Executive summary


The Interim Report provides an in-depth analysis of the main features commonly found in certain highly-digitalized business models and value creation in the digitalized age. It also considers the current state of implementation (and impact) of the BEPS package, in particular of those BEPS Action Points that are most relevant to digitalization, and further provides an overview of unilateral measures that have been introduced by countries in this area.

The Interim Report concludes that there is no consensus on the merits of, or need for, interim measures, noting that *a number of countries are opposed to such measures on the basis that they will give rise to risks and adverse consequences*. It does, however, include a framework that can be considered when designing interim measures to address the tax challenges of digitalization, as well as an outline of the possible long-term risks that will need to be addressed in designing interim taxes.
Further work will need to be carried out on digitalization analyses. An update on this work will be provided in 2019, as BEPS IF members work towards a consensus-based solution by 2020. On 20 March, the G20 welcomed the Interim Report, noting its commitment to work towards the same goal.

Detailed discussion

Background

On 5 October 2015, the OECD released its final report on the tax challenges of the digital economy (Action 1) under its BEPS Action Plan. The final report indicated that there would be follow-up work carried out in this area and that a supplementary report reflecting the outcomes of continued work on the overall taxation of the digitalization economy would be released by 2020.

The Interim Report

The Interim Report is organized into eight different chapters, including a number of figures, tables and boxes. The chapters are:

- Introduction to the Interim Report on the tax challenges arising from digitalization (Chapter 1)
- Digitalization, business models and value creation (Chapter 2)
- Implementation and impact of the BEPS package (Chapter 3)
- Relevant tax policy developments (Chapter 4)
- Adapting the international tax system to the digitalization of the economy (Chapter 5)
- Interim measures to address the tax challenges arising from digitalization (Chapter 6)
- Beyond the international tax rules: The impact of digitalization on other aspects of the tax system (Chapter 7)
- Conclusion to the Interim Report on the tax challenges arising from digitalization (Chapter 8)

Introduction to the Interim Report on the tax challenges arising from digitalization

The Interim Report opens by providing an overview of the impact of digitalization on society and the global economy. Digitalization has not only radically transformed aspects of everyday lives, the report says, but also the organization and functions of the economy and society itself. Its impact has also been remarked upon in relation to international tax rules and other aspects of the tax system. This changing environment brings many challenges to policymakers, as they need to ensure that the policy development and implementation will be designed in such a way that will support economic growth.

More specifically, digitalization has changed methods of communication and interaction among people and society. This affects and raises a number of issues in other areas, including jobs and skills, privacy and security, education, health and policy. Technology has brought new devices and machines that have transformed relationships and markets.

The Interim Report sets out evidence that connectivity has become increasingly ubiquitous and that an enormous amount of data is generated by constantly connected users and devices. Apart from bringing changes, digitalization plays a central role in fostering innovation. A number of emerging technologies, including the Internet of Things, digital crypto-currencies, the sharing economy, 3-D printing, advanced robotics and open government data have been introduced. For example, 3-D printing has increasingly entered the mainstream and even altered the supply chain, the Interim Report notes.

The Interim Report continues by providing background information of the work relating to the tax issues arising from digitalization undertaken by the OECD/G20 BEPS project, the members of the BEPS IF and the Task Force on the Digital Economy (TFDE, the subsidiary body of the OECD addressing this issue).

As part of the OECD/G20 BEPS project, and in the context of Action 1, the TFDE considered the tax challenges raised by the digital economy. Their 2015 report noted the direct and indirect tax challenges created by increased digitalization and provided an evaluation of the options to address these challenges. Conversely, the Interim Report mainly focuses on direct taxation. The Interim Report suggested that, together, the other BEPS Action Points would effectively address the challenges posed by the digital economy. In the Action 1 final report, the OECD also discussed a number of potential interim measures that countries may consider, but did not ultimately recommend any of them.

In March 2017, the G20 Finance Ministers called on the TFDE to bring forward the delivery of its interim report, so that it would be finalized by no later than April 2018. Leading up to the preparation of the Interim Report, on 22 September 2017, the OECD released a public consultation document.
seeking input with respect to the tax challenges raised by
digitalization and the potential options to address these
challenges. The request invited stakeholders to submit their
comments on: (i) the impact of digitalization on business
models and value creation; (ii) challenges and opportunities
for tax systems; (iii) the implementation of the measures
outlined in the BEPS package; and (iv) potential options to
address the direct tax challenges of digitalization. Following
this request for input, on 1 November 2017, the OECD held
a public consultation on the tax challenges of digitalization
at the University of California, Berkeley.

Digitalization, business models and value creation
Chapter 2 describes the impact of digitalization on
business models and value creation. It focuses on the main
characteristics of digital markets and processes of value
creation, while the analysis is complemented by case studies
with the aim of identifying the key factors that are prevalent
in more highly digitalized businesses.

The structure of businesses and the process of value creation
have significantly changed and evolved, becoming technically
very complex, notes the Interim Report. It identifies three
common characteristics that are frequently observed in
certain highly digitalized businesses and that are expected to
become common features of a wider number of businesses
as digitalization continues:

1. Cross-jurisdictional scale without mass: Digitalization has
made it possible for businesses to locate various stages of
their production processes across different countries and
to provide access to a great number of customers around
the world. Highly digitalized businesses can be heavily
involved in the economic life of a jurisdiction without any
significant physical presence and achieve operational
local scale without local mass.

2. Reliance on intangible assets, including intellectual
property (IP): Another characteristic of digitalized
businesses is that they increasingly invest in intangibles,
especially IP assets. It has been observed that the intense
use of IP assets (e.g., software, websites, and algorithms)
is central to the business models of such enterprises.

3. Data, user participation and their synergies with IP:
The business models of highly digitalized companies
include data, user participation, network effects and the
 provision of user-generated content. The benefits from
data analysis are also likely to increase with the amount of
collected information linked to a specific user or customer.

Even though the existence of the above three characteristics
of digitalized companies is recognized by the members of
the BEPS IF, there is no consensus on their relevance and
importance to the location of value creation and the identity
of the value creator(s).

After the identification of the key features of the digitalized
businesses themselves, the Interim Report continues by
analyzing the characteristics of digital markets, i.e., the
infrastructure on which those businesses develop. Digital
markets, it says, are characterized by direct network effects,
as the utility from the consumption of a specific good or
service is often dependent on the number of other end-users
consuming the same good or service. In multi-sided markets,
indirect network effects can also occur when a specific group
of end-users benefits from interacting with another group of
end-users, typically via an online platform.

A further characteristic noted in the Interim Report is that
the production of digital goods and services entails higher
fixed costs and lower variable costs. It has been observed
that due to psychological as well as monetary switching costs,
customers are usually locked in to a particular operating
system once they have acquired a specific device. Lastly,
complementarity is another feature of digital markets, as
customers derive more utility from consuming two or more
complementary goods together (e.g., laptop complemented
by software programs).

The Interim Report continues by discussing the impact
of digitalization on value creation in business models by
classifying the processes of value creation into three groups
and systematically describing the process in each of the
three groups:

i) Value chains, which is a theory of the company that
models a long-linked technology where value is created
by converting inputs into outputs through discrete but
related, sequential activities.

ii) Value networks, which is a more natural framework for
many more highly digitalized companies, relying on a
mediating technology that is used by platform operators
to link customers interested in engaging in a transaction
or relationship.

iii) Value shops, which operate in single-sided markets where
interactions take place with one specific type of user or
customer, and which are characterized by the use of an
intensive technology applied in order to solve a specific
customer demand or problem.
To help the analysis of various value creation processes, Chapter 2 also describes different business model case studies which are analyzed in detail with the objective of isolating the features relevant for the tax system. The business models examined in the case studies are: (i) a reseller of tangible goods as an example of a value chain, two multi-sided platforms; (ii) a ride-for-hire company and a social network as examples of value networks; and (iii) finally, a cloud computing company as an example of a value shop.

**Implementation and impact of the BEPS package**

In Chapter 3, the Interim Report considers the implementation and impact of the package of BEPS Action Points, in particular of those BEPS Action Points that the OECD believes are most relevant to digitalized business activity. These relevant measures include the direct tax measures developed under BEPS Action 7 (prevent the artificial avoidance of permanent establishment (PE) status), Actions 8-10 (assure that transfer pricing outcomes are in line with value creation), Action 3 (strengthen Controlled Foreign Company (CFC) rules), Action 5 (tackle harmful tax practices), Action 6 (prevent treaty abuse), as well as the new guidelines and implementation mechanisms relating to Value Added Tax (VAT) that were agreed under Action 1.

As the implementation of the BEPS measures is still in its early stages, data on the impact of the measures remains limited, says the Interim Report. Therefore, a systematic assessment of the effect of the various BEPS measures will only be possible in coming years, when the full impact of the behavioral responses of taxpayers will begin to be reflected in the micro- and macro-level data, and when new sources of data covering the post-BEPS period become available.

The various measures outlined in the 2015 BEPS Action 7 final report are currently being implemented in a number of existing tax treaties via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI). While the adoption rate of the PE-related provisions through the MLI is currently low, the Interim Report says, this does not reflect the full degree of implementation and impact of the MLI. According to the Interim Report, a significant number of multinationals have already started changing their business structures, which were previously based on remote sales models. Those multinationals have instead adopted local reseller models – a proactive step aimed at aligning their corporate structures with their economic activities. In realigning their structures, multinationals are reconsidering their global transfer pricing positions and/or relocating valuable assets, such as intangibles, in jurisdictions where substantial economic activities take place (i.e., so-called “on-shoring” of assets).

With regard to the BEPS minimum standards, there has already been significant progress in the context of IP regimes under Action 5. As set out in the 2017 Progress Report on Harmful Tax Practices, with the exception of two countries, all OECD and G20 countries with IP regimes now comply with the “nexus approach” - a total of 19 out of 21 such regimes. The implementation of Action 6 has also been widespread. Countries have started to implement the necessary treaty changes either through the MLI, or by updating their tax treaties through bilateral negotiations. Most BEPS IP jurisdictions have now implemented legislation for Country-by-Country (CbC) reporting and around 95% of multinational enterprises (MNEs) are expected to be affected by CbC reporting requirements.

The BEPS package also recommended the coordinated implementation of a number of measures requiring domestic law changes. Many countries have implemented the recommendations on domestic tax measures to neutralize the effect of hybrid instruments and entities. Among the European Union (EU) Member States, the EU Anti-Tax Avoidance Directive plays a central role for the implementation of such rules, while the United States (US) recently adopted – as part of the Tax Cuts and Jobs Act – anti-hybrid provisions.

Furthermore, the Interim Report notes, six countries have already partially adopted the Action 2 recommendations into domestic law. Similarly, various countries have also taken steps toward the implementation of the interest deductibility rules under Action 4, or are in the process of aligning their domestic legislation with those recommendations. Furthermore, the guidance related to mandatory disclosure rules (Action 12) is also being considered by a number of countries. To this end, the EU agreement on new transparency rules for intermediaries and taxpayers that was reached by the Council on 13 March 2018 and broadly implements Action 12, plays an important role.³

Implementation success is also noted in the Interim Report with respect to indirect taxation, where over 50 jurisdictions have adopted rules for the VAT treatment of business-to-consumer supplies of services and intangibles by foreign suppliers, in accordance with the OECD International VAT/GST Guidelines and as recommended in BEPS Action 1.
Relevant tax policy developments

Chapter 4 outlines the unilateral measures relevant to
digitalization that have been introduced by countries and
groups them into four categories: (i) alternative applications
of the PE threshold; (ii) withholding taxes; (iii) turnover
taxes; and (iv) specific regimes targeting large MNEs. Those
measures are characterized by aiming at protecting and/or
expanding the tax base in the country where the customers
or users are located, by including elements linked to a market
in the design of the tax base (e.g., sales revenue, place of
use or consumption) and by reflecting a discontent among
some countries with the taxation outcomes produced by the
current international income tax system. The Interim Report
sets out more detail on each:

i) Alternative applications of the PE threshold: Include
measures taken by some countries in order to amend
the way the threshold for source-based taxation of
business profits - the PE definition - is applied under their
domestic law and/or in tax treaties. The developments
noted are either measures incorporating digital presence
factors or the application of the “service PE” threshold
unconstrained by physical presence requirements. The
former measures are designed to establish nexus in
situations where a nonresident enterprise, physically
established in a remote location, is proactively taking
steps to create and maintain an ongoing interaction with
the users and customers of a given country. Examples of
countries that moved forward with the adoption of the
significant economic presence test are Israel and India.
The latter measures concern the view expressed by some
countries that the requirement of physical presence is
no longer relevant for the application of the “service PE” definition
in Article 5(3) (b) of the United Nations
(UN) Model Tax Convention (MTC). At the origin of this
position lies the concern that digitalization has facilitated
the adoption of centralized sales and distribution models,
where online services can be performed remotely without
any material presence in the markets being served. This
broad interpretation is known as the “virtual service PE”
and has been officially endorsed in Saudi Arabia.4

ii) Withholding taxes: Among the measures relevant in this
area, the Interim Report notes that some countries have
expanded their domestic definition of royalties subject
to withholding on a gross basis by incorporating into
that category items of income traditionally classified as
business profits in double tax treaties. Other measures
concern the creation of an exception to the PE threshold
for certain service fees in the domestic law and/or double
tax treaties, allowing a withholding tax on a gross basis
in the source country when the payer is resident in that
country. It should be noted that the OECD MTC does
not contain this exception, while it was recently added
to the UN MTC as part of its 2017 update. Lastly, other
countries introduced new withholding taxes on other
specific categories of income, such as income from
online advertising.

iii) Turnover taxes: The third group of unilateral measures
relates to actions outside the framework of income taxes
to assert taxing rights over nonresident enterprises, such
as foreign-based suppliers of digital products and services.
These measures include sectoral turnover taxes targeted
at revenue from online advertising services and they are
generally combined with broad nexus rules focused on the
destination of the supplies, being applied both to resident
and nonresident enterprises irrespective of their location.
Examples of countries that have adopted such measures
are India’s equalization levy, or Italy’s levy on digital
transactions.5

iv) Specific regimes targeting large MNEs: This group
includes more general legislative responses that either
create new administrative regimes aimed at restoring a
balance of power between the tax authorities and large
MNEs, or introduce specific anti-abuse rules to address
excessive use of base eroding payments by large MNEs.
As examples, the Interim reports mentions the Diverted
Profits Tax in the United Kingdom6 and Australia7 and
the base erosion and anti-abuse tax in the US.

Adapting the international tax system to the
digitalization of the economy

Chapter 5 considers potential long-term solutions to
addressing the tax challenges arising from digitalization, with
particular focus on revisions that may be required to existing
profit allocation and nexus rules. The chapter begins with an
analysis of these fundamental concepts, before continuing by
analyzing how the characteristics described in Chapter 2 of
the Interim Report may interact with such rules. On this topic,
the Interim Report states that members of the BEPS IF have
divergent views, and splits the countries in three broad groups:

- The first group of countries supports that some
characteristics of highly digitalized business models may
lead to misalignments between the location in which profits
are taxed and the location in which value is created. This
misalignment is, the Interim Report says, the result of the
active participation of users through an online platform, and the value that this participation creates for the business (i.e., user-generated value), which is a new and unique feature observed in some highly digitized business models that is not captured by the existing international tax framework.

The second group of countries shares the view that the ongoing digital transformation of the economy, and more generally trends associated with globalization, present challenges to the continued effectiveness of the existing international tax framework which are not exclusive or specific to highly digitalized business models. Some countries within this group also explicitly reject the suggestion that data and user participation should be considered as value creators by the business in the user’s jurisdiction.

The third group of countries considers that the BEPS actions have largely addressed the concerns of double non-taxation, even though it is still too early to fully assess the impact of all measures. These countries are generally satisfied with the existing tax system and do not currently see the need for any significant reform of the international tax rules.

While acknowledging these divergences, the Interim Report states that the members of the BEPS IF agree that they share a common interest in maintaining a single set of relevant and coherent international tax rules, to promote, inter alia, economic efficiency and global welfare. To that end, they have agreed to undertake a coherent and concurrent review of the two key aspects of the existing tax framework (the profit allocation and nexus rules) that would consider the impacts of digitalization on the economy.

Interim measures to address the tax challenges arising from digitalization

Chapter 6 discusses the option for adoption of interim measures. From its opening introduction, the Interim Report highlights that there is no global consensus on the merits of, or need for, interim measures and thus, it does not recommend the introduction of such measures. A group of countries, it says, are opposed to any such measure, as they consider that an interim measure will give rise to risks and adverse consequences. In contrast, other countries acknowledge these challenges, but at the same time consider that they do not outweigh the need to ensure that tax is paid in their jurisdictions on certain e-services supplied in their jurisdictions.

For the design of such measures, the Interim Report notes that those countries in favor of interim measures recognize the need to take the following considerations into account:

- Any new tax that a country introduces must be in compliance with its existing international obligations. These obligations include those imposed by bilateral tax treaties as well as a country’s obligations as a Member of the World Trade Organization or the EU and the European Economic Area.
- The policy intent of any interim measure should be temporary, as it is essential that countries maintain a commitment to achieve a broader global consensus and ensure that, once a global solution is found, it can be implemented in a swift and coordinated manner.
- The interim measures should be targeted at those businesses that are perceived to constitute the highest risk, which for a number of countries are those businesses that combine high levels of scale without mass, and have business models that rely heavily on user participation and network effects. A well-defined and targeted scope of the interim measures is predominant in order to minimize the collateral impact of the measure on other elements of the domestic and international tax system.
- A key objective of an interim measure should be to balance the need to address the rapidly emerging challenges raised by the digitalization of the economy while at the same time avoiding the risk of over-taxation. To that end, the rate of tax and the scope of the measure will be important factors.
- An important consideration while designing an interim measure should also be the avoidance of any negative impact on start-ups and small businesses in general due to the financial constraints and compliance obligations. An interim tax measure would need to have a threshold that does not inhibit those kind of businesses.
- Finally, taking into account its temporary feature, administrative cost and complexity should be kept to a minimum while designing an interim measure.

Beyond the international tax rules: The impact of digitalization on other aspects of the tax system

Chapter 7 discusses the implications of digitalization on other parts of the tax system beyond the international tax rules. From the design of the tax system through to tax administration, relevant developments include the rise of business models facilitating the growth of the “gig” and
“sharing” economies, as well as an increase in other peer-to-peer (P2P) transactions, the development of technologies such as Blockchain, and growing data collection and matching capacities.

One of the major changes to the economy facilitated by digitalization is the rapid growth in multi-sided online platforms which facilitate transactions between individual sellers of goods and services to individual consumers, P2P transactions, and the growth and proliferation of the “sharing” and “gig” economies. With regard to taxation, the Interim Report notes that multi-sided platforms facilitate integration into the formal economy, as previously unreported transactions are now carried out through those platforms, delivering an enhanced electronic audit trail and greater reporting of income. Also, such multi-sided online platforms drive growth and increase revenues, the Interim Report says, because they provide new opportunities for economic activity, and encourage movement into the formal economy. If this information of the P2P transactions that the online platforms facilitate can be made available to tax authorities, it can be integrated into data matching analysis to enhance tax compliance.

Technology is in fact expanding the capabilities of tax administrations in a wide range of ways, to enhance the effectiveness of compliance activities, improve taxpayer services, and reduce compliance burdens, notes the Interim Report. In order to realize the aforementioned benefits, areas where further work will assist governments to leverage from the latest technological developments are identified. Firstly, it is pointed out that with the rise of the gig and sharing economies, changes in the mix of taxable status in the economy – for example from employee to self-employed or incorporated – can have significant consequences. The understanding of the tax implications of the changing nature of work is therefore important in this regard. The evolution of the online platforms and the nature of the contracts between the platforms and their users may, for example, provide greater opportunities for activities to be structured in ways that minimize tax liabilities and reduce the tax base. The OECD stands ready to deliver further work on this topic while initial steps have already been taken. Secondly, fostering nascent economic activity and ensuring appropriate tax treatment requires that governments take into account the impact of administrative burdens on users of online platforms. Further work could be undertaken, says the Interim Report, to analyze options for achieving a balance between reducing the compliance burden for some taxpayers and preserving the level playing field. Thirdly, a further area is where a transaction involves payment from one individual to another, rather than being based on altruism or a cost sharing arrangement, then there can be taxable consequences for the parties involved. Platforms may create certain tax challenges for their users, including uncertainty among users regarding their tax liabilities, especially in cases where P2P transactions are involved. To address this challenge, the Interim Report discusses the improvement of taxpayer’s education and self-reporting and the obtaining of tax data about transactions facilitated by the platforms.

Conclusion to the Interim Report on the tax challenges arising from digitalization

The final chapter describes the areas of further work that have been described in the Interim Report, and the directions for the future work of the BEPS IF. Continuing to monitor the impact of the BEPS package, in particular after the US 2017 tax reform measures, will be an important part of the work of the TFDE going forward.

Despite the wide range of economies at varying levels of development and the different opinions, the members of the BEPS IF, says the Interim Report, agree on their common interest in maintaining a relevant and coherent set of international tax rules. It is recognized that uncoordinated and unilateral actions may lead to adverse impacts on investment and growth and increase the risks of double taxation and complexity.

The Interim Report identifies the different views among countries on whether and to what extent the features of highly digitalized business models and digitalization more generally should result in changes to the international tax rules. Even though there are different views, the Interim Report states that all the members of the BEPS IF agree on a coherent and concurrent review of two key aspects of the existing tax framework (nexus and profit allocation rules) that would consider the impacts of digitalization.

Following an update on progress in 2019, the BEPS IF will work towards a consensus-based solution by 2020. An important part of the work forward will also be the monitoring of the impact of the BEPS package and its implementation.
Implications

While countries clearly have different positions regarding the tax challenges arising from digitalization and possible solutions, the Interim Report notes that the BEPS IF members agreed to undertake a coherent and concurrent review of the nexus and profit allocation rules and that they will work towards a consensus-based solution. The Interim Report also notes that at present, there are divergent views on how the issue should be approached, with the European Commission potentially issuing its own set of related proposals as early as 21 March 2018.

Additionally, the Interim Report discusses interim measures that both the European Commission and some individual countries have indicated they may implement, believing that there is a strong imperative to act quickly.

Although an update on this work will be provided in 2019 and the BEPS IF is working towards a consensus-based solution by 2020, countries are already taking national action with respect to the tax treatment of activity in the digital economy.

It also remains to be seen how the European Commission may incorporate the findings of the Interim Report when releasing its proposal for a new legislative framework addressing tax challenges arising from digitalization.

Despite its interim character, the impact of the Interim Report is significant and many stakeholders will weigh in on it. It also remains to be seen whether and how the Interim Report will affect the ongoing tax policy transformation around the world. Also, the future will show whether the rules on nexus and profit allocation remain the same, or whether after adoption, other digitalized companies will be included under their threshold.

Companies should therefore consider putting in place or increasing their efforts to assess, quantify, plan for and comply with change at both multilateral and national levels.

Endnotes

1. The Inclusive Framework on BEPS brings together over 100 countries and jurisdictions to collaborate on the implementation of the OECD/ G20 BEPS Package.


5. See EY Global Tax Alert, Italy enacts Web Tax and new PE definition, dated 29 December 2017.


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