OECD releases final report on preventing the artificial avoidance of permanent establishment status under Action 7

Executive summary

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released its final report on preventing the artificial avoidance of permanent establishment status (Action 7) under its Action Plan on Base Erosion and Profit Shifting (BEPS). This report was released in a package that included final reports on all 15 BEPS Actions.

The document, Preventing the Artificial Avoidance of Permanent Establishment Status (the Action 7 Report or Final Report), proposes changes to the permanent establishment (PE) definition in Article 5 of the OECD Model Tax Convention (the OECD Model) to prevent the use of the following arrangements that are considered to enable a foreign enterprise to operate in another country without creating a PE:

• Commissionaire arrangements and similar strategies
• The use of specific preparatory or auxiliary activity exemptions, including the artificial fragmentation of so-called “cohesive” business activities into several smaller operations such that each part is able to benefit from the use of such specific activity exemptions

The Final Report also proposes the use of the Principal Purpose Test (PPT) rule that is being recommended under Action 6 to deal with strategies involving the splitting-up of contracts between closely related enterprises in the context of construction contracts or the inclusion of an alternative provision in the
Commentary to the OECD Model (the OECD Commentary) consisting of an automatic rule requiring the aggregation of time spent by closely related enterprises at the same building site or construction or installation project to calculate the 12 month threshold.

The Final Report, compared to the revised discussion draft on Action 7 that was issued in May 2015, contains no fundamental changes in terms of the position taken by the OECD on perceived BEPS abuses arising from the artificial avoidance of PE status. However, the Final Report reflects refinements from the earlier discussion drafts. In particular, the Final Report modifies the proposed amendments to Article 5(5) as well as Article 5(6).

Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the “authority to conclude contracts in the name of the enterprise” in order to create a PE. The final Action 7 Report would refer to persons (other than an independent agent) that habitually conclude contracts or “habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modifications by the enterprise,” where the revised discussion draft in contrast referred to “persons that habitually concluded contracts or negotiated the material elements of contracts.”

The Final Report also reflects changes to the proposed wording to tighten up the definition of independent agent in Article 5(6) by replacing the concept of “connected parties” with “closely related enterprises.” The Final Report includes, for this purpose, cases where a person possesses directly or indirectly more than 50% of the beneficial interest in the other or, if a company, more than 50% of the aggregate value and value of the company's shares or the beneficial equity interests.

EY is hosting a series of webcasts that will provide a comprehensive review of the final BEPS reports and outlook for country action. The final Action 7 Report will be addressed in a webcast on Permanent Establishment Developments and BEPS Action 7 on 5 November, 10 am EST.

Detailed discussion

Background

Article 5 of the OECD Model describes the circumstances in which an enterprise will be treated as having a PE in a country. The Action 7 Report includes several amendments to Article 5 to address the OECD’s concerns about the potential for companies to enter into arrangements that would, in its view, artificially avoid the occurrence of PEs. These proposals have been refined based on the comments received to prior discussion drafts from several rounds of public consultation. The final proposals reflect the OECD's further consideration of the issues raised and also provide new Commentary on the proposed changes to Article 5.

The proposals are summarized below.

Commissionaire arrangement

The Action 7 Report proposes to amend Article 5(5) such that an enterprise will be deemed to have a PE in a country where a person is acting in that country on behalf of the enterprise, and, in doing so, such person habitually concludes contracts, or “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modifications by the enterprise.” The relevant contracts for this purpose are those that are:

(a) In the name of the enterprise, or
(b) For the transfer of, or right to use, property that the enterprise owns or has the right to use, or
(c) For the provision of services by the enterprise

The activities described, however, will not create a PE for the applicable enterprise if:

- The activities are limited to the “preparatory or auxiliary” activities described in Article 5(4) (as modified by the Final Report’s proposal below).

Or

- The activities are carried on by certain independent agents under Article 5(6) (as modified by the Final Report, also discussed below).

Regarding the independent agent exception, a person acting in a country on behalf of an enterprise of another country will not cause the enterprise to have a PE in the first country if that person carries on a business in the first country “as an independent agent and acts for
the enterprise in the ordinary course of that business." The Action 7 Report also provides, however, that when a "person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related" that person cannot be considered an independent agent under Article 5(6) with respect to the applicable enterprise. For this purpose, the Final Report generally provides that a person is "closely related" to an enterprise if based on all the facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if:

(a) One possesses directly or indirectly more than 50% of the beneficial interest in the other (or, in the case of a company, more than 50% of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company).

Or

(b) Another person possesses directly or indirectly more than 50% of the beneficial interest (or, in the case of a company, more than 50% of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise.

The Final Report also proposes new guidance in the OECD Commentary on Article 5 on several significant issues around the above-mentioned amendments, including the following key points:

- Paragraph 32.8 of the OECD Commentary explains that typically a PE arises when contracts are concluded by an agent, partner or employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and its clients. The OECD Commentary also notes, however, that Article 5(5) may apply when the contracts entered into do not legally bind the enterprise to third parties with which those contracts are concluded, but are contracts for the transfer of, or right to use, property that is owned by the enterprise or that the enterprise has the right to use, or for the provision of services by the enterprise. For instance, the provision would apply to commissioneer structures in which the commissioneer does not enter into contracts with third parties that legally bind the enterprise but the enterprise's property is nevertheless transferred to those third parties. Therefore, a crucial condition in assessing paragraph (b) and (c) of Article 5(5) is whether the person acting on behalf of the enterprise has the right to use, or for the provision of services by the enterprise. For instance, the provision would apply to commissioneer structures in which the commissioneer does not enter into contracts with third parties that legally bind the enterprise but the enterprise's property is nevertheless transferred to those third parties. Therefore, a crucial condition in assessing paragraph (b) and (c) of Article 5(5) is whether the person acting on behalf of the enterprise has concluded or has played the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. The OECD Commentary makes clear that this result would apply even when the commissioneer does not disclose the identity of the enterprise to any third parties.2

- In contrast to the treatment of commissioneer-type arrangements, paragraph 32.12 of the OECD Commentary clarifies that Article 5(5) is not intended to apply when a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises. In such cases, the person is not acting on behalf of another enterprise and the contracts are not the type described under Article 5(5). Therefore, a distributor, including a so-called low risk distributor, would not cause the enterprise selling property to the distributor to have a PE in the distributor’s country of operation as long as the transfer of title to the property passed from the enterprise to the distributor (regardless of how long the distributor holds title in the product sold).3

- The phrase "or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise“ is aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State.4 The OECD’s view is that while the phrase “concludes contracts” is a relatively well-known test based on contract law, it was necessary to supplement
that test with one focusing on the substantive activities taking place in one State. This is to address cases where the conclusion of contracts is clearly the direct result of these activities even though the conclusion of the contract takes place outside that State. In this regard, the phrase must be interpreted to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise (i.e., where that person acts as the sales force of the enterprise). For example, it applies where a person solicits and receives (but does not formally finalize) orders that are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. However, it does not apply where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts. Here the OECD Commentary provides the example of representatives of a pharmaceutical enterprise actively promoting drugs produced by that enterprise by contacting doctors who subsequently prescribe these drugs. According to the OECD Commentary, such marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise even though the sales may significantly increase as a result of that marketing activity and therefore should not give rise to a PE.

Paragraph 33.1 clarifies that the person must “habitually” perform the specified acts in order to establish a PE for the enterprise, regardless of whether that person is concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. Thus, the presence of the person in the other State should be more than merely transitory in order to create a PE for the enterprise. The OECD Commentary provides that it is not possible to prescribe a precise frequency test to determine whether the “habitually” standard is met. Nonetheless, factors similar to those used for Article 5(6) would be relevant in making such a determination.

A PE that is created as a result of the amendments to Articles 5(5) and 5(6) will affect the rights and obligations resulting from the contracts that will be allocated to the PE. According to the proposed Commentary, this does not mean that the entire profits resulting from the performance of these contracts should be attributed to the PE. Instead, the determination of the profits to be attributed to the PE will be governed by the rules of Article 7. It specifies that the profits to be attributed to the PE in accordance with Article 7 will be only those that the PE would have derived if it was a separate and independent enterprise performing the activities of paragraph 5.

The proposal that a person cannot be an independent agent if it “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related” represents a change from the initial discussion draft which provided a similar limitation with respect to a person acting on behalf of “associated enterprises” and from the revised discussion draft which provided a similar limitation on a person acting on behalf of “connected enterprises.” The change to “closely related” enterprises comes after comments requesting a more definite standard. The proposed Commentary clarifies that the fact that the operation of this rule does not affect the operation of Article 5(7), which generally provides that the mere fact that a parent enterprise controls its subsidiary will not cause the parent to have a PE in the subsidiary’s country of residence. Articles 5(5) and 5(6) must still be applied to a parent-subsidiary relationship to determine if the subsidiary’s activities on behalf of its parent give rise to a PE for its parent. There also is guidance on what it means for a person to act “almost exclusively” for closely related enterprises. Here, the proposed Commentary indicates that a person will be treated as acting “almost exclusively” on behalf of closely related enterprises if that person has no significant business activities apart from those conducted for the closely related enterprises. An example illustrating this concept concludes that a sales agent acts...
“almost exclusively” for closely related enterprises when less than 10% of the agent’s sales are for non-closely related enterprises. In conclusion, while the Final Report does not contain major changes from the revised discussion draft, it does reflect some refinements to the proposed amendments to Articles 5(5) and 5(6), summarized as follows:

- Currently, Article 5(5) requires a person (other than an independent agent) acting on behalf of a foreign enterprise to have the “authority to conclude contracts in the name of the enterprise” in order to create a PE. The revised discussion draft referred to “persons that habitually conclude contracts or negotiate the material elements of contracts.” However, the Final Report refers to persons that habitually conclude contracts or “habitually play the role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.”

- The independent agent exemption in Article 5(6) currently uses the concept of “associated parties.” The revised discussion draft referred to “connected parties.” In the Final Report, the tightened definition of independent agent uses the concept of “closely related enterprises.”

Specific activity exemptions
Currently, Article 5(4) of the OECD Model specifically exempts certain activities from creating a PE where a place of business is used solely for activities listed in that paragraph. The Action 7 Report proposes to modify the wording of Article 5(4) such that each of the listed exemptions from PE status is restricted to activities that are of a preparatory or auxiliary character or the overall activity of the fixed place of business is of a preparatory or auxiliary character. Through this modification, the OECD aims to prevent what it views as the artificial avoidance of a PE through the use of these exemptions.

Meaning of “preparatory or auxiliary”
The Action 7 Report also provides additional Commentary guidance intended to clarify the meaning of “preparatory or auxiliary” using a number of examples. The decisive criterion is whether the activity performed at the fixed place of business itself forms an essential and significant part of the activity of the enterprise as a whole. In terms of the differences between what is considered preparatory or auxiliary, the OECD provides that as a general rule, an activity has a preparatory character if it is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activities of the enterprise as a whole. An activity has an auxiliary character if it is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole.

Examples of situations where such activities do not qualify for the exemption include:

- When an enterprise’s main business is the online sales of goods to customers, the maintenance of a large warehouse where a significant number of employees work for the main purpose of storing and delivering those goods sold by the enterprise.
would constitute an essential part of the enterprise’s sales and distribution business such that it would not have a preparatory or auxiliary character.  

• When an enterprise maintains a fixed place of business for the delivery of spare parts for machinery to customers but also for the maintenance and repairs of such machinery, this would go beyond the pure delivery requirement of sub-paragraph a), because these after-sales activities (maintenance and repair) constitute an essential and significant part of the services provided by an enterprise vis-à-vis its customers.

The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise - Article 5(4) sub-paragraph c)

Similarly, where a stock of goods is maintained for the purpose of processing by another enterprise (Article 5(4), sub-paragraph c)), the proposed Commentary provides that the mere presence of goods or merchandise belonging to an enterprise at the premises of another (e.g., a toll-manufacturer) would not be sufficient to make the premises a fixed place of business of the enterprise unless the enterprise is allowed unlimited access to a separate part of the toll-manufacturer’s facilities. If so, it would have that place at its disposal and it would be necessary to determine whether the maintenance of stock in these circumstances constitutes a preparatory or auxiliary activity for the enterprise. Here, the proposed Commentary illustrates that the activity would qualify for the exemption if the enterprise in question is merely a distributor of products manufactured by other enterprises. Because a distributor’s main business is not the manufacture of products, the maintenance of goods for processing by another would not form an essential and significant part of the distributor’s overall activity. However, the application of such exemption would still be subject to the application of the anti-fragmentation rule (discussed below).

In essence, an enterprise must be determined to have a fixed place of business at its disposal first, before it can be determined whether a specific activity exemption is applicable to the facts and circumstances.

The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise - Article 5(4) sub-paragraph d)

The proposed Commentary also provides that the exemption for a fixed place of business used for purchasing goods would not be available in a situation where the overall activity of the enterprise consists of selling these goods and where the purchasing activity represents a core function of that enterprise’s business.

With respect to a fixed place of business used for collecting information, the proposed Commentary provides an example of an investment fund that sets up an office in another state to collect information on possible investment opportunities in that state and concludes that, in this context, the collecting of information would be a preparatory activity. The same conclusion would apply if an insurance company set up an office to collect statistical information on risks in a particular market.
The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity – Article 5(4) sub-paragraph e)

The list of specific activity exemptions is not limited only to those specifically listed in sub-paragraphs a) to d) as evidenced by the wording in sub-paragraph e) which makes clear that the examples listed in a) to d) are examples of activities and that the list is not exhaustive.19 However, a fixed place of business which has the function of managing an enterprise, or a part of it, cannot be regarded as a preparatory or auxiliary activity, as managerial activity constitutes an essential part of the business operations.20

In essence, the proposed modifications to Article 5(4) are aimed at ensuring that profits derived from core activities (i.e., not of a preparatory or auxiliary character) performed in a country can be taxed in that country. This means that when a fixed place of business is used by an enterprise not only for activities listed in paragraph 4 but also for other activities that are not preparatory or auxiliary in nature, paragraph 4 will not apply and a PE will be created such that the profits attributable to this PE with respect to both types of activities may be taxed in the state where the PE is situated.21

Optional paragraph 4 wording

The Action 7 Report also proposes optional wording for Article 5(4) under which the activities listed are not subject to an explicit “preparatory or auxiliary” requirement. This is to address the concern of certain countries that consider the activities listed in paragraph 4 as being intrinsically preparatory or auxiliary in nature and that are of the view that subjecting these activities to such requirement would create greater uncertainty for both tax administrations and taxpayers. The proposed Commentary also provides that any concern about the inappropriate use of the paragraph 4 exceptions would be addressed by the new anti-fragmentation provision (discussed below).22

Fragmentation of activities between closely related parties

The Action 7 Report also proposes to incorporate a new anti-fragmentation rule by adding a new sub-paragraph 4.1 to Article 5. The purpose of an anti-fragmentation rule is to prevent the use of the specific activity exemptions in paragraph 4 to artificially avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities.23 The OECD takes the view that because of the ease of setting up subsidiaries, the existing anti-fragmentation rule should be extended to cases where these places of business belong to closely related enterprises.24 The proposed Commentary illustrates the application of the anti-fragmentation rule and when activities are seen as being “complementary functions that are part of a cohesive business operation” using two examples:

- A bank in country R has a number of branches in country S. Each branch in country S is a PE of the bank. The bank also has an office in country S where employees verify client information made in the context of loan applications submitted at these branches. The verification results are forwarded on business activities at the same place or another place in the same country and either:
  a) The place or other place constitutes a PE, or
  b) The overall activity by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not preparatory or auxiliary.

Also, the aggregation rule under the new paragraph 4.1 would only apply if the business activities carried on by the two enterprises constitute “complementary functions that are part of a cohesive business operation.”25 The proposed Commentary provides that in order for the anti-fragmentation rule to apply, at least one of the places where these activities are exercised must constitute a PE or, if this is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.26

The proposed Commentary illustrates the application of the anti-fragmentation rule and when activities are seen as being “complementary functions that are part of a cohesive business operation” using two examples:

- A bank in country R has a number of branches in country S. Each branch in country S is a PE of the bank. The bank also has an office in country S where employees verify client information made in the context of loan applications submitted at these branches. The verification results are forwarded
to the bank in country R where the information is analyzed and provided back to the branches for the purposes of deciding whether to grant the loans. Here, the anti-fragmentation rule would apply because there is a PE in country S and the business activities of the bank at its office in country S and the relevant branches are complementary functions that are part of the cohesive business of the bank in providing loans to clients in country S.

- A manufacturer and seller of appliances in country R (R Co) has a subsidiary in country S (S Co) that owns a store where it sells appliances that it acquires from R Co. R Co also owns a warehouse in country S where it stores items that are identical to those displayed by S Co in its store. When a customer buys an item from S Co, S Co employees go to R Co’s warehouse to take possession of the item before delivering it to the customer. Here, the anti-fragmentation rule would apply to prevent the exceptions in Article 5(4) from applying because R Co and S Co are closely related enterprises, S Co’s store is a PE of S Co (as the PE definition is not limited only to situations where a fixed place of business is maintained by an enterprise in another state but also in the same state), and the business activities of R Co at the warehouse and S Co at the store are complementary functions that are part of the cohesive business of storing goods (by R Co) in one place (R Co’s warehouse) to fulfill the delivery obligations resulting from the sale of these goods (by S Co) through another place (S Co’s store) in country S.

**Splitting-up of contracts**

The Action 7 Report also addresses concerns about the possibility of related parties splitting-up contracts into several parts, each covering a period of less than 12 months and each attributed to a different company in the same group in order to avoid PE status under Article 5(3). Article 5(3) deals with the creation of construction PEs if such construction, building or installation site lasts for a period of at least 12 months.

The Final Report proposes that the Principal Purpose Test (PPT) rule to be added to the OECD Model under BEPS Action 6 would prevent such abuses. The Final Report further proposes the inclusion of an example in the OECD Commentary to the PPT rule illustrating when it would be considered appropriate to aggregate the time that two related companies worked on a construction project because it is reasonable to conclude that one of the principal purposes of splitting up the contract is to obtain the benefit of the 12 month rule under Article 5(3). For countries that cannot address the issue via their domestic anti-abuse rules, an alternative automatic aggregation rule also will be included in the OECD Commentary as a provision to be used in treaties that would not include the PPT rule or by countries with specific concerns in this area.

The optional aggregation provision includes a *de minimis* exception, under which activities carried on for not more than 30 days would not be aggregated with other periods of activity. The aggregation rule also is restricted to situations when “closely related” enterprises perform “connected activities.” Hence if an enterprise of one country carries on activities described in Article 5(3) in a second country for a period of less than 12 months and one or more closely related enterprises perform “connected activities” at the same site or project for a period of more than 30 days, the periods of activity of the closely related enterprises will be aggregated for purposes of applying Article 5(3).

**Insurance**

As part of the work on Action 7, BEPS concerns were examined regarding situations where a large network of exclusive agents is used to sell insurance for a foreign insurer. However, it was concluded that it would be inappropriate to try to address these concerns through a PE rule because it would treat insurance differently from other types of businesses and that BEPS concerns in those cases should be addressed through the more general changes to Articles 5(5) and 5(6).

**Profit attribution to PEs and interaction with action points on transfer pricing**

The Final Report also notes that the work on Action 7 focused on whether the existing rules of Article 7 of the OECD Model would be appropriate for determining the
profits that would be allocated to PEs resulting from the changes included in the report. The conclusion was that these changes do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the Article 7 rules would apply to PEs resulting from these changes, in particular for PEs outside the financial sector.

The Final Report states that work on attribution of profit issues related to Action 7 could not be done before the work on Action 7 and Actions 8-10 is completed. Therefore, the Final Report indicates that follow-up work on attribution of profits issues related to Action 7 will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that is intended as a mechanism for implementing the treaty-based recommendations under the BEPS Action Plan.

Implications
The Action 7 Report sets forth specific amendments modifying paragraphs 4, 5 and 6 of Article 5 of the OECD Model, together with proposed Commentary to provide guidance on the new rules.

Once implemented, the Action 7 Report amendments will have implications for how companies operate global businesses going forward as current operating models could create new PEs in other countries for these companies. New PEs would mean additional tax filing obligations and increased potential for controversy. Moreover, the issue of profit attribution to these new PEs is an important matter for businesses, and the work on that issue has not yet been done.

Companies should evaluate how the proposals may affect their global businesses. Companies also should stay informed about PE developments in the countries where they operate or invest, as well as developments in the OECD related to the ongoing work on profit attribution to PEs.

Webcasts
EY is hosting a series of eight tax webcasts that will provide a comprehensive review of the final BEPS reports and the outlook for country action:

- OECD BEPS Project Outcomes: Highlights and Next Steps - 15 October, 10 am EDT
- New Reporting under BEPS Action 13 - 20 October, 10 am EDT
- Digital Economy Developments and BEPS Action 1 - 27 October, 12 noon EDT
- Permanent Establishment Developments and BEPS Action 7 - 5 November, 10 am EST
- Transfer Pricing and BEPS Actions 8-10 - 12 November, 10 am EST
- Anti-abuse Measures under BEPS Actions 3, 5, 6 and 12 - 19 November, 10 am EST
- Financial Payments and BEPS Actions 2 and 4 - 3 December, 10 am EST
- Dispute Resolution and BEPS Action 14 - 10 December, 10 am EST

For more information and to register for the webcast series, click here.

Endnotes
4. Proposed new paragraphs 32.5 and 32.6 of the OECD Commentary on Article 5, Action 7 Report, page 19.
17. Proposed new paragraph 22.5 of the OECD Commentary on Article 5, Action 7 Report, page 33.
18. Proposed new paragraph 22.6 of the OECD Commentary on Article 5, Action 7 Report, page 34.

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