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Technical Line

Preparing for a global minimum tax under the OECD's Pillar Two Global Anti-Base Erosion model rules

In this issue:

Overview 1
Key aspects of the GloBE rules 2
Five-step process for determining the GloBE minimum top-up tax 3
Step 1 – Identify MNE groups in the scope of the GloBE Rules..............3
Step 2 – Determine GloBE income or loss for each constituent entity...........4
Step 3 – Determine adjusted covered taxes...4
Step 4 – Compute GloBE excess profit, ETR and top-up tax 5
Step 5 – Determine application of IIR and UTPR.......................5
Key accounting considerations 8
Are IIR and UTPR in the scope of ASC 740?.........8
Enactment date 8
Accounting for top-up taxes under the GloBE rules 8
Disclosure........................9

What you need to know

- The OECD's Pillar Two GloBE model rules define the scope and mechanics of a 15% global minimum tax, which will be based primarily on financial reporting amounts with certain adjustments.
- Multinational entities with consolidated financial statement revenue of more than EUR750 million need to monitor legislation in the jurisdictions in which they operate because OECD member countries are expected to enact the GloBE rules in 2023 with effective dates beginning on 1 January 2024.
- In response to a technical inquiry, the FASB staff stated it believes that the GloBE minimum tax is an alternative minimum tax as discussed in ASC 740. Because the tax in the GloBE rules is an AMT, companies will need to consider the effects beginning in the period that includes the date the laws are effective.
- South Korea is currently the only nation to have enacted legislation consistent with the GloBE rules. The legislation is generally expected to be effective beginning 1 January 2024.

Overview

The Pillar Two Global Anti-Base Erosion (GloBE) rules issued by the Organisation for Economic Co-operation and Development (OECD) under the OECD Inclusive Framework on Base Erosion and Profit Shifting introduce a global minimum tax of 15% that would apply to a multinational enterprise (MNE) group with consolidated financial statement revenue in excess of EUR750 million.[1]

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Under the GloBE rules, an MNE group would be required to determine a combined effective tax rate for all entities located in a jurisdiction. When the combined entities' jurisdictional effective tax rate (ETR) is less than 15%, a top-up tax generally will be due to bring the jurisdictional effective tax rate to 15%.

Entities located in a jurisdiction that has enacted the rules will need to determine whether the minimum tax is due for all jurisdictions where the MNE group (including the ultimate parent) operates. The model rules also provide a mechanism to determine which entities are obligated to pay the top-up tax if an MNE group operates in more than one jurisdiction that has enacted the rules. If the ultimate parent is located in a jurisdiction that enacted the rules, it will generally be the entity obligated to pay the top-up tax to its country of domicile.

The 15% US corporate alternative minimum tax established by the Inflation Reduction Act is not expected to qualify as a global minimum tax under the GloBE rules. Notwithstanding any future legislative action in the US to enact the GloBE model rules, the US operations (including US ultimate parent entities) of an MNE group will be subject to the GloBE rules if the MNE group operates in a jurisdiction that has enacted them. Therefore, if the combined ETR of the US operations of an MNE group is less than 15%, the top-up tax would apply to the US operations.

On 31 December 2022, South Korea became the first country to enact legislation to implement the GloBE rules. The law contains an Income Inclusion Rule (IIR) and an Undertaxed Payment Rule (UTPR), both of which are effective 1 January 2024. Companies with South Korean entities in their MNE group should review the GloBE rules carefully to understand the effect on their taxation and prepare to account for any additional tax in the reporting period that includes 1 January 2024.

Other countries around the world are expected to enact legislation to implement the rules in 2023, and the laws are generally expected to be effective beginning 1 January 2024. All companies with multinational operations should monitor the status of legislation to implement the GloBE rules in countries in which they operate.

This publication provides a high-level summary of the GloBE approaches and the accounting implications for entities that will be subject to the rules.

The OECD has published GloBE Model Rules, GloBE Model Rules Commentary, GloBE Model Rules Examples and supplementary guidance, including safe harbor rules.[2] The OECD is expected to provide additional interpretive guidance to help entities apply the rules. We have also published an executive summary and discussion of the GloBE Model Rules, Commentary and Examples.[3]

Key aspects of the GloBE rules

The GloBE rules contain two primary provisions to determine how the top-up tax is assessed and which entity in an MNE group will be obligated to pay it:

- The IIR would impose the top-up tax on a parent entity for a low-taxed foreign subsidiary or subsidiaries.
- The UTPR would impose a top-up tax through the elimination of deductions (or other adjustments) on certain MNE group entities if low-taxed income of an entity in the MNE group is not subject to top-up tax under an IIR (e.g., when the parent entity of a low-taxed subsidiary is located in a jurisdiction that has not enacted the GloBE rules). The top-up tax would be paid by any entity in the MNE group located in a jurisdiction that has adopted the UTPR, regardless of its relationship to the low-taxed entity.

Under the GloBE rules, jurisdictions may also enact a Qualified Domestic Minimum Top-up Tax (QDMTT), which is a minimum tax that mimics the impact of the GloBE top-up tax on domestic companies. If a country's legislation includes a QDMTT, the amount of QDMTT owed locally would reduce any top-up tax otherwise incurred by the MNE group on the subsidiaries located in that jurisdiction.

The GloBE rules address how to determine which entity or entities in an MNE group would be subject to tax under an IIR or UTPR and the portion of top-up tax that is charged to each relevant entity.

The OECD notes that "The GloBE Rules apply a system of top-up taxes — that is, an IIR and a UTPR that brings the total amount of taxes paid on an MNE's excess profit in a jurisdiction up to the Minimum Rate [15%]. This top-up tax does not operate as a typical direct tax on income of an individual entity, but instead the tax imposed under the GloBE Rules is closer in design to an international alternative minimum tax."[4] However, any top-up taxes paid will not be recouped in a future year through any sort of credit mechanism or future offset.

Five-step process for determining the GloBE minimum top-up tax

Companies with multinational operations should monitor the status of legislation to implement the GloBE rules in countries in which they operate.

The top-up tax under the GloBE rules would be calculated and applied at a jurisdictional level using the following five steps:

- **Step 1:** Identify MNE groups in the scope of the GloBE rules
- **Step 2:** Determine GloBE income or loss for each constituent entity
- **Step 3:** Determine adjusted covered taxes
- **Step 4:** Compute the effective tax rate and top-up tax
- **Step 5:** Determine application of IIR and UTPR

Step 1 — Identify MNE groups in the scope of the GloBE Rules

Important elements

- Apply the monetary threshold (EUR750 million) to the annual revenue of the ultimate parent entity (UPE)
- Identify constituent entities located in each jurisdiction (e.g., controlled foreign corporations, permanent establishments)
- Remove any excluded entities (e.g., non-profit entities, pension funds)
- Identify the jurisdiction of each constituent entity

For purposes of the GloBE rules, an MNE group is generally a group of entities that are related through ownership or control, located in more than one jurisdiction and included in the UPE's consolidated financial statements.

An MNE group is in scope of the GloBE rules if the annual revenue in the UPE's consolidated financial statements is EUR750 million or more for two out of the four fiscal years immediately preceding the current fiscal year. The GloBE rules also address situations when entities join or leave MNE groups during a fiscal year as a result of transfers of direct or indirect ownership interests in the relevant entity.

The rules also address how MNE groups should take into account the impact of mergers and demergers when applying the EUR750 million consolidated revenue threshold to determine whether the rules apply to the MNE group in a particular fiscal year.

Step 2 — Determine GloBE income or loss for each constituent entity

> **Important elements**
>
> - Determine financial accounting net income or loss for each constituent entity located in each jurisdiction
> - Adjust financial net income or loss to GloBE basis income or loss

The starting point to determine the GloBE income or loss is the net income or loss of each constituent entity used in preparing the consolidated financial statements of the UPE, before any consolidation adjustments eliminating intra-group transactions, determined by applying the accounting standards (e.g., US GAAP) used by the UPE. The net income or loss is adjusted for certain items, including excluded dividends, accrued pension expense, excluded equity gains or losses, gains or losses from disposition of certain assets and liabilities, and other items.

If a constituent entity's financial accounting net income or loss includes amounts attributable to permanent establishments or other flow-through entities located in a different jurisdiction from that of the constituent entity, the constituent entity's GloBE income or loss is adjusted by that amount. The GloBE income attributable to the permanent establishments or other flow-through entities is reallocated to the jurisdiction of the permanent establishments or other flow-through entities.

Step 3 — Determine adjusted covered taxes

> **Important elements**
>
> - Identify covered taxes for each jurisdiction
> - Adjust covered taxes for deferred expense or (benefit) associated with certain temporary differences
> - Consider adjustment of the prior-year tax liability

Adjusted covered taxes of a constituent entity for a fiscal year would include the current tax expense recognized in its financial accounting net income or loss for the fiscal year adjusted by the net amount of certain additions and reductions (such as uncertain tax positions), total deferred tax expense/benefit and any increase or decrease for taxes recorded in equity or other comprehensive income relating to GloBE income or loss that is subject to tax under local tax rules.

The GloBE rules limit the total deferred tax expense or benefit used in the calculation of adjusted covered taxes. When determining the deferred tax expense to be included in covered taxes, the amount reflected in the financial statements is adjusted to remeasure the deferred tax expense or benefit using a rate of 15% if the applicable jurisdiction tax rate is above 15%. This deferred tax expense amount is also subject to several exclusions and adjustments.

Similar to the adjustment to GloBE income discussed above in step 2, if a constituent entity's financial accounting net income or loss includes covered taxes attributable to permanent establishments or other flow-through entities located in a different jurisdiction from the constituent entity, the constituent entity's covered taxes are reduced by that amount, and the covered taxes of the permanent establishments or flow-through entities are reallocated to the jurisdiction of the permanent establishments or flow-through entities.

Additionally, other taxes recognized by a constituent entity that are more directly related to the income of another constituent entity under a controlled foreign company tax are allocated to the covered taxes of that other constituent entity (e.g., taxes paid by a US corporation under global intangible low-taxed income (GILTI) or Subpart F).

Step 4 — Compute GloBE excess profit, ETR and top-up tax

Important elements

- Compute GloBE effective tax rate
- Compute GloBE excess profit
- Compute jurisdictional top-up tax for low-taxed jurisdictions
- Allocate top-up tax between low-taxed constituent entities

The GloBE ETR for a jurisdiction is equal to the sum of adjusted covered taxes of each entity located in the jurisdiction, divided by the net jurisdictional GloBE income. If the calculated GloBE jurisdictional ETR is less than 15%, a top-up tax may apply.

The top-up tax for a jurisdiction is the difference between 15% and the GloBE ETR in that jurisdiction, multiplied by the excess profit in that jurisdiction. The excess profit is the total jurisdictional GloBE income, less a substance-based income exclusion. The substance-based income exclusion provides an adjustment for a fixed return on certain tangible assets and a percentage of payroll costs in the specific jurisdiction. The jurisdictional top-up tax would be reduced by any tax payable pursuant to a QDMTT if implemented by the jurisdiction.

The resulting jurisdictional top-up tax is then allocated among the constituent entities located in the low-tax jurisdiction based on the ratio of each constituent entity's GloBE income for the fiscal year to the sum of the GloBE income of all constituent entities in the jurisdiction that have positive GloBE income for the fiscal year.

Step 5 — Determine application of IIR and UTPR

Important elements

- Identify the parent entity liable for the top-up tax under IIR
- Determine the amount of top-up tax paid by the PE under IIR
- Identify remaining amount, if any, that is allocable under UTPR
- Determine UTPR adjustment

In applying the IIR, a direct or indirect parent entity pays its allocable share of the top-up tax with respect to a low-taxed constituent entity. The IIR operates on a top-down approach, starting with the UPE. If the UPE is not located in a jurisdiction that has implemented an IIR, the highest parent entity in the ownership chain located in a jurisdiction that has implemented an IIR would pay its allocable share of the top-up tax. An exception to the top-down approach applies in certain split-ownership situations. The GloBE rules also address situations where there is a noncontrolling shareholder in the ownership chain of the MNE group.[5]

The UTPR imposes a top-up tax by denying deductions or other adjustments if the low-taxed income of an entity in the MNE group is not subject to top-up tax under an IIR. This may be the case when the jurisdiction in which an entity's parent operates has not enacted an IIR but the jurisdiction of a brother/sister entity in the group has enacted a UTPR. Constituent entities are denied a deduction (or required to make an equivalent adjustment) resulting in an additional cash tax expense for the amount of the UTPR top-up tax allocated to that jurisdiction. In the UPE's jurisdiction that has enacted an IIR, the UTPR generally does not result in additional top-up tax unless the UPE's jurisdictional ETR is below 15%.

The UTPR imposes a top-up tax by denying deductions or other adjustments if the low-taxed income of an entity in the MNE group is not subject to a top-up tax under an IIR.

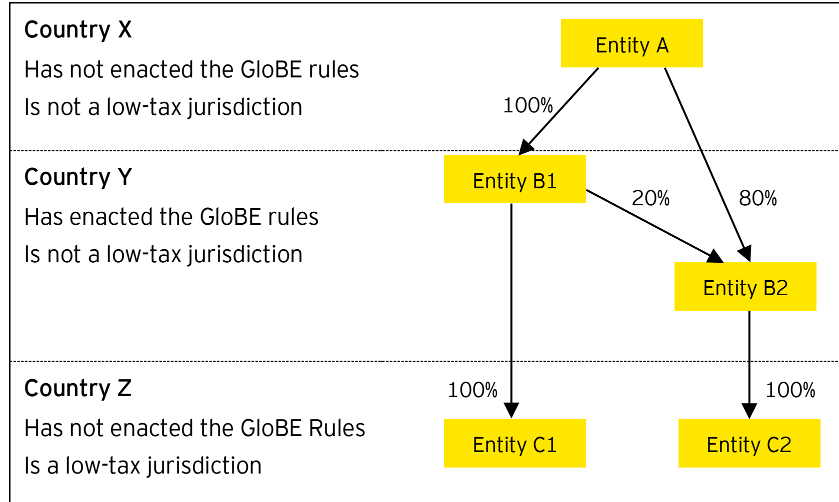
When constituent entities of an MNE group are not directly subject to the GloBE rules, the IIR and UTPR would be levied on them in jurisdictions that have enacted either the IIR or the UTPR. Thus, a constituent entity having no ownership in a lower-tier entity that has a calculated jurisdictional ETR below 15% could end up being the payor of any related top-up tax.

The following illustration demonstrates how the GloBE minimum tax may be determined in an MNE group.

Illustration: Application of the GloBE rules to an MNE group

Facts

- The diagram below illustrates the structure and location of the members of ABC Group, which is an MNE group:



- ABC Group has consolidated revenues in excess of EUR750 million.
- All entities are constituent entities subject to the GloBE Rules.
- Entities A, B1 and B2 have GloBE ETRs above 15%.
- Entities C1 and C2 have GloBE ETRs below 15% (i.e., they are low-tax entities).
- Only Country Y has enacted an IIR.
- Assume that the MNE group does not have any substance-based income exclusions, and therefore, excess profit equals GloBE income.
- For simplicity, only those entities located in the low-tax jurisdiction are subject to the top-up tax; so, throughout this illustration, GloBE income and covered taxes are provided only for those constituent entities.

Analysis

The analysis of the GloBE rules and their application to the MNE group involve the following steps.

Step 1: Identify the MNE groups in the scope of the GloBE rules

Entity A, located in Country X, is the UPE of the consolidated group (ABC Group). ABC Group has determined that it is an MNE group in the scope of the GloBE Rules.

Accordingly, it has identified its constituent entities and their locations as illustrated above. Using a top-down approach, Entities B1 and B2 are identified as the highest-level entities in the ownership chain operating in a jurisdiction that has implemented the GloBE rules. Thus, these entities are required to determine the amount of top-up tax due for any low-tax jurisdictions included in the group.

Step 2: Determine GloBE income or loss for each constituent entity

ABC Group has determined GloBE income for each of the constituent entities in the group based on the financial reporting net income with GloBE adjustments.

GloBE income is $600 for Entity C1 and $1,800 for Entity C2.

Step 3: Determine adjusted covered taxes

ABC Group has computed adjusted covered taxes as determined under the GloBE rules for each of the constituent entities in the group.

Adjusted covered taxes are $30 for Entity C1 and $240 for Entity C2. Adjusted covered taxes include current taxes payable adjusted for deferred tax expense.

Step 4: Compute GloBE excess profit, ETR and top-up tax

The GloBE ETR of the entities located in Country Z is 11.25% (i.e., total adjusted covered taxes of $270 for Entities C1 and C2 ($30 + $240) divided by total GloBE income of $2,400 for Entities C1 and C2 ($600 + $1,800).

Therefore, the Country Z top-up tax rate is 3.75% (i.e., 15% less ETR of 11.25%), and the Country Z top-up tax is $90 (i.e., total GloBE income of $2,400 for Entities C1 and C2 ($600 + $1,800) multiplied by the top-up tax rate (3.75%)). If there were substance-based exclusions available, the exclusion amount would reduce the amount of GloBE income used to determine the amount of the top-up tax.

The Country Z top-up tax is allocated to the Country Z constituent entities C1 and C2 based on the ratio of each entities' GloBE income to total Country Z GloBE income. Therefore, Entity C1 is allocated $22.50 equal to 25% (i.e., ($600 / $2,400)) of total Country Z top-up tax and Entity C2 is allocated $67.50 equal to 75% (i.e., ($1,800 / $2,400)) of total Country Z top-up tax.

Step 5: Determine the entities liable for payment of the top-up tax under the IIR and/or UTPR

Because only Country Y has introduced a qualifying IIR, the intermediate parent entities B1 and B2 are required to pay any top-up taxes. (Because all entities located in low-tax jurisdictions have parent entities that have implemented the IIR, the UTPR rules are not applicable in this illustration.)

Entity B1 is liable for, and will pay for, 100% of the Country Z top-up tax attributable to its wholly owned subsidiary, Entity C1 (i.e., $22.50 determined in Step 4 above). Entity B1 is also liable for 20% of the top-up tax attributable to Entity C2 based on its 20% indirect ownership interest in Entity C2 through Entity B2. The top-up tax attributable to Entity B1's ownership interest in Entity C2 is $13.50 (i.e., 20% of $67.50).

Entity B2 is liable for, and will pay for, 100% of the Country Z top-up tax attributable to its wholly owned subsidiary Entity C2 (i.e., $67.50 determined in Step 4 above).

Because Entity B2 is paying for 100% of the top-up tax attributable to Entity C2 (i.e., $67.50), and Entity B1 is also liable for top-up tax attributable to its indirect ownership of Entity C2, without relief, the top-up tax attributable to Entity B1's indirect 20% ownership interest in Entity C2 would be paid twice. To prevent double taxation, the GloBE rules allow for an offset of taxes paid by intermediate parent entities in the MNE group. Therefore, Entity B1 reduces its top-up tax payable by $13.50 (i.e., 20% of $67.50), which is the top-up tax attributable to its indirect ownership in Entity C2 that will be paid by Entity B2.

Key accounting considerations

Are IIR and UTPR in the scope of ASC 740?

Accounting Standards Codification (ASC) 740 applies to taxes that are based on income. As described above, taxes imposed by the GloBE rules are not typical direct taxes, which raises the question of whether they are in the scope of ASC 740. Based on the rules, we believe that in the consolidated financial statements of an MNE group the taxes imposed by the GloBE rules are income taxes and in the scope of ASC 740.

However, when a constituent entity (e.g., a subsidiary in the consolidated financial statements) is obligated to pay the tax imposed under the UTPR, the link between net profit of the taxpayer and taxes paid is far less direct. This is because the constituent entity does not have an ownership interest in the entity that is triggering the tax under the UTPR rules (e.g., a subsidiary that pays the UTPR for a parent or sister entity in a low-tax jurisdiction). Therefore, a detailed assessment is necessary to determine whether the top-up tax is in the scope of ASC 740 in the separate financial statements of entities that are obligated to pay the top-up tax under the UTPR rules or is in the scope of another ASC topic.

Enactment date

ASC 740 does not specify how to determine the enactment date of tax legislation. However, the enactment date is when all steps in the process for legislation to become law have been completed. MNE groups need to monitor when legislation implementing the GloBE rules is enacted in the jurisdictions where they operate either through wholly or partially owned subsidiaries, joint ventures, flow-through entities or permanent establishments. Different countries may enact the rules on different dates and the provisions of the laws may vary. This will result in additional complexity in accounting for the income tax effects.

The enactment date of the legislation in South Korea was 31 December 2022, under its parliamentary procedures.

Accounting for top-up taxes under the GloBE rules

The GloBE rules establish a system of top-up taxes that brings the total amount of taxes paid in a jurisdiction up to a minimum tax rate of 15%. The tax is determined on a jurisdictional basis rather than a typical direct tax on an entity's taxable income.

Because the determination of which entities in an MNE group are obligated to pay the top-up taxes will depend on facts and circumstances (i.e., the jurisdictions in which an entity operates and how they enact their tax laws to implement the GloBE rules), the entity that pays the top-up tax could be, among others, (1) the entity or entities located in the low-tax jurisdiction that implemented the rules, (2) a direct or indirect parent, (3) the UPE of an entity that operates in a low-tax jurisdiction or (4) an affiliated entity of the low-tax entity or entities in the consolidated reporting group.

ASC 740 does not explicitly address the accounting for income taxes based on a system like the one proposed in the GloBE rules. Therefore, it is not clear whether certain adjustments to financial reporting income made to arrive at GloBE taxable income and GloBE adjusted covered taxes represent temporary differences or whether the top-up taxes are akin to taxes levied in an alternative minimum tax (AMT) system.

In response to a technical inquiry, the staff of the Financial Accounting Standards Board (FASB) stated[6] that it believes the minimum tax in the GloBE rules is an AMT as discussed in ASC 740, and that entities should apply the guidance in ASC 740 on accounting for AMTs to taxes imposed under the GloBE rules. The staff believes the GloBE minimum tax should be viewed as a separate but parallel tax system that is imposed to make sure certain taxpayers pay at least a minimum amount of income tax.

The FASB staff cited ASC 740-10-30-11 through 30-12 and 740-10-55-31 and 55-32, acknowledging that those paragraphs address accounting for an AMT and require an entity to measure deferred taxes using the statutory tax rate under the regular tax system. ASC 740-10-30-11 states:

> "… [I]t would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity."

Therefore, the incremental tax an entity has to pay under the GloBE rules would be recognized in the period it arises, and deferred tax assets and liabilities would not be recognized or adjusted for the estimated future effects of the minimum tax.

The FASB staff believes the minimum tax in the GloBE rules is an AMT as discussed in ASC 740.

How we see it

Because a country may enact tax laws that differ from the GloBE rules, entities will need to evaluate provisions of laws enacted in each jurisdiction to determine whether they are consistent with the GloBE model rules in order to apply the accounting indicated by the FASB staff. Countries may also enact other changes to their corporate income tax laws at the same time they enact the GloBE model rules. Entities will need to analyze new tax laws to determine whether other law changes are required to be recognized in the period of enactment separately from Pillar Two.

Companies that prepare interim financial statements should consider the GloBE rules when determining their estimated annual effective tax rates.

Disclosure

If the GloBE rules have not yet been enacted in the jurisdictions in which an MNE group operates, there is no specific US GAAP disclosure requirement. However, companies may want to consider whether to provide additional information on the potential effect of the GloBE rules if they expect it to be material.

Item 303 of Regulation S-K requires the disclosure in a registrant's management's discussion and analysis (MD&A) of prospective information that is reasonably likely to have a material impact. The MD&A discussion should highlight material events and uncertainties known to management that are reasonably likely to cause reported financial information not to be indicative of future operating results or financial condition. Therefore, entities that file financial statements with the Securities and Exchange Commission should consider whether disclosure of the expected impact of the GloBE rules on their results of operations or financial condition is necessary.

Next steps

Entities need to begin planning for the implementation of the GloBE rules from both a tax and financial reporting perspective. They will need to implement processes and internal controls to gather information required to prepare the financial information at each jurisdictional level that will serve as inputs for the calculations that would be required by Steps 1 to 5 of the GloBE rules.

Entities should monitor developments in the relevant jurisdictions and engage with their advisers to determine the impact of the GloBE rules on their financial statements, audit and tax filings.

Endnotes:

1 This test will always be a euro-denominated test with the revenue being translated from the reporting currency in the consolidated financial statements to euros.

2 https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.

3 https://www.ey.com/en_gl/tax-alerts/oecd-releases-commentary-and-illustrative-examples-on-pillar-two-model-rules.

4 Page 8, OECD (2022), Tax Challenges Arising from the Digitalisation of the Economy — Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris.

5 For example, the Partially-Owned Parent Entity rule, which is outside the scope of this publication.

6 https://fasb.org/Page/PageContent?pageId=/meetings/pastmeetings/02-01-23.html&bcpath=tff

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