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Tax Court invalidates tax regulation in *Varian*, first case to consider validity since *Loper Bright*

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In *Varian,* the first case to consider the validity of a Treasury regulation after *Loper Bright* (in which the U.S. Supreme Court rejected the longstanding *Chevron* doctrine), the Tax Court invalidated the regulation in question and ruled that the taxpayer was entitled to the favorable tax treatment provided by a statutory mismatch in effective dates between new Section 245A and a corresponding change to Section 78.

Factual background

The Tax Court considered an issue in *Varian Medical Systems v. Commissioner*[1] that resulted from a mismatch in the effective dates of two statutory changes enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA). The first statutory change was the enactment of new Section 245A and the second was a corresponding amendment to Section 78.

Section 245A provides a deduction for domestic corporate parents receiving foreign source dividends from certain 10% owned foreign subsidiaries. Section 78 has been in the Code since the Subpart F regime was enacted in 1962 and, prior to the amendment at issue in *Varian*, provided that when a domestic corporation claimed a foreign tax credit (FTC) for foreign taxes deemed paid in connection with a Subpart F inclusion or the receipt of a dividend from certain 10% owned foreign subsidiaries, it was also treated as receiving a dividend (commonly known as the "Section 78 gross-up") in respect of those foreign taxes.[2] Section 78 has always included an exception specifying that the domestic corporation is not deemed to receive the Section 78 gross-up for purposes of the dividends received deduction under Section 245.[3] This exception is necessary to prevent the dividends received deduction from effectively undoing the Section 78 gross-up. When Congress enacted new Section 245A in the TCJA, it therefore expanded the exception to include Section 245A, with the result that the domestic corporation would not be entitled to a Section 245A deduction for the Section 78 gross-up.

There was a potential mismatch, however, between the effective date of new Section 245A and the effective date of the corresponding amendment to Section 78. While new Section 245A applied to distributions made after December 31, 2017,[4] the amendment to Section 78 was effective for "taxable years of foreign corporations beginning after December 31, 2017, and … taxable years of United States shareholders in which or with which such taxable years of foreign corporations end."[5] For calendar year taxpayers, that would be the tax year beginning January 1, 2018, so there would be no mismatch. But for fiscal year taxpayers, that would be the tax year beginning sometime after January 1, 2018, thus creating a window during which the Section 245A deduction was available to offset a Section 78 gross-up.

The taxpayer in *Varian* was a fiscal year taxpayer whose first taxable year beginning after December 31, 2017 began on September 29, 2018. As a result, under the statute, the Section 245A deduction was available for any Section 78 gross-up deemed received between January 1, 2018 and September 28, 2018, including the Section 78 gross-up in respect of the taxpayer's Section 965 inclusion for its year ending September 28, 2018.

In 2019, the IRS and Treasury seemingly acknowledged the mismatch in the statute and attempted to eliminate it with Treasury Regulation section 1.78-1, which provides that "[a] Section 78 dividend is … not treated as a dividend for purposes of Section 245 or 245A" and is effective for any Section 78 dividends received after December 31, 2017.[6]

Tax Court holding

The Tax Court unanimously held invalid the regulation that attempted to fix the mismatch in the statute and held that the taxpayer was entitled to a Section 245A deduction for any Section 78 gross-up deemed received between January 1, 2018 and September 28, 2018, the last day of its tax year. The Tax Court reasoned that the regulation "impermissibly attempts to change an unambiguous provision of the statute" by modifying the clear effective date of amended Section 78 and therefore "falls outside the boundaries of any authority that Congress may have delegated under Section 245A."[7]

Notably, however, the Tax Court sustained a separate argument by the Commissioner that, although the Section 245A deduction was available for the taxpayer's Section 78 gross-up, Section 245A(d)(1) applied to preclude the taxpayer from claiming FTCs for foreign taxes paid on the portion of earnings corresponding to the Section 78 gross-up. Section 245A(d)(1) provides that "no credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed" under that section. Accordingly, the taxpayer in *Varian* was entitled to its claimed Section 245A deduction, but its FTCs were correspondingly reduced.

Key takeaways

No apparent impact of *Loper Bright*

Varian was the first application by any court of the Supreme Court's decision in *Loper Bright Enterprises v. Raimondo*[8] to a challenge to the validity of a tax regulation. In *Loper Bright*, the Supreme Court overruled *Chevron v. Natural Resources Defense Council, Inc.*[9] and held that deference to an agency's permissible interpretation of an ambiguous or silent statute conflicted with the longstanding proposition that courts decide legal questions. The case is therefore widely expected to both encourage and strengthen challenges to tax regulations. (See our prior update on *Loper Bright*.)

Despite quoting extensively from *Loper Bright*, the Tax Court's reasoning offers little insight into the impact *Loper Bright* will have on challenges to Treasury regulations. Indeed, the Tax Court emphasized the lack of ambiguity regarding the two effective dates and went so far as to say that, even under the prior *Chevron* framework, courts were required to reject administrative interpretations that are contrary to Congress's clear intent expressed in the statute.[10] The Section 78 regulation in *Varian* was unambiguously inconsistent with the statute, compelling the court's conclusion even under the prior framework. And the court matter-of-factly concluded that no delegation of authority to Treasury could overcome the statutory effective dates. (In this way, *Varian* suggests that the conclusion reached by the district court in *Liberty Global, Inc. v. United States*,[11] where the court invalidated Treasury regulations promulgated under Section 245A that similarly attempted to close a gap in applicability dates of the TCJA legislation, was correct on the merits.)

Potential disallowance of FTC

Taxpayers who have previously claimed, or have preserved the ability to claim, Section 245A deductions for Section 78 gross-ups should note the Tax Court's holding that Section 245A(d)(1) applies to disallow FTCs for the foreign taxes attributable to the Section 78 gross-up. Depending on the particular facts – including the foreign tax rate relative to the U.S. tax rate and the application of the FTC limitation provisions – a taxpayer may find itself worse off applying Section 245A to its Section 78 gross-up than applying the regulation that attempted to fix the mismatch.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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1 163 T.C. No. 4 (2024).

2 I.R.C. § 78. This provision ensures that a domestic corporation claiming FTCs with respect to taxes deemed paid as a result of Subpart F inclusions or dividends does not also get the benefit of a reduction in income as a result of those deemed paid taxes.

3 Section 245 provides a deduction to a corporate shareholder equal to a specified percentage of the U.S. source portion of any dividend received from certain 10% owned foreign corporations.

4 Pub. L. No. 115-97, § 14101(a), 131 Stat. 2054, 2192 (2017).

5 Pub. L. No. 115-97, § 14301(c)(1), 131 Stat. 2054, 2225 (2017).

6 Treas. Reg. § 1.78-1(c). In early 2019, the Chairman of the House Ways and Means Committee released a Tax Technical and Clerical Corrections Act Discussion Draft related to the TCJA that included a proposed fix for the effective date mismatch between Section 245A and amended Section 78, but Congress did not act on the proposal. Chairman Kevin Brady, Committee on Ways and Means, U.S. House of Representatives, *Tax Technical and Clerical Corrections Act Discussion Draft*, at 73 (Jan. 2, 2019), https://republicans-waysandmeansforms.house.gov/uploadedfiles/tax_technical_and_clerical_corrections_act_discussion_draft.pdf.

7 163 T.C. at 31.

8 603 U.S. __ (2024) (No. 22-451), together with *Relentless, Inc. v. Department of Com.*, (No. 22-1219).

9 467 U.S. 837 (1984).

10 163 T.C. at 30 (citing *Chevron*, 467 U.S. at 842).

11 No. 1:20-cv-03501-RBJ (D. Colo. Apr. 4, 2022).