increase in basis provided by the preceding sentence shall be made only to the extent to which such amount required to be included in gross income under section 951(a) was so included in gross income.

(2) *Limitation on amount of increase in case of election under section 962.* In the case of a United States shareholder who makes the election under section 962 for the taxable year, the amount of the increase in basis provided by subparagraph (1) of this paragraph shall not exceed the amount of United States tax paid in accordance with such election with respect to the amounts included in such shareholder's gross income under section 951(a) for such year (as determined under § 1.962–1).

(b) *Rules of application*—(1) *Property defined.* The property of a United States shareholder referred to in paragraph (a)(1)(ii) of this section shall consist of—

(i) Stock in a foreign corporation;

(ii) An interest in a foreign partnership; or

(iii) A beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share of stock.* Any increase under paragraph (a) of this section in the basis of a United States shareholder's stock in a foreign corporation shall be made in the amount included in gross income under section 951(a) or in the amount of United States tax paid in accordance with an election under section 962, as the case may be, with respect to each share of such stock.

(c) *Illustration.* The application of this section may be illustrated by the following examples:

Example 1. Domestic corporation M owns 800 of the 1,000 shares of the one class of stock in controlled foreign corporation R which owns all of the one class of stock in controlled foreign corporation S. Corporations M, R, and S use the calendar year as a taxable year. In 1964, S Corporation has $100,000 of earnings and profits after the payment of $11,250 of foreign income taxes, and $100,000 of subpart F income. Corporation R has no earnings and profits. With respect to S Corporation, M Corporation is required to include in gross income $80,000 (800/1,000×$100,000) under section 951(a), and $9,000 ($80,000/$100,000×$11,250) under section 78. On December 31, 1964, M Corporation must increase the basis of each share of its stock in R Corporation by $100 ($80,000/800).

Example 2. A, an individual United States shareholder, owns all of the 1,000 shares of the one class of stock in controlled foreign corporation T. Corporation T and A use the calendar year as a taxable year. In 1964, T Corporation has $80,000 of earnings and profits after the payment of $20,000 of foreign income taxes, and $80,000 of subpart F income. A makes the election under section 962 for 1964 and in accordance with such election pays a United States tax of $23,000 with respect to the $80,000 included in his gross income under section 951(a). On December 31, 1964, A must increase the basis of each share of his stock in T Corporation by $23 ($23,000/1,000).

[T.D. 6850, 30 FR 11854, Sept. 16, 1978]

§ 1.961–2 Reduction in basis of stock in foreign corporations and of other property.

(a) *Reduction in basis*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the adjusted basis of a United States person's—

(i) Stock in a foreign corporation;

(ii) Interest in a foreign partnership; or

(iii) Beneficial interest in a foreign estate or trust (as defined in section 7701(a)(31)),

with respect to which such United States person receives an amount which is excluded from gross income under section 959(a), shall be reduced under section 961(b), as of the time such person receives such excluded amount, by the sum of the amount so excluded and any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(2) *Limitation on amount of reduction in case of election under section 962.* In the case of a distribution of earnings and profits attributable to amounts with respect to which an election under section 962 has been made, the amount of the reduction in basis provided by subparagraph (1) of this paragraph shall not exceed the sum of—

(i) The amount of such distribution which is excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962–3; and

(ii) Any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(b) *Reduction with respect to each share of stock.* Any reduction under paragraph (a) of this section in the adjusted basis of a United States person's stock in a foreign corporation shall be made with respect to each share of such stock in the sum of—

(1)(i) The amount excluded from gross income under section 959(a); or

(ii) The amount excluded from gross income under section 959(a) after the application of section 962(d) and § 1.962–3; and

(2) The amount of any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States on or with respect to the earnings and profits attributable to such excluded amount when such earnings and profits were actually distributed directly or indirectly through a chain of ownership described in section 958(a)(2).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

(d) *Illustration.* The application of this section may be illustrated by the following examples:

Example 1. (a) Domestic corporation M owns all of the 1,000 shares of the one class of stock in controlled foreign corporation R, which owns all of the 500 shares of the one class of stock in controlled foreign corporation S. Each share of M Corporation's stock in R Corporation has a basis of $200. Corporations M, R, and S use the calendar year as a taxable year. In 1963, S Corporation has $100,000 of earnings and profits after the payment of $50,000 of foreign income taxes and $100,000 of subpart F income. For 1963, M Corporation includes $100,000 in gross income under section 951(a) with respect to S Corporation. In accordance with the provisions of § 1.961–1, M Corporation increases the basis of each of its 1,000 shares of stock in R Corporation to $300 ($200+$100,000/1,000) as of December 31, 1963.

(b) On July 31, 1964, M Corporation sells 250 of its shares of stock in R Corporation to domestic corporation N at a price of $350 per share. Corporation N satisfies the requirements of paragraph (d) of § 1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, the earnings and profits attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963 are distributed to R Corporation which incurs a withholding tax of $10,000 on such distribution (10 percent of $100,000) and an additional foreign income tax of 33⅓ percent or $30,000 by reason of the inclusion of the net distribution of $90,000 ($100,000 minus $10,000) in its taxable income for 1964. On June 30, 1965, R Corporation distributes the remaining $60,000 of such earnings and profits to corporations M and N: Corporation M receives $45,000 (750/1,000×$60,000) and excludes such amount from gross income under section 959(a); Corporation N receives $15,000 (250/1,000×$60,000) and, as M Corporation's successor in interest, excludes such amount from gross income under section 959(a). As of June 30, 1965, M Corporation must reduce the adjusted basis of each of its 750 shares of stock in R Corporation to $200 ($300 minus ($45,000/750+$10,000/1,000+$30,000/1,000)); and N Corporation must reduce the basis of each of its 250 shares of stock in R Corporation to $250 ($350 minus ($15,000/250+$10,000/1,000+$30,000/1,000)).

Example 2. The facts are the same as in paragraph (a) of example 1, except that in addition, on July 31, 1964, R Corporation sells its 500 shares of stock in S Corporation to domestic corporation P at a price of $600 per share. Corporation P satisfies the requirements of paragraph (d) of § 1.959–1 so as to qualify as M Corporation's successor in interest. On September 30, 1964, S Corporation distributes $100,000 of earnings and profits to P Corporation, which earnings and profits are attributable to the $100,000 included in M Corporation's gross income under section 951(a) for 1963. Corporation P incurs a withholding tax of $10,000 on the distribution from S Corporation (10 percent of $100,000). As M Corporation's successor in interest, P Corporation excludes the $90,000 it receives from gross income under section 959(a). As of September 30, 1964, P Corporation must reduce the basis of each of its 500 shares of stock in S Corporation to $400 ($600 minus ($90,000/500+$10,000/500)).

[T.D. 6850, 30 FR 11854, Sept. 16, 1965]