

Varian limits Section 245A to directly held stock and adopts post-Section 965(c) FTC denominator



April 14, 2026

In brief

What happened?

The US Tax Court on April 8 resolved cross-motions for summary judgment in *Varian Medical Systems, Inc. and Subsidiaries v. Commissioner*, 166 T.C. No. 8, relating to how Varian's 2018 tax year dividend received deduction (DRD) under Section 245A and disallowed foreign tax credits (FTCs) under Section 245A(d) should be computed. In granting the IRS's motion, the court held that Varian satisfied the Section 246 holding period rule with respect to first-tier controlled foreign corporations (CFCs), but not lower-tier CFCs whose stock was not directly held by Varian or a US group member, and that the Section 245A(d) FTC disallowance formula must use the post-Section 965(c) amount in the denominator rather than the pre-Section 965(c) amount.

Why is it relevant?

The opinion is significant because it resolves issues left open after *Varian Medical Systems, Inc. and Subsidiaries v. Commissioner*, 163 T.C. 76 (2024), the Tax Court's August 2024 unanimous reviewed opinion (*Varian I*). In *Varian I*, the court held that Varian was entitled to a deduction under Section 245A for amounts treated as dividends under Section 78 for its final tax year beginning before December 31, 2017, and that a proportionate amount of deemed paid taxes attributable to the Section 78 dividend was disallowed under Section 245A(d). However, *Varian I* did not clarify if the Section 246 holding period rule would restrict the Section 245A deduction, particularly for amounts related to lower-tier CFCs.

The 2026 opinion does not disturb the earlier holding in *Varian I* but substantially narrows its practical benefit by holding that Section 246(c) disallows the Section 245A deduction for amounts attributable to lower-tier CFCs held through foreign subsidiaries, and that the Section 245A(d) FTC disallowance formula must use the post-Section 965(c) amount in the denominator. As a result, the opinion is important both for establishing that direct ownership matters in applying Section 246(c) to Section 245A, and for clarifying how the related FTC disallowance must be computed in the Section 965 context.

The opinion also is relevant beyond the Section 78 context because the court left open how the direct-ownership requirement under Section 246(c) could apply in other contexts where Section 245A is coordinated with deemed-dividend rules, such as Sections 1248(j) and 964(e)(4).

Actions to consider

Taxpayers with fiscal-year CFCs and Section 965 inclusions, especially those with lower-tier CFCs, should revisit Section 245A positions that rely on indirect ownership for holding-period purposes and should test Section 245A(d) computations using post-Section 965(c) amounts. Taxpayers also should consider whether the court's direct-ownership analysis under Section 246(c) could affect positions involving other provisions coordinated with Section 245A, including Sections 1248(j) and 964(e)(4).

In detail

Background

For a discussion of *Varian I* regarding Varian's right to a deduction under Section 245A and that its FTCs would be reduced by Section 245A(d), refer to this [PwC Tax Insight](#).

Court's analysis

The court reviewed two main issues: first, whether the Section 246(c) holding-period rule limited Varian's Section 245A deduction by excluding Section 78 amounts attributable to lower-tier CFCs whose stock Varian did not directly hold; and second, whether the denominator in the Section 245A(d)(1) FTC disallowance formula set forth in *Varian I* should use the pre- or post-Section 965(c) amount. The Tax

Court ruled against the taxpayer on both points, holding that direct ownership is required for the Section 246(c) holding period and that the Section 245A(d)(1) computation must use the post-Section 965(c) amount in the denominator.

Overview

The court began by explaining the relationship between Sections 243, 245, 245A, and 246. Sections 243, 245, and 245A each allow corporate deductions for certain dividends, while Section 246 imposes limitations on those deductions. Specifically relevant are the holding periods provided in Section 246(c), which denies a deduction for a dividend on stock if the stock “is held by the taxpayer” for less than a required period around the ex-dividend date. For Section 245A deductions, Section 246(c)(5) imposes a modified holding period and additional ownership-status requirements.

The court noted that there was no dispute that Varian’s direct stock ownership in nine first-tier CFCs satisfied the statutory holding period; however, for the 13 lower-tier CFCs whose shares were held by intermediate foreign corporations, the IRS argued that the taxpayer itself did not hold those shares and therefore the Section 246(c) requirement was not satisfied. Varian argued both that the IRS was precluded from raising the holding period issue as it should have been raised in the lead up to, or in a Motion for Reconsideration of, *Varian I*, and that Section 246 should be read to permit the deduction anyway.

Regarding Varian’s argument that the IRS forfeited or abandoned any Section 246 holding period argument by not raising it earlier, the court sided with the IRS. The court noted that the prior proceedings did not clearly raise the issue. Further, the court was persuaded by the fact that the holding period issue raises a recurring and purely legal issue with no disputed facts, and thus it would not prejudice Varian for the court to consider the issue. Based on this reasoning, the court exercised its discretion to overlook any potential forfeiture of the argument to reach the merits.

Observation: The court’s exercise of discretion to consider the merits of the holding period issue could be difficult to challenge even though Varian’s forfeiture argument was supported by the nature of the prior proceedings and various statements in *Varian I*.

Holding period

The court first addressed which shares matter for Section 246(c). It reasoned that Section 78 treats an amount equal to taxes deemed paid by a foreign corporation as a dividend received by the domestic corporation from that foreign corporation. As such, each Section 78 amount is linked to the specific foreign corporation that paid the tax, and not indirectly through the chain of ownership. Because the dividend is treated as coming from the foreign corporation that paid the tax, the court concluded the Section 78 dividend is a dividend “on [the] share[s] of [that CFC]” for purposes of Section 246(c)(1). Thus, to deduct Section 78 amounts tied to lower-tier CFCs, the taxpayer would need to satisfy the requisite holding-period with respect to the shares of those lower-tier entities.

The court next considered whether stock is “held by the taxpayer” only when directly owned, or also when indirectly owned through another entity. Drawing on dictionary definitions, the Section 7701 definition of taxpayer, Section 1223 holding-period principles, and longstanding corporate law, the court concluded that direct ownership is required. The court relied heavily on the principle that corporations and shareholders are separate legal and taxable entities and on *Dole Food Co. v. Patrickson*, 538 U.S. 468 (2003), where the Supreme Court held that ownership through intermediary corporations is not the same as direct ownership. Because Varian’s lower-tier CFC shares were owned by foreign subsidiaries, not by Varian or a US group member directly, the court held those shares were not “held by the taxpayer.”

Observation: For Section 246(c)(1), the court adopted a formal ownership approach, not a look-through approach. The court emphasized that if Congress “had intended for the term “held” to include indirect ownership, it could have said so, as it did in at least 22 other instances of the Code” and that Section 246(c)(5)(B) expressly incorporates concepts that rely on indirect ownership.

The court rejected Varian’s argument that Section 78 amounts are not “dividend[s] on any share of stock,” noting that Varian had argued the opposite position in the lead up to the 2024 opinion in *Varian I*. Thus, the court restated that Section 78 amounts treated as dividends must also be treated as dividends paid by reason of stock ownership for Section 246(c).

The court also rejected Varian’s argument that the term “hold” is broad enough to include indirect ownership, relying on *Dole Food* and related authorities and the repeated use of “directly or indirectly” elsewhere in the Code.

The court did not believe that Section 246(c)(5)(B), which considers indirect ownership and requires a foreign corporation to be a specified 10%-owned foreign corporation during the entirety of the taxpayer’s holding period, replaces the holding period requirement of Section 246(c)(1). Rather, the court rejected that reading based on the phrase “only if,” which creates a necessary condition, not a sufficient one. In the court’s view, Section 246(c)(5)(B) adds another requirement; it does not replace Section 246(c)(1).

The court also was not persuaded by Varian’s arguments that the court’s interpretation would conflict with other Code provisions, including Sections 245(b), 1248, and 964(e). With respect to Section 245(b), the court explained that indirect ownership can still matter to determine whether an ownership threshold is met or what percentage deduction is available, even if actual dividends remain tied to directly owned stock. Further, the court declined to address Section 1248 or Section 964(e), stating that those provisions were not at issue in the case.

Observation: The court relied on the fact that Section 246(c)(1) only refers to stock that is “held by the taxpayer,” without qualification or clarification, and, therefore refused to interpret the provision to include indirect ownership.

Observation: Varian leaves open how the Section 246(c) direct-holding rule applies when Section 245A is coordinated with other deemed-dividend provisions. For example, Section 1248(j) could raise the

question whether Section 246 tests the holding period by reference to the first-tier stock actually sold or to lower-tier stock whose earnings and profits help determine the dividend amount, while Section 964(e)(4) could raise the question in the case of a lower-tier CFC seller because the statute treats the income as if it were a dividend from the selling CFC. Even so, the court's narrow interpretation increases uncertainty regarding the treatment of lower-tier structures in both settings.

Section 245A(d)

The court also addressed a computational dispute regarding the FTC disallowance in Section 245A(d) that arose from its prior decision. In *Varian I*, the court established a formula for identifying the disallowed FTC by multiplying deemed paid FTCs by a fraction whose numerator is the Section 78 gross-up and whose denominator is the net Section 965 inclusion plus the Section 78 gross-up. The parties agreed as to the amount of deemed paid FTCs and the Section 78 gross-up and agreed that both of these amounts were determined with regard to the Section 965(c) deduction. Thus, the dispute centered on the meaning of "net section 965 inclusion" in the denominator of the court's formula. Varian asserted the "net section 965 inclusion" was the Section 965(a) inclusion amount after reduction for deficits described in Section 965(b), while the IRS asserted the amount must be further reduced by the Section 965(c) deduction.

The court first discussed that the purpose of the formula is to identify foreign taxes paid with respect to the deductible dividend and to preserve the appropriate ratio between earnings, taxes, and Section 78 gross-up. The court then set forth computations to illustrate that the ratio of FTCs to the Section 965(a) inclusion amount was the same as the ratio of disallowed taxes computed using the IRS's position, while Varian's approach would result in a significantly lower ratio of disallowed taxes.

The court emphasized that the FTC haircut rules in Section 965(g)(1) and (4) operate in tandem with Section 965(c), such that where Section 965(c) reduces the effective net amount taken into account, the associated credits and gross-up are reduced as well. The court explained that if the Section 965(c) deduction reduced the effective US tax base but FTCs and the Section 78 gross-up were left unreduced, the taxpayer would claim credits computed as though the full inclusion were taxed at ordinary rates, creating a mismatch. As a result, Congress addressed the issue through Section 965(g)(1), which disallows a portion of FTCs, and Section 965(g)(4), which correspondingly reduces the Section 78 gross-up. Based on the above, the court held that the denominator in the Section 245A(d)(1) formula should be consistent and that the "net section 965 inclusion" must reflect the post-Section 965(c) amount.

Observation: Based on the court's holding related to Section 246(c), the Section 245A(d) disallowance formula is relevant only for foreign taxes deemed paid from Varian's nine first-tier CFCs.

Court's conclusion

The court held that Section 246 disallows the portion of Varian's Section 245A deduction attributable to lower-tier CFCs, and the formula for the Section 245A(d)(1) FTC disallowance must use the post-Section 965(c) amount in the denominator.

See also

- Tax Insight: US Tax Court rules taxpayer is allowed a Section 245A DRD for the Section 78 Gross Up but disallows FTCs (August 29, 2024)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

International Tax Services

Aaron Junge
+1 (202) 739-1053
aaron.junge@pwc.com

Elizabeth Nelson
+1 (202) 460-8329
elizabeth.nelson@pwc.com

David Sotos
+1 (202) 701-3236
david.sotos@pwc.com

Micah Gibson
+1 (412) 559-2800
micah.j.gibson@pwc.com

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