

Tax

Insurance Tax Review 2007/08



Foreword

Welcome to the second annual PricewaterhouseCoopers LLP (PwC) UK Insurance Tax Review. Like 2006, 2007 did not allow much time for relaxation and neither should we expect much rest in 2008. The pace of reform, both in insurance taxation and in the wider tax environment, has arguably never been more rapid.

This Review considers the developments over the past 12 months and what we should expect from 2008. It is intended for those who do not consider themselves tax experts but who need an understanding of how tax developments may impact their business. We hope, however, that tax specialists will also find it of interest.

There seems little doubt that the Government / HMRC tax simplification agenda has not really simplified the tax position of insurance groups. Maybe the most we can hope for is greater certainty to aid business decision making and planning – although unfortunately this greater certainty still seems a distance away. That said, there have been successes for the industry coming out of the new consultation environment and there is still plenty of opportunity for the industry to influence the direction of future changes. PwC will continue to participate fully in that process, both in its own right and supporting individual clients.

With over 100 specialists focusing on insurance tax matters, the PwC Insurance Tax Team is uniquely placed to offer thoughts and insights on how tax developments have and will impact insurance companies. This booklet can only scratch the surface of such issues and if you would like to discuss these matters further then please call your usual PwC contact or any of the contacts listed on page 20. Alternatively, you can contact one of the particular subject specialists indicated at the end of each article.

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Introduction – 2007's highs and lows and the prospects for 2008

2007 was another year of great change for insurance taxation. Much of the change was positive and emerged from the ongoing consultation process between the industry and HMRC. Both the life and non-life sectors have seen change. In the non-life sector we have seen the abolition of section 107 - a far reaching development that is discussed on page 8. In the life sector there has been a greater variety of change including the amalgamation of five pre-existing categories of business into a single gross roll-up category, the abolition of the Crown option and extensive changes to the legislation dealing with transfers of business.

So, considerable change. But unfortunately not much chance to draw breath in 2008 as there is still a lot of work to do: both to tidy up the loose ends of the 2007 changes and to start to address other issues where progress has been slow to date.

Tax does not develop in a vacuum and the commercial and regulatory developments in the industry bring their own tax changes. A particularly interesting example of this in 2007 was the introduction of the regulatory rules dealing with insurance special purpose vehicles (ISPVs), the introduction of which opens a number of commercial opportunities, and which required tax changes to enable them to operate as intended. PwC was heavily involved in this development which is discussed on page 9.

In general the changes in 2007 represent progress and, particularly in the case of ISPVs, offer some exciting possibilities. However, despite the undoubted progress made in the consultation process, the end of the year once again saw unwelcome developments in the Pre Budget Report (PBR) - the apparently unintended implications for the competitive position of life bonds of the proposals to introduce an 18% flat rate of capital gain tax (CGT) for individuals, and the proposed amendments to the life reinsurance provisions. These are discussed on page 7. Both demonstrate the continuing need for proper consultation so that the wider implications of proposed changes are fully identified and addressed before announcements are made.

So what does 2008 hold in store?

Much has been achieved over the last year, but there is more work to do in a number of areas. These include the wide-ranging apportionment discussions (with a view to change in 2009), clarification and refinement to section 107 for general insurers and the resolution of a number of outstanding points on the transfer of business provisions for life insurers.

That in itself is a fairly full programme and although one hopes that there will be less new legislation in 2008 than 2007 there are likely to be a number of announcements come Budget day. At the very least HMRC have mentioned that they intend to look at certain aspects of the tax treatment of interest paid on reinsurance deposit-backs and if past years are any guide then there will be surprises too.

That then leaves our hope that the spirit of openness demonstrated by all parties to the consultation process continues and that this bears fruit in the form of a better legislation. At time of writing we also have to hope that the Government will act in relation to the CGT changes announced in the 2007 PBR.

Gross roll-up business – pension business loss streaming and foreign currency assets

As expected, Finance Act 2007 (FA 2007) brought about the amalgamation of various Case VI business categories (pension, overseas life, life reinsurance etc) into one – gross roll-up business (GRB) – from the first period of account beginning on or after 1 January 2007. However, when the rules were being finalised, there were two main sticking points between the industry and HMRC – (1) streaming of brought forward pension business (PB) losses; and – (2) to what extent assets can be said to be backing overseas life assurance business (OLAB). Such assets are called foreign currency assets (FCAs), and investment return arising on FCAs is directly attributed to GRB.

Regarding PB losses, HMRC are firm in saying that streaming will stay. Indeed, the only proposed movement on this issue in the year – which deals with the unusual case of an I - E company transferring business to an actual Case I company - further entrenches HMRC's position.

FCAs were defined by FA 2007 as assets managed under the control of someone at an overseas permanent establishment (PE) – effectively a branch – or assets in a non-sterling currency certified as being all assets held to meet GRB liabilities in that currency. This gives rise to a number of problems. Many groups with overseas PEs simply do not have the investment management activity undertaken locally, and so arguably do not fall within the first limb of the FCA definition. Secondly, the second limb is technically failed if some assets are managed overseas, or if, say, assets in one currency support liabilities in another. Thirdly, an overseas tax authority may deem certain assets to be held by a local PE that the current rules do not allow to be treated as FCAs. In response to representations, HMRC are likely to change both limbs of the FCA definition, so that there is direct attribution of investment return on assets (if any) separately “backing” OLAB or reinsured OLAB liabilities, and on assets not within that limb but attributed to an overseas PE for the purposes of its local tax requirements.

It also seems likely that companies will be able to elect for these new rules to apply from the introduction of the new GRB regime ie from 2007 – a welcome change for those companies for whom the original 2007 provisions were simply unworkable.

Summary

Unfortunately, PB loss streaming will remain for the time being. Positive movement can be expected for those few companies for whom the 2007 provisions presented practical problems. The detailed wording of the new provisions will however need to be closely scrutinised to ensure it does not create problems for others.

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Crown option

HMRC's power to exercise the Crown option to tax a company on a Case I basis has caused a great deal of uncertainty for a number of life insurers over recent years, particularly for those writing large amounts of protection business.

Prior to 2007 HMRC could choose to assess life insurers (other than pure reinsurers) either under the I-E regime or on a Case I basis, depending on which gave rise to higher tax. Where a company was taxed on a Case I basis, even if only for one year, this could give rise to adverse tax consequences such as a loss of brought forward management expenses.

However, following changes made in 2007, the Crown option has been abolished. The I-E basis is now mandatory for life insurers subject to two exceptions - pure reinsurers and life insurers whose business is all, or substantially all, gross roll up business - both of which are taxed on a Case I basis.

As a consequence of these changes, HMRC required an alternative means of avoiding a loss of tax in a year where the Case I basis would have given rise to higher tax than the I-E basis. A new mechanism has therefore been introduced to tax the excess of notional Case I profits over I-E profits in a year (at the full rate of corporation tax) with a corresponding relief available in future periods (at the policy holder rate). These changes have also effectively replaced the expense restriction test.

Summary

The Crown option has in the past caused a great deal of uncertainty for life insurers - in some circumstances it has prevented real commercial transactions from taking place. The change to remove the Crown option and the certainty this brings over the basis of taxation for life insurance companies is therefore a very welcome change for the industry.

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Structural assets

The tax treatment of structural assets, particularly shares in subsidiaries, held within the long term insurance fund (LTIF) has been one of the life industry's longstanding concerns. In many cases structural subsidiaries have been held in LTIFs for historical reasons and they could not be transferred to shareholders due to the tax cost and/or commercial issues. Further, the holding of a structural subsidiary in the non-profit fund of a life insurance company is not necessarily tax efficient as it can result in double taxation if profits are taxed in the subsidiary and then again in the LTIF through movements in the regulatory value of the subsidiary (or distributions).

The holding of structural assets in the non-profit fund has also caused concern for HMRC as a result of the tax relief obtained for substantial "write downs" which can occur due to the regulatory valuation rules where the non-profit fund of a life insurer acquires an insurance subsidiary or where a loan is made from the non-profit fund to a subsidiary.

New rules

Legislation was introduced in 2007 to deal with "structural assets" held within the non-profit fund of a life insurer and which applies for accounting periods beginning on or after 1 January 2007. Structural assets include shares in, or loans made to, UK or overseas insurance subsidiaries.

Under new section 83XA Finance Act 1989 income and value movements in respect of structural assets held in a non-profit fund are no longer taken into account when computing the Case I and Case VI (trading) profits of the company. Instead, structural assets are effectively treated as assets of the shareholder fund for tax purposes with income and gains in relation to those assets taxed under normal corporation tax rules at the full corporation tax rate. Also, there are special rules dealing with the situation where an asset becomes a structural asset of the non-profit fund for the first time or ceases to be held by the non-profit fund (or to meet the definition of a structural asset).

Summary

The new structural asset rules are to be welcomed as they ensure that the tax system aligns with the commercial reality, although some practical difficulties are already emerging from the drafting of the sections. At present the rules only apply to insurance subsidiaries but it is acknowledged by all parties that there is a good reason for a case for extending the rules to other structural subsidiaries, such as service companies. At present the key issue is how to clearly define non-insurance subsidiaries to be included within the new rules, without bringing in investment assets which should be excluded. Consultation is continuing and further changes in this area are expected in due course.

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Transfers of business

Last year's Insurance Tax Review highlighted the positive reforms to make the tax regime governing life insurance transfers of business more straightforward. These changes impacted on the I - E elements of the tax computation. However, we cautioned against this good news by trailing the proposed reform of the Case I elements of the computation that were to be introduced during 2007.

FA 2007 indeed contained many changes to Case I basis computations. There are new rules for the taxation of a transferor and a transferee as well as a targeted anti-avoidance rule (TAAR). Although the rules were enacted in FA 2007, the effective date was delayed. This recognised that in this regard the Act really was a working draft and that further regulations would be needed to finalise it. Consultation with the industry continued throughout the year and finally the regulations were laid. The regulations, which amend the FA 2007 provisions, introduce a number of new principles to the transfer of business framework. Most of these changes have effect for transfers of long term insurance business taking place on or after 1 July 2008, although some have effect earlier.

From the transferor's perspective there are now a series of rules intended to ensure that if assets which have not previously been taxed leave its long-term insurance fund but are not transferred to the transferee's long-term fund, an amount equal to the untaxed amount is brought into charge. This addresses a number of situations where assets may have been transferred directly to the shareholders fund, or where assets were left behind in the transferor which was then de-authorised, with the result that they escaped tax. These provisions replace a series of provisions that had been built up over a number of years and were intended to have a similar effect. However, a significant change for the transferor is that a profit on a transfer (for example where more liabilities are transferred than assets) will now be brought into tax. Previously this was a tax nothing. An equivalent provision has not been brought in to relieve a loss on a transfer.

From the transferee's perspective the new provisions ensure that a profit on a transfer is taxable (unless the profit had previously been taxed in the transferor) and in the transferee's case relief is also given for a loss. It is disappointing that despite continued lobbying the regulations do not provide for symmetry of treatment between the parties to the transfer and that a profit can arise in a transferee but with no relievable loss in the transferor.

The TAAR is entirely new. It can apply either looking at transfer scheme arrangements as a whole or at any part of them and transfer scheme arrangements include the scheme together with associated operations, including contracts of reinsurance. The rule acts to bring into charge an amount equivalent to the Case I advantage obtained from any tax motivated element of the transaction. A Case I advantage is a comparison test, comparing the actual transaction with the transaction excluding the tax motivated element. It applies separately to the transferor and the transferee. A clearance mechanism is available to provide confirmation that there is no tax motive or there is no group advantage (if an advantage is offset by a disadvantage in a group situation there may be no charge). The TAAR will bring an extra layer of complexity to transfers of business, although HMRC will point out that it will not apply if there is no tax motive. However, determining whether such a motive exists, and agreeing this is the case, may not be straightforward.

Disappointingly, despite the number of changes made during 2007 to protect the exchequer from perceived loss of tax, a number of simplification measures have not been taken. These include putting insurers on a level playing field with other corporates and allowing tax relief for the purchase of intangibles, including goodwill, and providing certainty over the VAT position and over the tax position of policy holders on a transfer of long term insurance business.

Summary

There has been significant change but the revised provisions appear no less complicated than those they replaced. The rules are yet to be tested and are likely to be a challenge for the first few "complicated" transfers that fall within them. A number of opportunities for reform to meet businesses needs have not yet been accepted by HMRC and the industry is working to keep these on the agenda.

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Financing-arrangement-funded transfers to shareholders

New legislation will apply for periods beginning on or after 1 January 2008 dealing with the situation where a company monetises the Value-In-Force (VIF) in its non-profit funds by way of a financial reinsurance (finre) or contingent loan for the benefit of its shareholders.

Pre-2008, when a non-profit fund entered into financial reinsurance, it was taxed on the release of liabilities in its trading profits computations. When the liabilities were subsequently recaptured, the recapture was tax deductible. One consequence of this tax treatment was that companies couldn't enter into finres unless they could either shelter or shoulder the upfront tax charge. Going forward, the tax position for finres reverses - the release of the liabilities on inception of the finre will not be brought into the trading profit computations, and the recapture is not tax deductible. It remains to be seen whether, as a result, companies will begin entering into finres more readily.

For contingent loans, where they are not used to support a transfer to shareholders, the tax position for non-profit funds under the new rules will be unchanged – the receipt of a contingent loan does not give rise to taxable profits, the repayment does not give rise to a tax deduction. However, where a contingent loan is put into a with profits fund, a company will no longer be able to gain a tax advantage by getting a tax deduction for the receipt of a contingent loan, which was reversed on repayment, as was the case where the contingent loan was accounted for through Form 40 of the FSA return.

Going forward, where a finre or contingent loan is used to support a transfer to shareholders, a charge to tax, known by the somewhat cumbersome name of "financing-arrangement-funded transfers to shareholders" (FAFTS) will arise in the trading profit computations. This charge will reverse when the contingent loan is repaid or the liabilities reinsured under a finre are recaptured, except where the repayment or recapture is funded by a further contingent loan or finre, where the reversal is deferred until the further contingent loan or finre is repaid or recaptured. The mechanics of this are all new for finres. They also mean that a charge in relation to a contingent loan now only arises where it is actually used to fund a transfer to shareholders – under the old regime, where there was a contingent loan and a transfer to shareholders, the tax rules automatically assumed it was funded by the loan.

Finally, we also note that HMRC did originally propose to extend the FAFTS rules to cover capital contributions into non-par funds. This has been opposed all along by the industry, and HMRC agreed not to pursue it in the 2008 Finance Bill. But the proposal remains on the table, and could reappear in 2009.

Summary

Overall, the changes should benefit companies with contingent loans in their non-profit funds which also make transfers from that fund to shareholders. They will also benefit companies entering into finres.

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Pre-Budget Report – capital gain tax & reinsurance

The Pre-Budget Report (PBR) included two unwelcome measures affecting life insurers.

The first was an apparently unintended consequence of the proposal to introduce an 18% flat rate of capital gain tax (CGT) for individuals. Although this proposed change is for individuals only it potentially has a serious impact on the competitiveness of life investment products compared to collective investment vehicles. Very broadly, investment return accruing on life bonds is subject to tax at the 20% rate within the life company, with a further 20% charge accruing to a higher rate policy holder when their policy matures. By contrast, under the new proposals, the maximum tax charge on direct investment in equities or investment via a collective vehicle would be 18%, potentially further reduced by taking maximum advantage of the available annual tax exempt band for gains.

The industry has been engaged in discussions with HM Treasury, and indeed Ministers, since October and those discussions continue. The industry is hopeful that the original proposals will be modified to restore a competitive position between investment products. PwC has supported the industry, particularly around illustrative modelling, whilst these discussions have been taking place.

Media speculation has focused on the impact this proposal, if unaltered, could have on new business. It is also possible that as the scope of the changes becomes clearer, some existing policyholders might choose to either surrender or assign existing bonds. In turn, this could create a high volume of tax reporting obligations on life insurers (such as those which exist under the chargeable events rules) within a fairly narrow timescale.

As a separate matter, HMRC has concerns about reinsurance treaties under which the reinsurer economically bears the cedent's acquisition expenses, but which leaves the tax deduction for the expenses with the cedent. Unfortunately the measure originally announced to target this perceived "mischief" would have had a far wider impact. Following discussions with the industry, HMRC is presently working on a revised proposal that is intended to meet the industry's concerns about over-wide impact but at the same time prevent a tax advantage arising in from treaties where the reinsurer bears expenses on behalf of the cedent.

Comment

From the industry's point of view, both of these issues were introduced in an unfortunate manner. Whilst the CGT changes were introduced as a policy change, it is understood that the consequential impact on investment competitiveness was not intended. Nevertheless it is disappointing that this competition impact on life insurance products does not seem to have been considered before introduction. We hope that in future, Treasury will consult more widely on policy measures in advance to ensure that the wider impacts are well understood.

By contrast, the reinsurance provisions were within HMRC's control and, given the existence of a well-developed consultation process, it would have been preferable for HMRC to have consulted more widely before announcing the original flawed proposals. Whilst HMRC may regard the original proposals as an anti-avoidance measure, the nature of the arrangements which caused the concern was such that we believe wider consultation would have been possible prior to the announcement. Again, we would hope that similar proposals will be subject to wider discussion in future.

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Section 107 – general business reserves

2007 was a year of, what appears on the face of it, subtle change in the general insurance space. However, the impact of the legislative changes is far reaching, and as with many legislative changes, the devil is definitely in the detail!

The Budget saw the widely anticipated repeal of the s107 regime. The end of the need to undertake the detailed discounting calculations are welcomed by the industry and many readers will be thankful that they have (or are just about to!) submitted their final s107 calculations.

The end of the ability to disclaim technical provisions is however, one that the industry is continuing to come to terms with. Since 2000 the disclaimer regime allowed many to efficiently manage their loss position across the cycle of loss and profit periods. With one final chance to disclaim in the 2007 returns, we are seeing the industry pay very close attention to modelling their profit forecasts and future income streams to ensure that they are best placed to utilise their losses in as an effective manner as they can.

There are ongoing discussions between HMRC and the industry led by the ABI in relation to the tax deductibility of technical provisions. It is HMRC's intention to introduce legislation that allows them to disallow tax deductions for technical provisions that are above an "appropriate amount". Draft regulations released in early December provide three proposed definitions of an appropriate amount and the industry is feeding comments back to HMRC. The definitions include an undiscounted best estimate of claims outstanding plus a 20% margin, undiscounted best estimate plus a 75% confidence level amount and then a discounted best estimated plus risk margin. Again the devil is without doubt in the detail.

New legislation was introduced in 2007 to allow corporate members to transfer losses intra-group in the same manner as non-Lloyds operations. This was a welcome addition to the legislation designed to reduce the impact of the repeal of s107, in particular disclaimers, on the Lloyds market. The interpretation of the detailed legislation is however not free from doubt and we are aware of a number of alternative readings that can result in significantly different outcomes when determining how much of the loss is available to transfer between the group members. We look forward to explanatory notes from HMRC being introduced in 2008 which we hope will help to clarify HMRC's view of the detailed legislation.

Summary

The changes announced in 2007 should represent an easing of the compliance burden, welcome news to many. Organisations will, however, need to ensure that they are actively managing the transition from the old regime and maintain the ongoing consultations with HMRC.

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Insurance special purpose vehicles

Following the implementation of the EU Reinsurance Directive, it has been possible to set up insurance special purpose vehicles (ISPVs) with effect from 31 December 2006. ISPVs are likely to be used either as part of a capital markets transaction or, within groups, as pure reinsurance companies.

These companies will be subject to a more relaxed regulatory framework and will generally require less capital than a regulated insurer.

For tax purposes, if these companies form part of a capital markets transaction they will be taxed under an amended version of the securitisation company regulations (originally aimed at banking type transactions) which taxes ISPVs on the basis of their financial accounts, as prepared under the rules applicable on 31 December 2006 (i.e. "old UK GAAP") and not the FSA return, as for other insurers (an ISPV will not have an FSA return). Other securitisation vehicles in the chain with the ISPV will be taxed on their "turn", as set out in formulae detailed in the banking securitisation rules.

Where ISPVs are not part of capital markets transaction (i.e. "intra-group" ISPVs) they will also be taxed on the basis of their financial accounts (but on those actually prepared, unlike the capital market rules) and not the FSA return, for the same reason.

There have also been discussions between the industry and HMRC during 2007 on how to tax an intra-group ISPV where the business reinsured into the ISPV includes BLAGAB. This has resulted in further regulations being laid in early December 2007. Essentially, an intra-group BLAGAB ISPV will effectively be taxed on an I-E basis, although the necessary information will be drawn from its IAD accounts (as no FSA return will be prepared). An annuity reinsurer will be taxed as a DI trading company.

We have recently advised on the first conversion of an insurance company to an ISPV, which required close liaison with the FSA and HMRC. This is an exciting development and demonstrates that there are opportunities for groups to benefit from the use of these vehicles (from a regulatory perspective) even where no new transactions are undertaken. Any UK group with an intra-group reinsurance vehicle should consider whether converting that vehicle to an ISPV would give them a regulatory/capital benefit.

Summary

The use of ISPVs provides an excellent opportunity for groups to manage their capital requirements more efficiently, now that we have appropriate tax legislation for such vehicles, and we would expect to see these vehicles being used more widely by UK groups going forward.

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Regulatory and accounting developments

Solvency II

On 10 July 2007, the European Commission published its draft Framework Directive on Solvency II for insurers/reinsurers. The publication of the Draft Solvency II Directive is a major step forward in the development of EU solvency requirements. The EU has now formally set 2012 as the implementation date for Solvency II which is later than previously expected, although is still believed by the EU to be an ambitious target given the radical changes proposed. The structure is based on three pillars; quantitative requirements, supervisory review and disclosure requirements. The valuation basis for assets and liabilities will be market consistent. The valuation of technical provisions will be mark to market where hedgeable, or best estimate plus a risk margin where not. Companies will be required to assess their capital requirements on a more risk sensitive basis, using management judgement and not simply relying on formulaic valuations. Internal models will need to be more sophisticated than at present. A third Quantitative Impact Study (QIS) took place in the first half of 2007; the results have now been published and QIS 4 is now planned.

IFRS

The IASB published its discussion paper *Preliminary Views on Insurance Contracts* on 3 May 2007 as part of Phase II of their project to issue an IFRS for insurance projects. The paper proposes that an insurer should measure its insurance liabilities using three building blocks, such a measurement being termed as a "current exit value". This is defined as the amount an insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another insurer. Other topics addressed by the paper include policy holder behaviour, participating contracts and the reporting of changes in insurance liabilities.

The response deadline has now passed and the IASB will analyse and discuss results in 2008 with a view to publishing an Exposure Draft of a standard in 2009.

GENPRU

GENPRU was implemented on 31 December 2006, bringing greater alignment of the capital rules for insurers, banks and investment firms. This was accompanied by INSPRU which covers rules specific to insurers including capital resources requirements, credit and market risk and insurance groups. At the same time the EU Reinsurance Directive was implemented in the UK which saw a relaxation of the rules in respect of the calculation of technical provisions and solvency requirements for life reinsurance protection and PHI business written by pure reinsurers and mixed insurers.

Individual Capital Adequacy Standards

The FSA's Individual Capital Adequacy Standards (ICAS) regime has been in place since 31 December 2004. Every insurer has now had its Individual Capital Assessment (ICA) reviewed by the FSA at least once and FSA has recently published a sector briefing *ICAS – Lessons learned and looking ahead to Solvency 2* highlighting the lessons learned to date and areas for future development. One area highlighted in the sector briefing and also in proposed changes to FSA rules and guidance is an increase in the focus on group capital positions. The industry has made significant strides in adopting a risk based capital regime. However, the bar continues to be raised and significant work is required to further embed ICA into risk management frameworks particularly if firms wish to get their ICA model approved for use under Solvency II.

Permitted links regulations

Rules were introduced on 7 October 2007 of long awaited changes to the permitted links regime. It replaces the pre-existing regime with principles based high level rules which should allow firms greater flexibility in designing products whilst maintaining consumer protection. These include deregulatory changes which should reduce the need for waivers, and a revised list of assets which may be permitted links thereby widening the investments that may be used for such products.

Summary

All this will have tax effects that need to be considered now in order to avoid unrestricted tax costs and ensure revised capital arrangements are efficient.

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Policyholder tax

Two fairly fundamental tax changes announced this year have had an impact on life and pensions providers and their policyholders: the announced changes on CGT, which could impact on the competitiveness of life policies as investments, and the change to basic rate, which will impact on net personal pension contributions and relief at source claims being made by insurers.

The former issue was discussed at page 7. The basic rate of tax will be reduced from 22% to 20% in April 2008. Providers of personal pension business can of course accept contributions net of basic rate and reclaim the relief at source from HMRC. It has been several years since the last change in basic rate, so now personal pension providers should be considering the system changes that need to be made to reflect the rate change. They need to ensure from April 2008 that both pension scheme members continue to make correct net contributions, and systems remain robust and tax relief continues to be claimed accurately from HMRC.

Summary

A reduction in the basic rate of tax is always welcome, and in this case insurers should ensure that they are aware of the policyholder tax implications where they are administering net 'personal' pension contributions and making relief at source claims.

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Indirect tax

Reforming the VAT exemptions - European Commission proposals for the future shape of the exemptions for financial and insurance services

On 28 November 2007, the European Commission published draft proposals for a Directive aimed at modernising and simplifying the scope of the VAT exemptions for financial and insurance services. These proposals are currently expected to come into effect on 31 December 2009.

The proposals include new definitions of the services to be included within the exemptions and cost sharing arrangements using special purpose vehicles, but cross-border VAT grouping has been dropped by the Commission. Further proposals include the introduction of an option to tax insurance businesses in all member states as a means of reducing the compliance burdens associated with applying the exemptions. These last proposals will not be implemented until two years after the other proposals.

Insurance groups and intermediaries alike will be interested in the revised definition of exemptions for insurance related services. Under the proposals, exemption would be available for intermediary services and many 'back office' services such as claims handling, but only where the provider has the authority to bind, exercises some 'insurance specific' expertise or plays a part in altering the legal or financial obligations between the insurer and the insured.

The substance of the proposals is likely to change before introduction so affected businesses will be following developments closely.

VAT and IPT case law

After the landmark Halifax case on transactions entered into solely for the purposes of VAT avoidance, the insurance case of WHA Ltd became the first case before the UK appeal court where HMRC sought to apply the Halifax tests to negate a VAT advantage that it considered 'abusive'. HMRC was successful in arguing that the establishment of overseas companies purely to give rise to a UK VAT deduction constituted an artificial redirection of supplies from their normal route and the deduction was denied.

HMRC has also become more aggressive in attacking IPT planning arrangements. Budget 2007 saw amendments to the definition of 'premium' for IPT purposes designed to close down a loophole that had been exploited to provide insurance IPT free using options and rights payments. However, HMRC suffered a setback at Tribunal in the case of DSG International Insurance Services Ltd. DSG, where arrangements which used an Isle of Man service company to put insurance contracts outside the scope of UK premium tax were held to be effective.

Insurance intermediaries

The Tribunal decision in Insurancewide.com Services Ltd appears to have restricted the scope of the exemption for insurance intermediaries. The appellant generated commission by providing a comparison website for analysing potential customers' needs and providing indicative quotes and links to insurance providers. The Tribunal held that the provision of information on possible products and prices and referral of customers to potential insurers was not within the exemption as Insurancewide was not acting as an agent in providing these services. This decision will be of particular note to businesses distributing insurance through aggregator websites and internet based sales with affinity partners.

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Taxation of companies' foreign profits

In June 2006, the long awaited discussion document on the taxation of foreign profits was published by HM Treasury / HMRC. The discussion document encompassed proposals for revisions to the taxation of dividends, the controlled foreign companies (CFC) regime, interest relief and the Treasury Consent rules. Below are some principal issues which may be of relevance to insurance businesses located in the UK which arise from these proposals.

Potential impact

The proposed controlled companies (CC) rules may significantly increase the tax and compliance burden for insurance companies, because of the application of the rules to UK as well as foreign entities, and the absence of several of the exemptions available under the current CFC regime.

Of particular concern to insurance and reinsurance groups may be the impact of the proposals to treat certain active income as passive income. In this regard, it is to be hoped that the final legislation contains the same safeguards in relation to income arising from assets held for regulatory capital purposes and from third party reinsurance business, as are contained in the existing CFC rules.

Also of concern is the proposal to treat any income derived from intangible assets as passive income under the proposed CC regime. This proposal may result in UK taxation of worldwide income from intangibles. For UK headquartered insurance groups, this proposal is likely to be of particular concern in relation to brand names and trademarks, many of which could be deemed to result in the apportionment of significant 'passive' income to the UK.

The proposed restrictions to the amount of interest relief claimed by UK members of a multinational group by reference to the group's total consolidated finance costs may adversely affect the UK's competitiveness as it may discourage investment into the UK by foreign insurance groups.

Portfolio dividends

Whilst the consultation document does not deal with the taxation of portfolio dividends in detail, it does suggest three options to counter current discriminatory treatment of EU dividends in the hands of corporate investors. These options are credit for underlying tax, exemption from tax and the taxation of dividend returns with specific carve-outs for certain entities. Developments in this area are likely to be of particular interest to many insurance companies.

Summary

The proposed changes may create significant winners and losers and restructuring may be required for many groups to minimise the adverse impact of the proposals. The consequences of the changes are likely to vary for each group and are unlikely to be uniform across the industry.

While Ministers will make the final decision, it is anticipated that the next key announcement will involve the publication of a consultation document. This is likely to appear around the time of the 2008 Budget.

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EU developments

Many insurers have already taken filing positions in their tax returns based on EU law – for example to argue that dividends received from EU portfolio investments should be tax exempt. Others have filed claims seeking recovery of withholding taxes.

FII case

Although the ECJ's decision was handed down in the *FII* case in December 2006, it is worth reconsidering briefly. The most important issue in the *FII* case was whether it was acceptable for the UK to give an exemption from corporation tax for the receipt of UK dividends but to tax dividends received from European Economic Area (EEA) companies. The ECJ found for portfolio dividends that the UK rules were discriminatory and would have to be changed. The rules can also be discriminatory for non-portfolio holdings – but that will depend on each company's particular circumstances.

How should insurers respond?

Many UK insurers have already filed their tax computations on the basis that all EEA portfolio dividends should be exempt from tax. Those companies that have not already filed on this basis in anticipation of the decision should now consider re-filing their computations on the basis that the exemption should also apply to EEA portfolio dividends in order to claim recovery of the UK corporation tax already paid on those dividends.

Amurta case

2007 saw another decision from the ECJ in a withholding tax case in favour of the taxpayer in the *Amurta* case. This reinforced earlier decision that it may be contrary to the EU treaty freedoms to the extent that recipient company cannot obtain full credit for withholding tax. This case is relevant to portfolio shareholdings, as the EU Parent-Subsidiary Directive should already eliminate any withholding tax on shareholdings of 15% or more with effect from 1 January 2007 (the shareholding threshold could be higher or lower depending on the year in question).

How should insurers respond?

Insurance companies frequently suffer withholding taxes when they invest in the shares of companies based in other EU member states in circumstances where the comparable domestic company either does not pay withholding tax or receives a refund of the taxes withheld. We have continued to assist UK insurers with the filing of claims for the repayment of substantial amounts of withholding taxes in a number of EU jurisdictions including Germany, France, Italy, Netherlands, Portugal and Spain. Insurance companies investing in equities in EU member states should wish to consider filing protective reclaims with the relevant taxation authorities to reclaim EU withholding taxes paid that represent a restriction on EU treaty freedoms.

Summary

EU case law is becoming increasingly important to insurers as they typically have extensive cross-border investments. In 2007, we saw many more life insurers submitting claims. By taking the actions mentioned above companies may be able to increase their post-tax investment returns as well as recovering withholding taxes incurred in relevant member states.

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OECD - attribution of profits to permanent establishments

The Organisation for Economic Cooperation and Development (OECD) has been working since 1998 on a project to promote international consensus and consistency in the taxation of permanent establishments (PEs). The OECD's approach is based on the premise that it is necessary to determine the profits which the PE might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

The end is finally in sight. Final versions of Parts I to III of the Report (covering general considerations, banking and global trading) were released at the end of December 2006 and a revised draft of Part IV, which relates to the insurance industry, was released on 22 August 2007. The consultation period for Part IV is now over and the OECD now has to decide whether and how they should incorporate the feedback received and to release a final version of Part IV, hopefully in the first quarter of 2008.

But what does this really mean? Groups trading through branch networks have always had to consider the tax implications of how profits are attributed between their various operations so what is new? The reality is that the OECD's project has put the spotlight on the insurance sector. At the very least, it will have been an education process for many tax authorities in obtaining a greater understanding of a complex and diverse industry.

It has also highlighted the need for both tax authorities and taxpayers to gain a better appreciation of the real value drivers behind an insurance operation's business model, in order to be able to ensure that the assets, liabilities, underwriting profit and investment income are recognised in the appropriate location for tax purposes. It is no longer possible to assume that tax authorities who have previously accepted branch accounts as being a reasonable representation of the results for tax purposes will continue to do so.

However, whilst this may seem likely to be another increase in the compliance burden, proactive tax departments will also see opportunities to work with the business to optimise the group's operating model, both operationally and from a tax perspective. During 2007, many groups have considered or have already undertaken internal restructuring, for a number of reasons, which have resulted in an increase in branch operations. Consideration of the OECD's authorised approach (AOA) to the attribution of profits to PEs at the outset of a restructuring exercise, as well as being best practice, gives tax departments the opportunity to influence the outcome.

From a UK perspective, HMRC has always maintained that it considers its interpretation and application of the UK branch taxation legislation to be entirely consistent with the authorised OECD approach and is applying the principles in the current draft report already. However, our recent discussions with HMRC indicated that it is now considering whether to make an explicit reference to the Report in UK legislation, in a similar way to which the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations is explicitly referenced in the UK transfer pricing legislation.

Summary

The OECD approach to attribution of profits to PEs of insurance companies needs to be better understood by FDs and tax departments as it highlights tax risks and sometimes opportunities to those who fully understand the value drivers within an insurance company.

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PowerTaxLife

PowerTaxLife (PTL) is our proprietary life insurance tax software which is used across the industry. The computation that it produces follows the format of the computation in our widely-used Life Insurance Tax Handbook. PTL can deal with multiple sub-funds, with-profit business, non-profit business, actual Case I computations, mutual computations and friendly societies. It offers a number of user options in particular offering choices in a number of contentious areas.

PTL is supported by a number of our insurance tax professionals.

Version 2007 of the software is currently available and is fully FA 2007 compliant – including the preparation and reconciliation of the Form CT600.

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Our team

We have more than 100 tax professionals providing services to the insurance industry and previously have been shortlisted as the best tax team in a Big Four firm for the LexisNexis Taxation Awards.

From within the insurance tax practice we provide a full range of tax advisory and compliance services including M&A, transfer pricing, international structuring, VAT, IPT, stamp duty, Human Resource Services tax and tax investigations. The integration of specialist teams into our insurance practice ensures that clients are provided with comprehensive industry-focused solutions.

“PwC is the only firm that we deal with where there is a complete team visibly allocated to us and we know who to speak to across a whole range of taxes – life tax, international tax, general corporate, VAT, employee taxes, tax investigations etc.”

Deputy Head of Tax, FTSE 100

As well as a large team based in London we have insurance tax teams in Edinburgh, Leeds, Bristol, Manchester and Liverpool and a global network of specialists.

The reach of our team enables us to deploy experienced and credentialed insurance tax specialists to address specific industry issues, meet deadlines or just deal with the unexpected.

Team news

We have welcomed 13 new members to the insurance team in the last 12 months:

- Kathleen Anderson
- Kapil Kalra
- Sarah Bryant
- Sonal Shah
- Shaneen Tie
- Anish Patel
- Gurdeep Singh
- Miriam Friel
- Andrew Robertson
- Sameer Desai
- Madeleine Broeckelmann
- Cem Erkus
- Russell Grievie
- John Hood

Not forgetting the members of our team who have been seconded to clients / overseas offices / HM Treasury:

- Mark Peers – to Royal & SunAlliance
- Elisha Stimson – to Royal & SunAlliance
- Ayesha Patel – to HBOS
- Thomas Groenen – in New York
- Samantha Dunkling – in Sydney
- Peter Sproul – in Boston
- Richard Sumner – to HM Treasury

And finally we would like to congratulate our newly promoted director, Lindsay Hayward and senior manager, Elaine Ogle.

Meet our newly promoted director - Lindsay Hayward

What skills do you bring to the partner / director team?

I have worked in the insurance team for 11 years, on both life and general/London markets clients. One of my main areas of specialism in recent years has been M&A and corporate restructuring transactions, including the financing and capital management of insurance groups. I can also be seen at various Oracle conferences and other seminars, talking on a variety of topics.

I enjoy my job immensely and I am looking forward to using my enthusiasm and skills to make a positive difference to our clients' experience of dealing with us and also our peoples' experience of working in the PwC insurance team. Being involved in the strategy of the team is also something that I particularly enjoy, especially in such a changing market.



What do you think you and your clients will be focusing on over the next year?

The insurance industry was very active in the M&A area last year, particularly around the acquisition of closed books of business. The recent changes to the finance markets are unlikely to affect this and we are already seeing M&A activity this year. There is a continued increase in focus on the post-tax cost of capital – that, combined with the “credit crunch”, will undoubtedly see more groups focus on innovative financing. Insurance groups have also had to respond to the increased competition in the market, including start-ups and inversions. This means that we are likely to see further corporate restructuring, with an emphasis on the territories in which the “valuable” parts of the business are situated, in addition to the focus on efficient financing and capital management.

HMRC announced last year that it would bring increasing attention to transfer pricing, and I have already seen an increase in HMRC's interest in reinsurance and finance arrangements with offshore jurisdictions. There has been a particular focus on the London markets, given the ongoing movement of risk to Bermuda. Transfer pricing is a risk which can be mitigated in most cases by being prepared and I would expect to see groups continuing to take action in this respect by ensuring their transfer pricing positions are fully justified (including benchmarking or actuarial analysis, where appropriate) and properly documented.

Based on recent discussions with our clients, I would expect to see an increased focus on improving the effectiveness of the tax function, mainly around controls, automation of processes and freeing up valuable tax resource. Another key area will be managing clients' relationships with HMRC, particularly given their change in approach over the past year or so, including the introduction of risk reviews.

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