Litigation Finance Update: US Tax Court Refutes Loan Treatment for Upfront Litigation Support Payments in *Novoselsky v. Commissioner*

By Mark Leeds and Stephanie Wood [1]

To the best of our knowledge, the decision in *Novoselsky v. Commissioner*,[2] released on May 28, 2020, is the first modern reported case to directly address the US tax treatment of the receipt of litigation support payments. In the litigation support arrangement in *Novoselsky*, a lawyer received upfront payments designated by documentation as non-taxable loans. If a litigation was successful, the lawyer was required to repay the upfront advance, plus a premium (or interest), from the attorney's fees he received in that lawsuit. If the litigation was unsuccessful, however, the lawyer was not required to repay the advance. For US federal income tax purposes, the lawyer treated the upfront payments as non-taxable loans.[3] The Internal Revenue Service (the "IRS") asserted that the upfront payments resulted in current income to the lawyer. The court held for the IRS and sustained the imposition of substantial penalties. The decision is likely to have significant ramifications in the litigation finance market.

In *Novoselsky*, the upfront payments to the lawyer were provided by investors seeking high returns on invested capital and by persons whose interests were economically aligned with the position being taken by the clients of the lawyer in a particular litigation. In one arrangement, two doctors provided class action litigation financing for a *per annum* return of 18% (simple, not compounded) if the litigation was successful. In another arrangement, a person advanced $500,000 to the taxpayer, who would have paid $1 million to the funder if the litigation was successful. In a third arrangement, a doctor advanced $250,000 in exchange for a return of that money plus $42,500 per year from the first dollars received by the lawyer in another class action. In all cases, the lawyer deposited the advances into his personal or business account. All of these arrangements were designated as non-recourse loans, secured by any recovery received by the taxpayer. No arrangement required the lawyer to segregate the amount of the advances or use them in any particular way.

The court framed the issue as to whether the litigation advance payments should be treated as loans by asking whether the taxpayer's obligation to repay was "unconditional and not contingent upon some future event."[4] The court then discussed cases, including two early cases in which litigation costs were funded, in which arrangements were not treated as loans for federal income tax purposes because the obligation to return the advance was contingent upon a future event.[5] After reviewing these cases, the

IRS held that litigation support advances would not be treated as loans because the lawyer's obligation to repay was contingent upon a successful prosecution of the litigation. Instead, the court held that the advances were prepaid income to the lawyer, which was taxable in the year in which the lawyer received the advance.

The court buttressed its conclusion that the litigation support payments were taxable as ordinary income to the taxpayer by examining the multi-factor test used by the courts to distinguish debt from equity and other situations in which an issue was posed as to whether an advance was debt or an item of income. These factors include whether:

1) the promise to repay is evidenced by a note or other instrument;
2) interest was charged;
3) a fixed schedule for repayments was established;
4) collateral was given to secure payment;
5) repayments were made;
6) the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and
7) the parties conducted themselves as if the transaction was a loan.[6]

In the court's view, these factors did not support loan treatment for the litigation funding payments. There was no formal promissory note or fixed schedule for repayment. The parties did not view the lawyer's personal ability to repay the advances as relevant. Certain agreements provided for bonus income, not interest. Importantly to the court, the parties did not treat the transactions as loans because the advances were not made with a "reasonable expectation of repayment regardless of the success of the venture."[7]

I. Authorities Addressing Certain US Federal Income Tax Issues Posed by Litigation Finance (What We Know)

Although *Novoselsky*, is the first decided case addressing a modern litigation funding transaction, the tax issues surrounding litigation financing have received some attention over the years. In *Bercaw v. Commissioner*[8] (cited by the Tax Court in *Novoselsky*), the taxpayer's son was injured while playing in a public park and the taxpayer's wife, acting as *guardian ad litem*, initiated a lawsuit against the town in which the park was located. The taxpayer agreed to fund the cost of the litigation, with the oral understanding that he would be reimbursed for the amounts he paid if the litigation was successful. The lawsuit was eventually abandoned and the taxpayer received back about 25% of his advances. He claimed a deduction for the amounts advanced that he did not recover as a bad debt expense. The court held that since the taxpayer's wife was obligated to return the advances only from a successful conclusion of the lawsuit, the repayment obligation "was subject to a condition precedent, i.e., recovery of sufficient funds, which condition was never fulfilled and consequently the guardian's obligation [to repay] never arose." Accordingly, the court denied the bad debt deduction to the taxpayer.

In *Estate of Paine v. Commissioner*[9] (also cited by the Tax Court in *Novoselsky*), the taxpayer made weekly advances over a five-year period to an unrelated woman who had initiated a lawsuit alleging the theft of intellectual property by a theater company. The litigant signed a promissory note in favor of the taxpayer that entitled the taxpayer to 25% of any recoveries in the litigation, as consideration for the cash advances. The litigant also signed subsequent similar notes promising to pay a fixed dollar amount of any such recovery in exchange for subsequent advances. The plaintiff lost the lawsuit and the taxpayer received nothing in return for his advances. The taxpayer claimed a loss for nonbusiness bad debt in that year. The Tax Court held that the advances did not create a debtor-creditor relationship. As a result, the court denied the taxpayer's bad debt deduction.

Clearly, the result in *Estate of Paine* is particularly harsh. The facts recited in the case make clear that the taxpayer had advanced money to a third party with the intent to earn a positive pre-tax return on such advances. When the lawsuit was lost, the taxpayer experienced an economic loss with respect to an activity entered into for profit. Although, in the court's view, the relationship between the litigant and the taxpayer was not that of debtor-creditor, the taxpayer should have been entitled to a tax deduction with respect to an activity entered into for profit.[10]

In *Long v. Commissioner*,[11] in 2002, the taxpayer purchased an option to buy real estate on which he intended to build condominiums that would be sold to homebuyers. In 2004, the seller balked at proceeding and the taxpayer won a judgment against the seller that compelled the seller to honor the agreement. The seller then appealed the judgment. In 2006, the taxpayer sold his rights in the lawsuit for $5.75 million. The issue before the court was whether the gain on the sale of the lawsuit was ordinary income or capital gain. The IRS asserted that the character should be determined by looking through the lawsuit to the underlying land.[12] The IRS further asserted that the land would be inventory in the taxpayer's hands. Under this analysis, the gain recognized by the taxpayer would have been ordinary income.[13]

The appeals court rejected this approach in part. The appeals court agreed that the character of the income should be determined by looking through the litigation claim. In the view of the appeals court, however, the underlying claim related to an option to purchase the real estate, not the real estate itself. The court concluded that the option was a capital asset in the hands of the taxpayer. Accordingly, the court held that the gain from the disposition of the rights in the lawsuit should be characterized as capital gain. Importantly, the court also recognized that the litigation right itself could be a capital asset. It bolstered its conclusion that the gain was capital in character by stating that if one viewed the transaction as a sale of the litigation right, the gain would still be a long-term capital gain. The court likewise rejected the argument that the payment for the litigation rights was a substitute for ordinary income.

Long also addressed the "flip side" of the issue addressed in *Estate of Paine*, that is, whether the repayment of an advance subject to a condition precedent was deductible. In *Long*, before the taxpayer sold his litigation appeal rights for $5.75 million, he repaid outstanding loans by transferring property plus the right to receive $600,000 from a disposition of the land that became embroiled in the litigation. The sale of the litigation recovery rights triggered the obligation of the taxpayer to pay the $600,000, and he used $600,000 from the proceeds to satisfy this obligation. The taxpayer claimed a deduction for the payment. The IRS claimed that the $600,000 was a nondeductible loan repayment. It appeared that the court simply accepted the IRS's position without analyzing whether the advance was properly treated as a loan. If the court had looked to the decision in *Estate of Paine*, it is our view that it is unlikely that the court would have found that the obligation to pay the $600,000 was a loan repayment because it was subject to an uncertain condition precedent.

In FSA 20154701F,[14] the IRS addressed the character of the income to a person who purchased an undivided interest in a litigation recovery directly from the plaintiff to the lawsuit (as opposed to a purchase of fees from the lawyer in the case). The FSA does not recite any details about the lawsuit itself. In the facts considered, the taxpayer advanced funds and then received recoveries in excess of the amount that he had advanced. The taxpayer treated the amounts representing gain as long-term capital gain, as he held the litigation recovery rights for more than one year before he received payment. The FSA does not recite that the IRS contested the status of the litigation recovery rights as capital assets. Although the taxpayer conceded that the recoveries were not gains from the sale or exchange of a capital asset, he asserted that they should be treated as such under Section 1234A(1) of the Internal Revenue Code of 1986, as amended (the "Code"). The IRS disputed the application of Code § 1234A in a not-very-convincing manner. Specifically, the IRS held that Code § 1234A could not apply without a sale or exchange. Ironically, Code § 1234A is premised on the fact that there is no sale or exchange and treats a "cancellation, lapse, or other termination" as such for certain transactions.

II. Certain Issues Posed by Litigation Funding Arrangements

We address two sets of issues raised by the decision in *Novoselsky*. First, we address the effect of the decision to engage in a litigation finance transaction by the persons undertaking the litigation or their lawyer. The *Novoselsky* decision strongly supports the conclusion that all transactions in this area should be undertaken by the litigants or their class and not their lawyers. Second, we address certain issues posed to investors in litigation funding transactions, particularly tax-exempt investors and non-US investors. For these investors, the *Novoselsky* decision stresses the importance of the fact that recoveries by such investors should be structured and documented to be treated as payments on derivatives or as sales or exchanges of capital assets.

A. INCOME RECOGNITION BY PLAINTIFFS AND LAWYERS

Novoselsky makes clear that lawyers engaging in non-recourse litigation finance transactions face a significant risk that the amount they receive to fund a lawsuit will be immediately taxable as ordinary income, even if the transaction is documented as a loan or other contractual arrangement.[15] Concomitantly, the lawyers should be entitled to a trade or business expense for all amounts later paid to funding entities.[16] This scheme of taxation is essentially a reverse tax shelter – the lawyers will only have the after-tax amounts of the advances available to them to fund litigation expenses and will only later receive a tax benefit for the repayment of the advances and capitalized expenses.

The rules governing sales of litigation claims by plaintiffs are more promising. Under *Long*, if the underlying claim would give rise to capital gain or return of an investment, any gain portion of a sale of litigation recovery rights should be treated as capital gain. Furthermore, *Long* and FSA 20154701F offer support for the conclusion that the litigation claim, in and of itself, should be treated as a capital asset. The key to accessing these authorities is to structure a transaction that gives rise to a "sale or exchange."[17]

Thus, *Long* offers a path for reducing the tax bite from a sale or other financing of lawsuit proceeds mandated by the *Novoselsky* decision. Specifically, if the plaintiff in the case (i) is entitled to claim lower tax rates for long-term capital gains and (ii) can be relatively comfortable that a sale or disposition of the litigation proceeds would generate a long-term capital gain, the plaintiff can sell a portion of his rights instead of the lawyer selling her rights in all or a portion of her fees. The plaintiff and his lawyers could alter the right to their relative entitlements through a contractual mechanism that reduces the attorneys' fees by all or a portion of the amount that the plaintiff must pay to the litigation funder. Of course, such an arrangement must be carefully drafted to ensure that the transaction is not a disguised sale of fees by the lawyer and that it is a sale or exchange.

Another avenue to avoid the immediate taxation of amounts paid to fund litigations would be for the litigation funder and the law firm and/or the plaintiff to enter into an arrangement that is treated as a partnership for federal income tax purposes. The contribution of cash by the litigation funder in such an arrangement should not be taxable to the other co-venturers because it should be treated as a non-taxable contribution to capital.[18] Substantial care must be exercised to ensure compliance with the rules prohibiting lawyers from fee sharing with non-lawyers and, in states in which champerty is illegal, to ensure that such rules are not violated. Furthermore, distributions to the lawyer are likely to be treated as taxable guaranteed payments.[19] Thus, the use of an arrangement taxable as a partnership defers, but does not avoid, the current income challenge. Furthermore, as discussed below, such an arrangement may heighten the risk that a non-US or tax-exempt litigation funder earns income that is subject to net US income tax.

Given the challenges presented by the alternatives discussed above, many litigation fundings have been structured as forward contracts.[20] Tax practitioners conversant in financial products have opined that the form of these transactions should be respected. Specifically, forward contract (or, if funding payments are made over time, notional principal contract) treatment should govern such arrangements for tax purposes.[21] Under this analysis, the litigation funder is treated as having made a financial wager, in which it makes the upfront payment, and in return receives the right to receive an uncertain amount if there is a recovery. If this analysis is sustained, the party being funded would not be taxed on the upfront payment and the parties would be taxed on their net recoveries at the end of the transaction.[22] The arguments in favor of swap or forward contract treatment are enhanced if the litigation itself relates to physical or intangible assets that would generate capital gains if sold. In light of the IRS's success in *Novoselsky*, the IRS might be more likely to challenge this treatment if the underlying assets are attorneys' fees or other ordinary income items. In the same way that the IRS was successful in disregarding the ostensible loan in that case, it could take the same approach with a forward contract or swap over fee income.

B. TRADE OR BUSINESS ISSUES FOR THE LITIGATION FUNDING ENTITIES

Private investment funds and certain public funds have been significant participants in the US litigation funding market.[23] These funds typically have both non-US and tax-exempt investors. If the purchase or funding of an interest in a litigation constituted the conduct of a US trade or business, recoveries would create income taxable in the US for both of these classes of investors. Importantly, in rare instances, the litigation funding entity obtains the right to manage the conduct of the litigation. The exercise of this right could exacerbate the issue as to whether the purchase of litigation rights constitutes the conduct of a US trade or business. The ultimate issue here is whether the purchase and management of litigation claims can be treated as non-taxable investment activities.

At the outset of this discussion, it is worth noting that transactions respected as forward contracts or swaps should not pose a significant risk of creating unrelated business taxable income ("UBTI") to tax-exempt investors or income effectively connected to the conduct of a US trade or business ("ECI") for non-US investors. Income from notional principal contracts is not treated as UBTI. If the contract itself is respected as a financial instrument, it should be treated as a security, and the income from swaps and forwards should be protected from ECI status by the "trading for one's own account" safe-harbor.[24] Thus, the forward contract (and notional principal contract) format for litigation finance, while difficult to achieve, favors both of the financed and financing parties.

When derivative treatment cannot be assured, the issue becomes whether an acquisition of an interest in a litigation settlement constitutes trade or business income. In a now seminal case, the Supreme Court held that investment activities are not considered to be trade or business activities. In *Higgins v. Commissioner*,[25] the taxpayer had "extensive investments in real estate, bonds and stocks." The taxpayer devoted a significant portion of his own time to managing these investments and hired others whose full-time job was to manage his investments. The taxpayer sought to deduct the salaries and costs of managing these investments, which included the rental of office space.[26] "The office kept records, received securities, interest and dividend checks, made deposits, forwarded weekly and annual reports and undertook generally the care of the investments. . ."[27] The taxpayer argued that the management "of one's own securities might be a trade or business where there was sufficient extent, continuity, variety and regularity." The Supreme Court found otherwise, holding, "[n]o matter how large the estate or how continuous or extended the work required may be," the managing of one's own investments will not constitute the conduct of a trade or business.

In another case, a taxpayer who spent 40-60 hours per week managing commodities activities undertaken for his own account was not considered to be engaged in the conduct of a trade or business.[28] Similarly, a stockbroker that actively investigated and followed the investments made by his family was not considered to be engaged in the conduct of a trade or business. In that case, there was very little variation in the investments from year-to-year.[29]

Abegg v. Commissioner,[30] is typical of the fact patterns in the cases cited above. In *Abegg*, a Panamanian corporation employed a US investment manager as an employee and held several million dollars' worth of stocks and securities. Additional contributions were made to the capital of the corporation over time and the company used these additional proceeds to acquire additional assets. It incurred approximately $50,000 per year in expenses and salaries in the United States "collecting dividends and interest, managing existing investments, and investigating the acquisition of new investments." The court, citing *Whipple v. Commissioner*,[31] and *Liang v. Commissioner*,[32] held that management of investments do not constitute the conduct of a trade or business for federal income tax purposes, even though the company maintained a US office, had an employee and filed state law qualification forms to do business in New York. Specifically, the court held that "the purchase and sale of investment securities . . . do not amount to engaging in business."

The IRS has ruled that the performance of ancillary activities in the United States to a trade or business conducted abroad does not cause a non-US person to be engaged in the conduct of a trade or business in the US. In Revenue Ruling 72-418,[33] the IRS concluded that a US representative office of a German bank did not constitute a permanent establishment where it performed certain activities, on the basis that such activities were of a mere preparatory or auxiliary nature.[34] The activities performed by the US representative office (each without fees earned in respect thereof) in Revenue Ruling 72-418 were as follows:

a) Investigation of and obtaining information regarding various commercial and financial matters in the United States of interest to the bank, and submitting reports thereon to its head office in Germany. The nature of these reports covers a large field varying from specific credit reports on American banks to reports on general financial conditions in the United States.

b) Assisting the bank's American and German customers with information, and furnishing German customers with letters of introduction to American banks or manufacturing corporations. On occasions, the US representative office authenticated signatures on letters or cables to the home office in Germany.

c) Establishing and maintaining contacts with banks, financial institutions, business corporations and government agencies in the United States, and furnishing them with information regarding German banking, financial, and business matters, and current interest and discount rates generally prevailing in Germany.

d) On rare occasions, communicating with the bank's debtors in the United States and obtaining information regarding the possibility of repayment of past due obligations.

e) Advertising for the bank throughout the United States in newspapers, periodicals and by personal contacts.

Even if litigation financing was considered to rise above investment activities, litigation funding should not constitute a trade or business unless such activities are conducted with "the continuity and regularity necessary for that activity to constitute a trade or business."[35] The Tax Court has explicitly held that an S corporation that engaged in a single litigation funding transaction was not engaged in the conduct of a trade or business.[36] As noted above, if transactions entered into in a litigation funding program are respected as notional principal contracts or forward contracts, the receipt of amounts by a non-US person (either directly or through a partnership) should not be treated as ECI.[37]

Once a taxpayer has engaged in a sufficient number of litigation funding transactions to begin to contemplate whether it is engaged in trade or business or investment activities, the authorities discussed above, including the new decision in *Novoselsky*, offer guidance on structuring transactions. First, to the extent possible, if derivative treatment is not assured, the transaction should offer a fall-back position that the litigation funding entity purchased an undivided interest in the underlying claim. Second, the purchasing party should refrain from negotiating extensive control rights over the prosecution of the litigation so that the litigation funder is purchasing an asset, not undertaking a trade or business of managing litigations. If possible, control rights should be limited to veto rights over the counsel prosecuting the claim. In addition, the buying and selling of litigation recovery rights would support the notion that such rights are financial assets and should be treated as such in evaluating transactions in such rights. Last, the litigation funding party should not be considered to be engaged in business activities to the extent of its US contacts by reason of the fact that it actively secures and evaluates claims. Such activities should be treated as ancillary or preparatory activities that are not trade or business activities.

C. FDAP INCOME ISSUES FOR NON-US INVESTORS

Non-US taxpayers can be subject to a 30% US withholding tax on certain items of US-source income that is not ECI.[38] Generically, these items of income are referred to as fixed, determinable or periodical or "FDAP" income. If the litigation financing has been structured as a derivative that does not constitute ECI, the US federal income tax issue becomes whether income on the derivative constitutes FDAP. If the derivative constitutes a notional principal contract, the payments on the derivative should not constitute FDAP because swap income is sourced to the residence of the payee.[39] Concomitantly, if the derivative constitutes a forward contract, gain from the settlement of the forward contract should not constitute ECI.[40]

If derivative treatment cannot be adequately assured, gain from the disposition of an insurance funding transaction could be considered to constitute an item of FDAP income to the extent that the underlying claim would generate ordinary income to a US holder of the claim.[41] Under *Long*, this risk is ameliorated to the extent that the investor is able to successfully assert that the claim itself is a capital asset in its hands. In addition, if the investor is a non-US person entitled to the benefits of a tax treaty providing for an exemption of income that is not explicitly enumerated in the treaty, such provision may exempt the investor from the imposition of tax on litigation settlement income even if such income is determined to be ordinary in character.

III. Concluding Observations

Novoselsky has crystalized the risk that the form of a litigation funding transaction may not govern its US federal income tax treatment. Accordingly, participants in the litigation financing markets should carefully evaluate the strengths of back-up positions for their transactions in the event that the IRS is able to successfully assert that the form of such transactions should not determine the US federal income tax consequences of the litigation funding. Remedial actions taken prior to an IRS audit of a transaction are likely to present an effective remediation of any transaction components that did not anticipate the decision in *Novoselsky*.

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2 T.C. Memo. 2020-68.

3 For an overview of the industry, see Sykes, *Litigation Finance for Tax Cases: A Win-Win for Taxpayers and Counsel,* Tax Notes (Oct. 31, 2016).

4 Citing *Frierdich v. Comm'r*, 925 F.2d 180, 185 (*citing US v. Henderson*, 375 F.2d 36, 39 (5th Cir. 1967)) *aff'g* T.C. Memo. 1989-103, as amended by T.C. Memo. 1989-393.

[5] *Taylor v. Comm'r*, 27 T.C. 361 (1956), *aff'd*, 258 F.2d 89 (2d Cir. 1958) (obligation to return an advance only if monies were successfully managed not treated as a loan for federal income tax purposes); *Clark v. Comm'r*, 18 T.C. 780 (1952), *aff'd*, 205 F.2d 353 (2d Cir. 1953) (similar).

[6] *Welch v. Comm'r*, 204 F.3d 1228 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-121.

[7] *Gilbert v. Comm'r*, 248 F.2d 399, 406 (2d Cir. 1957), remanding T.C. Memo. 1956-137.

[8] 6 T.C.M. 27 (1947), *aff'd* 165 F.2d 521 (4th Cir. 1948).

[9] T.C. Memo. 1963-275.

[10] See Section 212 of the Internal Revenue Code of 1986, as amended (the "Code"). Code § 212 was added to the Code in 1954, the same year in which the taxpayer claimed the bad debt deduction.

[11] 772 F.3d 670 (11th Cir. 2014), *aff'g in part*, *rev'g in part* T.C. Memo. 2013-233.

[12] See *P.G. Lake v. Comm'r*, 356 US 260 (1958).

[13] See Code § 1221(a)(1).

[14] November 20, 2015.

[15] See *Anschutz Company v. Comm'r*, 664 F.3d 313 (10th Cir. 2011), *aff'g* 135 T.C. No. 5 (2010) (transaction structured as non-taxable variable prepaid forward contract held to be a current sale of stock subject to contract).

[16] Code § 162(a).

[17] See Code § 1222 (capital gains arise from the sale or exchange of capital assets).

[18] Code § 721(a).

[19] Code § 707(c).

[20] See Wood and Kresse, *Is Litigation Finance Tax Treatment in Jeopardy?*, Tax Notes (Mar. 7, 2016).

[21] Wood and Board, *Monster* McKelvey *Estate Tax Case and Litigation Finance*, Tax Notes (Sep. 4, 2017). For a contrary view, see Sheppard, *Is Litigation Funding a Trade or Business?*, Tax Notes Federal (Mar. 23, 2020).

[22] Rev. Rul. 2003-7, 2003-1 C.B. 363.

[23] The market has become so large that Burford Capital PLC, a publicly traded United Kingdom company, specializes only in litigation funding. See Braverman, *Letter to the Editor*, Tax Notes (Mar. 26, 2020).

[24] Code § 864(b)(2); Treas. Reg. § 1.864(b)-1(b).

[25] 61 S.Ct. 475 (1941).

[26] The parties conceded that the real estate activities were trade or business activities.

[27] *Higgins v. Comm'r*, 61 S.Ct. 475, 476 (1941).

[28] *Steffler v. Comm'r*, T.C. Memo. 1995-271 (1995).

[29] *Rothbart v. Comm'r*, 26 T.C. 680 (1956).

[30] 429 F.2d 1209 (2nd Cir. 1970) *aff'g* 50 T.C. 145 (1968).

[31] 373 US 193 (1963).

[32] 23 T.C. 1040 (1955), *acq*. *King v. Comm'r*, 89 T.C. 445 (1987), *acq*. *Chen v. Comm'r*, T.C. Memo. 2004-132.

[33] 1972-2 C.B. 661.

[34] Many US treaties contain articles that explicitly provide that ancillary activities in the US do not create a permanent establishment for non-US companies eligible for the benefits of that treaty.

[35] *Garcia v. Comm'r*, T.C. Memo. 2018-38 (S corporation not considered to be in the trade or business of litigation funding where the only transaction engaged in by the S corporation was contributed to the company by its sole shareholder).

[36] Id.

[37] Prop. Treas. Reg. § 1.864(b)-1(b).

[38] Code § 871(a)(1). The applicable tax rate can be reduced by a tax treaty.

[39] Treas. Reg. § 1.863-7(b)(1).

[40] Treas. Reg. § 1.871-7(d).

[41] Rev. Rul. 2009-14, 2009-21 I.R.B. 1031, Situation 3, as modified by Rev. Rul. 2020-5, 2020-9 I.R.B. 454.