USP, a domestic corporation, owns 100% of CFC1 which, in turn, owns 100% of CFC2. At the beginning of Year 1, at a time when CFC2 has a value of $300 and CFC2 has zero applicable earnings (within the meaning of section 956(b)(1)), CFC2 loans $100 to USP in exchange for a note. During Year 1, CFC2 generates $100 of non-subpart F earnings and profits. Shortly before the end of Year 1, CFC2 distributes $100 to CFC1 that results in a $100 dividend to CFC1 and, as a result, CFC2 takes the position that it's applicable earnings under section 956(b)(1) are reduced from $100 to $0.

The USP note held by CFC2 is United States property (within the meaning of section 956(c)(1)(C)), and CFC2 generated $100 of earnings and profits during Year 1. As a result, USP would have an income inclusion of $100 pursuant to section 951(a)(1)(B), but for the applicable earnings limitation under section 956(b)(1). However, as a result of the Year 1 dividend CFC2 paid to CFC1, CFC2 does not have any applicable earnings and USP, therefore, would not have a section 951(a)(1)(B) inclusion. If a dividend reduces or eliminates the applicable earnings of a CFC, within the meaning of section 956(b)(1), such that it reduces a U.S. shareholder's inclusion pursuant to section 951(a)(1)(B), the dividend is not eligible for the section 954(c)(6) exception. Thus, the dividend income of CFC1 is not eligible for the section 954(c)(6) exception.