

US final and proposed regulations on passive foreign investment companies have both favorable and unfavorable implications for insurance companies

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Executive summary

Final regulations ([T.D. 9936](#); Final Regulations) and proposed regulations ([REG-111950-20](#); 2020 Proposed Regulations) under the passive foreign investment company (PFIC) rules include provisions that significantly affect insurance companies. Those provisions include:

- ▶ Detailed guidance on the identification of applicable insurance liabilities, computation of the ratio of applicable insurance liabilities to total assets, identification of the applicable financial statement and adjustments required to amounts reported on the applicable financial statement
- ▶ Modified standards for determining when a foreign insurance company is in "runoff-related" or "ratings-related" circumstances
- ▶ Re-proposed guidance on the active conduct test, which would favorably permit active conduct to be demonstrated by meeting either a facts-and-circumstances test or a modified active-conduct-percentage test that excludes investment activities
- ▶ Rules on the treatment of certain subsidiaries and partnerships held by a qualifying insurance corporation (QIC) that would limit the amount of assets and income derived by such entities that is treated as non-passive

- ▶ Rules that treat the assets and income of a domestic insurance company subsidiary of a foreign parent as non-passive, subject to a limitation that is part of the 2020 Proposed Regulations

This Tax Alert focuses on aspects of the Final Regulations and 2020 Proposed Regulations that deviate from the 2019 Proposed Regulations and are particularly relevant to insurance companies. A general overview of the Final Regulations and 2020 Proposed Regulations is contained in EY Global Tax Alert, [US final and proposed PFIC regulations provide a mix of favorable and unfavorable provisions](#), dated 15 December 2020 (the General Alert). Terms and concepts used but not defined herein generally have the meaning ascribed to them in the General Alert.

The Final Regulations apply to tax years of United States (US) persons that are shareholders in certain foreign corporations prospectively, beginning on or after the date of publication of the Final Regulations in the Federal Register (which, as of the date of this Alert, is still pending). The 2020 Proposed Regulations would apply prospectively to tax years of US persons beginning on or after the date the regulations finalizing the 2020 Proposed Regulations are published in the Federal Register. Comments to the 2020 Proposed Regulations are due 90 days after the date of filing of the 2020 Proposed Regulations in the Federal Register. The IRS specifically requests comments on several topics included in the 2020 Proposed Regulations.

Detailed discussion

For purposes of applying the PFIC tests to a tested foreign corporation, Internal Revenue Code¹ (IRC) Section 1297(b)(2)(B) (PFIC Insurance Exception) treats otherwise passive income as non-passive income only if (1) the foreign corporation is a QIC, (2) the foreign corporation is engaged in an insurance business, and (3) the income is derived from the active conduct of that insurance business. For a detailed overview of the PFIC Insurance Exception and 2019 Proposed Regulations, see EY Global Tax Alert, [US proposed regulations on passive foreign investment companies have implications for insurance companies](#), dated 25 July 2019.

This Tax Alert is organized into the following four parts:

- ▶ **Part I** addresses the determination of a foreign insurance company's status as a qualifying insurance corporation (QIC).
- ▶ **Part II** discusses the determination of whether a QIC is engaged in the active conduct of an insurance business.

- ▶ **Part III** explains the treatment of certain subsidiaries of a QIC and certain domestic insurance company subsidiaries of a foreign parent corporation.
- ▶ **Part IV** summarizes other notable provisions relevant for insurance companies.

Part I: Determining whether a foreign corporation is a QIC

Definition of applicable insurance liabilities

A foreign insurance company's applicable insurance liabilities (AIL) are relevant for the 25% AIL-to-total asset-test (25% Test) and the 10% AIL-to-total-asset test required for the alternative facts-and-circumstances test for runoff-related or ratings-related circumstances (Alternative Facts-and-Circumstances Test).²

The Final Regulations provide a more detailed definition of AIL, including the deletion of the term "occurred losses" in the definition of AIL. AIL generally includes losses (both reported and unreported) and unpaid loss adjustment expenses on all incurred losses (whether the losses are paid or unpaid).

The Final Regulations also expressly exclude certain liabilities from the definition of AIL. AIL does not include any amount held by an insurance company as a deposit liability that is not an insurance liability, such as a funding agreement, guaranteed investment contract, premium or other deposit funds, structured settlements, or any other substantially similar contract issued by an insurance company. Significantly, AIL also does not include "the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life expectancy of one or more individuals." The Final Regulations do not provide further guidance on the specific types of life insurance or annuity contracts subject to this exclusion, or the amount of reserves for such contracts that are subject to the exclusion.

If the applicable financial statement (AFS) used for purposes of the 25% Test or Alternative Facts-and-Circumstances Test reports the AIL of an entity other than the foreign corporation whose QIC status is being determined (such as a consolidated subsidiary that is an insurance company), the Final Regulations require the AIL of the other entity to be excluded from the AIL used in the QIC status determination. In the Preamble to the Final Regulations, Treasury and IRS also note that, if an AFS reports insurance liabilities as an

aggregate of more than one category of insurance liabilities, it is intended that the aggregate amounts be broken out to identify the liabilities which constitute AIL under the and Final Regulations.

Implications

While the Final Regulations helpfully conform certain terms used in the definition of AIL to those used in the insurance industry, the exclusion from AIL of reserves for a life insurance or annuity contract whose payments do not depend on the life expectancy of one or more individuals raises a question as to the types of life insurance or annuity contracts to which this limitation applies. A foreign insurance company that issues life insurance and annuity products should carefully analyze the potential implications of this limitation on its ability to obtain QIC status.

The Final Regulations are expected to result in a more complex calculation of the ratio of AIL to total assets because of requirements to adjust certain amounts on the AFS or analyze financial statement notes and supporting schedules.

Limitations on AIL

The Final Regulations generally define AIL as the lesser of the following three amounts: (i) the amount of AIL shown on any financial statement that the foreign corporation filed or was required to file with its applicable insurance regulatory body; (ii) the amount of AIL reported on the AFS (whether or not the AFS statement is filed with its regulator, if the AFS is prepared on the basis of GAAP or IFRS); or (iii) the amount of AIL required by the applicable law or regulation of the jurisdiction of the applicable insurance regulatory body. If the applicable insurance regulatory body permits the company to hold a smaller amount of AIL than what is required (as a permitted practice of the applicable regulatory body), then that lesser amount is used for purposes of (iii).

The 2020 Proposed Regulations would require, as an adjustment to arrive at AIL, reducing liabilities on an AFS by the amount of assets that are reported on the AFS and represent amounts relating to those liabilities that may be recoverable from other parties through reinsurance (e.g., reinsurance recoverable). The reduction would apply to both related and unrelated party reinsurance. The Preamble to the 2020 Proposed Regulations indicates that the adjustment is aimed at conforming financial reporting standards that report amounts recoverable from other parties as reinsurance for unpaid losses on the asset side of the balance sheet to those standards that instead reduce balance sheet liabilities. A corresponding reduction to total

assets would also be permitted under the 2020 Proposed Regulations to take into account the amount of any liabilities reduced under the rule. The Preamble to the 2020 Proposed Regulations states that the liability reduction rule is not intended to apply to modified coinsurance arrangements (modco), but comments are requested on whether further guidance is necessary for modco arrangements and the proposed elimination rule generally.

Implications

Foreign insurance companies should carefully consider the limitations on the amount of AIL in their determinations of QIC status. Companies currently calculating their AIL-to-total-assets ratio using a balance sheet that reports items such as reinsurance recoverable as an asset, rather than as a reduction of liabilities, should model the impact of the 2020 Proposed Regulations on their 25% Test.

Alternative Facts-and-Circumstances Test

Among other requirements, the Alternative Facts-and-Circumstances Test requires the failure of the foreign corporation to satisfy the 25% Test to be solely due to runoff-related or ratings-related circumstances.³

Runoff-related circumstances

The Preamble to the Final Regulations states that Treasury and IRS believe the Alternative Facts-and-Circumstances Test for runoff-related circumstances should be limited to "extremely limited" circumstances in which an insurance company is in the process of exiting the insurance business, and should not be available to runoffs occurring in the context of the ordinary course of an ongoing business. The Final Regulations retain the standard for runoff-related circumstances from the 2019 Proposed Regulations, with slight favorable modifications.

While a foreign corporation must still make claims payments during the annual reporting period, the Final Regulations no longer require those payments to cause the company's ratio of AIL to total liabilities to fall below 25%. Further, the Final Regulations delete the requirement that the runoff company have a plan of liquidation, but instead require the company to be in the process of terminating its pre-existing, active conduct of an insurance business under the supervision of its applicable insurance regulatory body or any court-ordered receivership proceeding. Finally, the Final Regulations require there to be no plan or intention for the runoff company to enter into any insurance, annuity or reinsurance contract other than in the case of a contractually obligated renewal.

Ratings-related circumstances

The Final Regulations tighten the scope of insurance companies that can potentially qualify for the Alternative Facts-and-Circumstances Test for ratings-related circumstances. A financial guaranty company is deemed to satisfy the ratings-related circumstances standard (however, its ratio of AIL to total assets must be at least 10%). Otherwise, the ratings-related-circumstances standard can only be satisfied by either an insurance company that exclusively provides mortgage insurance, or an insurance company that has more than half its net written premiums for the year (or the average of the current and prior two years) from insurance coverage against the risk of loss from a catastrophic loss event (that is, a low-frequency but high-severity loss event).

The Final Regulations modify the standard for ratings-related circumstances. The modifications generally require that the failure to satisfy the 25% Test must be solely due to (i) capital and surplus that a generally recognized credit agency requires for the company to obtain a public rating on financial strength, and (ii) the company maintaining that capital and surplus in order to “obtain the minimum credit rating necessary for the [current year] to be able to write the business in its regulatory or board supervised business plan.”

Making the election to apply the Alternative Facts-and-Circumstances Test

Under the Final Regulations, only a US shareholder of the foreign insurance company may elect to apply the Alternative Facts-and-Circumstances Test, by completing the appropriate part of Form 8621. For this purpose, the Final Regulations determine stock ownership according to the PFIC ownership attribution rules under Treas. Reg. Section 1.1298-1(b)(8). The Final Regulations provide a de minimis exception under which a US shareholder is deemed to make the election (and forego the Form 8621 filing requirement) if the value of the shareholder’s stock is \$25,000 or less (\$50,000 for a joint return).

For the election to be made, the foreign insurance corporation (or its foreign parent corporation) must provide certain information specified in the regulations to the shareholder (either directly or by making the information publicly available) on the foreign insurance corporation’s eligibility to qualify under runoff or ratings-related circumstances. A United States person may not, however, rely upon any statement by the foreign corporation (or its foreign parent corporation) to make the election if the shareholder

knows or has reason to know, based on reasonably accessible information, that the statement made by the foreign corporation (or its foreign parent corporation) was incorrect.

Implications

The Final Regulations did not expand the scope of facts and circumstances that can qualify as runoff or ratings-related circumstances to the extent requested by many commentators; in some respects, they further restricted the applicability of Alternative Facts-and-Circumstances Test.

The guidance provided in the Final Regulations on electing to apply the Alternative Facts-and-Circumstances Test requires careful consideration. Not only do the Final Regulations fail to provide an option for the foreign insurance company (or its foreign parent corporation) to make the election, but the requirement to treat the US person making the election as a shareholder of the corporation under the PFIC ownership attribution rules creates a potentially complex analysis when the foreign insurance company is a subsidiary of a foreign parent corporation.

Identification of the AFS

Identifying the AFS of a foreign insurance company is necessary to determine the ratio of AIL to total assets. Section 1297(f)(4)(A) generally defines an AFS as a financial statement for financial reporting purposes that is prepared on the basis of GAAP or IFRS, or is the statement filed with the applicable insurance regulatory body, in that order of priority.

The 2020 Proposed Regulations would incorporate detailed ordering rules for prioritizing between multiple financial statements prepared at the same level of priority (e.g., multiple financial statements prepared on the basis of GAAP). The Proposed Regulations also would establish general guidelines for determining an AFS when multiple financial statements are prepared taking into account assets and liabilities of different legal entities.

As a starting point, the 2020 Proposed Regulations would require a financial statement to include a complete balance sheet, statement of income, statement of cash flows (or equivalent under the applicable reporting standard), and the related exhibits, schedules, forms and footnotes that usually accompany the balance sheet, income statement and cash flow statement. Financial statements not meeting this standard would not be within the scope of a potential AFS. Second, unaudited GAAP or IFRS financial statements

would not be within the scope of a potential AFS. Third, if a financial statement is prepared on a consolidated basis, it generally falls within the scope of a potential AFS only if the parent of the consolidated group is the foreign insurance company being tested for QIC status. Fourth, if both a consolidated and unconsolidated financial statement exist at the same level of priority (e.g., both audited statements prepared on the basis of GAAP and used for reporting to shareholders), the unconsolidated financial statement has priority over the consolidated financial statement.

For GAAP or IFRS financial statements, the 2020 Proposed Regulations would establish additional levels of priority. For example, a financial statement filed with the SEC or foreign equivalent takes priority over an audited financial statement used for credit purposes. An audited financial statement used for credit purposes takes priority over an audited financial statement used for reporting to shareholders. At the lowest level of priority is an audited financial statement used for any other substantial non-tax purpose. These levels of sub-priority do not change the general hierarchy for AFS - an audited financial statement prepared on the basis of GAAP for purposes of reporting to shareholders would take priority over an audited financial statement prepared on the basis of IFRS that is filed with a foreign governmental agency equivalent to the SEC.

Implications

Although the proposed ordering rules and additional guidelines for determining an AFS provide helpful clarity on how to determine the AFS when a foreign insurance company issues multiple financial statements under different reporting standards, they would impose a potentially complex determination that requires careful analysis.

Part II: Determining whether a QIC is engaged in the active conduct of an insurance business

The active conduct test proposed as part of the 2019 Proposed Regulations was withdrawn and re-proposed as part of the 2020 Proposed Regulations. In a much-welcomed change from the 2019 Proposed Regulations, the 2020 Proposed Regulations would treat a QIC as engaged in the active conduct of an insurance business if it satisfies either a facts-and-circumstances test (Factual Requirements Test) or a modified version of the active conduct percentage test (Active Conduct Percentage Test).

Core functions

Both the Factual Requirements Test and Active Conduct Percentage Test focus on the “core functions” of the QIC, which the 2020 Proposed Regulations generally define as the QIC’s underwriting, investment, contract and claims management, and sales activities (each of these functions is further defined in the 2020 Proposed Regulations).

Insurance companies precluded from meeting the active conduct test

Certain insurance companies would be deemed to fail the active conduct test under the 2020 Proposed Regulations, denying the applicability of the PFIC Insurance Exception to these companies. First, a QIC that has no or a nominal number of employees and relies exclusively (or almost exclusively) on independent contractors to perform its core functions would be deemed to fail the active conduct test. Second, certain securitization vehicles (such as vehicles used to issue catastrophe bonds, sidecars or collateralized reinsurance vehicles), as well as insurance-linked securities funds that invest in securitization vehicles, would be deemed to fail the active conduct test. The Preamble to the 2020 Proposed Regulations explains that these vehicles are excluded because they are “designed to provide a passive investment return tied to insurance risk rather than participation in the earnings of an active insurance business.”

Factual Requirements Test

The Factual Requirements Test consists of a two-part requirement. First, the QIC’s officers and employees would have to carry out substantial managerial and operational activities on a regular and continuous basis with respect to all the QIC’s core functions. Second, the QIC’s officers and employees would have to perform virtually all the active decision-making functions relevant to underwriting. Numerous definitions and additional guidance are provided on these requirements, a brief summary of which follows.

Generally, a QIC’s officers and employees would be considered to carry out substantial managerial and operational activities relevant to the QIC’s core functions only if they were involved in all levels of planning and implementation related to the QIC’s core functions. This involvement in planning and implementation of the QIC’s core functions would have to be by officers or senior employees with appropriate experience who devote virtually all of their work to those activities and similar activities for related entities.

The active decision-making functions relevant to a QIC's underwriting activities would generally be those underwriting activities most important to decisions of the QIC relating to the assumption of specific insurance risks. The development of underwriting policies and parameters that change infrequently would not be treated as an active-decision-making function without further ongoing involvement by the QIC's officers and employees. Generally, the guidance provided on the Factual Requirements Test contemplates an active, contract-by-contract involvement by the QIC's officers and employees.

Active Conduct Percentage Test

The Active Conduct Percentage Test would be satisfied if a QIC's total costs for its officers and employees for services rendered around its core functions (other than investment activities) were at least 50% of its total costs for all services rendered around its core functions (other than investment activities). If any part of a QIC's core functions (including investment management) were outsourced to an unrelated entity, however, the QIC's officers and employees would have to meet certain oversight requirements specified in the regulations.

The total costs taken into account for the Active Conduct Percentage Test would generally be the compensation costs of the QIC's officers and employees and related expenses (determined in accordance with Section 482 and taking into account all expenses that would be included in the total services costs under Treas. Reg. Section 1.482-9(j) and Treas. Reg. Section 1.482-9(k)(2)) for services performed around core functions. For services provided by third parties, total costs generally means the amount paid or accrued to the service provider. Total costs do not include ceding commissions paid or accrued for reinsurance contracts or commissions or fees paid or accrued to brokers or sales agents to procure reinsurance contracts.

Officers and employees of a related party

For purposes of the active conduct test, a QIC's officers and employees generally includes the officers and employees of a related party, provided three requirements are satisfied. First, the related party must be a qualified affiliate of the QIC, which generally requires both entities to be within a commonly controlled group that satisfies certain requirements. Second, the QIC must exercise regular

oversight and supervision over the services performed by the related entity's officers and directors. Third, the related party must be compensated by the QIC for its services in accordance with Section 482 and other requirements.

Implications

Overall, the active conduct test in the 2020 Proposed Regulations represents a favorable change for the insurance industry compared to the test in the 2019 Proposed Regulations. The optionality afforded by meeting the active conduct test either by the Factual Requirements Test or the Active Conduct Percentage Test is welcome. The exclusion of investment activities from the Active Conduct Percentage Test is a welcome change that better reflects common practices in the insurance industry. The changes to the types of related-party relationships that can be taken into account in the active conduct tests are also a favorable improvement over the relatively limited scope of related party relationships that could be taken into account in the 2019 Proposed Regulations. In light of these changes, insurance companies should revisit prior analyses to assess the impact of the changes. Companies wishing to rely on the Factual Requirements Test should begin assessing their facts and circumstances against the detailed guidance, numerous definitions and explicit carve-outs provided in the regulations.

Part III: Treatment of subsidiaries and partnership investments

Treatment of 25%-owned subsidiaries and partnerships of a QIC

For purposes of applying the PFIC Tests, Section 1297(c) requires a tested foreign corporation to take into account its proportionate share of the assets and gross income of any corporate subsidiary for which it owns at least 25% (by value) (a look-through subsidiary). As discussed in the General Alert, the Final Regulations adopt a similar look-through rule for partnerships (a look-through partnership).

When a QIC is the tested foreign corporation, the Final Regulations define the assets and income of its look-through subsidiary or look-through partnership that are treated as non-passive under the PFIC Insurance Exception as the greater of two amounts. The first amount is the QIC's

proportionate share of the look-through entity's assets and income that are treated as non-passive in the hands of the look-through entity (i.e., under the relevant PFIC characterization rules applied at the level of the look-through entity). The second amount is the QIC's proportionate share of the income or assets, respectively, of the look-through entity multiplied by the ratio of: (i) the net equity value of the interest in the entity held by the QIC; over (ii) the value of the QIC's proportionate share of the assets of the look-through entity it takes into account under Section 1297(c).

Treatment of domestic insurance company subsidiaries of a tested foreign corporation

The Final Regulations treat the assets and income of a domestic insurance company subsidiary of a tested foreign corporation that is a Qualifying Domestic Insurance Company (QDIC) as non-passive (QDIC Exception). The definition of a QDIC comes from the 2019 Proposed Regulations, except that the 2019 Final Regulations require the domestic insurance company subsidiary to be a look-through subsidiary under Section 1297(c). In a welcome reversal from the 2019 Proposed Regulations, the Final Regulations do not adopt a rule that would have excluded the QDIC Exception for purposes of determining whether a foreign corporation is a PFIC when applying the PFIC ownership attribution rules in Section 1298(a)(2).

The 2020 Proposed Regulations would impose a limitation on the amount of passive assets and income of a QDIC that is treated as non-passive under the QDIC Exception. The amount of passive assets treated as non-passive under the QDIC Exception would be limited to an applicable percentage of the company's total insurance liabilities (non-passive asset limitation). The applicable percentage is 200% for insurance companies taxed as life insurance companies taxable under Part I of Subchapter L, and 400% for non-life insurance companies taxable under Part II of Subchapter L. Total insurance liabilities are generally based on reserves computed according to Subchapter L rules. Total insurance liabilities for non-life insurance companies include unearned premium reserves. The amount of the QDIC's passive income that would be treated as non-passive under the QDIC Exception would be limited to the amount of the QDIC's passive income multiplied by the ratio of (i) the QDIC's non-passive asset limitation; to (ii) the QDIC's total passive assets.

Implications

Under the Final Regulations, a QIC with a look-through subsidiary or look-through partnership may have passive income and passive assets for purposes of the PFIC Tests, even if the QIC qualifies for the PFIC Insurance Exception. A detailed analysis should be performed for any PFIC status determination of a QIC that has look-through subsidiaries or look-through partnerships (e.g., investment vehicles).

While the QDIC Exception is favorable for foreign-based groups with a domestic insurance company subsidiary, consideration should be given to the impact of the limitation on the amount of assets and income of a QDIC that can be treated as non-passive under the 2020 Proposed Regulations.

The limitation on the amount of non-passive assets and income of a QDIC under the 2020 Proposed Regulations contains no exceptions for insurance companies such as domestic financial guaranty companies, which, for foreign financial guaranty companies, were afforded a favorable exception in the Alternative Facts-and-Circumstances test for rating-related circumstances. The use of bright-line 200%/400% applicable percentages that depend on a domestic insurer's status as a life/non-life insurance company also poses potential whipsaw effects if the company sees a change in its status.

Part IV: Other items of importance for insurance companies

Treasury and the IRS declined to provide guidance on the extent to which certain requirements under the IRC and regulations for life insurance and annuity contracts apply for PFIC status determinations. According to the Preamble to the 2020 Proposed Regulations, Treasury and the IRS are evaluating whether further guidance on the applications of these provisions in the PFIC context is necessary or appropriate, and request comments on the issue. Treasury and the IRS declined requests by commentators to make the exception to foreign personal holding company income under Section 954(i) available as an exception to passive income for the PFIC Tests. Treasury and the IRS also declined requests to make US shareholders of controlled foreign corporations under the Subpart F related-person-insurance-income (RPPI) rules eligible for the exclusion from the PFIC rules under the "overlap rule" of Section 1297(d).

Implications

While the Final Regulations and 2020 Proposed Regulations in many respects bring desirable clarity to the operation of the PFIC regime for insurance companies, certain issues remain unresolved. Although the policy reasons underlying certain rules in the IRC and regulations concerning the

US federal income tax treatment of life insurance and annuity contracts are arguably not relevant in the PFIC context, the lack of clear guidance creates significant potential complexity for PFIC assessments of foreign-based life insurance companies as well as potential disparate conclusions as to their PFIC status.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Section 1297(f)(1) and (2).
3. Section 1297(f)(2).

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