

*Budget 2011: Is George's
marvellous medicine working*
23 March 2011

The Chancellor's Budget 2011

Overview

The Chancellor delivered a welcome plan for growth. He has taken some significant steps towards creating a tax system that is more supportive of business investment and growth. Alongside further clarification on matters that were already under discussion in existing consultations, the additional cut in the main rate of corporation tax will be an unexpected attraction; but the Chancellor's effective tax increases in the banking and oil and gas sectors are less palatable. The expected reintroduction of enterprise zones and changes to investment incentives and entrepreneurs' relief will be a boost to support new and growing businesses. It's more difficult to see the incentives for elements of the other two overarching ambitions for growth in encouraging exports and creating a more educated and flexible workforce.

He also announced a number of bold and unexpected moves, including a radical new relief from inheritance tax on gifts to charities and a reduction, rather than the planned increase, in fuel duty. Similarly, although it has been widely trailed, the decision to consult on integrating the income tax and national insurance systems will be very welcome. But this will have significant implications for all businesses which will need to be carefully thought through.

As well as the specific reliefs that will be abolished after the review by the Office of Tax Simplification (OTS), the Budget includes a wide-ranging review of existing and proposed legislation which will remove anomalies and reduce the impact of the tax system on business. This can only be welcomed.

Outlook for the economy and the public finances

The Budget was fiscally neutral – the giveaways broadly balance out the takeaways. We consider this fiscally neutral stance to be prudent given the large budget deficit and the uncertain global economic outlook. But the Chancellor may need to revisit his plans later this year if the economic recovery shows signs of stalling.

The Office for Budget Responsibility (OBR) forecast for 2011 economic growth was revised down to 1.7% from 2.1% as published in November 2010. In contrast, the economic growth forecasts over the medium term have been revised slightly upwards from 2.8% to 2.9%

in 2014 and 2015. According to our analysis, more modest growth is likely in each year from 2011 to 2014 because of fragile consumer confidence, forthcoming public spending cuts (which have hardly started yet), rising global commodity prices and recent problems in Japan and the Middle East which make the global economic outlook uncertain.

The OBR's forecasts for public sector net borrowing for 2010/11 have been revised down slightly from £149bn to £146bn but up slightly to £46bn in 2014/15 (as compared to the £35bn forecast in November 2010). Our analysis suggests a somewhat slower fall

in public borrowing to around £53bn in 2014/15 due to more subdued economic growth with cumulative borrowing over the next four years around £20bn higher in our main scenario than in the new OBR forecasts.

Some of the detailed measures announced by the Chancellor, such as easing regulatory burdens on small businesses, are welcome. But the overall impact on economic growth is unlikely to be large given that the state of the public finances prevented any material net injection of money into the economy.

Corporate and business tax

General

The planned reduction in the main rate of corporation tax is to come more quickly than envisaged and will ultimately go further, accelerating the Government's move to make the UK tax system more competitive. But not every sector will benefit.

It had already been announced that the main rate of corporation tax will be reduced from 28% to 27% from 1 April 2011, but this will reduce further to 26% from that date. By 2014 the UK rate of corporation tax will have reduced to 23%. A reduction in the rate of corporation tax is a good start but needs to be accompanied by other measures to increase competitiveness and simplicity in the UK tax system.

The reduction in the rate has not been extended to ring fence profits from oil and gas, which remains at 30%. This, coupled with an increase in the supplementary charge for oil and gas companies from 20% to

a headline rate of 32%, is likely to lead to a significant increase in the tax liability for companies in this sector. The increase in the tax rate may also introduce uncertainty for investment decisions given its variability (and the mechanism has not yet been determined). In particular, the reduced return on investment may affect further investment in the North Sea.

In his speech, the Chancellor stressed that the decrease in the main corporation tax rate would not affect the overall amount of taxes paid by banks, as there will be an increase in the bank levy. This doesn't support the Government's aim to improve the simplicity and competitiveness of the UK tax system and for London to remain a world-leading financial centre. The tinkering with the rate of the bank levy has resulted in four different rates being in force during the course of 2011 and 2012. This is representative of the complex tax rules the sector now faces.

The corporation tax reform programme

There was welcome clarity around the shape of some aspects of the corporate tax reform agenda; many of the reforms are largely as they were set out toward the end of last year but we now have one or two significant developments as a result of the consultations which have taken place. We are disappointed that there was no announcement on the new controlled foreign company (CFC) rules for intellectual property.

- The finance company exemption due to be introduced from 2012 will have a low effective tax rate of just 5.75% (a reduction from the 8% previously proposed) and we anticipate a positive relaxation of the interim CFC proposals making them more widely applicable. There's an opportunity to

put in place simple offshore financing structures delivering immediate benefits, and ready to avail of the new low rate.

- For businesses considering acquisitions, there will be a welcome extension to the CFC motive test 'period of grace', giving a blanket CFC exemption for effectively three years, for accounting periods starting on or after 1 January 2011.
- The branch exemption proposals may not be as widely applicable as had originally been hoped for. The intention was to make branches more viable for doing business with an alignment of the taxation of branches and companies. But given the existing rules governing the taxation of branch profits, you'll need to carefully consider where profits sit in your group in order to successfully apply the branch exemption, which may require clearance from HM Revenue & Customs (HMRC) to avoid uncertainty.

- Changes to the taxation of innovation and intellectual property, including the introduction of a patent box 10% tax regime in April 2013, have been confirmed. The proposal is to make this patent box available for both royalty income and patent income 'embedded' in the price of patented products. We look forward to further details being set out in a consultation document to be released in May 2011.

Overall, the reforms have wide-reaching implications. All groups with foreign operations held by the UK will need to understand the new rules. While CFCs are here to stay, we are moving away from the historic CFC exemptions and these will be replaced with a set of new, modern exemptions.

The improved CFC regime coupled with the existing dividend exemption, capital gains exemption, 0% rate dividend withholding tax and greater certainty over interest deductibility, could make the UK a more attractive holding company location.

Research and development

There was some excellent news for business in relation to research and development (R&D) tax credits, particularly regarding the regime for small and medium-sized enterprises (SMEs). With the rate for SMEs increasing to 200% from April 2011 and to 225% from April 2012:

- for tax-paying companies, this equates to an increase in the cash tax saving of 5% for this year and the next, taking the cash saving from the current 21% up to 31% from April 2012; while
- for loss-makers it looked on the face of it as if the cash back would increase proportionately (since there was no mention of a change in the 14% rate of recovery) but HMRC has confirmed to us that the intention is to reduce the rate initially to 12.5% and then to a lower figure when the rate becomes 225%.

Proposals to abolish from 2012 the pay as you earn (PAYE) and National Insurance contribution (NIC) cap on the cashback for surrendered losses (subject to consultation) would particularly benefit those with a small workforce but large R&D expenditure.

Both of the above changes are subject to European Union (EU) approval which makes the effective dates less certain (the date for previous changes was delayed in similar circumstances). It's also possible that some other change(s) might be requested before approval is given.

The abolition of the £10,000 minimum expenditure rules for all companies is also generally welcome, as is the fact that for all companies work undertaken for customers will be treated as R&D under the large company regime if it's part of the customer's R&D project. This provides further certainty and relief, particularly to contract research organisations in the life sciences sector.

Disappointingly, the Government has confirmed that it will not publish a response to the recent consultation until May 2011, when the detail of the above proposals will also be incorporated.

Short life assets

Currently a short life asset (SLA) election, which accelerates the capital allowances due, is beneficial where an asset is sold or scrapped within four years of the end of the period in which it is bought. This four year limit is to be extended to eight years for assets acquired on or after 1 April 2011 for corporation tax, or on or after 6 April 2011 for income tax. The overall aim of this is to ensure that tax relief is given for the depreciation of more assets over their useful life.

But SLA elections are administratively cumbersome and it can require substantial amounts of work to ascertain, prepare and monitor such elections. It's disappointing that the Government has not found a simpler method of accelerating allowances in the not unusual situation where assets are sold or scrapped within eight years of their acquisition.

Business rates

The extension of the small business rate relief holiday by one additional year to 1 October 2012 is good news. If your business has planned for it, you'll see a degree of consistency.

The 100% business rate discount applicable for a business that moves into an enterprise zone during this Parliament is worth up to £275,000 over five years, so the regime will be much more attractive to small businesses. Other advantages for the 21 new enterprise zones are welcomed, including simplified planning processes, superfast broadband and the potential for enhanced capital allowances in areas where there is a strong focus on high value manufacturing. The brief details announced look likely to encourage businesses into the enterprise zones. There's some evidence from the 1980s/90s that this kind of measure can play a real role in attracting new business into an area, although there's a risk that business is simply attracted from neighbouring areas outside the enterprise zone. But the

true value of the measures will be revealed once more detail is available.

The big disappointment was that nothing more was done to help those paying 100% empty rates.

Corporate capital gains

There are small amendments to the planned corporate capital gains changes involving, principally, de-grouping but also pre-entry losses and value-shifting or depreciatory transactions. One further piece of anti-avoidance has been included, but businesses will generally benefit from the overall package. In particular, those which operate via divisions have been seriously disadvantaged in the past if they wanted to sell one of those divisions, and the changes will alleviate most of the disadvantages. It's a shame that there still don't appear to be any complementary proposals in relation to the treatment of intellectual property.

Employment taxes

The Government had said that it would take action to prevent attempts to avoid tax and NIC through the use of employee benefit trusts (EBTs), ‘tax-free, lifetime loans that are never repaid’ and other arrangements such as employer-financed retirement benefit schemes (EFRBS). Revised measures are to be brought in with effect from 6 April 2011 and are expected to raise around £760m per year.

When the draft legislation was published on 9 December 2010, it was very wide ranging and covered many normal commercial situations that had nothing to do with tax avoidance.

The original rules were widely criticised as being unworkable so it’s good news that the Government has listened. Until the new rules are published, it’s difficult to tell exactly how far the Government has gone. Changes to protect legacy pension schemes and employee share plans are welcomed. But there’s still a concern that many, everyday transactions will be caught and so employers will need to take care to ensure that unexpected tax bills do not arise.

Bonuses which are deferred and can be clawed back in the event of poor performance are seen as important by many

stakeholders. But the original rules were so wide ranging that they actively discouraged this – employees could end up paying 52% tax and NIC before a bonus is paid, even if it’s eventually never actually received. The new version of the rules will contain some exemptions – until we see the actual rules we don’t know whether they will cover all the types of plans.

The Budget continued with the focus on encouraging ‘green’ vehicles. The benefit in kind changes are unlikely to make a significant difference in the choice of low emission cars.

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Personal taxes

Integration of income tax and NIC

The announcement of a consultation on the integration of income tax and NIC heralds a potentially radical change. The Chancellor already foresaw problems with a simple amalgamation of income tax and NIC, such as the position of pensioners, and indicated any change would not happen quickly. While the integration of these two regimes makes a great deal of sense from an administrative perspective, the complexities and issues that will have to be addressed should not be underestimated. So the timeframe of a number of years for any merger to be completed

seems sensible. In the shorter term, there's plenty of scope for aligning the bases of the calculation of the two 'taxes'. In the meantime, the Chancellor confirmed that NIC will not be extended to individuals above state pension age or to other forms of income such as pensions, savings and dividends.

Residence and domicile

The proposed increase in the remittance basis charge from £30,000 to £50,000 for longer term (12 years) resident, but non-domiciled (non-doms) individuals, is unwelcome, but there were suggestions that more radical reform was being

considered. The Government's announcement that there will be no other substantive changes to the tax regime for non-doms for the remainder of this Parliament at least gives those individuals some level of certainty. Removing the tax charge on remittances for those investing in the UK should encourage such investments, although we'll have to wait for more details until June 2011 when a further consultation document is published. It's still unclear whether other countries (particularly the US) will accept the remittance basis charge as a tax charge and so creditable against tax liabilities incurred on the same income in those countries.

While clarification around how to work out whether an individual is UK resident, with a statutory test, would be very welcome, it's important that the final proposed legislation is simple to understand and operate. Any statutory residence test, following consultation to be started in June, must provide individuals (and if relevant, their employers) with certainty regarding their residence position. For employees assigned to the UK for the shorter term, there's nothing in the proposals to indicate that relief for overseas workdays has been changed: this helps to maintain the UK's competitiveness against other countries with specific expatriate tax regimes.

Entrepreneurs' relief

The enhancement of entrepreneurs' relief, which reduces the rate of capital gains tax paid by taxpayers on qualifying disposals to 10% (from a maximum rate of 28%) for certain disposals of business assets or shareholdings, is significant: the increase in the lifetime allowance from £5m to £10m from 6 April 2011 means the relief will then be worth £1.8m compared to £900k. Equally important, it was welcome news that there were no other changes to the rules or conditions relating to entrepreneurs' relief.

Charitable giving

Measures to encourage charitable giving will be of interest to both the voluntary sector and those who donate to charity. The reduction from 40% to 36% in the rate of inheritance tax applicable from 6 April 2012, where 10% or more of a deceased's net estate is left to charity should provide additional incentives for substantial charitable legacies.

The relaxation on the limits which restrict the value of benefits that individuals may receive as a result of making charitable donations that qualify for Gift Aid, raising the overall cap of £500 to £2,500 from 6 April 2011, should encourage more giving. Similar arguments apply to the simplification of the administration of Gift Aid through the introduction of online filing and allowing charities to claim Gift Aid on up to £5,000 of small donations per year without the need for

Gift Aid declarations. While the removal of the self-assessment giving scheme (also known as SA Donate) may be seen as unwelcome, the take up was apparently low and vulnerable to fraud and any resources saved can be ploughed into the new online claims Gift Aid system.

Venture capital reliefs

There was also encouragement to help small companies raise finance, with the Chancellor proposing a significant boost to the venture capital tax reliefs, by increasing the tax relief available, and raising some of the size limits for qualifying companies. The increase in the maximum amount an individual can invest in a qualifying enterprise investment scheme (EIS) company, being doubled from £500,000 to £1m, should be particularly helpful to companies raising funds from business angel investors. The changes announced will be welcome to many small

companies which have struggled to raise funds in recent times, and have particularly found the changes brought in since 2006 unduly restrictive, although it's disappointing that it will be 12 months before the current restrictions are raised. All changes are subject to obtaining State Aid approval, which we understand is in progress (this accounts for the delay in implementing some of the proposed changes).

The rate of income tax relief given for EIS investments made through an approved EIS fund will depend upon the date on which the fund closes. Funds which close by 5 April 2011 will receive income tax relief of 20%, but if they close after 5 April 2011 the rate of relief will be 30%; managers of approved EIS funds will want to consider delaying the closing of the fund beyond 5 April 2011. But if an EIS investment made in the 2011/12 tax year is carried back to 2010/11, the rate

of relief will be 20%, not 30%; so investors will need to carefully consider whether a carry back claim should be made.

Companies whose businesses consist to a substantial extent (i.e. 20% or more) of the receipt of feed-in tariffs (or equivalent) will no longer be eligible to receive venture capital trust (VCT)

and EIS funding. This change will affect most green energy generating companies, and not just solar power. The timescale for the change will depend upon when the investment is made in such companies. The policy objective is that companies benefitting from such subsidies should not also benefit from EIS and VCT funding.

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VAT, Customs, Excise

The small shift in low value consignments relief (LVCR) from £18 to £15 is unlikely to have a significant effect on retail sales, though the Government is also exploring options with the European Commission for limiting the scope of the relief further. LVCR is an EU-wide administrative simplification to reduce costs for businesses. The Government believes it's being exploited in relation to sales of various retail products, such as

DVDs and contact lenses. The cost of LVCR to the Exchequer has risen from £85m to £130m annually over the last five years, reflecting the growth of internet shopping and the willingness of UK companies to relocate their operations outside the EU to exploit the relief. If there is no other solution, it intends to revisit the level of the LVCR again in Budget 2012.

The VAT rules on business samples have been far too restrictive for many years and do not reflect modern business practices. We welcome the relaxation of the rules to reflect a judgment of the European Court of Justice which extended the relief available to businesses providing samples for marketing purposes and remind businesses that there may be scope for retrospective claims for overpaid VAT.

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Low carbon policies

Fuel duty

The planned rise in fuel duty, expected to add 5p to a litre of petrol from April 2011, has been postponed and instead there is to be a 1p reduction. Individuals and small businesses will find this particularly helpful although it seems contrary to the commitment to increase environmental taxes. But fuel duty is already significantly in excess of other fuel taxes in terms of the price it places on carbon dioxide emissions, so this is an area that should probably not be a target for additional environmental taxation.

Air passenger duty

Proposals to reform air passenger duty (APD) into a per plane tax have been set aside, for the moment, as this would be contrary to international law (while the Government lobbies to get that changed). A small planned increase in APD has also been postponed until next year. A broader consultation will now take place on other potential changes to APD with the aim of simplifying the tax. There are currently four bands and the consultation proposes to reduce this to three or two bands. Simplification of taxes is

usually welcome; but this could undermine the ability of the tax to capture the environmental cost of flying. This also highlights the ongoing question as to whether APD is really an environmental tax or a mechanism for raising revenue.

Carbon floor price

The introduction of a carbon price floor for the power sector was widely expected. The precise details and its interactions with other mechanisms are not yet clear. The carbon price floor is in line with current market expectations for carbon prices, so

there is a reasonable prospect of the floor providing certainty to investors, without embedding a big extra cost to the power sector. The details of this mechanism will determine whether it really is a floor, or more of an additional tax. The Government needs to think carefully about how it positions these changes so as not to adversely affect British competitiveness.

Green investment bank

The amount of funds available to the green investment bank is to be tripled to £3bn. The Government anticipates that

this will, together with private capital, ensure £18bn of funds are available by 2014/15. The Government also confirmed that the bank will not be allowed to borrow until 2015 at the earliest and even then it will be subject to national debt reduction targets being met. While the increase is welcome, the UK still requires £200bn of infrastructure investment to meet environmental targets and the constraints on borrowing serve to highlight the funding gap that still needs to be filled. Other policies are also needed to encourage private sector investment.

“The Government needs to think carefully about how it positions the introduction of a carbon floor price so as not to adversely affect British competitiveness.”

Anti-avoidance

The Government has issued further details of its plans to tackle tax avoidance and maintain fairness in the tax system. At the heart of these plans is a new HMRC anti-avoidance strategy with a focus on prevention, detection and effective counteraction of tax avoidance.

HMRC has reinforced its intention to use litigation to counter tax avoidance and sets out details of recent cases

before the Courts. HMRC will continue to allocate its resources to those taxpayers, individual and corporate, demonstrating the highest risks and use its relationship-managed approach to identify such risks. HMRC will consult during the summer of 2011 on proposals to remove any cash flow advantages that users of some tax avoidance schemes may accrue. It's not known how HMRC will determine which arrangements might be subject to the proposed restriction.

HMRC will continue to further strengthen the disclosure of tax avoidance scheme rules to aid early detection and counteraction activity. The first quarterly notifications by promoters of users of tax avoidance schemes are due imminently.

The consideration of a general anti-avoidance rule (GAAR) is also still ongoing, with the study group, headed by Graham Aaronson QC, due to report to the Government by 31 October 2011.

Specific anti-avoidance measures include those set out below.

- Avoidance involving income tax losses and unauthorised unit trusts have been identified as particularly high risk areas and will be subject to consultation and potential legislative changes in 2011 and 2012.
- There's further confirmation of the rules to counter avoidance in relation to accounting derecognition, group mismatches (tax asymmetries within groups) and functional currency changes. Changes to the debt cap rules and foreign exchange tax matching are really refinements rather than new anti-avoidance rules. The new election for investment companies to use a currency other than their accounting 'functional currency' will help some companies affected by hedging difficulties otherwise resulting from the above changes.
- Three stamp duty land tax (SDLT) avoidance loopholes are also specifically being closed. In the meantime, HMRC is likely to follow up its previous public announcements on 'sub-sale schemes' with continued investigation and litigation. The Budget speech referred to the need to tackle evasion and avoidance in relation to high value property by some wealthy people; it may well be referring to selling property enveloped in a company, although there are no further references in the supporting documents, and it's not clear what action is envisaged.

Administration

A number of reliefs identified as obsolete by the OTS are to be abolished in the Finance Bill 2011. Of those earmarked for abolition in the Finance Bill 2012, subject to consultation, many are unlikely to have a material impact, though others such as the tax exemption on late night taxis, may have more significant impact in some sectors and businesses. Each business will need to study the details closely to identify which reliefs being abolished affect their company and their employees and if necessary make representations.

In response to the OTS review of small business measures, a commitment has been made to improve the way in which the contentious rules in IR35 are administered, affecting many contractors and freelancers who trade through their own companies or partnerships. The proposals for a specialist helpline, revised guidance and IR35 Forum should help improve understanding, but will still be a disappointment for those who had been hoping for a suspension or abolition of IR35.

The Government's emergency Budget in June 2010 announced a review of how the consumer price index (CPI) could be used

for the indexation of taxes and duties to yield an additional £1bn by 2015/16. From 6 April 2012, CPI will replace the retail price index (RPI) as the indexation measure for all NIC rates, limits and thresholds. But in order to protect employers from increased cost during the life of the current Parliament, the secondary NIC threshold will be over-indexed when compared to CPI and will continue to rise by the equivalent of RPI from April 2012 until 2015/16. Other important moves to the CPI basis are, from 6 April 2012, for individual savings accounts (ISAs) and the capital gains tax annual exemption.

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Other measures

The Chancellor's announcement about potential changes to the real estate investment trust (REIT) regime went further than the industry expected and will give a much-needed boost to the property market. Not only will there be simplification to the ownership requirements and requirements for listing but a whole raft of measures which will make REITs easier to operate and to understand. Those changes, coupled with abolishing the entry charge and allowing them more flexibility over holding cash, are clearly focused on encouraging new entrants into the regime, but they're also good news for existing REITs.

A further tweak will allow anyone buying a block of residential properties to pay SDLT by

reference to the appropriate SDLT rate applicable to the average value and not the aggregate value. The intention is to encourage investment via buy-to-lets in residential property. This was unexpected but seems sensible with a reasonable anti-avoidance rule suggested, though we'll need to see the proposed wording to be certain. It could be of value to registered social landlords who no longer receive grant funding.

The transfer pricing legislation is to be updated to reflect the change from the 1995 Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines to the substantially revised 2010 version. Without the change, mentioned in the

Budget Red Book, there would be a mismatch between the UK's transfer pricing rules and those that have already adopted the new guidelines. This will increase pressure on companies to produce higher-quality transfer pricing documentation. The renewed emphasis on analysis of comparability factors and on the choice and application of methods will increase the compliance cost for many companies. New material on business restructurings is essential reading if you have internal reorganisations that result in reductions of UK profits.

A number of important announcements were made in the insurance sector. A technical note on the new post-Solvency II life insurance tax regime was

published on 23 March 2011, with a further consultative document due in April 2011. This marks the most significant changes to the taxation of life insurers for 20 years. Although the broad basis of the tax regime remains the same, the mechanics of the tax computation will drastically change. As a

consequence, the amount of tax life insurers pay, and the timing of when this is paid, is likely to change. Understanding the impact of the proposals on their business and on returns to shareholders will be a real challenge to insurers. There are some specific measures too for both life and non-life insurers.

A timetable for reform

Against the backdrop of a fiscally neutral Budget, the Chancellor announced a wide range of measures aimed largely at promoting growth. Some of the potential benefits ought to be seen more immediately than others but setting out a longer-term programme for reform is welcome. Nothing was said

about the Treasury Committee's recent proposal for advancing the Finance Bill processes so that the legislation is in place, before Christmas 2011, at least three to four months before its provisions would come into effect. That would take the advantages we've seen from earlier publication of draft legislation one step further.

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