

## OECD documents on BEPS 2.0 include new details and identify issues under consideration on Pillar One and Pillar Two

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### Executive summary

On 31 January 2020, the Organisation for Economic Co-operation and Development (OECD) released a Statement by the Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges Arising from the Digitalization of the Economy (the [Statement](#)). According to the Statement, members of the Inclusive Framework - which currently includes 137 jurisdictions - have affirmed their commitment to reach an agreement on new international tax rules by the end of 2020.

Attached to the Statement are more detailed documents, including an outline of the architecture and a revised workplan for Pillar One, relating to revised nexus and profit allocation rules, and a progress update on Pillar Two, relating to new global minimum tax rules. With respect to Pillar One, the Inclusive Framework has endorsed a unified approach as the basis for the ongoing negotiation of a consensus-based solution. With respect to Pillar Two, the Inclusive Framework has welcomed the progress that has been achieved to date.

With respect to both Pillars, the documents include new details on the proposed approaches and identify key issues under consideration and areas where more work is to be done in the coming months.

## Detailed discussion

### The Statement

The Statement and its more detailed annexes released on 31 January 2020 by the OECD reflect the outcome of the plenary meeting of the Inclusive Framework, where the 137 participating jurisdictions reached agreement on plans to move ahead with work on the two-pillar approach for addressing the tax challenges of digitalization. The Statement reports that the members of the Inclusive Framework have affirmed their commitment to reach an agreement on a consensus-based solution by the end of 2020. To reach this objective, the Statement indicates that it is intended that the Inclusive Framework at its next meeting in early July 2020 will reach agreement on the key policy features of the solution that would form the basis for a political agreement.

With respect to Pillar One on revised nexus and allocation rules, the Statement indicates that the Inclusive Framework has endorsed a unified approach as the basis for the ongoing negotiation of a consensus-based solution. In this regard, the Statement emphasizes the need for the new rules to provide improved tax certainty and minimize complexity. The Statement also notes that there are technical challenges involved in developing workable rules and highlights the critical policy differences among countries that must be resolved, including:

- ▶ The US proposal for implementation of Pillar One on a “safe harbor” basis, which was communicated in a 3 December 2019 letter from US Treasury Secretary Mnuchin to OECD Secretary-General Gurría, and the concerns expressed by many other Inclusive Framework members about this proposal
- ▶ The extent of the binding nature of dispute prevention and resolution mechanisms, as well as the scope of such mechanisms
- ▶ The suggestion by some members regarding digital differentiation in the quantum of Amount A (the profits to be specially allocated to market jurisdictions)
- ▶ The suggestion by some members regarding regional differentiation in computing and allocating Amount A
- ▶ The concerns expressed by some members, as well as businesses, about the continued application of digital services taxes

With respect to Pillar Two on new global minimum tax rules, the Statement indicates that the Inclusive Framework has welcomed the significant progress that has been achieved to date on the technical design of new rules. The Statement also notes that more work needs to be done.

Finally, the Statement references the progress on the ongoing work on economic analysis and impact assessments of Pillars One and Two.

The Statement is accompanied by annexes that provide more detailed discussion of the work on both Pillars:

- ▶ Annex 1 is an Outline of the Architecture of a unified approach on Pillar One (the Pillar One Outline). The Outline has two annexes:
  - Annex A is a Programme of Work to Develop a Consensus-based Solution to Pillar One Issues (the Revised Pillar One PoW), which replaces the previous OECD workplan adopted in May 2019
  - Annex B is a flowchart diagram illustrating the types of MNE Groups Impacted by Amount A
- ▶ Annex 2 is a Progress Note on Pillar Two (the Pillar Two Progress Note)

### The Pillar One Outline

The Pillar One Outline provides further details on the unified approach endorsed by the Inclusive Framework as the basis for further negotiation. The approach draws heavily on the OECD Secretariat proposal for a “unified approach” under Pillar One that was released on 9 October 2019 for comment by stakeholders<sup>1</sup> and was discussed during a public consultation hosted by the OECD on 21-22 November 2019.<sup>2</sup>

Importantly, the Pillar One Outline states the expectation that any Pillar 1 agreement must include a commitment by the Inclusive Framework countries both to implement the new rules and “at the same time to withdraw relevant unilateral actions.”

The Pillar One Outline describes the unified approach as encompassing three elements:

- ▶ Amount A, under which a share of the deemed residual profit is allocated based on a formulaic approach to market jurisdictions using the new nexus standard that is not dependent on physical presence.

- ▶ Amount B, which is a fixed remuneration based on the arm's length principle for defined baseline distribution and marketing functions that take place in a jurisdiction. Amount B requires nexus under existing rules.
- ▶ Amount C, which covers any additional profit where in-jurisdiction functions exceed the baseline activity compensated under Amount B. Like Amount B, Amount C requires nexus under existing rules. Amount C also encompasses dispute prevention and resolution mechanisms.

Key points addressed in the Pillar One Outline are highlighted below.

### The new taxing right

#### *Businesses in scope*

For the new taxing right under Amount A, the Pillar One Outline sets out two categories of businesses that are to be considered in scope. The first category is those businesses that generate revenue from the provision of *automated digital services* on a standardized basis to a large population of customers or users across multiple jurisdictions. This is expected to include, but is not limited to, the following:

- ▶ online search engines;
- ▶ social media platforms; online intermediation platforms, including the operation of online marketplaces, irrespective of whether used by businesses or consumers;
- ▶ digital content streaming;
- ▶ online gaming;
- ▶ cloud computing services; and
- ▶ online advertising services.

The second category is *consumer-facing businesses* that generate revenue from the sale of goods and services of a type commonly sold to consumers (i.e., individuals that are purchasing items for personal use and not for commercial or professional purposes). This category also covers businesses that sell consumer products indirectly through third-party resellers or intermediaries that perform routine tasks, and it is intended that businesses that generate revenue from licensing rights over trademarked consumer products and businesses that generate revenue through licensing a consumer brand and commercial know-how will also be in-scope. Businesses selling intermediate products and components that are incorporated into a finished product sold to consumers would generally be out of scope.

The second category is expected to include, but is not limited to, the following:

- ▶ personal computing products (e.g., software, home appliances, mobile phones);
- ▶ clothes, toiletries, cosmetics, luxury goods;
- ▶ branded foods and refreshments;
- ▶ franchise models, such as licensing arrangements involving the restaurant and hotel sector; and
- ▶ automobiles.

The Pillar One Outline indicates that further work will be needed on the definitions with respect to these categories.

The Pillar One Outline states that extractive industries and other producers and sellers of raw materials and commodities will not be in scope of the consumer-facing business definition. Similarly, it states that most of the activities of the financial services sector (including insurance) take place with commercial customers and will therefore be out of scope. It further states that a compelling case exists for consumer-facing businesses such as retail banking and insurance to be excluded given the impact of prudential regulation and licensing requirements. Finally, it indicates that consideration might be given to whether there are any unregulated financial services, such as digital peer-to-peer lending platforms, that require special consideration.

The Pillar One Outline notes that nearly all bilateral tax treaties provide for exclusive residence-country taxing rights over profits from the operation of ships and aircraft in international transport, and it indicates that it is therefore considered inappropriate to include airline and shipping businesses in the scope of the new taxing right.

The Pillar One acknowledges that work will be required on possible segmentation of business lines for purposes of the new taxing right, in order to determine what is practicable and verifiable.

#### *The new taxing right - Thresholds*

To ensure that the compliance and administrative burdens are proportionate with the intended benefits, the Pillar One Outline indicates that the new taxing right will operate with a number of thresholds:

- ▶ The new taxing right will be limited to multinational enterprise (MNE) groups that meet a specified gross revenue threshold - such as, for example, the Country-by-Country reporting threshold of EUR 750 million

- ▶ A further carve-out will be considered for situations where the total aggregated in-scope revenue is less than a specified threshold
- ▶ A carve-out will also be considered for situations where the total profit to be allocated under the new taxing right would not meet a specified *de minimis* amount

### Nexus

The Pillar One Outline states that for MNEs in scope, the “new” nexus will be created based on indicators of significant and sustained engagement with market jurisdictions. The generation of in-scope revenue in a jurisdiction over a period of years will be the primary evidence of such engagement. In this regard, a revenue threshold would be set based on the size of the particular market, with an absolute minimum to apply in all cases. For automated digital services that are in scope, the revenue threshold would be the only test required for nexus. For other in-scope activities, nexus will not be created merely on the basis of satisfaction of a revenue threshold; a sustained interaction with the market will be necessary for nexus. Further work will be required on the use of possible additional or “plus” factors to determine nexus.

The rules will be designed to avoid spill-over effects on existing nexus rules so that the new nexus remains exclusively applicable to the new taxing right and cannot be used as a basis for creating a nexus for other taxes, nor in any other non-tax context.

Additional work will also be done to design clear and administrable rules that will determine which market jurisdiction will be considered to be the source of revenues for purposes of applying the nexus revenue threshold in, and to allocate profits to, that jurisdiction.

### Quantum of Amount A - The tax base

In what the Pillar One Outline acknowledges as a deviation from the traditional transfer pricing separate-entity approach, the calculation of Amount A will be based on a measure of profit derived from the consolidated group financial accounts - with the possibility of segmentation on a regional or business line basis to be explored further. Profit before tax is described as the preferred profit measure to compute Amount A. In addition, it is specified that the rules will cover both profit and loss and will include loss carry-forward rules. Moreover, the work on design of the loss rules will explore how to account for losses incurred before the new rules are in place.

It is noted that the quantum of Amount A could be weighted to reflect the level of digitalization of the in-scope activities. Further negotiation will explore such an approach. In addition, further consideration will explore whether there should be regional differentiation as to quantum of Amount A and the portion allocated to market jurisdictions and whether the portion of the profit allocated to market jurisdictions should be different for different businesses.

### Quantum of Amount A - The allocation key

The Pillar One Outline indicates that because the allocation key would be based on sales of a type that generate nexus, specific revenue-sourcing rules will need to be developed by reference to different business models. One illustration included in the Pillar One Outline is online advertisement, where revenue will be deemed to be sourced in the jurisdiction where the advertisement is viewed, not where it is purchased.

### Elimination of double taxation

The Pillar One Outline acknowledges the complexity involved in overlaying Amount A on the traditional transfer pricing system and the need for appropriate mechanisms to eliminate double taxation. In particular, approaches will need to be established for identifying the entities from which profit is to be reallocated. Further work will be done to ensure administrable and fair double taxation relief mechanisms.

### Interactions and potential for double counting

The Pillar One Outline also discusses the need to address any possible interactions between Amounts A, B and C that are not appropriately dealt with by the mechanisms to eliminate double taxation. The stated objective is to simplify the computation of the return for the activities within scope, and reduce disputes and uncertainty about the pricing of certain types of distribution activities.

The Pillar One Outline notes that there will be no significant interaction between Amounts A and B, given that Amount A reflects residual profits and Amount B reflects routine profits. However, where both Amount A and Amount C are allocated to a market jurisdiction because the MNE group already has a taxable presence in that jurisdiction, double counting may arise. Areas in which possible double counting might need to be considered relate to:

- (1) marketing intangibles in the local jurisdiction;
- (2) comparability adjustments under the arm's length principle; and
- (3) uncommon interpretations of the arm's length principle.

The Pillar One Outline indicates while further consideration of these possible instances of double counting will be required, no such double counting situations should give rise to double taxation given the application of mechanisms to eliminate double taxation. Nevertheless, as any transfer pricing reassessment could give rise to interactions between Amount A and Amount C, further work will be undertaken to identify such interactions.

*The fixed return for defined baseline distribution and marketing activities (Amount B)*

The Pillar One Outline states that Amount B aims to standardize the remuneration of distributors that buy products from related parties for resale and, in doing so, perform “baseline marketing and distribution activities.”

The Pillar One Outline indicates that Amount B likely will include distribution arrangements with routine levels of functionality, no ownership of intangibles and no or limited risks. Defining what entities and activities would qualify could be achieved by a positive definition based on qualitative and quantitative factors, together with a list of activities and entities that would be out of scope.

In addition, because the fixed return is based on the arm’s length principle, work will explore how to reflect different functionality levels, industries and regions. This means that Amount B might differ for different functionality levels, industries and regions.

The Pillar One Outline indicates that it is expected that treaty changes will not be required in order to implement this new profit allocation rule. However, it identifies several key technical aspects that will need to be progressed in order to permit informed implementation.

*Tax certainty: dispute prevention and resolution*

As tax certainty is an essential element of the unified approach, the Pillar One Outline explores mechanisms for dispute prevention and resolution. It indicates that agreement on tax certainty is considered to be critical to the overall agreement.

The Pillar One Outline indicates that there is agreement to explore an innovative approach setting up a new binding process for early dispute prevention (before the tax assessments are made) which would be available on all aspects of Amount A. This could be done for example with use of representative panels which would have a review function and be able to provide tax certainty. Work on the process and governance of such panels will be required.

Likewise, the issue of delivering binding agreements by all tax administrations will need to be addressed in the design of the process. The role of the tax administration of the jurisdiction of the ultimate parent entity also will need to be considered.

The Pillar One Outline also states that appropriate mandatory binding dispute resolution mechanisms will also be developed in relation to Amount A.

It is acknowledged in the Pillar One Outline that currently there are differing positions on the breadth of the application of the new dispute resolution mechanism. Also acknowledged is that there is a need to explore innovative approaches that could be used. In addition, as some jurisdictions have domestic obstacles to the adoption of mandatory binding arbitration, it may be necessary to consider alternative mechanisms that can be adopted by all members of the Inclusive Framework.

The Pillar One Outline further notes that enhancing mutual agreement procedures (MAP) is also an important aspect of the work on tax certainty and dispute prevention and resolution. This could be addressed in the work planned for the 2020 review of BEPS Action 14, as well as other ongoing work to improve the effectiveness and efficiency of multilateral MAP.

Finally, in relation to Amount C, the Pillar One Outline indicates that specific enhancing measures to be enacted domestically could be explored, such as:

- ▶ Limiting the time during which any adjustments with respect to Amount C could be made
- ▶ Limiting or suspending collection for the duration of any disputes related to Amount C

*Implementation and administration*

The Pillar One Outline acknowledges that implementing the new rules will require changes to domestic legislation and tax treaties. According to the Pillar One Outline, a new multilateral convention could be negotiated that would apply between jurisdictions that do not currently have a bilateral treaty, supersede the relevant provisions of existing treaties concluded to eliminate double taxation and contain all the international rules needed to implement the unified approach. It is intended that this would ensure that all jurisdictions can implement the unified approach consistently and at substantially the same time.

Furthermore, the Pillar One Outline notes that it may be appropriate to introduce the relevant requirements on a phased basis, and/or to possibly adopt a simplified approach to the compliance requirements for a designated initial period through transition rules.

It is also expected that any consensus-based agreement must include a commitment by members of the Inclusive Framework to implement this agreement and at the same time to withdraw relevant unilateral actions, and not adopt such unilateral actions in the future. Further work will be required to determine the nature of a critical mass for these purposes, and the consequences of that critical mass not including all jurisdictions.

#### *Further consideration of alternative global safe harbor system*

The Pillar One Outline indicates that pursuant to the US proposal for treatment of Pillar One as a safe harbor, an alternative approach to Pillar One implementation will be considered according to which an electing MNE group would agree, on a global basis, to be subject to Pillar One. The Revised Pillar One PoW sets forth a non-exhaustive list of considerations to be addressed by the Inclusive Framework and relevant working parties:

- ▶ whether there are appropriate potential scope modifications to Amount A to reflect the nature of this alternative global safe harbor system;
- ▶ the need for operating and administration rules for an alternative safe harbor approach;
- ▶ appropriate mechanisms to avoid double taxation in light of a safe harbor approach;
- ▶ implications for unilateral measures in the context of the specific safe harbor proposal described in this section; and
- ▶ behavioral implications for taxpayers and jurisdictions.

### **The Revised Pillar One PoW**

The Revised Pillar One PoW organizes the remaining work to be undertaken to further develop the unified approach into eleven workstreams, which align to the elements of the Pillar One Outline:

1. Scope of Amount A
2. New nexus rules and related treaty considerations for Amount A
3. Tax base determinations
4. Quantum of Amount A

5. Revenue sourcing under Amount A
6. Elimination of double taxation under Amount A
7. Interactions between Amounts A, B and C and potential risks of double counting
8. Features of Amount B
9. Dispute prevention and resolution for Amount A
10. Dispute prevention and resolution for Amounts B and C
11. Implementation and administration

The Revised Pillar One PoW also sets forth a timeline, with the Inclusive Framework continuing to work toward reaching an agreement on the key policy features of a consensus-based solution by July 2020 and producing a final report setting out the technical details of the consensus-based solution by the end of 2020.

In order to meet this objective, the Revised Pillar One PoW notes that aspects of the work will need to be completed in June 2020 to support a decision on the relevance and feasibility of key features. Examples of work to be completed by June 2020 include the definition of the categories of business activities falling within the scope of the new taxing right and the determination of the appropriate thresholds for the percentage or percentages of profit that will be reallocated under the new taxing right. The Revised Pillar One PoW notes that other aspects of the work that support the technical design and implementation of the solution will be completed in November 2020, including for example the identification of tax treaty changes required to remove barriers to implementation of the new taxing right.

### **The Pillar Two Progress Note**

The Pillar Two Progress Note provides an update on the GloBE proposal that was described in the consultation document on three design aspects under Pillar Two<sup>3</sup> released by the OECD on 28 November 2019 for comment by stakeholders and was discussed during a public consultation hosted by the OECD on 9 December 2019.<sup>4</sup>

The Pillar Two Progress Note indicates that work is advancing at a fast pace but that significant work remains. It also notes that the Inclusive Framework appreciates the input received so far and looks forward to continued close engagement.

It identifies a series of technical and design issues that remain under discussion in the Inclusive Framework:

- ▶ **Income inclusion rule:** The income inclusion rule would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate. The actual rate to be applied under the GloBE proposal has not yet been discussed by the Inclusive Framework. Extensive work is underway around the use of financial accounts as a basis for the income determination as well as different mechanisms to address temporary differences between tax and financial accounting. Policy choices for blending have been identified through the technical work and supported by the public consultation and written comments submitted. Different options are still under consideration for carve-outs. In this regard, the Pillar Two Progress Note states that carve-outs for BEPS Action 5 compliant regimes would undermine the policy intent and effectiveness of the GloBE proposal, but it also acknowledges that some jurisdictions have stressed the importance of substance based carve-outs to ensure the focus of Pillar Two is on remaining BEPS issues.
- ▶ **Switch-over rule:** The GloBE proposal should apply equally to foreign branches and foreign subsidiaries that are taxed at an effective rate of tax below the minimum rate. The switch-over rule is a mechanism designed to ensure that the income inclusion rule applies to foreign branches exempt under double tax treaties. It would only apply where countries have committed to use the exemption method in their tax treaties. For example, it would turn off the benefit of an exemption for income of a branch, or income derived from foreign immovable property, and replace it with the credit method where that income was subject to a low effective rate of tax in the foreign jurisdiction. A simple switch-over rule is being developed to facilitate implementation of the income inclusion rule, which will need to consider the final design of the income inclusion rule to ensure consistency in scope.
- ▶ **Undertaxed payments rule:** The undertaxed payments rule would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax) for a payment to a related party if that payment was not subject to tax at or above a minimum rate. A number of proposals for the design of the undertaxed payments rule have been considered. These proposals have been designed to limit complexity, compliance and administration costs and the risk of over-taxation.
- ▶ **Subject to tax rule:** The subject to tax rule would complement the undertaxed payment rule by subjecting a payment to withholding or other taxes at source and adjusting eligibility for treaty benefits. This rule, which is still under discussion, could be based on existing provisions in the Commentary to the OECD Model Convention on Income and on Capital. According to the Pillar Two Progress Note, further consideration will be given to the scope of the payments covered, the design of the minimum tax rate test, the extent of the adjustment required, the use of a de minimis threshold and the role of the subject to tax rule vis-à-vis the undertaxed payment rule.

In addition, the Pillar Two Progress Note indicates that there is ongoing work on all aspects of co-ordination, simplification and the compatibility with international obligations. There are also ongoing work-streams looking into possible thresholds (such as the EUR 750 million revenue threshold used for country-by-country reporting).

### Next steps for the OECD

A report from the OECD Secretary General on the ongoing work on the BEPS 2.0 project will be delivered in advance of the next meeting of G20 finance ministers and central bank governors in Riyadh, Saudi Arabia, on 22-23 February 2020.

Aspects of the workplan on Pillar One will need to be completed in June 2020, where the related output is necessary to support a decision on the relevance and feasibility of key features of the consensus-based solution to Pillar One. At the Inclusive Framework meeting in early July it is intended that political agreement on the detailed architecture of this proposal will be reached. Other aspects of the work programme will be completed in November 2020, where the related output is only necessary to support the technical design and implementation of the consensus-based solution.

With respect to Pillar Two, significant work on key issues is advancing with technical progress on many aspects of the GloBE proposal but significant work still remains. Work will continue with a series of meetings already planned in 2020.

With respect to the ongoing work on the economic analysis and impact assessment of Pillars One and Two, the OECD has announced that it will host a webcast on 13 February 2020 that will include presentation of preliminary results as to the revenue and investment effects of the proposed approaches.

## Implications

The agreement reached in the Inclusive Framework means that work on the BEPS 2.0 project is continuing to move forward. The complex issues underlying the Pillar One and Pillar Two work will be the subject of policy and technical discussions among the Inclusive Framework jurisdictions throughout 2020. The Statement and its annexes underscore that the international tax changes contemplated with these Pillars will have implications well beyond digital businesses and digital business models. The ongoing project, with the participation of 137 jurisdictions, could lead to fundamental changes in the global international tax system under which multinational businesses operate and could have significant consequences in terms of both the overall tax liabilities of businesses and the tax revenues of countries.

It is important for companies to follow these developments closely as they unfold in the coming months. Companies may want to consider engaging with the OECD and policymakers at both national and multilateral levels on the business implications of these proposals. The Statement and its annexes provide further details how these rules could apply, allowing companies to evaluate the potential impact of these changes on their business models and consider what the proposed new international tax landscape would mean for them.

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## Endnotes

1. See EY Global Tax Alert, [The OECD takes next step on BEPS 2.0 - Proposal for a "unified approach" for additional market country tax](#), dated 10 October 2019.
2. See EY Global Tax Alert, [OECD hosts public consultation on proposed "unified approach" under Pillar One of BEPS 2.0 project](#), dated 27 November 2019.
3. See EY Global Tax Alert, [BEPS 2.0 - Pillar Two: the OECD issues consultation document on design of global minimum tax rules](#), dated 8 November 2019.
4. See EY Global Tax Alert, [OECD hosts public consultation on global anti-base erosion \(GloBE\) proposal under Pillar Two of BEPS 2.0 project](#), dated 13 December 2019.



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