



TaxNewsFlash

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U.S. Tax Court: Taxpayer's section 245A dividends received deduction partially disallowed under section 246, foreign tax credit disallowance increased under section 965

The U.S. Tax Court today held that (1) the holding period limitations under section 246(c)(5) applied to disallow the portion of the taxpayer's dividends received deduction (DRD) under section 245 attributable to its lower-tier controlled foreign corporations (CFCs), and (2) in determining the amount of the taxpayer's foreign tax credit (FTC) disallowance under section 245A(d)(1), the taxpayer's net section 965 inclusion amount must be reduced by the taxpayer's section 965(c) deduction.

The case is: *Varian Medical Systems, Inc. v. Commissioner*, 166 T.C. No. 8 (April 8, 2026). Read the Tax Court's [opinion](#)

Summary

In *Varian Medical Systems, Inc. v. Commissioner*, 163 T.C. 76 (2024), the Tax Court held that the taxpayer—the parent company of a consolidated group of medical device and software manufacturers with its principal place of business in Palo Alto, California—was entitled to a DRD under section 245A with respect to amounts that the taxpayer treated as dividends under section 78, but was not entitled to claim FTCs with respect to such amounts.

Examining the plain text of the effective date provisions of section 245A and the amendments to section 78 under the "Tax Cuts and Jobs Act" (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 was entitled under section 245A to a deduction for amounts properly treated as dividends under section 78 for its 2018 tax year. The court further found that Treas. Reg. § 1.78-1 did not alter this conclusion because it cannot contravene the clear statutory text. The court agreed with the IRS, however, that section 245A(d)(1) disallowed the taxpayer's FTCs to the extent they were attributable to amounts the taxpayer properly treated as dividends under section 78 and deducted under section 245A.

The taxpayer and the IRS subsequently filed cross-motions for summary judgment pertaining to the computation, for the 2018 tax year, of the taxpayer's DRD under section 245A and disallowed foreign tax credits under section 245A(d)(1). The taxpayer argued that (1) the IRS was precluded from arguing that the holding period limitations under section 246(c)(5) applied to disallow a portion of the taxpayer's claimed DRD under section 245A, because as a procedural matter the argument was too late, (2) as a substantive matter, the

taxpayer's claimed DRD was allowed in full under section 246, and (3) in determining the amount of its FTC disallowance under section 245A(d)(1), the taxpayer's net section 965 inclusion must be determined without regard to section 965(c) (e.g., the formula used to compute the taxpayer's FTC disallowance under section 245A(d)(1) must include a pre-section 965(c) amount in the denominator of the fraction). The IRS disagreed with the taxpayer on each point and contended that the taxpayer's arguments regarding section 245A(d)(1) was too late.

The Tax Court held that it would not treat the IRS as having forfeited its argument concerning section 246, and it agreed with the IRS that section 246 disallowed a portion of the taxpayer's DRD under section 245A. Specifically, the court found that the term "held" as it is used in section 246(c)(1) requires direct ownership, and cannot be satisfied by indirect ownership (i.e., ownership through another entity). Thus, the court agreed with the IRS that shares held by the taxpayer's foreign subsidiaries during the relevant period were not treated as the taxpayer's assets and were not held by the taxpayer or members of its U.S. group within the meaning of section 246(c)(1). As a result, the taxpayer satisfied the holding period with respect to its first-tier CFCs and did not satisfy the holding period with respect to its lower-tier CFCs.

The court also held that it would not treat the taxpayer as having forfeited its argument concerning section 245A(d)(1), but it agreed with the IRS that the formula used to compute the taxpayer's FTC disallowance under section 245A(d)(1) (i.e., disallowed FTC = deemed paid FTC x section 78 gross-up/(net section 965 inclusion + section 78 gross-up)) must include the post-section 965(c) amount in the denominator of the fraction. In other words, the court agreed with the IRS that the net section 965 inclusion must equal the section 965(a) inclusion amount reduced by the taxpayer's section 965(c) deduction. Because the taxpayer's section 965(c) deduction constituted more than half of the taxpayer's section 965(a) inclusion amount, its inclusion almost doubled the percentage of the taxpayer's disallowed FTCs, increasing it from 6.5% to 12.52%.

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