

US: Final BEAT regulations adopt proposed BEAT guidance with some changes

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Executive summary

On 2 September 2020, the United States (US) Treasury Department and the Internal Revenue Service (IRS) released final regulations ([T.D. 9910](#)) on the base erosion anti-abuse tax (BEAT) under Internal Revenue Code¹ Section 59A (2020 final BEAT regulations). The regulations finalize proposed BEAT regulations that were issued on 2 December 2019 (2019 proposed BEAT regulations), and revise certain final BEAT regulations issued on the same date (2019 final BEAT regulations).² More specifically, the 2020 final BEAT regulations generally adopt the aggregate group rules, the election to waive deductions and the partnership rules of the 2019 proposed BEAT regulations. The 2020 final BEAT regulations also provide generally taxpayer-favorable refinements to the nonrecognition transaction anti-abuse rule introduced by the 2019 final BEAT regulations. This Tax Alert discusses the 2020 final BEAT regulations in light of these changes.

Detailed discussion

Rules for determining a taxpayer's aggregate group

The BEAT generally applies to a corporation that: (i) is subject to US net income tax; (ii) has average annual gross receipts of at least US\$500 million for the prior three years (the gross-receipts test); and (iii) has a "base erosion percentage"

of 3% or more (2% or more for a taxpayer that is a member of an affiliated group with a domestic bank or registered securities dealer) (the base-erosion-percentage test). A corporation subject to the BEAT is an “applicable taxpayer.” An aggregation rule applies to treat the taxpayer and certain affiliated corporations as one person for purposes of applying the gross-receipts and base-erosion tests to determine whether the taxpayer is an applicable taxpayer. In general, a taxpayer’s aggregate group comprises corporations that would be included in the same controlled group of corporations (defined in Section 1563(a)) as the taxpayer, except that a “more than 50%” threshold applies instead of “at least 80%.”

Changes in composition of a taxpayer’s aggregate group

Under the 2020 final BEAT regulations, a taxpayer measures the gross-receipts test and base-erosion-percentage test by reference to the gross receipts, base erosion tax benefits and deductions (collectively, “items”) of each aggregate group member whose tax year ends “with or within” the taxpayer’s tax year (a with-or-within approach). This rule appeared in the 2019 proposed BEAT regulations and was a change from the 2018 proposed BEAT regulations, which based gross receipts and the base erosion percentage on the taxpayer’s aggregate group as of the end of the taxpayer’s tax year.

A change in the taxpayer’s ownership does not cause a taxpayer to leave its own aggregate group. A change in the taxpayer’s ownership (or change in ownership of the taxpayer’s aggregate group member) results in member(s) joining or leaving the taxpayer’s aggregate group. Solely for purposes of applying the gross-receipts and base-erosion-percentage tests, the taxpayer only takes into account member items that occur when the members were part of the taxpayer’s aggregate group.

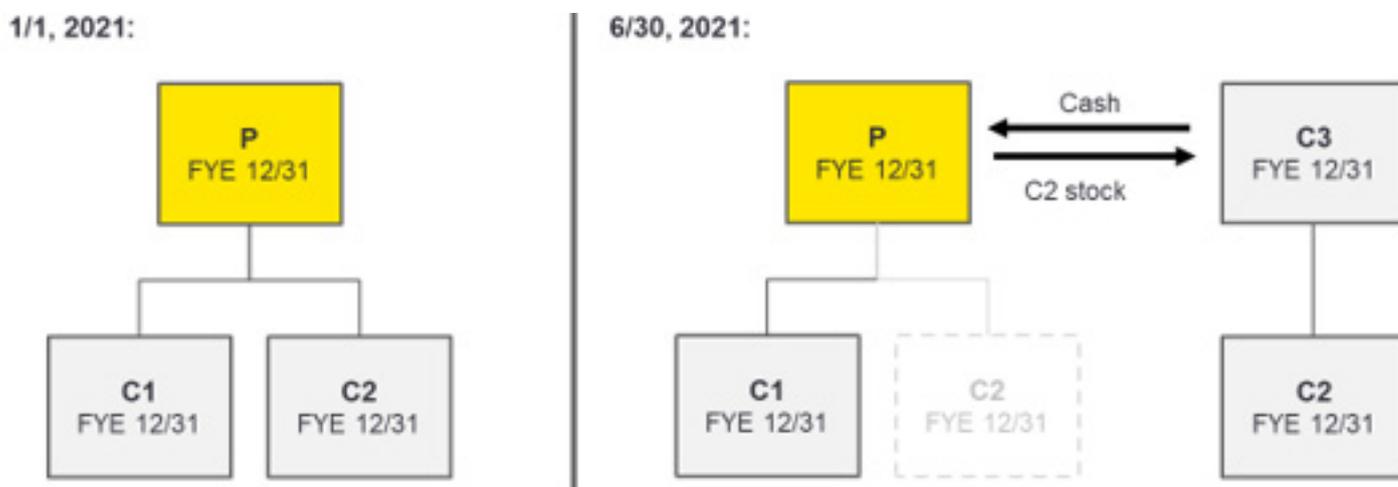
The 2020 final BEAT regulations treat a member that is joining or leaving the group as having a “deemed [tax] year-end” at the end of the day of the transaction that causes the corporation to join or leave the aggregate group (to the extent the transaction does not otherwise end the member’s tax year). This deemed tax year-end must be considered for purposes of applying the with-or-within approach, i.e., testing the gating thresholds by reference to the gross receipts, base erosion tax benefits and deductions of each aggregate group member whose tax year ends “with or within” the taxpayer’s tax year.

The items of a joining (or departing) member taken into account by the taxpayer as part of its aggregate group by reference to the member’s deemed year-end are determined by treating the member’s books as closing (a deemed closing of the books). Alternatively, a member’s items (except for an “extraordinary item”) may be allocated on a pro-rata basis without a closing of the books. The allocation of an “extraordinary item” is based on the date the item is taken into account; an extraordinary item attributable to a transaction occurring after (but on the same day as) the event causing the member to join or leave the taxpayer’s aggregate group is treated as taken into account at the beginning of the following day. An “extraordinary item” includes items identified as extraordinary items under the consolidated group rules of Treas. Reg. Section 1.1502-76(b)(2)(ii)(C) (e.g., capital gains and losses, income from discharge of indebtedness, subpart F inclusion, net operating loss carryovers, tort settlements), and any other payment not made in the ordinary course of business that would be treated as a base erosion payment.

The timing of the deemed tax year-end at the end of the day on which the transaction takes place (the end-of-day rule) under the 2020 final BEAT regulations is a change from the 2019 proposed BEAT regulations. The proposed rule treated the deemed tax year-end as occurring immediately before the transaction that caused the corporation to join or leave the aggregate group (the time-of-transaction rule). The end-of-day rule under the 2020 final BEAT regulations is consistent with other provisions of the Code and regulations, such as Section 381, which provide that an acquiring corporation succeeds to certain attributes as of the close of the day of the acquisition transaction. Similarly, Treas. Reg. Section 1.1502-76(b) provides that, when a member joins or leaves a consolidated group, it has a tax year-end at the end of the day. In the interest of simplicity, the end-of-day rule should be a welcome change. The following illustrates the application of the aggregation rules based on an example provided by the 2020 final BEAT regulations.

Example 1

Facts. P corporation owns 100% of the stock of C1 and C2, both domestic corporations. Each corporation is a calendar-year taxpayer that does not file a consolidated return. P has owned all the stock of C1 and C2 since 2015. On 30 June 2021, P sells the stock of C2 to C3, an unrelated domestic corporation, in exchange for cash.



Aggregate group of P. C2 is treated as having a deemed tax year-end on 30 June 2021, as a result of the sale of C2. C2 leaves the aggregate group of P at the end of the day on 30 June 2021. For purposes of the base-erosion-percentage test, the aggregate group of P takes into account the base erosion tax benefits and deductions of P and C1 for the period of 1 January to 31 December 2021. However, the aggregate group of P only takes into account the base erosion tax benefits and deductions of C2 allocable to the period from 1 January through the end of the day on 30 June 2021. For purposes of the gross-receipts test, the aggregate group of P takes into account the gross receipts of P, C1, and C2, for 2018, 2019 and 2020. (In 2022, for purposes of the gross-receipts test, the aggregate group of P takes into account the gross receipts of P and C1 for 2019, 2020, and 2021, but only the gross receipts of C2 for 2019, 2020 and the period of 1 January 2021 through the end of the day on 30 June 2021.)

Aggregate group of C3. C2 is treated as having a deemed tax year-end on 30 June 2021, as a result of the sale of C2. C2 joins the aggregate group of C3 at the end of the day on 30 June 2021. For purposes of the base-erosion-percentage test, the aggregate group of C3 takes into account the base erosion tax benefits and deductions of C3 for the period of 1 January through 31 December 2021. However, the aggregate group of C3 takes into account the base erosion tax benefits and deductions of C2 allocable to the period from 1 July through 31 December 2021. For purposes of the gross-receipts test, the aggregate group of C3 only takes into account the gross receipts of C3 for 2018, 2019 and 2020. (In 2022, for purposes of the gross-receipts test, the aggregate group of C3 takes into account the gross receipts of C3 for 2019, 2020 and 2021, and the gross receipts of C2 for the period of 1 July 2021 through 31 December 2021.)

Determination of gross receipts and base erosion percentage for short tax years

The 2020 final BEAT regulations provide additional rules for applying the gross-receipts test and base-erosion-percentage test when the taxpayer or its aggregate group member has a short tax year. When the taxpayer itself has a tax year of less than 12 months (a short tax year), the taxpayer must annualize its items by multiplying the total amount for the short tax year by 365 and dividing the result by the number of days in the short tax year. Under the 2019 proposed BEAT regulations, this annualization rule applied for the taxpayer's gross receipts but not for its base erosion tax benefits and deductions.

The 2020 final BEAT regulations also clarify how the taxpayer determines the gross receipts and base erosion percentage of its aggregate group when the taxpayer has a short tax year. Compared to the 2019 proposed BEAT regulations, this rule applies only when the taxpayer has a short tax year *and* a member of its aggregate group does not have a tax year that ends with or within the taxpayer's short tax year. In such cases, the taxpayer must use a reasonable approach to determine the gross receipts and base erosion percentage of the aggregate group for the short tax year. The 2020 final BEAT regulations provide an example of a reasonable approach, which would take into account 12 months of the member's items by reference to either: (1) the 12-month period ending on the last day of the taxpayer's short tax year; (2) the member's tax year that ends nearest to the last day, or begins nearest to the first day, of the taxpayer's short tax year; or (3) an average of member's two tax years ending before and after the taxpayer's short tax year. The 2020 final BEAT regulations state that a reasonable

approach does not include an approach that excludes the items of the aggregate group member that has no with-or-within year.

The 2020 final BEAT regulations provide two limited rules, but not a general annualization rule, for when a member of the taxpayer's aggregate group has a short tax year. The first rule annualizes an aggregate group member's items when (1) the member has two (or more) tax years that end with or within the taxpayer's tax year, and (2) the combined length of the two years is more than 12 months. For example, this could occur when the same aggregate group member has both a regular 12-month tax year, and a short tax year because it leaves the taxpayer's aggregate group (causing either an actual or a deemed tax year-end), and both years end with or within the taxpayer's tax year. The annualization is accomplished by taking the total amount of the gross receipts, base erosion benefits and deductions of that member, multiplying by 365, and dividing the result by the total number of days in the multiple tax years. The following, based on an example provided by the preamble to the 2020 final BEAT regulations, illustrates how this annualization rule works.

Example 2

Facts. USP, a calendar-year taxpayer, owns 100% of the stock of USS, a domestic corporation with a 30 June year-end. On 30 November 2020, USS leaves USP's aggregate group.

Analysis. Absent the special rules for short tax years, USP would be required to take into account USS's gross receipts, base erosion tax benefits, and deductions for the full tax year ended 30 June 2020 (a full 12-month tax year) and a second short tax year of 1 July 2020, through 30 November 2020. Thus, but for a special rule, USP would include 17 months of gross receipts, base erosion tax benefits, and deductions from USS in its gross-receipts test for its tax year ending 31 December 2020. Under the special rule, USP must annualize USS's gross receipts, base erosion tax benefits, and deductions by multiplying the total respective amounts by 365 and then dividing the result by the total number of days in the 17-month period.

The second rule applies when a member's tax year is less than 12 months because the member changed its tax year-end (other than as a result of Treas. Reg. Section 1.1502-76, by which a subsidiary in a consolidated group must adopt its common parent's tax year). Given the limited circumstances, this second rule does not appear to apply when the taxpayer's aggregate group member has a deemed tax year-end or

even an actual tax year-end as a result of a transaction. The Preamble indicates that Treasury and the IRS adopted this rule to address potential abuse when a taxpayer's aggregate group member could change its tax year-end (e.g., from 31 December to 31 January); in that case, the taxpayer would never include the member's items during the remainder of the taxpayer's tax year in which the member's year-end changed (i.e., 11 months from 1 February until 31 December, assuming the taxpayer has a calendar year).

Perhaps motivated by similar concerns, Treasury and the IRS also include a new anti-abuse rule that may apply when a taxpayer's, or its aggregate group member's, tax year changes. If a taxpayer or its aggregate group member enters into a transaction (or series of transactions), plan, or arrangement with another aggregate group member or a foreign related party with the principal purpose of changing the period taken into account under the gross-receipts test or base-erosion-percentage test to avoid applicable taxpayer status, then the anti-abuse rule applies the respective test as if that transaction (or series of transactions), plan, or arrangement never occurred.

Treatment of predecessors

The 2020 final BEAT regulations also clarify the predecessor rule for the gross-receipts test. Under the predecessor rule, any reference to a taxpayer includes a reference to its predecessor when determining a taxpayer's gross receipts. The 2020 final BEAT regulations state that a predecessor *is* the distributor or transferor corporation in a Section 381(a) transaction in which the taxpayer is the acquiring corporation. This should be a helpful simplification compared to the 2019 proposed BEAT regulations, which implied other potential predecessors by using "includes" in place of "is."

Further, the 2020 final BEAT regulations provide that a taxpayer only includes its predecessor's gross receipts to the same extent that the predecessor would have included such gross receipts. For example, when the taxpayer's predecessor is a foreign corporation, the taxpayer would include in its gross-receipts test only the predecessor's gross receipts that are taken into account in determining effectively connected income (ECI). This is consistent with the general rule for a foreign corporation's gross receipts.

The 2020 final BEAT regulations also clarify the scope of the "no duplication" rule, which complements the predecessor rule. The no-duplication rule provides that gross receipts of a member should only be taken into account once by the aggregate group of the taxpayer when the member is also a

predecessor of the taxpayer. This prevents double counting when, for example, a wholly-owned subsidiary liquidates into a taxpayer in a Section 332 liquidation, causing the subsidiary to become the taxpayer's predecessor. Absent the no-duplication rule, both the aggregation rule and the predecessor rule would require the taxpayer to include the subsidiary's gross receipts from the part of its with-or-within year preceding the transaction.

Election to waive allowed deductions

The base erosion percentage for any tax year generally equals the total base erosion tax benefits for the year (the numerator) divided by the total deductions for the year (including base erosion tax benefits) but excluding deductions allowed under Sections 172, 245A or 250, and certain other deductions that are not base-eroding payments. In general, base erosion tax benefits are defined as deductions allowed with respect to base erosion payments. Base erosion payments principally consist of (i) any amount paid or accrued by the taxpayer to a "foreign related party" for which a deduction is allowable; and (ii) any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition of depreciable (or amortizable) property.

The 2020 final BEAT regulations, consistent with the 2019 proposed BEAT regulations, define "allowed deduction" (for purposes of determining a taxpayer's base erosion tax benefits) as all deductions that could properly be claimed for the tax year, the result being that a taxpayer's base erosion tax benefits will generally equal its base erosion tax payments. The 2020 final BEAT regulations also adopt the favorable waiver election that was introduced by the 2019 proposed BEAT regulations and allows taxpayers to forego claiming all or part of an otherwise allowable deduction (BEAT waiver election). Subject to certain exceptions, the waiver of a deduction under the BEAT waiver election is operative for all US federal income tax purposes.

The 2020 final BEAT regulations maintain the same procedures for making the BEAT waiver election as provided by the 2019 proposed BEAT regulations. Accordingly, a taxpayer may elect to waive an allowable deduction (or multiple deductions) on an original filed federal income tax return or an amended return (if filed within three years of the original filing date). A taxpayer may also make the election during an examination of its income tax return for the relevant tax year, provided the amended return does not decrease or revoke a prior waived deduction. The election is not considered a method of accounting under Section 446;

accordingly, IRS consent is not required, and taxpayers may choose whether to make the election on a year-by-year basis. Taxpayers must maintain contemporaneous documentation and provide information on each deduction waived.

The 2020 final BEAT regulations treat waived deductions attributable to a consolidated group member as noncapital, nondeductible expenses that decrease the tax basis in the member's stock for purposes of the stock basis rules in Treas. Reg. Section 1.1502-32. This treatment prevents the shareholder from subsequently benefitting from a waived deduction when disposing of the member's stock. Likewise, the 2020 final BEAT regulations also include provisions addressing the waiver of deductions in the context of partnerships (discussed in further detail later).

Lastly, in a welcome change, the final regulations include as part of the BEAT waiver election a provision for the waiver of any premium or other consideration paid or accrued by an insurance company for any reinsurance payments that would be a base erosion tax benefit. In the 2019 proposed BEAT regulations, the BEAT waiver election applied only to "deductions." A base erosion tax benefit, however, generally includes reductions in gross income for any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments that are taken into account under Section 803(a)(1)(B) (for life insurers) or Section 832(b)(4)(A) (for non-life insurers). In the Preamble to the 2020 final BEAT regulations, Treasury and the IRS acknowledged that the policy rationale for the BEAT waiver election applies equally to insurance-related base erosion payments; the regulations now allow taxpayers to waive these amounts in the same manner as deductions. Insurance-related base erosion payments that are waived under the BEAT waiver election remain subject to the insurance excise tax under Section 4371.

Application of BEAT to partnerships

The 2019 final BEAT regulations generally apply an aggregate approach in determining whether payments to or from a partnership (whether domestic or foreign) are base erosion payments. For example, payments are treated as paid to, or paid by, each partner in accordance with the partners' distributive share of the partnership's income or expense as determined under Section 704. The 2019 proposed BEAT regulations addressed certain other implications of the BEAT provisions applied to partnerships, and the 2020 final BEAT regulations adopt and expand on those proposed rules.

ECI exception

In response to comments, the 2020 final BEAT regulations expand the ECI exception to certain partnership transactions when: (i) the taxpayer is treated as making a base erosion payment as a result of a deemed transaction with a foreign related party; and (ii) the foreign related party is subject to US federal income tax on income allocations from the partnership. Examples include when:

- ▶ A US taxpayer contributes cash and a foreign related party of the US taxpayer contributes depreciable property to the partnership
- ▶ A partnership with a partner that is a foreign related party of the taxpayer engages in a transaction with the taxpayer or
- ▶ A partnership engages in a transaction with a foreign related party of a partner in the partnership

Modified certification procedures were included to implement the expanded ECI exception.

Curative allocations

If a partnership adopts the curative allocation method of making Section 704(c) allocations, the 2020 final BEAT regulations treat a partner as having a base erosion tax benefit attributable to its base erosion payment to the extent the partnership allocates curative income items away from the partner rather than allocating curative deduction items to the partner. The 2020 final BEAT regulations retain the relevant example from the 2019 proposed BEAT regulations. Further, curative allocations that arise under Section 704(c) as a result of a revaluation are treated similarly.

Partnership anti-abuse rules

The 2020 final BEAT regulations adopt the 2019 proposed rule that treats a taxpayer as having a direct interest in a partnership interest or asset if the taxpayer acquires a derivative of a partnership interest (or partnership asset) with the principal purpose of eliminating or reducing a base erosion payment. In response to comments received, the 2020 final regulations clarify that the partnership anti-abuse rule for derivatives does not apply when a payment with respect to a derivative on a partner asset qualifies for the qualified-derivative-payment exception under Treas. Reg. Section 1.59A-3(b)(3)(ii) and Treas. Reg. Section 1.59A-6.

The final regulations retain a second partnership anti-abuse rule that would generally apply when a partnership receives (or accrues) income from a person not acting in a partner

capacity (or from a non-partner) and allocates that income to its partners with a principal purpose of eliminating or reducing a base erosion payment. The anti-abuse rule applies only when the allocations, in combination with any related allocations, do not change the economic arrangement of the partners.

Application of BEAT waiver election to partnerships

The 2020 final BEAT regulations expand the BEAT waiver election to expressly permit a waiver of deductions that are allocated from a partnership. The election is made by the partner, rather than the partnership. A partner treats the waived amount as a nondeductible expenditure under Section 705(a)(2)(B) and reduces its outside basis in the partnership accordingly.

Coordination with Section 163(j)

When a partner waives a deduction under the BEAT waiver election that was taken into account by the partnership, the 2020 final BEAT regulations treat the increase in the partner's income resulting from the waiver as a "partner basis item" (as defined in Treas. Reg. Section 1.163(j)-6(b)(2)). The increase in the partner's income resulting from the waiver is added to the partner's computation of its Section 163(j) limitation. The partner's waiver does not impact the partnership's Section 163(j) computation.

Coordination with BBA audit procedures

The 2020 final BEAT regulations do not address the interaction of the BBA audit procedures and the BEAT more generally. However, the Preamble indicates that the Treasury and the IRS will review implementation of the BBA audit procedures to determine whether future guidance in this area is required for BEAT. The Preamble did explain that inconsistent reporting under Section 6222 does not include a partner reporting a partnership item as waived under the BEAT waiver election.

Exclusion for corporate nonrecognition transactions

The 2020 final BEAT regulations favorably refine the anti-abuse rule introduced by the 2019 final BEAT regulations. The rule applies to transactions that increase the adjusted basis of property acquired by a taxpayer from a foreign related party under a nonrecognition transaction under Sections 332, 351, 355, or 368 (specified nonrecognition transaction). The anti-abuse rule was introduced in connection with the exclusion from base erosion payments

for amounts transferred to, or exchanged with, a foreign related party under a specified nonrecognition transaction.

First, the revised anti-abuse rule turns off the application of the nonrecognition exception only to the extent of the basis step-up amount (as opposed to the entire adjusted basis of the transferred property). Second, the revised anti-abuse rule generally applies if, for example, a transaction resulted in an increase to the adjusted basis of property acquired in a specified nonrecognition transaction and a principal purpose of the transaction was to increase the taxpayer's depreciation or amortization deductions without increasing the taxpayer's base erosion tax benefits. The revised anti-abuse rule, however, maintains the per-se rule, which deems a transaction between related parties to have such a principal purpose if it increases the adjusted basis of property within the six-month period before the taxpayer acquires the property in a specified nonrecognition transaction.

The revised anti-abuse rule applies to tax years beginning on or after the publication of the rule in the Federal Register (e.g., 2021 for calendar-year taxpayers), but taxpayers may apply the revised anti-abuse rule for tax years beginning after 31 December 2017, subject to certain consistency requirements discussed next. In the absence of an application of the revised anti-abuse rule, the original anti-abuse rule applies for tax years ending on or after 17 December 2018, and before the revised anti-abuse rule applies.

Effective dates of the 2020 final BEAT regulations

In general, rules on the composition of the aggregate group, the BEAT waiver election, and the revised nonrecognition anti-abuse rule as finalized by the 2020 final BEAT regulations apply to tax years beginning on or after the publication of the regulations in the Federal Register (e.g., 2021 for calendar-year taxpayers). Partnership anti-abuse rules, as finalized by the 2020 final BEAT regulations, and

the partnership rule to treat certain curative allocations as base erosion tax benefits apply to tax years ending on or after 2 December 2019.

Taxpayers may apply these rules in their entirety for tax years beginning after 31 December 2017, and before their applicability date, provided that (once applied) taxpayers continue to apply them in their entirety for all subsequent tax years. A taxpayer may alternatively apply only the BEAT waiver election rules for tax years beginning after 31 December 2017, and before their applicability date, provided that (once applied) taxpayers continue to apply the BEAT waiver rules in their entirety for all subsequent years.

Implications

Although the 2020 final BEAT regulations did not contain any major departures from prior guidance, several of the changes that were made are generally favorable, particularly from a consistency standpoint. Taxpayers may continue to apply the BEAT waiver election rules, as adopted and modified by the 2020 final BEAT regulations, before the final regulations apply. The added guidance addressing insurance-related base erosion payments and deductions allocable from a partnership and its impact in relation to Section 163(j) should be taken into account when applying the election. Taxpayers that acquired depreciable or amortizable property from a foreign related party under the nonrecognition exception should evaluate whether the nonrecognition anti-abuse rule applies, and whether the revisions in the 2020 final BEAT regulations may provide some relief. Taxpayers should also begin to familiarize themselves with the aggregate group rules of the 2020 final BEAT regulations and consider how those rules, in light of prior and future corporate acquisitions and dispositions, may impact their status as an applicable taxpayer subject to BEAT.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. For discussion of the 2019 proposed and final BEAT regulations, see EY Global Tax Alert, [US final and proposed BEAT regulations provide some relief for taxpayers](#), dated 9 December 2019.

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