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U.S. Tax Court: Taxpayer entitled to dividends received deduction under section 245A, but not foreign tax credits, on amounts treated as dividends under section 78

The U.S. Tax Court today held that the taxpayer is entitled to a dividends received deduction (DRD) under section 245A with respect to amounts that the taxpayer treated as dividends under section 78, but it not entitled to claim foreign tax credits (FTCs) with respect to such amounts.

The case is: *Varian Medical Systems, Inc. v. Commissioner*, 163 T.C. No. 4 (August 26, 2024). Read the Tax Court's opinion

Summary

The taxpayer is the parent company of a consolidated group of medical device and software manufacturers with its principal place of business in Palo Alto, California. The taxpayer operates through corporations in many different countries, at least some of which are controlled foreign corporations (CFCs) as that term is defined in section 957(a). The taxpayer and its CFCs are fiscal year taxpayers, and relevant for the year at issue in this case, the fiscal year of the taxpayer and its CFCs started on September 30, 2017, and ended on September 28, 2018 (the "2018 Year").

On its consolidated federal income tax return for the 2018 Year, the taxpayer elected to claim FTCs for foreign taxes that it was deemed to pay under section 960 and was therefore required to "gross up" its taxable income under section 78 by reporting a dividend of approximately $159 million. The taxpayer also claimed a deduction of approximately $60 million under section 245A in connection with the dividend it was treated as receiving under section 78 from its first-tier CFCs.

The IRS disallowed Varian's claimed deduction under section 245A and determined, in the alternative, that if the taxpayer was entitled to deduct its section 78 dividend under section 245A, then section 245A(d) would disallow any FTCs attributable to that amount.

The taxpayer petitioned the Tax Court for a redetermination of the IRS' determinations and also alleged for the first time that it was entitled to additional section 245A deductions of approximately $100 million, primarily related to the portion of its section 78 dividend arising from its lower-tier CFCs. The taxpayer then filed a motion for partial summary judgment asking the court to determine as a matter of law that it is entitled to a deduction under section 245A for its section 78 dividend for the 2018 Year.

Section 245A, which was enacted by the "Tax Cuts and Jobs Act" (TCJA), provides a DRD for certain dividends received by a U.S. corporation from certain foreign corporations. As in effect before the TCJA, section 78 provided that, for taxpayers who claimed FTCs, a specified amount "shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation." TCJA amended section 78 to provide that amounts treated as dividends under section 78 do not qualify for the DRD under section 245A.

Examining the plain text of the effective date provisions of section 245A and the amendments to section 78 under the TCJA, the Tax Court found that the TCJA's amendments to section 78 did not take effect until a tax year starting after section 245A took effect. Thus, the court held that as a result of this effective date mismatch, the taxpayer is entitled under section 245A to a deduction for amounts properly treated as dividends under section 78 for its 2018 Year. The court further found that Treas. Reg. § 1.78-1 does not alter this conclusion because it cannot contravene the clear statutory text.

The Tax Court agreed with the IRS, however, that section 245A(d)(1) disallows the taxpayer's FTCs to the extent they are attributable to amounts the taxpayer properly treated as dividends under section 78 and deducted under section 245A.

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