HYBRID INSTRUMENTS AND THE INDIRECT CREDIT METHOD –
DOES IT WORK?

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INTRODUCTION

T HE MANAGEMENT OF A CORPORATION
normally has freedom to create a capital
structure according to its business needs.
The decision whether to use debt or equity to evidence contributions to the corporation depends on
the level of involvement the management grants the
investor. Creditors whose claims are not satisfied
when due can force the corporation into bankruptcy
while discontented shareholders can only make
use of their vote in the general assembly.[1] Beside
this important difference, equity typically has no
maturity date and provides the right to receive a
share of the profit and the risk to participate in
losses. Debt typically has a maturity date and
provides for fixed annual interest payments with
no managerial rights and no participation in gains
of the company.[2]

From a tax perspective, it is important to classify an instrument as debt or equity because for
the issuer only interest can be tax deductible while
dividends are not. The investor usually has to tax
interest income whereas there is often shareholder
relief for dividend income. In attaching different
tax consequences to debt as compared with equity,
tax law assumes that only these alternatives can
be distinguished from one another. In fact, debt
and equity are only two edges of a spectrum of an
infinite number of investment instruments, which
can assume every shape.

GENERAL IMPLICATIONS OF THE
INDIRECT CREDIT METHOD

Besides the direct credit method that credits
foreign withholding taxes, some countries have also
implemented the indirect credit method.[3] With this
method it is possible to credit the foreign corporate
taxes that have been paid by the foreign corporation. However, to avoid the taxation of an after-tax
amount, the foreign corporate taxes are deemed to
be dividends for domestic taxation purposes. In
each jurisdiction the investor has to fulfill special
criteria to qualify for the indirect credit method.

The computation of the indirect credit can be
defined by the following formula:

$$\text{Indirect Credit} = \frac{\text{Dividends Received}}{\text{Accumulated Profits}} \times \text{Cumulative Foreign Income Taxes}$$

The domestic corporation is deemed to have paid
the foreign taxes in proportion to the dividends
received. The foreign accumulated profits are the
after-tax profits of the foreign corporation that have
been retained. If the foreign corporation therefore
is always distributing its profits, the accumulated
profits equal the paid-out dividends. However,
the foreign accumulated profits and the dividends
received are determined according to the domestic
rules governed by Sec 964 IRC to ensure that the
numerator and the denominator are computed
according to the same principles.[4] Foreign taxes
are computed after the foreign law.[5]

The above equation can be rewritten as follows:

$$(1) \qquad c_e = \frac{y(1-t)Bt}{B(1-t)} = yt.$$

B = Taxable Basis according to domestic law
y = Yield
t = Tax Rate
c_e = Indirect Credit (Equity)

The dividends are part of the after-tax profits and
therefore have already been taxed with the foreign
tax rate ($y(1-t)$). The accumulated profits equal
the foreign profits after taxes ($B(1-t)$) and only
steadily rise if the corporation retains earnings.
It can be seen that the indirect credit of a typical
equity instrument remains constant (yt) regardless
of the amount of the retained earnings.

In order to compute the U.S. taxes due, Sec 78
IRC adds the foreign taxes that can be credited
according to Sec 902 IRC to the distributed dividends.[6] This gross up equals the computation of the
indirect credit and therefore can be expressed as

($y\,t$). This gross-up is then treated as a constructive distribution in order to allow the determination of U.S. taxes from a basis before foreign taxes.[7] Using 35 percent as the U.S. corporate tax rate, the U.S. taxes – before consideration of the foreign tax credit – are therefore computed in the following way:

$$\left(y(1\ -\ t)\ +\frac{y(1\ -\ t)\ Bt}{B(1\ -\ t)} \right)0.35.$$

In other words the taxes which are first deducted from the foreign taxable income in order to compute the dividend amount ($y\,(1-t)$) are added back in proportion to the accumulated profits ($y\,(1-t)$ + $y\,t$) and therefore always result in 0.35 y. As a consequence the tax burden with the indirect credit method is always at least the U.S. tax rate.

Unfortunately foreign taxes cannot be credited infinitely because tax authorities refrain from paying out taxes that were charged in foreign countries. Therefore most countries have special provisions that limit the foreign tax credit to the amount of taxes attributable to the taxpayer's foreign source taxable income. Besides this general limitation, many other provisions exist. Some countries treat income earned in each foreign country separately in determining the foreign tax credit (per country limitation), while others make separate credit calculations for particularly high- or low-taxed types of income, called "baskets" of income.

The foreign tax credit limitations of the U.S. tax law are governed by Sec 904 IRC. Foreign taxes in excess of the applicable limitations cannot be credited in the taxpayer's current year but may be carried back one preceding tax year and carried forward ten years.[8] The excess credits will only be usable to the extent that they, and the creditable foreign taxes for that year, do not exceed the limitations according to Sec 904 IRC.[9]

The foreign tax credit is generally limited to the amount of taxes attributable to the taxpayer's foreign-source taxable income no matter where it was earned.[10] The purpose of the limitation is to prevent taxes imposed by foreign jurisdictions with higher tax burdens than domestic rates from offsetting US tax on income from U.S. sources.

The overall limitation of the foreign tax credit can be expressed as a fraction:[11]

Taking into consideration that the foreign source taxable income equals the dividend after taxes plus the gross-up and the worldwide income consists of foreign source taxable income and domestic source taxable income (I) the above equation can be rewritten as:

(2) $l_e =$

$$\frac{\left(y(1-t)+\dfrac{y(1-t)Bt}{B(1-t)} \right)\left(y(1-t)+\dfrac{y(1-t)Bt}{B(1-t)}+I \right)0.35}{y(1-t)+\dfrac{y(1-t)Bt}{B(1-t)}+I}$$

$=0.35\,y.$

B = Taxable Basis according to domestic law
y = Yield
t = Tax Rate
I = Domestic Source Taxable Income

In this example, it is assumed that the domestic taxes are 35 percent. As a consequence only 35 percent can be given as an indirect credit. In this case no taxes would have to be paid to domestic authorities.

With this fraction it is also possible that high-taxed foreign-source income can be matched in the numerator with foreign-source income that is subject to a low or to no foreign taxation if the domestic tax law does not use a per country limitation. The tax burden of all foreign income is therefore averaged. This technique is also called cross-crediting. From a business perspective, it is optimal that the indirect credit equals the foreign tax credit limitation. If the indirect credit is lower than the foreign tax credit limitation, the U.S. tax law would impute taxes on the difference; if the indirect credit is higher than the foreign tax credit limitation, part of the indirect credit can only be carried forward or backward. The optimal result would be achieved if the indirect credit reduces the foreign tax credit limitation to zero.

The tax burden of a typical equity instrument considers both the foreign taxes and the domestic taxes that have to be paid. While the foreign taxes can easily be determined, the domestic taxes depend on the gross-up and the indirect credit that can be granted:

The tax burden is computed by taking the dividend after taxes and adding the gross-up in order to

$$\text{Foreign Tax Credit Limitation} = \frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Taxes on Worldwide Income before Credits}$$

determine the foreign source taxable income. This amount is then multiplied by the U.S. tax rate that is assumed to be 35 percent. From these U.S. taxes, a foreign tax credit can be granted and therefore reduces the tax burden. The foreign taxes that were levied on the foreign profits must be added in order to determine the overall tax burden:

$$(3) \quad b_e = \left(y(1-t) + \frac{y(1-t)Bt}{B(1-t)} \right) 0.35 - \frac{y(1-t)Bt}{B(1-t)} + yt$$

$$= 0.35y.$$

As a result, the tax burden of a typical equity instrument is always 35 percent. The underlying assumption of the above equation is that foreign taxes are lower than the foreign tax credit limitation ($y\,t < 0.35\,y$) and therefore can consequently be fully deducted.

If this is not the case and the indirect credit is higher than the foreign tax credit limitation ($y\,t > 0.35\,y$), only an amount up to the U.S. taxes can be credited. As a consequence, the tax burden is reduced to the foreign tax rate:

$$(4) \quad bl_e = \left(y(1-t) + \frac{y(1-t)Bt}{B(1-t)} \right) 0.35 - 0.35y + yt = yt.$$

In case the foreign taxes are higher than the domestic taxes, the tax burden of a typical equity instrument equals the dividend distribution before taxes times the foreign tax rate.

HYBRID INSTRUMENTS AND THE INDIRECT CREDIT METHOD

From a business perspective, one of the many advantages of hybrid instruments is the opportunity of a double non-taxation due to the qualification conflict in different countries. One of the requirements is that the instrument must be qualified as debt in the country of the issuer. This leads to a deductibility of the interest payments. In the country of the investor a qualification as equity is necessary in order to obtain a shareholder relief for dividends.

If the exemption method is employed in the investor's country, foreign dividends are not taxed. The exemption method acts on the assumption that the dividends already have been taxed in the country of the issuer and therefore the right of taxation is abandoned. The only obstacle to double non-taxation is withholding tax that cannot be credited and therefore can prevent a double non-taxation. Practically this is not often the case as interest payments rarely result in a withholding tax due to numerous tax treaties.

However, if the investor's country uses the indirect credit for avoiding double taxation, the situation gets more complex. The country of investor adds the dividends and the deemed foreign taxes to taxable income and subsequently taxes the worldwide income regardless of whether a taxation of foreign income has taken place. In order to mitigate the double taxation, the foreign taxes can then be credited against the taxes due in the country of the investor.

Example 1:

In this example, the tax burden of a typical debt instrument, a typical equity instrument, and a hybrid instrument are compared. The yield of the capital contribution of 1,000 is 10 percent, the foreign corporate tax rate is 25 percent, and the U.S. tax rate is 35 percent:

		Typical Equity	Typical Debt	Hybrid Instrument
Foreign Profit		100	100	100
Interest Deduction		0	-100	-100
Foreign Taxes	25%	-25	0	0
Profit after Taxes		75	0	0
		Dividends	Interest	Dividends
Income		75	100	100
Dividend Gross-Up		25	0	0
Taxable Income		100	100	100
Taxes	35%	-35	-35	-35
Indirect Foreign Tax Credit		0	25	0
Taxes Due		-10	-35	-35
Effective Taxes		**35**	**35**	**35**

In the case of an equity instrument, the remuneration is not tax deductible in the foreign country and therefore has to be taxed abroad. The distributed dividends are then grossed-up with the foreign taxes, and the sum is added to the taxable income in the United States and then taxed according to U.S. tax law. Because dividends are eligible for an indirect credit, the taxes due can be reduced by the indirect credit. Tax burden in case of dividends is always at least the U.S. rate. In the case of a debt instrument, the remuneration is tax deductible as interest in the country of the issuer. In the United States, the interest income is part of the worldwide income and therefore taxed as such. However, no indirect credit can be claimed because only dividends are entitled to that credit. The remuneration of the hybrid instrument is deductible as interest due to the qualification as debt in the country of the issuer. In the United States, the remuneration that is considered to be a dividend must then be added to the worldwide income and be taxed accordingly. Because no foreign taxes have been paid, there is no gross-up and no indirect credit. As can be seen from this example, hybrid instruments do not generate indirect credits by themselves.

Assuming that besides the yield of the capital contribution the corporation realizes profits of 1,000, the following computation can be made:

instrument and a debt instrument. In both cases interest is deductible and the remaining profit is taxed according to foreign tax law. The indirect credit is computed according to the previously mentioned formula. As stated earlier, the accumulated profits have to be determined according to U.S. tax principles. Consequently the distribution of a hybrid instrument that is deductible due to the classification as interest in the foreign country is not tax deductible according to U.S. tax law and therefore must be added back to the amount of the accumulated profits.[12] Therefore it is assumed that 29.41 (100/(1.000-250+100)*250) of the foreign taxes can be attributed to the distribution of 100. Because 100 is assumed to be the net amount, 29.41 has to be grossed-up to obtain the foreign taxable income before taxes.

What has changed in comparison to the other calculations? The company does not distribute all of its earnings and, therefore, foreign taxes – that are not used for crediting – are available for the foreign tax credit.

The analysis of this issue can be made by examining the formula of the indirect credit computation. It then becomes clear that there can never be an indirect credit if there are no foreign taxes paid in the country of the issuing corporation. The formula of the indirect credit will always result in zero. Consequently, hybrid instruments can only be used when there are retained earnings for which taxes have been paid. These taxes can then

		Typical Equity	Typical Debt	Hybrid Instrument
Foreign Profit		1,100	1,100	1,100
Interest Deduction		0	-100	-100
Foreign Taxes	25%	-275	-250	-250
Profit after Taxes		825	750	750
		Dividends	Interest	Dividends
Income		75	100	100.00
Dividend Gross-Up		25	0	29.41
Taxable Income		100	100	129.41
Taxes	35%	-35	-35	-45.29
Indirect Foreign Tax Credit		0	25	29.41
Taxes Due		-10	-35	-15.88
Effective Taxes		**35**	**35**	**-15.88**

As can be seen in this example, the effective taxes of a hybrid instrument can be decreased to one-half. The analysis shows that the tax consequences abroad are identical for a hybrid

be used for the calculation of the indirect credit. Of course foreign taxes can only be credited once and, therefore, only few or no credits are available if the corporation distributes all of its profits at a later

time. Therefore it is necessary that the corporation retains earnings permanently if it wants to reduce the tax burden instead of only benefiting from a deferral of U.S. taxes.

When hybrid instruments are held by a domestic investor, the determination of the indirect credit, the foreign tax credit limitation, and the tax burden are different compared to a typical equity instrument. According to domestic law principles, the most important difference is that an equity instrument is assumed and therefore the amount received is assumed to be a dividend for which an indirect credit can be granted. In fact no taxes have been charged for the amount paid to the domestic investor (y). The accumulated profits, which can be defined as the profit after taxes ($B - B\,t$), are determined according to the U.S. tax law and therefore the remuneration of the hybrid instrument is not deductible. As a consequence the amount of the remuneration of the hybrid instrument must be added to the accumulated profit after taxes. The nondeductibility of this remuneration leads to higher accumulated profits and therefore to a decrease of the indirect credit. The foreign taxes however are based on a taxable income that does not include the payment to the U.S. corporation.[13] The indirect credit of hybrid instruments (c_h) therefore can be illustrated as follows

$$(5) \quad c_h = \frac{yBt}{B - Bt + y}.$$

B = Taxable Basis according to domestic law
y = Yield
t = Tax Rate
c_h = Indirect Credit (Hybrid Instrument)

As already mentioned, it is important to know the limitations on foreign tax credits. Generally speaking, the credit is limited to the amount of U.S. taxes attributable to the taxpayer's foreign-source taxable income.

The increase of the indirect credit in case of a hybrid instrument unfortunately does not only mean that more foreign taxes can be credited against the U.S. taxes, but also that the U.S. taxable income increases. If we assume the marginal U.S. tax rate to be 35 percent and no domestic income, the fraction of the foreign tax credit limitation in the case of a hybrid instrument (l_h) can be rewritten as:

$$(6) \quad l_h = \frac{\left(y + \frac{yBt}{B - Bt + y}\right)\left(y + \frac{yBt}{B - Bt + y} + I\right)0.35}{y + \frac{yBt}{B - Bt + y} + I}$$

$$= 0.35\,y + \frac{0.35\,yBt}{B - Bt + y}.$$

After analyzing the indirect credit and the limitation, it is necessary to determine the tax burden of a hybrid instrument. First we take the yield of the instrument that remains untaxed in the foreign country due to a classification as debt. Then we add the gross-up to determine the taxable income according to domestic law. This income is taxed with the marginal tax rate of 35 percent. If the foreign tax rate is lower than the U.S. tax rate, the tax burden of a hybrid instrument (b_h) can be computed by taking the U.S. taxes and deducting the foreign tax credit (indirect credit).

$$(7) \quad b_h = \left(y + \frac{yBt}{B - Bt + y}\right)0.35 - \frac{yBt}{B - Bt + y}$$

$$= 0.35\,y - \frac{0.65\,yBt}{B - Bt + y}.$$

If the indirect credit is higher than the foreign tax credit limitation, it is only allowed to consider the amount of the foreign tax credit limitation. As a result, the formula of the foreign tax credit limitation of a hybrid instrument (7) replaces the indirect credit:

$$(8) \quad bl_h = \left(y + \frac{yBt}{B - Bt + y}\right)0.35 - \frac{yBt}{B - Bt + y}$$

$$- \left(0.35\,y - \frac{0.65\,yBt}{B - Bt + y}\right) = 0.$$

Consequently the tax burden of the hybrid instrument can be reduced to zero under certain circumstances.

As mentioned previously, hybrid instruments do not result in any decrease of the tax burden if the foreign corporation does not retain profits. If we assume that the corporation retains earnings as high as possible ($B = infinity$) in order to determine the maximum tax advantage, we receive the following results:

	c_e	l_e	b_e	bl_e	c_h	l_h	b_h	bl_h
$B \to \infty$	yt	0.35y	0.35y	yt	$\dfrac{y_t}{1-t}$	$\dfrac{0.35y}{1-t}$	$\dfrac{0.35y - ty}{1-t}$	0.

As can be seen from the above table, the computation of the indirect credit (c_e), the foreign tax credit limitation (l_e) and the tax burden (b_e and bl_e) are not influenced by retained earnings. In other words, it does not matter if the foreign corporation is retaining profits or not, the indirect credit and the tax burden of a typical equity instrument remain constant. In case of a hybrid instrument, we can see that retaining profits to a maximum leads to a different computation of the indirect credit (c_h), the foreign tax credit limitation (l_h), and the tax burden (b_h).

If a specific foreign tax rate (t) is inserted in the previous equations, assuming that the foreign corporation is retaining profits to a maximum ($B \to \infty$), we receive the following results:

hybrid instrument, the foreign tax credit limitation equals the indirect credit at 35 percent. From this point the tax burden is determined by crediting the foreign tax credit limitation instead of the indirect credit. The tax burden is therefore highlighted in grey.

Recapitulating it can be said that the hybrid instruments always lead to a lower tax burden. However, only if the foreign tax rate equals or is higher than the domestic tax rate is double non-taxation possible.

Example 2:

The following example will illustrate the influence of hybrid financial instruments on the indirect

t	5%	10%	15%	20%	25%	30%	35%	40%	45%	50%
c_e	0,05y	0,1y	0,15y	0,2y	0,25y	0,3y	0,35y	0,4y	0,45y	0,5y
l_e	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y
b_e	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y	0,35y			
bl_e							0,35y	0,4y	0,45y	0,5y
c_h	0,05y	0,11y	0,18y	0,25y	0,33y	0,43y	0,54y	0,67y	0,82y	0,1y
l_h	0,37y	0,39y	0,41y	0,44y	0,47y	0,5y	0,54y	0,58y	0,64y	0,7y
b_h	0,32y	0,28y	0,24y	0,19y	0,13y	0,07y	0y			
bl_h							0y	0y	0y	0y

The indirect credit in case of a typical equity instrument (c_e) develops consistently with the foreign tax rate. The reasoning behind is that it is assumed that only the taxes paid in the foreign country can be granted as an indirect credit. In comparison, the indirect credit of a hybrid instrument (c_h) is not consistent with the foreign taxes but increases with the foreign tax rate. This development is due to the untaxed yield that causes the indirect credit to rise. The foreign tax credit limitation of a hybrid instrument (l_h) also does not develop equally but increases with the augmentation of the foreign tax rate. Interestingly, both in the case of the equity instrument and the

credit method. We therefore assume a foreign tax rate of 25 percent. If the tax rate of 25 percent is inserted in the formula of the indirect credit of a typical equity instrument (1) and the formula of a typical hybrid financial instrument (5), respectively, we receive the following:

$$c_{e25} - (yt)\big|_{t=0.25} = 0.25\,y$$

$$c_{h25} = \left(\frac{yBt}{B - Bt + y}\right)\Bigg|_{t=0.25}$$

$$= \frac{0.25\,yB}{0.75\,B + y}$$

Of course the foreign tax credit limitation (l_e and l_h) also has to be considered. If we insert the foreign tax rate in the formula of a typical equity instrument (2) and the formula of a hybrid instrument (6), respectively, we receive the following result:

$$l_{e25} = 0.35y$$

$$l_{h25} = \left(0.35y + \frac{0.35yBt}{B - Bt + y} \right)\Bigg|_{t=0.25}$$

$$= 0.35y + \frac{0.0875yB}{0.75B + y}.$$

These results can be illustrated as shown in Figure 1.

As can be seen in Figure 1, the indirect credit and the foreign tax credit limitation of a typical equity instrument are not influenced by retained earnings. It does not matter if the foreign corporation is distributing all of its profits or not, the indirect credit and the foreign tax credit limitation remain constant. However, the indirect credit and the foreign tax credit limitation of a hybrid instrument clearly increase with retained earnings. This tendency is not unlimited but shows in both cases as asymptotical behavior. In order to determine the maximum, it is therefore necessary to consider B as infinite:

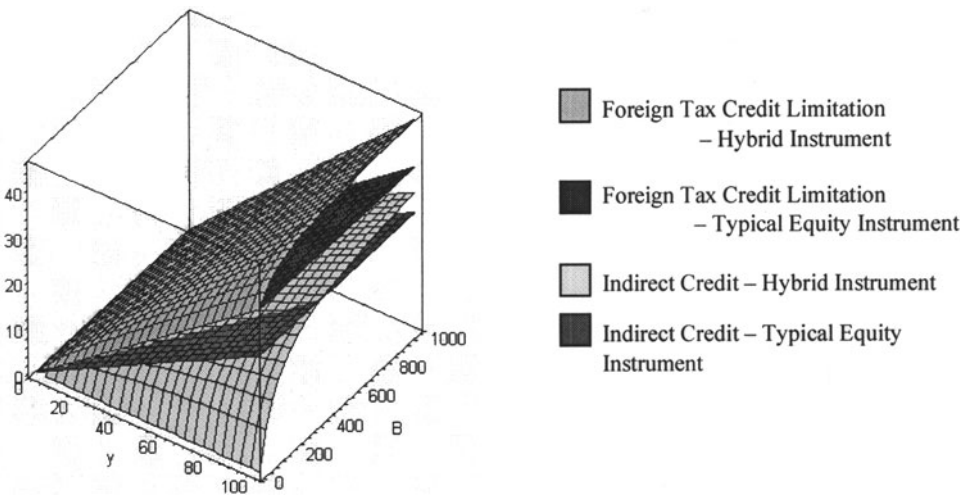$$\lim_{B \to \infty} \left(\frac{0.25yB}{0.75B + y} \right) = 0.3333333333y$$

$$\lim_{B \to \infty} \left(0.35y + \frac{0.35yB0.25}{B - B0.25 + y} \right)$$

$$= 0.4666666667y.$$

If the foreign tax rate is 25 percent and the foreign corporation is retaining profits to a maximum, the indirect credit can be increased to 33.33 percent. Comparing the indirect credit in the case of a hybrid instrument and a typical equity instrument, the indirect credit can be increased by 8.33 percentage points. It can be seen that the indirect credit of a hybrid instrument is clearly higher if more profits are retained. Comparing the foreign tax credit limitation in the case of a hybrid instrument and a typical equity instrument, the foreign tax credit limitation can be increased by 11.66 percentage points.

In both cases, the foreign tax credit limitation exceeds the indirect credit and therefore is not considered when computing the tax burden of both instruments. As a consequence the tax burden is

Figure 1: **Indirect Credit and Foreign Tax Credit Limitation - Foreign Tax Rate of 25%**

determined according to formula (3) in the case of equity instruments and formula (7) in the case of hybrid instruments:

$$b_{h25} = \left(0.35 y - \frac{0.65 yBt}{B - Bt + y} \right)\Bigg|_{t=0.25}$$

$$= 0.35 y - \frac{0.1625 yB}{0.75B + y}$$

$$b_{e25} = (yt)|_{t=0.25} = 0.25 y.$$

As can be seen from Figure 2, the tax burden of a hybrid instrument is always lower than the tax burden of an equity instrument; although, the indirect credit of a hybrid instrument only exceeds the indirect credit of a typical equity instrument if a certain amount of profits are retained. The reason for this advantage of hybrid instruments can be traced back to the fact that there is no taxation in the foreign country.

The marginal tax burden can be reduced to 13.33 percent if the foreign tax amounts to 25 percent: consequently, with hybrid instruments it is possible that the tax burden can be lowered by 21.66 percentage points compared to a typical equity instrument (4).
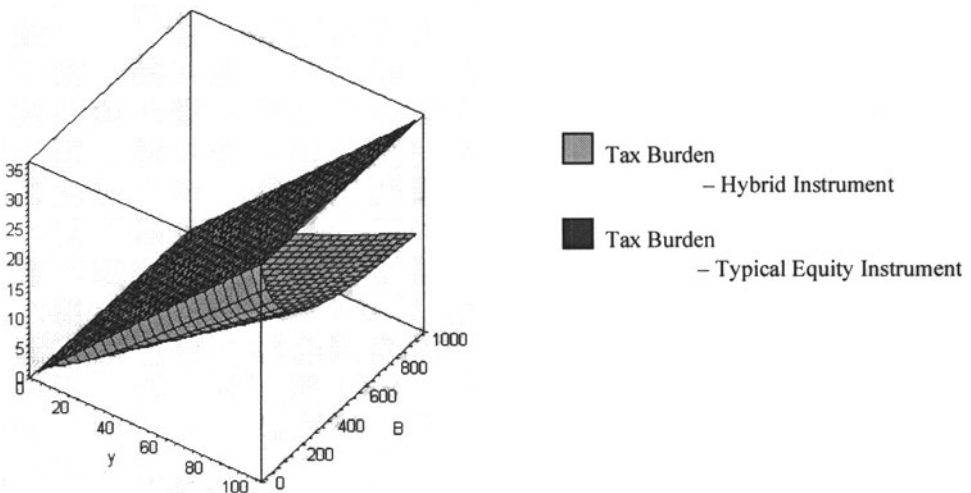
$$\lim_{B \to \infty} \left(0.35 y - \frac{0.1625 yB}{0.75B + y} \right) = 0.1333333333 y.$$

CONCLUSION

Hybrid instruments are a common way to finance a corporation. With these instruments it is possible to be flexible and adjust to the exact demands of the issuer and the investor. From a tax perspective, those hybrid instruments need to be classified into debt or equity in order to apply tax law correctly. Every tax jurisdiction has its specific way to fulfill this task. It is therefore possible that in the international field, one country can treat a specific instrument as equity while the other country treats it like debt. This qualification conflict can either lead to double taxation or double non-taxation of the yields in question.

An instrument that is qualified as debt in a foreign country and as equity in the domestic country causes a different computation of the indirect credit and the foreign tax credit limitation. Most importantly, hybrid instruments that are qualified as debt in the foreign country cannot lead to a tax cut because no foreign corporate taxes have been paid. It is therefore necessary that the foreign corporation pay taxes – preferably for other profits that are not distributed. In this case an indirect credit can be determined for the hybrid instrument. The computation is slightly different from an equity instrument because the yield is considered to be an after-tax amount and the accumulated profits are determined according to domestic law. However, an indirect credit can be granted although

Figure 2: **Tax Burden - Foreign Tax Rate of 25%**

no taxes have been paid for the hybrid instrument abroad. As a consequence, the tax burden is reduced.

The benefit of hybrid finance is dependent on the foreign tax rate. Only if the foreign corporation is paying taxes corresponding to the domestic tax rate is double non-taxation possible. In this case, however, the foreign corporation still has to retain enough earnings.

Generally speaking, cross-border transactions with hybrid instruments and the indirect credit method can lead to a lower tax burden. However, these transactions are difficult to manage and can be disadvantageous for the taxpayer if an indirect credit is denied.

Notes

[1] This of course is not the case if debt is held in proportion by the shareholders.

[2] Widmayer (2001).

[3] The following countries have implemented the indirect credit method: China, Estonia, Great Britain, Jamaica, Canada, Malaysia, Mexico, Zambia, Singapore, United States of America, and Cyprus (Vogel and Lehner, 2003, Art 23, Rz 90).

[4] Sec 964 IRC contains detailed rules for computing earnings and profits, while they also allow some leeway by providing that adjustments must be made to the accounts of the foreign corporation only if they are material, Regs 1.964-1 Gustafson, Peroni, and Pugh (2001); West (1996, p. 162); and Lau and Soltis (2004, p. 290) provide a detailed description of the computation of the accumulated profits.

[5] Bittker and Eustice (2000): 15.21[2][c].

[6] American Chicle Co. v. US (1942); Bittker and Eustice (2000): 15.21[2][d].

[7] "The 'gross-up' prevents the U.S. corporate taxpayer from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of the actual distribution or subpart F inclusion reflects only after-foreign tax profits" (Joint Committee on Taxation, 1987; Gattegno and Yesnowitz, 2005, p. 32).

[8] Sec 904(c) IRC, Reg 1.904-2(a); Fuller (2004, p.333); Schuch and Toifl (1997); Gustafson, Peroni, and Pugh, (2001, p.353); Russell (2004 p. 10); and Doering (2005, p 55). Before the American Jobs Creation Act of 2004, the excess credits could be carried back two preceding tax years and carried forward five years, this amendment will increase the competitiveness of U.S. companies.

[9] Gustafson, Peroni, and Pugh (2001, p. 353); Jones (2001, p. 332); and Andersen (2002) Unused credits of a basket can only be carried back or carried forward within that basket.

[10] Jones (2001, p. 331); Jones and Rhoades-Catanach (2004, p. 295); Bittker and Lawrence (2003); Bittker and Eustice (2000); and Wacker (2004).

[11] Wacker (2004) and Doernberg (2001, p. 211).

[12] Gustafson, Peroni, and Pugh (2001, p. 315).

[13] For simplicity reasons the following assumptions are made in the analysis: The taxable income (B) is computed identically (except from the remuneration of the hybrid instrument) in the US and the foreign tax law. The tax rate in the foreign country remains constant over the years. The US tax rate is assumed to be the marginal tax rate of 0.35.

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