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Updated: New Bond Financing Options – Build America Bonds and Recovery Zone Bonds

Since our last distribution discussing new bond financing options authorized by the American Reinvestment and Recovery Act, the IRS has provided additional interim guidance on Build America Bonds, Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds. In addition, the United States Treasury allocated \$10 billion of the Recovery Zone Economic Development Bonds and \$15 billion of the Recovery Zone Facility Bonds to all 50 states, the District of Columbia and American territories and then made sub-allocations to certain counties and large municipalities.

Overview of Build America Bonds

The American Recovery and Reinvestment Tax Act of 2009 (the “Stimulus Act”) creates a new category of municipal bonds -- “Build America Bonds” -- that provide tax benefits to issuers and investors different from the tax benefits provided by conventional tax-exempt municipal bonds. During 2009 and 2010, state and local government issuers may elect to issue their otherwise tax-exempt governmental (not private activity) bonds as Build America Bonds.

Unlike the tax-exempt interest associated with traditional municipal bonds, interest paid by issuers of Build America Bonds is treated as taxable income to holders of these bonds. But state and local government issuers can choose one of two tax benefit options for their Build America Bonds. If the issuer designates its Build America Bonds as “Build America Bonds (Tax Credit),” bondholders will receive a tax credit equal to 35% of the interest paid on the bonds, which will lower the interest rate issuers must pay on the bonds to attract investors. This provides an indirect subsidy to the state or local government issuer. If the issuer designates its Build America Bonds as “Build America Bonds (Direct Payment),” the issuer will receive periodic payments from the federal government in an amount equal to 35% of the interest paid to bondholders.

The third type of Build America Bond is the Recovery Zone Economic Development Bond (Direct Payment), which may be issued only by local governments in certain areas where employment declined in 2008. On Friday June 12, 2009, the U.S. Treasury identified these local governments and the dollar amount of bonds that can be issued by each. An issuer of Recovery Zone Economic Development Bonds (Direct Payment) will receive periodic payments from the federal government equal to 45% (instead of 35%) of the interest paid to the bondholders.

Issuers of Build America Bonds must comply with all requirements applicable to the issuance of tax-exempt governmental bonds, including the private business use and private loan restrictions in Code section 141, the arbitrage and rebate rules in Code section 148, and the registration requirements, federal guaranty limitations, advance refunding limitations, reporting requirements and hedge bond limitations in Code

section 149. Build America Bonds (Tax Credit) are not treated as federally guaranteed¹ as a result of the federal government's grant of a credit to bondholders.

Issuers also need to consider several additional requirements for issuing Build America Bonds. The requirements, limitations and procedural guidance are discussed below.

Build America Bond (Tax Credit)

Requirements

An obligation, other than a private activity bond, qualifies as a Build America Bond (Tax Credit) if it meets the following requirements:²

1. the bond is issued before January 1, 2011;
2. the issuer makes an irrevocable election to treat the bond as a Build America Bond,³ and
3. the interest on the bond would have been excludable from gross income⁴ but for application of the Build America Bond rules.⁵

The Build America Bonds (Tax Credit) are similar to tax-exempt governmental bonds: they may be issued to finance the same types of expenditures, namely capital expenditures, working capital expenditures and refundings of prior issues. In addition, issuers of Build America Bonds (Tax Credit) must comply with all requirements applicable to the issuance of tax-exempt governmental bonds.

To qualify as a Build America Bond (Tax Credit), the issue price of the bond cannot include more than a *de minimis* amount of premium over the stated principal amount of the bond.⁶ For purposes of the

arbitrage rules,⁷ the yield on Build America Bonds (Tax Credit) is determined without regard to the credit allowed to the bondholder.⁸

Tax Treatment of Bondholder

A holder of a Build America Bond (Tax Credit) is entitled to claim a tax credit equal to 35 percent of the interest payable on the interest payment date of the bond.⁹ Additional information about the tax treatment of a bondholder is included at the end of this summary - see *Tax Treatment of an Investor in a Build America Bond (Tax Credit)*.

Build America Bond (Direct Payment)

Before January 1, 2011, state and local governments have the choice of issuing certain Build America Bonds that are "qualified bonds."¹⁰ Issuers of "qualified" Build America Bonds are entitled to a payment¹¹ by the United States Treasury with respect to each interest payment under those bonds. The payment is in lieu of the credit that would otherwise be allowed to the bondholder.¹²

The amount of the credit is equal to 35 percent of the interest paid under the bond on the interest payment date.¹³ Notice 2009-26 advises that for arbitrage purposes, issuers should calculate the yield on Build America Bonds (Direct Payment) by applying Section 148 of the Code but reduce the amount of the interest paid on the bond by the amount of the credit payments received.¹⁴

Building on the earlier example, the Conference Report provides the following illustration:

Under the special rule for qualified bonds, in lieu of the tax credit to the holder, the issuer is allowed a credit equal to 35 percent of each interest payment made under such bond. If in

¹ For purposes of § 149(b) of the Code.

² § 54AA(d)(1) of the Internal Revenue Code of 1986 (the "Code"), as added by the American Recovery and Reinvestment Tax Act of 2009 (H.R. 1) (the "Stimulus Act").

³ The rules of § 54AA would apply to the bond if the issuer makes this election.

⁴ Under § 103 of the Code.

⁵ As described in § 54AA of the Code, as added by the Stimulus Act.

⁶ The *de minimis* amount is determined under rules similar to the rules of § 1273(a)(3) of the Code.

⁷ § 148 of the Code.

⁸ § 54AA(d)(2)(B) of the Code, as added by the Stimulus Act.

⁹ § 54AA(b) of the Code, as added by the Stimulus Act.

¹⁰ § 54AA(g)(2) of the Code, as added by the Stimulus Act.

¹¹ The Code characterizes the payment as a "refundable credit."

¹² §§ 54AA(g) and 6431(a) of the Code, as added by the Stimulus Act.

¹³ § 6431(b) of the Code, as added by the Stimulus Act.

¹⁴ § 6431(c) of the Code, as added by the Stimulus Act.

2009 or 2010, the issuer elects to receive the credit, in the example above, for the State or local issuer's bond to sell at par, the issuer would have to issue the bond with a \$1,000 interest coupon. The taxpayer who holds such a bond would include \$1,000 on interest in his or her income. From the taxpayer's perspective the bond is the same [as] the taxable bond in the example above and the taxpayer would be willing to pay par for the bond. However, under the provision the State or local issuer would receive a payment of \$350 for each \$1,000 coupon paid to bondholders. (The net interest cost to the issuer would be \$650.)

Requirements

Build America Bonds (Direct Payment) are treated as a "qualified bond" if the following requirements are met: (1) the bonds are issued before January 1, 2011; (2) the issuer makes an irrevocable election to treat the bond as a Build America Bond;¹⁵ and (3) the entire amount (100%) of the "available project proceeds" of the issue is used for new money capital expenditures. Available project proceeds may not be spent on working capital or used to refund other bonds (except in the limited circumstances described below). The available project proceeds are calculated as follows:¹⁶

1. The proceeds from the sale of the issue, less
2. Issuance costs, provided the costs do not exceed two percent of the proceeds, plus
3. Any investment earnings on the sale proceeds.¹⁷

The amount of the available project proceeds does not include a reasonably required reserve¹⁸ for debt service with respect to the issue.¹⁹ This limitation on the use of available project proceeds effectively places a two percent limit on the use of bond proceeds to pay costs of issuance.

¹⁵ The election is to have § 54AA(g) of the Code apply to the bonds. §§ 54AA(g)(2)(A) and (B) of the Code, as added by the Stimulus Act.

¹⁶ The term "available project proceeds" is defined in § 54A of the Code.

¹⁷ § 54A(e)(4) of the Code, as added by the Stimulus Act.

¹⁸ As determined in accordance with § 150(a)(3) of the Code.

¹⁹ § 54AA(g)(2)(A)(ii) of the Code, as added by the Stimulus Act.

For purposes of "qualified" Build America Bonds, a "capital expenditure"²⁰ is one of the following:

1. any cost of a type that is properly chargeable to a capital account under general federal income tax principles,
2. any cost of a type that would be chargeable with a proper election or
3. any cost of a type that would be chargeable with application of the definition of "placed in service" under Treas. Reg. sec. 1.150-2(c).

Like the Build America Bonds (Tax Credit), the issue price of the Build America Bonds (Direct Payment) cannot include more than a *de minimis* amount of premium over the stated principal amount of the bond.²¹ In addition, the Build America Bonds (Direct Payment) must be issued to finance governmental purposes for which tax-exempt governmental bonds could be issued.

There is one exception to the requirement that Build America Bonds (Direct Payment) be used only for new money capital expenditures. Notice 2009-26 provides that Build America Bonds (Direct Payment) may be used to reimburse otherwise-eligible capital expenditures that were paid or incurred after the effective date of the Stimulus Act (February 17, 2009) and that were originally financed with temporary short-term financing issued after that date. In this situation, the reimbursement will not be treated as a refunding issue.²²

Notice 2009-26 also advises that for arbitrage purposes, issuers should calculate the yield on Build America Bonds (Direct Payment) by applying Section 148 of the Code but reduce the amount of the interest paid on the bonds by the amount of the credit payments received.²³

²⁰ According to the Conference Committee Report for the Stimulus Act, H. REPT. 111-16, the term "capital expenditure" has the same meaning as provided by Treas. Reg. § 1.150-1(b).

²¹ The *de minimis* amount is determined under rules similar to the rules of § 1273(a)(3) of the Code.

²² Under Treas. Reg. §§ 1.150-1(d) or 1.150-2(g).

²³ § 6431(c) of the Code, as added by the Stimulus Act.

Recovery Zone Economic Development Bonds (Direct Payment)

Certain local governments located in areas where employment has declined during 2008 are eligible to issue Recovery Zone Economic Development Bonds (Direct Payment) prior to January 1, 2011. These bonds are Build America Bonds (Direct Payment) with a deeper federal subsidy (a federal payment equal to 45 percent rather than 35 percent of the interest paid under the bond on the interest payment date). In Notice 2009-50, the Treasury Department allocated the \$10 billion of available volume cap for 2009 and 2010 for Recovery Zone Economic Development Bonds (Direct Payment) to the 50 States, the District of Columbia, and the American territories. Allocations were based on their relative employment declines. Washington has been allocated \$90,000,000, Oregon \$103,450,000, Alaska \$90,000,000, and Idaho \$90,000,000. Other states are allocated amounts, as shown on the attached schedule. Certain counties and large municipality are entitled to the state allocation as shown in the attached schedule.²⁴

A “large municipality” is a municipality with a population in excess of 100,000.²⁵ The attached schedule provides suballocations to counties and large municipalities in Washington, Oregon, Alaska and Idaho as well as to counties and large municipalities in other states. The portion that a county or large municipality receives is based on the ratio of its 2008 employment decline to the 2008 statewide employment decline. The locality must use the proceeds in a recovery zone, but the issuer itself can designate the zone and it appears that issuers have broad discretion in defining the zone. Large municipalities that receive an allocation may use the allocation themselves or waive the allocation and have the amount reallocated by the state. Alternatively, large municipalities may further suballocate the funding to other local governments.

Recovery Zone Economic Development Bonds (Direct Payment) are treated as “qualified bonds” like the Build America Bonds (Direct Payment)

²⁴ § 1400U-1(a)(3)(A) of the Code, as added by the Stimulus Act.

²⁵ § 1400U-1(a)(3)(B) of the Code, as added by the Stimulus Act.

described above. Issuers of such bonds receive a payment at a rate of 45 percent instead of the lower 35 percent.²⁶ In general, the same requirements and limitations described above apply, including the limitation that the bond proceeds be used only for capital expenditures. For this type of bond, the issuer must designate the bond as a Recovery Zone Economic Development Bond.²⁷

As the name suggests, the bond proceeds must be used to promote development or other economic activity in a “recovery zone.” Qualified purposes include the following: (1) capital expenditures paid or incurred with respect to property located in the zone; (2) expenditures for public infrastructure and construction of public facilities; and (3) expenditures for job training and educational programs.²⁸ Recovery zones include areas designated by the issuer, consistent with the allocations described below, as having significant poverty, unemployment, rate of home foreclosures, general distress or as being economically distressed by reason of the closure or realignment of a military installation pursuant to the Defense Base Closure and Realignment Act of 1990. A recovery zone also includes any area for which a designation as an empowerment zone²⁹ or renewal community³⁰ applies.

Procedural Framework for Claiming Interest Subsidy Payment

The procedures described below for claiming the interest subsidy payment for the Build America Bonds (Direct Payment) and the Recovery Zone Economic Development Bonds (Direct Payment) apply to the initial period of 2009. The IRS and Treasury Department intend to publish refined procedures for 2010 and after. It is anticipated that these direct payment procedures will be moved to an electronic platform.

²⁶ § 1400U-2 of the Code, as added by the Stimulus Act.

²⁷ § 1400U-2(b)(1) of the Code, as added by the Stimulus Act.

²⁸ § 1400U-2(c) of the Code, as added by the Stimulus Act.

²⁹ § 1391(b)(2) of the Code.

³⁰ § 1400E of the Code; § 1400U-1(b) of the Code, as added by the Stimulus Act.

Initial Interest Subsidy Payment Procedures

Notice 2009-26 describes the initial interest subsidy payment procedures. Issuers submit Form 8038-CP, *Return for Credit Payments to Issuers of Qualified Bonds*, to the IRS to request a payment of the credit. The form and instructions are currently available on the IRS' website. The IRS will be ready to accept Form 8038-CP for processing beginning May 1, 2009. Issuers can expect to receive the payment within 45 days of filing the form.³¹

For fixed rate bonds, the due date for filing Form 8038-CP is the 45th day before the applicable interest payment date with respect to the bonds. Form 8038-CP may not be filed earlier than the 90th day before the relevant interest payment date. The credit amount will be paid on a contemporaneous basis by the applicable interest payment date.

For variable rate bonds, the due date for filing Form 8038-CP is the 45th day after the last interest payment date within the quarterly period for which reimbursement is requested. The credit amount will be paid quarterly on a reimbursement basis for interest paid by the issuer during the quarter, including the interest payment date with respect to which the return requesting payment relates.

Elections to Issue Build America Bonds

Issuers of Build America Bonds are required to make the elections to issue the applicable bonds on their books and records on or before the issue date of such bonds.

Information Reporting for Build America Bonds (Tax Credit)

Issuers of Build America Bonds (Tax Credit) report the issuance of the bonds on Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*.

Issuers of Build America Bonds (Direct Payment) and Recovery Zone Economic Development Bonds (Direct Payment) report the issuance of the bonds on Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*, at least 30 days before the first Form 8038-CP is filed to request payment

with respect to an interest payment date for that issue. However, for bonds issued before July 1, 2009, Form 8038-G may be filed less than 30 days before the filing of the first Form 8038-CP, provided Form 8038-G is filed separately from and prior to the filing of Form 8038-CP. If the issue price is less than \$100,000, then the issuers should file Form 8038-G using the instructions found in Notice 2009-26 instead of filing Form 8038-GC, *Information Return for Small Tax-Exempt Governmental Bond Issues, Leases and Installment Sales*.

Finally, the Notice instructs issuers of these bonds to attach a schedule to Form 8038-G containing certain information. For fixed rate bonds, the schedule should be titled "Fixed Rate Bond – Debt Service Schedule" and include the following data: (1) each interest payment date, (2) total interest payable on such date, (3) total principal amount of bonds expected to be outstanding on such date, (4) credit payment expected to be requested from the IRS on such date, and (5) earliest date that bonds can be called. For variable rate bonds, the schedule should be titled "Variable Rate Bond – Debt Service Schedule" and include the following data: (1) each interest payment date, (2) total principal amount of bonds expected to be outstanding on such date, and (3) description of how interest on the bonds is computed.

Future Procedural Issues

The IRS and the Treasury Department are soliciting input on the direct payment procedures. In particular, public comment is sought for the following aspects: (1) using an electronic platform to make the payments and specific features necessary to make such a platform work; (2) frequency of payments of variable-rate bonds; (3) making direct payments solely to issuers instead of third parties designated by the issuers; and (4) imposing uniform interest payment dates to improve the program's efficiency.

Tax Treatment of an Investor in a Build America Bond (Tax Credit)

A holder of a Build America Bond (Tax Credit) benefits in two ways: the bondholder receives a payment of interest and the bondholder is entitled to claim a tax credit. Both the interest payment and

³¹ In accordance with § 6611(g) of the Code.

the tax credit are included in the gross income of the bondholder for purposes of federal income tax.³²

The tax credit is equal to 35 percent of the interest payable on the interest payment date of the bond.³³

The tax credit may offset the bondholder's federal income tax liability, provided that the bondholder holds the bond on one or more interest payment dates of the bond.³⁴

A bondholder may use the credit against federal income tax liability to the extent that the credit does not exceed the following:³⁵

1. the sum of the bondholder's regular tax liability³⁶ and alternative minimum tax liability,³⁷ less
2. the sum of the credits allowed under Sections 21 through 54E of the Code as calculated without reference to the following:
 - a. Sections 31 through 37 of the Code and
 - b. the Build America Bond credit.

Any unused portion of the allowable credit may be carried forward to succeeding tax years and added to the credit allowable for such taxable year.³⁸

For state income tax purposes, the interest and the credit are treated as exempt from federal income tax. In the future, states may opt to treat the interest and credit differently.

The Conference Committee Report for the Stimulus Act provides the following example illustrating the calculation of the bondholder's tax credit:

For example, if a taxable bond of comparable risk pays a \$1,000 coupon and sells at par, then if a State or local issuer issues an equal-sized bond with coupon of \$741.00, such a bond should also sell at par. The taxpayer who acquires the latter bond will receive an interest

payment of \$741 and may claim a credit of \$259 (35 percent of \$741). The credit and the interest payment are both included in the taxpayer's income. Thus, the taxpayer's taxable income from this instrument would be \$1,000. This is the same taxable income that the taxpayer would recognize from holding the comparable taxable bond. Consequently the issuer's bond should sell at the same price as would the taxable bond.

Rules for Certain Bondholders - REITs, RICs, S Corporations, and Partnerships

For purposes of the federal tax credit, bondholders of the Build America Bonds (Tax Credit) are subject to rules similar to those set forth in Sections 54A(g), (h) and (i) of the Code.³⁹ For example, if the bondholder of a Build America Bond (Tax Credit) is a real estate investment trust (REIT), the beneficiaries are entitled to the credit and the gross income included in income with respect to the credit is treated as a distribution to the beneficiaries.⁴⁰ Similarly, if the bondholder of a Build America Bond (Tax Credit) is an S corporation or a partnership, then the credit allocated to the shareholders or partners is treated as a distribution.⁴¹ Finally, rules similar to those pertaining to REITs will extend to regulated investment companies (RICs).⁴² RICs that hold Build America Bonds (Tax Credit) may elect to include the interest payment in income, increase the dividend paid deduction by the same amount, and pass the credit through proportionately to respective shareholders. Like REIT beneficiaries, any gross income included in income with respect to the credit is treated as distributed to those shareholders. Notice 2009-26 does not provide guidance with respect to these bondholders; however, it is anticipated that the Treasury Secretary will issue guidance explaining these procedures in more detail.⁴³

³² § 54AA(f)(1) of the Code, as added by the Stimulus Act.

³³ § 54AA(b) of the Code, as added by the Stimulus Act.

³⁴ § 54AA(a) of the Code, as added by the Stimulus Act.

³⁵ § 54AA(c) of the Code, as added by the Stimulus Act.

³⁶ As defined in § 26(b) of the Code.

³⁷ As imposed by § 55 of the Code.

³⁸ § 54AA(c)(2) of the Code, as added by the Stimulus Act.

³⁹ § 54AA(f)(2) of the Code, as added by the Stimulus Act.

⁴⁰ Similar to the rules under § 54A(h) of the Code.

⁴¹ Similar to the rules under § 54A(g) of the Code.

⁴² Under § 853A of the Code, as added by the Stimulus Act.

⁴³ § 54AA(h) of the Code, as added by the Stimulus Act.

Recovery Zone Facility Bonds

Recovery Zone Facility Bonds are a new category of tax-exempt private activity bonds created by the Stimulus Act.⁴⁴ Like other tax-exempt private activity bonds, these bonds may be issued on a tax-exempt basis notwithstanding that the bond-financed property will be used by private business, if other requirements are met. This new category of bonds should permit certain projects that would have otherwise have been financed on a taxable basis to be financed on a tax-exempt basis. These bonds may be issued to finance purchases of certain types of depreciable property that is used in recovery zones.⁴⁵ A recovery zone is defined in the same way for Recovery Zone Facility Bonds as it is for Recovery Zone Economic Development Bonds.

Eligible depreciable property must meet the following requirements: (i) the property was constructed, reconstructed, renovated or acquired by purchase after it was deemed in a recovery zone; (ii) the property was first used in a recovery zone by a taxpayer, and (iii) substantially all of the property is in the recovery zone and is being used as a qualified business.⁴⁶ Eligible depreciable property may be privately owned and operated. A qualified business is any trade or business except residential rental property or certain businesses such as golf courses, massage parlors, hot tub or suntan facilities, gambling facilities or liquor stores.⁴⁷

Similar to Recovery Zone Economic Development Bonds, Recovery Zone Facility Bonds are subject to volume cap limitations. In Notice 2009-50, the Treasury Department allocated the \$15 billion of available volume cap for 2009 and 2010 for Recovery Zone Facility Bonds to the 50 States, the District of Columbia, and the American territories. Allocations were made using the same methodology outlined above. Washington has been allocated \$135,000,000, Oregon \$155,175,000, Alaska \$135,000,000 and Idaho \$135,000,000. See the attached schedule for suballocations to certain counties and large municipalities in Washington,

Oregon, Alaska and Idaho, and other states. Large municipalities that receive an allocation may use the allocation themselves or waive the allocation and have the amount reallocated by the state. Alternatively, large municipalities may further suballocate the funding to other local governments.

Summary

Build America Bonds and Recovery Zone Bonds are new alternatives for state and local government issuers of tax-exempt bonds. Issuers of Build America Bonds that can access the taxable bond market may be able to take advantage of either a tax credit to bondholders or a direct federal subsidy payment, subject to the requirements detailed above. Recovery Zone Bonds offer additional tax incentives for issuers of municipal bonds intended to promote job creation and stimulate economic recovery in distressed areas. Call your bond counsel or financial advisor to consider whether Build America Bonds are a good fit for financing your capital projects and whether Recovery Zone Bonds can help spur economic activity in your area.

⁴⁴ § 1400U-3 of the Code, as added by the Stimulus Act.

⁴⁵ Depreciable property is determined using the guidelines set forth in § 168 or § 179 of the Code.

⁴⁶ § 1400U-3(c)(1) of the Code, as added by the Stimulus Act.

⁴⁷ § 1400U-3(c)(2) of the Code, as added by the Stimulus Act.

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