

- dealers or traders in securities or currencies,
- financial institutions or other US holders that treat income in respect of the ordinary shares or ADSs as financial services income,
- insurance companies,
- tax-exempt entities,
- US holders that hold the ordinary shares or ADSs as a part of a straddle or conversion transaction or other arrangement involving more than one position,
- US holders that own, or are deemed for US tax purposes to own, 10% or more of the total combined voting power of all classes of our voting stock,
- US holders that have a principal place of business or "tax home" outside the United States, or
- US holders whose "functional currency" is not the US dollar.

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For US federal income tax purposes, holders of ADSs will be treated as the owners of the ordinary shares represented by those ADSs.

The discussion below is based upon current UK law and the provisions of the US Internal Revenue Code of 1986, or the Code, and regulations, rulings and judicial decisions as of the date of this Annual Report; any such authority may be repealed, revoked or modified, perhaps with retroactive effect, so as to result in tax consequences different from those discussed below. This discussion is also based on the current Income Tax Treaty between the United Kingdom and the United States. A new Income Tax Treaty has been agreed between representatives of the United Kingdom and United States governments. However, the new Income Tax Treaty is subject to ratification by both the United Kingdom and United States governments, and thus there can be no assurance as to whether and when the new Income Tax Treaty will come into force, or, if so, as to the impact of any resulting changes in the Income Tax Treaty on the summary tax consequences set forth below. In addition, the following discussion assumes that The Bank of New York will perform its obligations as depositary in accordance with the terms of the depositary agreement and any related agreements.

**Because US and UK tax consequences may differ from one holder to the next, the discussion set out below does not purport to describe all of the tax considerations that may be relevant to you and your particular situation. Accordingly, you are advised to consult your own tax advisor as to the US federal, state and local, UK and other, including foreign, tax consequences of investing in the ordinary shares or ADSs. The statements of US and UK tax law set out below are based on the laws and interpretations in force as of the date of this Annual Report, and are subject to any changes occurring after that date.**

#### ***UK Income Taxation of Distributions***

Under the Income Tax Treaty, subject to certain exceptions, a US holder who is a resident of the United States (and is not a resident of the United Kingdom) for purposes of the Income Tax Treaty is entitled to receive, in addition to any dividend that we pay, a payment from the Inland Revenue in respect of such dividend equal to the tax credit to which an individual resident in the United Kingdom for tax purposes would have been entitled had he received the dividend (which is currently equal to one-ninth of the dividend received), reduced by a UK withholding tax equal to an amount not exceeding 15% of the sum of the dividend paid and the UK tax credit payment. At current rates the withholding tax entirely eliminates the tax credit payment but no withholding in excess of the tax credit payment is imposed upon the US holder. Thus, for example, a US holder that receives a \$100.00 dividend also will be treated as receiving from the Inland Revenue a tax credit payment of \$11.11 (one-ninth of the dividend received), but the entire \$11.11 payment will be eliminated by UK withholding tax, resulting in a net \$100.00 distribution to the US holder.

#### ***US Income Taxation of Distributions***

Distributions that we make with respect to the ordinary shares or ADSs, other than distributions in liquidation and distributions in redemption of stock that are treated as exchanges, will be taxed to US holders as ordinary dividend income to the extent that the distributions do not exceed Pearson's current and accumulated earnings and profits. The amount of any distribution will equal the sum of the cash distribution and its associated UK tax credit payment; thus, as described above under "UK Income Taxation of Distributions," the recipient of a \$100.00 cash distribution will be deemed to have received a total distribution of \$11.11. Distributions, if any, in excess of our current and accumulated earnings and profits will constitute a nontaxable return of capital to a US holder and will be applied against and reduce the US holder's tax basis in its ordinary shares or ADSs. To the extent that these distributions exceed the tax basis of the US holder in its ordinary shares or ADSs, the excess generally will be treated as capital gain.

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Dividends that we pay will not be eligible for the dividends received deduction generally allowed to US corporations under Section 243 of the Code.

In computing its US federal income tax liability, a US holder generally may elect for each taxable year to claim a deduction or, subject to the limitations on foreign tax credits generally, a US foreign tax credit for foreign income taxes withheld from any distributions paid on the ordinary shares or ADSs. In the case of US holders and subject to certain limitations, a foreign tax credit may be claimed for the amount of UK withholding taxes deemed to be imposed under the Income Tax Treaty. As discussed above (see "UK Income Taxation of Distributions"), the amount of UK withholding tax deemed to be imposed is equal to one-ninth of the associated cash distribution, or \$11.11 on a \$100.00 cash distribution. To qualify for this credit, a US holder must make an election on Form 8833 (Treaty-Based Return Position Disclosure), which must be filed with its tax return for the relevant taxable year, in addition to any other filings that may be required. For US foreign tax credit purposes, dividends that we pay generally will be treated as foreign-source income and as passive income, subject to the separate foreign tax credit limitation for passive income. The availability of foreign tax credits depends on your particular circumstances.

In the case of distributions in pounds, the amount of the distributions generally will equal the US dollar value of the pounds distributed, determined by reference to the spot currency exchange rate on the date of receipt of the distribution by the US holder in the case of shares or by The Bank of New York in the case of ADSs, regardless of whether the US holder reports income on a cash basis or an accrual basis. The US holder will realize separate foreign currency gain or loss only to the extent that this gain or loss arises on the actual disposition of pounds received. For US holders claiming tax credits on a cash basis, taxes withheld from the distribution are translated into US dollars at the spot rate on the date of the distribution; for US holders claiming tax credits on an accrual basis, taxes withheld from the distribution are translated into US dollars at the average rate for the taxable year.

## **UK Income Taxation of Capital Gains**

Under the Income Tax Treaty, each country generally may tax capital gains in accordance with the provisions of its domestic law. Under present UK law, a US holder that is not a resident, and, in the case of an individual, not ordinarily resident, in the United Kingdom for UK tax purposes and who does not carry on a trade, profession or vocation in the United Kingdom through a branch or agency to which ordinary shares or ADSs are attributable will not be liable for UK taxation on capital gains or eligible for relief for allowable losses, realized on the sale or other disposal (including redemption) of these ordinary shares or ADSs.

## **US Income Taxation of Capital Gains**

Upon a sale or exchange of ordinary shares or ADSs to a person other than Pearson, a US holder will recognize gain or loss in an amount equal to the difference between the amount realized on the sale or exchange and the US holder's adjusted tax basis in the ordinary shares or ADSs. Any gain or loss recognized will be capital gain or loss and will be long-term capital gain or loss if the US holder has held the ordinary shares or ADSs for more than one year.

Gain or loss realized by a US holder on the sale or exchange of ordinary shares or ADSs generally will be treated as US-source gain or loss for US foreign tax credit purposes.

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## **Estate and Gift Tax**

The current Estate and Gift Tax Convention, or the Convention, between the United States and the United Kingdom generally relieves from UK Inheritance Tax (the equivalent of US Estate and Gift Tax) the transfer of ordinary shares or of ADSs where the transferor is domiciled in the United States, for the purposes of the Convention. This relief will not apply if the ordinary shares or ADSs are part of the business property of an individual's permanent establishment in the United Kingdom or pertain to the fixed base in the United Kingdom of a person providing independent personal services. If no relief is given under the Convention, inheritance tax may be charged on the amount by which the value of the transferor's estate is reduced as a result of any transfer made by way of gift or other gratuitous transfer by an individual, in general within seven years of death, or on the death of an individual. In the unusual case where ordinary shares or ADSs are subject to both UK Inheritance Tax and US Estate or Gift Tax, the Convention generally provides for tax paid in the United Kingdom to be credited against tax payable in the United States or for tax paid in the United States to be credited against tax payable in the United Kingdom based on priority rules set forth in the Convention.

## **Stamp Duty**

No stamp duty or stamp duty reserve tax (SDRT) will be payable in the United Kingdom on the purchase or transfer of an ADS, provided that the ADS, and any separate instrument or written agreement of transfer, remain at all times outside the United Kingdom and that the instrument or written agreement of transfer is not executed in the United Kingdom. Stamp duty or SDRT is, however, generally payable at the rate of 1.5% of the amount or value of the consideration or, in some circumstances, the value of the ordinary shares, where ordinary shares are issued or transferred to a person whose business is or includes issuing depositary receipts, or to a nominee or agent for such a person.

A transfer for value of the underlying ordinary shares will generally be subject to either stamp duty or SDRT, normally at the rate of 0.5% of the amount or value of the consideration. A transfer of ordinary shares from a nominee to its beneficial owner, including the transfer of underlying ordinary shares from the Depositary to an ADS holder, under which no beneficial interest passes is subject to stamp duty at the fixed rate of £5.00 per instrument of transfer.

## **Close Company Status**

We believe that the close company provisions of the UK Income and Corporation Taxes Act 1988 do not apply to us.

## **Documents on Display**

Copies of our Memorandum and Articles of Association, the material contracts described above and filed as exhibits to this Annual Report and certain other documents referred to in this Annual Report are available for inspection at our registered office at 80 Strand, London WC2R 0RL (c/o the Company Secretary), or, in the United States, at the registered office of Pearson Inc. at 1330 Avenue of the Americas, 7th Floor, New York, New York, 10019 (c/o Mr. John Fallon) during usual business hours upon reasonable prior request.

## **Item 11. Quantitative and Qualitative Disclosures About Market Risk**

### **Introduction**

Our principal market risks are changes in interest rates and currency exchange rates. Following evaluation of these positions, we selectively enter into derivative financial instruments to manage our risk exposure. For this purpose, we primarily use interest rate swaps, interest rate caps and collars,

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forward rate agreements, currency swaps and forward foreign exchange contracts. Managing market risks are the responsibility of the group financial director who acts pursuant to policies approved by our board of directors. A treasury committee of the board receives regular reports on our treasury activities, which our outside advisers also review periodically.

We have a policy of not undertaking any speculative transactions, and we hold the derivative and other financial instruments for purposes other than trading.

We have formulated our policies for hedging exposures to interest rate and foreign exchange risk, and have used derivatives without regard to existing or future US GAAP requirements on hedge accounting. We are satisfied that the present policies achieve our objectives, and that the near equivalence between the carrying book value and fair value of our financial liabilities and derivative contracts confirms this. However, our existing derivative contracts do not qualify for hedge accounting under US GAAP.

The following discussion and tables address market risk only and do not present other risks that we face in the normal course of business, including country risk, credit risk and legal risk.

### **Interest Rates**

Our financial exposures to interest rates arise primarily from our borrowings, particularly those in US dollars. We manage our exposure by borrowing at fixed and variable rates of interest, and by entering into derivative instruments. Objectives approved by our board concerning the proportion of outstanding fixed rate debt govern our use of these financial