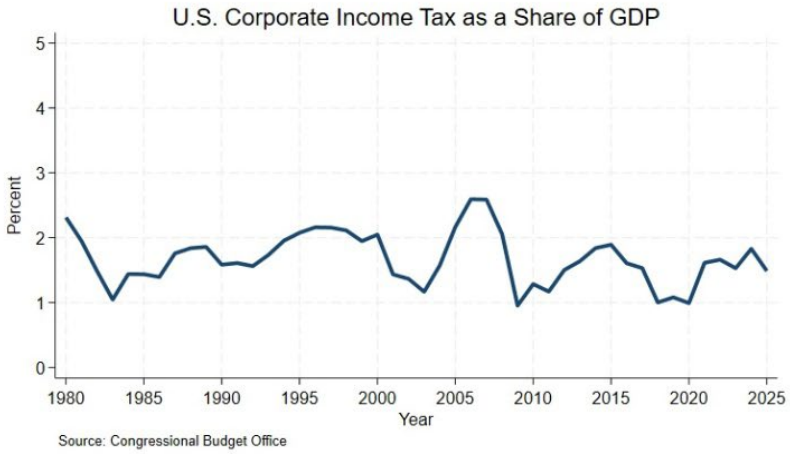
Another factor is the evolution of legislation. Policymakers have provided accelerated depreciation on a continuous basis over the past two decades. The TCJA reduced the top

corporate tax rate to 21% from 35%. OBBBA in 2025 put substantial new business tax cuts into place (Gale, Looney, and Patel 2026).

APPENDIX FIGURE A1

Multinational profits rise while corporate tax receipts remain flat







Source: Reproduced from the 2025 Economic Report of the President.

Appendix B: Measuring the net dollar-denominated position and the wealth transfer

This appendix builds upon Tables 4 and 5 of Section V. It classifies foreign claims on the United States into classes defined by their exposure to the reform, states the assumptions behind each step, and carries those classes through to the one-time gain under each adjustment channel. All values come from the Bureau of Economic Analysis release of June 24, 2026, and are stated as of 2025:Q2 in trillions of nominal dollars. Shares of GDP use GDP over the four quarters ending in 2025:Q2, $29.97 trillion, to align with the date of the foreign-claims data.

1. Sources

The calculation uses data from the BEA International Investment Position. Table 1.2 (U.S. net international investment position, expanded detail) provides the composition of foreign claims by instrument. Table 4.1 (U.S. debt positions by currency, sector, and maturity) reports U.S. debt by currency of denomination. It also gives the stock of dollar claims that U.S. residents hold abroad. Table 4.1 was introduced in the 2022 Survey of Current Business and is available quarterly from 2020:Q1.

Separating claims fixed in dollars from claims on real U.S. cash flows requires data on three elements the IIP does not report. These come from the Treasury International Capital survey at its end-June 2025 benchmark: foreign holdings of Treasury inflation-protected securities, investment fund shares, and preferred and other equity. Our analysis uses the 2025:Q2 baseline because that is the latest benchmark available (BEA NIPA Table 1.1.5).

There are no data on embedded leverage inside U.S. firms or on the ultimate owners of certain foreign-owned U.S. assets. The latter omission is likely to overstate the foreign asset position to the extent U.S. owners hold U.S. assets via a foreign territory.

The exchange-rate appreciation formula under tax-inclusive versus tax-exclusive conventions follows Driessen and Keightley (2017); the asymmetric construction of the net dollar position follows the logic of Costinot and Werning (2019).

2. The crosswalk

Table B1 provides a mapping from the categories BEA reports to the five types of claims shown in Table 4: claims fixed in dollars, claims on real U.S. cash flows, indexed claims, claims with no U.S. exposure, and financial derivatives. Two assumptions are needed. First, investment fund shares and preferred equity are reported as equity, but part of what they hold is fixed in dollars. We assume this share to be 10%. Second, equity in U.S. multinationals is a claim that comes from a combination of U.S. and foreign operations, but only earnings derived from U.S. operations are exposed to U.S. tax. We assume foreign operations account for 14.2% of the value of U.S. equity. That is the ratio of U.S. direct investment abroad, $11.2 trillion, to a derived value of total U.S. equity ($78.9 trillion). Total U.S. equity is not reported, so we infer it by scaling up total foreign holdings of $31.6 trillion under the assumption that foreign holdings represent 40% of the total, applying Rosenthal and Burke's (2020) estimate of the foreign-owned share of U.S. corporate equity in 2019.

TABLE B1

Crosswalk from reported BEA categories to the five types of claims, 2025:Q2

	$ trillions	Assumption applied	Source line
Claims fixed in dollars			
Portfolio debt securities	15.6		1.2 L44
Currency and deposits	4.8		1.2 L59
Loans	4.6		1.2 L60
Direct-investment debt	1.8		1.2 L41
Trade credit and advances	0.3		1.2 L62
Special drawing rights allocations	0.2		1.2 L63
As reported	27.3		
less TIPS, which ride the price level	-0.8	Reported by TIC	
less foreign-currency debt	-2.1	Reported in Table 4.1	4.1 L45
plus nominal holdings inside fund shares and preferred equity	0.5	Assumed 10%	
Total claims fixed in dollars	**24.8**		
Real claims on U.S. cash flows			
Portfolio equity and investment fund shares	19.7		1.2 L43
Direct-investment equity	11.9		1.2 L40
As reported	31.6		
less nominal holdings moved above	-0.5	Assumed 10%, as above	
less foreign operating value	-4.5	Assumed 14.2%	
Total real claims on U.S. cash flows	**26.6**		
Indexed claims			
Treasury inflation-protected securities	0.8	Principal follows the CPI	TIC benchmark
Claims with no U.S. exposure			
Foreign-currency debt of U.S. issuers	2.1	Reported in Table 4.1	4.1 L45
Foreign operating value of U.S. equity	4.5	Assumed 14.2%, as above	
Total claims with no U.S. exposure	**6.6**		
Financial Derivatives	**2.2**	Gross negative fair values	1.2 L38
Total foreign claims on the United States	**61.0**		1.2 L36

Notes: The assumed 10% nominal share is $500 billion, more than the $200 billion foreign investors hold in money-market funds alone. Financial derivatives are reported as gross negative fair values. BEA's annual revision of June 24, 2026, introduced a new market-value methodology for direct-investment equity, reducing total foreign claims at 2025:Q2 from $65.7 trillion to $61 trillion. Components may not sum to totals because of rounding.
Source: BEA International Investment Position Tables 1.2 and 4.1, release of June 24, 2026; Treasury International Capital survey, end-June 2025.

Table 5 nets the $24.8 trillion of foreign-held claims fixed in dollars (Table B1) against the $9.2 trillion of dollar-denominated debt that U.S. residents hold abroad, reported on line 2 of Table 4.1, leaving a net fixed-dollar position of $15.6 trillion.

3. Valuing claims under alternative combinations of tax changes and price changes

The gains in Table 5 follow from an accounting identity. Let F_{pre} denote the nominal present value of a claim's pre-tax cash flows, P_h the dollar price of the consumption basket of asset owner h (for a foreign holder this is the dollar price of foreign consumption, which falls when the dollar appreciates), and $t_{old,h}$ and $t_{new,h}$ the effective tax burdens on those cash flows before and after the reform. Any claim's value (V) in the holder's own consumption units changes by:

$$V_{post,h} / V_{pre,h} = [(F_{post} / F_{pre}) \times (P_{pre,h} / P_{post,h}) \times (1 - t_{new,h})] / (1 - t_{old,h}).$$

The first two factors capture the nominal revaluation of the cash flows and the change in the holder's purchasing power. The last two capture the imposition of the new tax and the change in (or elimination of) the old tax.

In our reform, for a foreign holder of a claim on real U.S. cash flows, the product of the first two factors is 1.25 under either channel. If the dollar appreciates, there are no changes in the income flows, so $F_{post} = F_{pre}$ and the first factor is 1. The dollar price of foreign consumption falls by 20%, so $P_{post,h} = 0.8\ P_{pre,h}$ and the second factor, $P_{pre,h} / P_{post,h}$, is 1.25. If, instead, the price level changes, $F_{post} = 1.25\ F_{pre}$ and $P_{post,h} = P_{pre,h}$, so the first factor is 1.25 and the second is 1. In other words, the change in the real value of the nominal flows is the same whether F changes or P_h changes. For a domestic holder, the product of the first two factors is 1 under either channel. If the price level rises, $F_{post} = 1.25\ F_{pre}$ and $P_{post,h} = 1.25\ P_{pre,h}$. If the dollar appreciates, neither changes.

The gain across types of claims therefore depends on the tax factors. For corporate equity, the old tax rate was 21% and the new tax rate in the VAT base (on a comparable tax-inclusive basis) is 20%. Both are paid at the firm level, so they are the same for domestic and foreign holders. For a domestic holder, the value changes by 0.80/0.79, approximately a wash. For the foreign holder, however, the first two factors multiply to 1.25 and the new tax factor is 0.80, so 1.25 × 0.80 = 1: the revaluation offsets the new tax. The forgiven corporate tax remains, 1/0.79, so the foreign holder's claims rise by about 25% (26.6% to be precise).

For a claim outside both the corporate tax and the VAT, the old and new tax factors equal one, so the foreign holder keeps the 25% gain from the first two factors. In contrast, a U.S. holder of a claim outside the base gains nothing under either channel. Under the price-level channel, P_h rises with the VAT-inclusive price level, but F_{post} rises by the same amount. Under the exchange-rate channel, neither changes. That is the benchmark used in Section V.C. A fixed-dollar claim differs because its cash flows are contractual and do not rise with U.S. prices, so $F_{post} = F_{pre}$ under either channel. Its foreign holder gains 25% under dollar appreciation and nothing under the price-level channel. Its U.S. holder loses 20% under the

price-level channel (Section IV.A).

For an asset that was untaxed before the reform and is in the VAT base, there is no old tax to forgive. For a foreign holder, the change in the valuation of the income streams exactly offsets the change in valuation from the new tax, so that 1.25 × 0.80 = 1, and there is no windfall. For a U.S. holder, there is no revaluation to offset the new tax, and the asset loses 20% of its value under either channel.

4. Sensitivity

Table 5 reports the one-time gain to foreign holders under each adjustment channel: $11.2 trillion under a DBCFT and $7.3 trillion under our proposal. The $3.9 trillion difference between them is what routing the adjustment through the price level avoids. These figures depend on three assumptions. Two are the assumptions about how to allocate the IIP-reported categories among fixed-dollar and equity-based claims. The third is the level of capitalization of the corporate tax into existing share values. Under an assumption of full capitalization, repealing the corporate tax raises those values by $\tau_c/(1-\tau_c)$, or 26.6% under the 21% statutory rate. This estimate should be viewed as a ceiling, however, to the extent that the corporate tax is borne by both capital and labor. Table B2 varies each assumption one at a time, holding the other two at their central values of 10%, 14.2%, and full capitalization.

TABLE B2

Sensitivity of the one-time gain to foreign holders, $ trillions, 2025:Q2

	DBCFT	Our proposal	Difference
Central case	11.2	7.3	3.9
Foreign operating share 0%	12.4	8.5	3.9
Foreign operating share 25%	10.3	6.4	3.9
Nominal share 0%	11.2	7.4	3.8
Nominal share 25%	11.2	7.1	4.1
Capitalization 0.8	9.8	5.9	3.9
Capitalization 0.6	8.4	4.4	3.9

Notes: The central case is a 10% nominal share of investment fund shares and preferred equity, a 14.2% foreign operating share of U.S. equity, and full capitalization of the corporate tax into existing share values. Each row varies one assumption and holds the other two at their central values.

The difference between the two adjustment channels is largely insensitive to these assumptions. The foreign operating share of U.S. multinationals and the level of capitalization both affect the estimate of how much real claims gain, and this source of wealth transfer cannot be avoided by either adjustment channel. As a result, this component of the one-time gain is identical under either proposal. Only the assumptions

affecting the allocation of fixed-dollar claims move the difference, and when this assumption ranges from 0 to 25%, the difference shifts by only $300 billion.

Three additional caveats all reduce the foreign position of fixed-dollar claims, but cannot be quantified from published tables. First, and as noted in the paper, BEA records the immediate counterparty rather than the ultimate owner, so claims recorded as foreign may belong to U.S. residents who route them through offshore entities. Second, some foreign holders of dollar claims hold matched dollar liabilities, so their exposure to a currency appreciation is smaller than their gross holdings (Du and Schreger 2022). Third, a foreign shareholder in a leveraged U.S. firm holds a claim on a company that owes dollars, so their net exposure to claims on fixed dollars is smaller than the recorded amount. The fixed-dollar transfer in Table 5, and hence the difference between the two channels, is therefore best understood as an upper bound.

Appendix C: Characteristics of alternative tax systems

Table C1 compares our proposal with four benchmarks: a classic (comprehensive) income tax, the current U.S. income tax, the DBCFT, and a standard VAT. The first three groups of rows describe how each system is constructed. The last two summarize the economic consequences developed in Sections II, IV, V, and VI.

TABLE C1

Characteristics of alternative tax systems

Characteristic	Classic income tax	Current income tax	DBCFT	VAT	Our proposal
Tax Base					
Revenue from sales	Yes	Yes	Yes	Yes	Yes
Normal return to capital	Yes	Partly	No	No	No
Economic rents	Yes	Yes	Yes	Yes	Yes
Treatment of Costs					
Investment	Depreciated	Mostly expensed	Expensed	Expensed	Expensed
Wages	Deductible	Deductible	Deductible	Not deductible	Not deductible
Interest payments	Deductible	Mostly deductible	Not deductible	Not deductible	Not deductible
Design					
Wage credit to workers	No	No	No	No	Yes
Border adjusted	No	No	Yes	Yes	Yes
Adjustment mechanism	N/A	N/A	Exchange rate	Price level	Price level
Distortions					
Organizational form	Yes	Yes	No	No	No
Investment choices	Yes	Yes	No	No	No
Financing	Yes	Yes	No	No	No
Profit shifting	Yes	Yes	No	No	No
Foreign Windfall Upon Transition					
Fixed-Dollar Claims	N/A	N/A	Yes	Largely avoided	Largely avoided
Real Claims	N/A	N/A	Yes	Yes	Yes, absent transition recapture

Appendix D: Additional details about the mechanics of the proposal

This appendix provides additional details about the mechanics of the proposal. Sections D.1 and D.2 take up how the credit reaches the worker and how workers at different average tax rates fare under each delivery path. Sections D.3 through D.6 follow every dollar across the firm, the worker, and the government in a sequence of progressively richer firms. Throughout, the VAT rate is $\tau = 25\%$ on a tax-exclusive basis, so the price level rises from 1.00 to 1.25. Each table below shows both the nominal and real net position of each actor. Throughout this exercise, we highlight the worker's real consumption and the government's net real revenue and where it comes from. Section D.3 replicates the labor-only firm used in Section III.

1. Delivering the worker credit

The worker credit could be delivered in many ways; we compare two options. The first ends ordinary withholding and reconciles the credit against the worker's liability at annual filing; some of it can also be advanced through the year, which Section D.2 takes up directly. The second leaves withholding in place and adds the credit to each paycheck directly. In either case, the worker's underlying tax liability is determined by the same progressive income tax schedule in place today. Only the timing and the mechanics of payment are different.

The first path imposes a relatively light administrative burden since it requires nothing new. Withholding is simply eliminated, and the difference is settled once per year at filing. Consider how a worker from Section III.B fares throughout the year under this path. With withholding suspended, the worker's take-home pay rises to $100 immediately. This restores the worker's real consumption to its pre-reform level in real time. At filing, the credit and the tax liability the worker faces exactly cancel: The worker has $125 in taxable income ($100 plus the $25 worker credit) and owes $25 in taxes. As a result, the worker has nothing left to reconcile at filing time.

This exact cancellation, however, happens because this worker's tax rate (20%) matches the tax-inclusive VAT rate. For anyone else, ending withholding alone does not deliver the right amount of take-home pay during the year to bring workers back to their pre-reform real consumption. Section D.2 walks through what happens for workers who face rates that are lower or higher than 20% under the progressive income tax schedule.

Consider how the same worker fares under the second path. Withholding remains in place, but the $25 credit is added to each paycheck. Because it is taxable, the worker now earns $125 in taxable income and has $25 withheld from their paycheck. This, again, restores the worker's real consumption to its pre-reform level right away, as under the first path. At filing, the amount withheld already covers their full liability, so they have nothing left to reconcile, just as under the first path.

Under path 2, unlike path 1, the fact that workers do not have anything to reconcile at filing time doesn't depend on the worker's tax rate. The credit is added directly to pay, and ordinary withholding taxes it appropriately, calibrated to each worker's own rate. For this

reason, this mechanism will restore pre-reform consumption across the income distribution.

This is the case for path 2 over path 1. The case against it is administrative: Someone has to deliver the credit to every worker with every paycheck, and each way of doing that faces hurdles. First, firms could pay the credit directly and net it against their own VAT liability, but for firms with less cash flow, that may not be possible. Firms could instead be reimbursed through a refundable payroll tax credit, but employer payroll tax is only 7.65% of wages, far short of the credit, so most firms would still be required to fill the gap.

We do not resolve which paths is better. What matters is that the choice is open, and earlier access to the credit for workers must be traded against an administrative cost.

2. Worker purchasing power across the distribution

The worker facing a 20% tax rate is not typical. The average combined income and payroll tax is about 17% (OTA 2024a), and workers nearer to the median face a lower rate closer to 10%. For these more representative rates, the two paths for credit delivery diverge in exactly the way described in Section D.1.

TABLE D1

Real consumption for workers facing different average tax rates under two credit delivery strategies

	Pre-Reform	Path 1 Eliminate Withholding		Path 2 Deliver with Payroll	
	Real Consumption	Within Year Real Consumption	At Filing	Within Year Real Consumption	At Filing
25% ATR	$75	$80	$75	$75	$75
20% ATR	$80	$80	$80	$80	$80
17% ATR	$83	$80	$83	$83	$83
10% ATR	$90	$80	$90	$90	$90

Table D1 shows the real consumption for various workers who face different average tax rates (ATR) under the two delivery strategies. Under Path 1, workers with an ATR less than 20% consume less during the year than they did before the reform. They do not return to their pre-reform consumption until they receive their refund at filing time. By contrast, workers with an ATR greater than 20% can consume more during the year, but they will owe additional tax liability at filing time. In other words, the reform is neutral for workers whose rate is exactly 20%. Workers below that rate would run a shortfall until filing their taxes and receiving a refund. Workers with a higher ATR would owe taxes at tax time.

3. A firm that produces with labor alone

Consider a firm whose only input is labor—for example, a law firm—that pays a worker $100 and earns no return to capital.

Under the VAT, before the credit. The firm's value added is the $100 wage, which the VAT taxes in full because wages are not deductible. The firm collects $25, adding it to the price, so its output sells for $125 at the register.

TABLE D2

Net effects: VAT without wage credit

	Receives	Pays	Net Nominal	Net Real
Firm	$125 (register)	$100 wage + $25 VAT	$0	$0
Government	$25 VAT	—	$25	$20
Worker	$100 wage	—	$100	$80

The worker still earns $100, but the real value of that wage would fall to $80 because the VAT has taken 20% of the worker's purchasing power. The firm marks up its price by the same 25% and prices rise economy-wide. Because the worker's paycheck is unaffected by the price-level adjustment, his or her purchasing power falls.

Under a destination-based cash-flow tax. The DBCFT is the same tax with one change: wages are deductible. The tax base for a firm whose value added is entirely wages is $100 − $100 = $0, so this firm owes nothing. The DBCFT's adjustment runs through the exchange rate rather than domestic prices, so there is no tax on wages: The price level stays flat, and the worker's $100 buys $100 worth of goods.

TABLE D3

Net effects: DBCFT

	Receives	Pays	Net Nominal	Net Real
Firm	$100	$100 wage	$0	$0
Government	—	—	$0	$0
Worker	$100 wage	—	$100	$100

The DBCFT does not affect wages because its adjustment runs through the exchange rate and there are no changes in domestic nominal prices.

Under the VAT, with the credit. Now return the wage tax to the worker as the worker credit, $\tau W = 25\% \times \$100 = \$25$. Assume the credit is transferred through the government, for simplicity; how it actually reaches the worker is a separate question taken up in Section D.1, and does not change the net positions shown here.

TABLE D4

Net effects: VAT with worker credit

	Receives	Pays	Net Nominal	Net Real
Firm	$125 (register)	$100 wage + $25 VAT	$0	$0
Government	$25 VAT	$25 credit	$0	$0
Worker	$100 wage + $25 credit	—	$125	$100

The credit restores the full purchasing power: The $25 raised by the VAT is simply transferred back to workers as a credit. The worker ends exactly in the same position as under the DBCFT.

It is natural to ask why the worker is made whole through a credit rather than simply a higher wage. Suppose that nominal wages increased to $125. The firm now owes 25% ×

$125 = $31.25 because wages are part of the VAT base, so the register price becomes $156.25. Once again, the worker's real consumption is 125 / 1.5625 = $80—unchanged. The register price for a labor-only firm earning no profits is always 1.25 times the wage, so the worker's real wage will always be 80% of its pre-tax level no matter how high the nominal wage is set.

4. A firm that also earns an economic rent

Now let the firm earn an economic rent of $40. Value added is now $100 in wages plus $40 in rent, or $140. The VAT is $35, and the register price is $175. The worker's wages and the credit are unchanged.

TABLE D5

Net VAT effects: Firm with economic rent

	Receives	Pays	Net Nominal	Net Real
Firm	$175 (register)	$100 wage + $35 VAT + $40 to owner	$0	$0
Worker	$100 wage + $25 credit	—	$125	$100
Owner	$40 rent	—	$40	$32
Government	$35 VAT	$25 credit	$10	$8

In real terms, the worker is again unaffected, consuming $100 both before and after the imposition of the VAT. The owner's after-tax real earnings are $32. The government collects $8. In short, the VAT revenue comes entirely from the rent. The gross VAT collected of $35 is 25% of the $100 wage ($25, which is refunded directly to the worker) plus 25% of the $40 rent ($10, kept by the government).

5. A firm whose worker also owes income tax

Suppose, as in Section III, that the worker currently owes $20 of income tax on the $100 wage. Taxable income rises to $125. Taxed at 20%, the worker owes a total of $25, which the credit covers.

TABLE D6

Net VAT effects: Adding individual income taxes

	Receives	Pays	Net Nominal	Net Real
Firm	$175 (register)	$100 wage + $35 VAT + $40 to owner	$0	$0
Worker	$100 wage + $25 credit	$25 income tax	$100	$80
Owner	$40 rent	—	$40	$32
Government	$35 VAT + $25 income tax	$25 credit	$35	$28

In real terms, total income is unchanged. After tax, the worker's net income is unchanged. Of the government's $28, $8 comes from owners' rents, as above, and $20 comes from the worker.

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