

## Qualified Opportunity Funds: Investment and Structuring Considerations

***Recent guidance from Treasury clarifies fundamental aspects regarding the investment of deferred capital gains in QOFs.***

### Key Points:

- Investors in qualified opportunity funds may derive significant tax benefits in the form of gain deferral and tax-free appreciation under rules enacted as part of tax reform legislation passed at the end of 2017.
- Recent proposed regulations have provided clarifications that may help spur the formation of qualified opportunity funds, but fund sponsors and investors will continue to face uncertain tax outcomes pending further guidance.

### Overview

Tax reform legislation enacted last year created significant new tax benefits for investors in qualified opportunity funds (QOFs). The purpose of the law is to spur economic development and job creation in distressed communities. A QOF is an investment vehicle that invests in real estate or other businesses located in certain census tracts that have been designated as qualified opportunity zones (QOZs). Treasury has certified nearly 9,000 census tracts as QOZs, including tracts in every state, Washington D.C., Puerto Rico, and the US Virgin Islands. A list and map of all QOZs can be found [on Treasury's CDFI Fund website](#).

Treasury issued proposed regulations and additional guidance related to QOFs on October 19, 2018. This *Client Alert* summarizes the key features of the QOF rules, and addresses some practical implications for structuring and investing in QOFs in light of the recent guidance. Taxpayers may rely on the proposed regulations until Treasury issues final regulations.

Notably, while the recent guidance addressed some critical questions relating to QOFs that should facilitate the formation of (and investment in) QOFs, significant questions regarding the tax treatment of QOFs remain unanswered. Treasury has indicated that additional guidance on QOFs may be provided this year.

## Key Tax Benefits for Investors in QOFs

Summary of QOF Investor Tax Benefits		
Eligibility for QOF Tax Benefits	Deferral / Exclusion of Capital Gain	No Tax on Future Appreciation in QOF Interest Held for 10 Years
<p>Investor recognizes a capital gain.</p> <p>Within 180 days, Investor invests an amount equal to the amount of gain Investor desires to be deferred in a QOF.</p>	<p>Investor is permitted to defer recognition of the capital gain for US federal income tax purposes until the earlier of December 31, 2026 or upon disposition of its interest in the QOF.</p> <p>If Investor holds its QOF interest for five years, Investor will not be subject to US federal income tax on 10% of the deferred gain.</p> <p>If Investor holds its QOF interest for seven years, Investor will not be subject to US federal income tax on an additional 5% (for a total exclusion of 15%) of the deferred gain.</p>	<p>If Investor holds its QOF interest for at least 10 years, Investor generally will not be subject to US federal income tax on any additional gain recognized by Investor (in excess of the deferred gain recognized in 2026) on the disposition of its QOF interest, provided the disposition occurs prior to 2048.</p>

### Only Capital Gains Eligible for Deferral by Investing in a QOF

Only “capital gains” recognized prior to 2027 are eligible for deferral if timely invested in a QOF. There is no limit on the amount of capital gains that a taxpayer may defer by investing in a QOF.

- Eligible gains include both short-term capital gains and long-term capital gains, as well as Section 1231 gains treated as capital gains (generally, gains from the sale of depreciable property in excess of prior depreciation deductions).
- Certain capital gains are not eligible for deferral, including if either:
  - Capital gains are recognized on a sale of property to a related party (generally 20% common ownership or certain family relationships).
  - The sold property is subject to offsetting positions that significantly diminish the investor’s risk of loss.

### Types of Investors Eligible for the QOF Tax Benefits

Any investor that recognizes an eligible capital gain for US federal income tax purposes may take advantage of the tax benefits of investing in a QOF, including individuals, corporations (including real estate investment trusts [REITs] and regulated investment companies), and partnerships. The discussion below addresses special rules applicable to partnerships.

### Example of QOF Tax Benefit

Facts: Investor is an individual calendar year taxpayer who recognizes US\$100 of long-term capital gain on July 5, 2018. On December 31, 2018, Investor invests US\$100 in a QOF. Investor makes a timely election on her 2018 tax return to treat the investment as an interest in a QOF.

Upon making the investment, Investor defers taxation of her US\$100 capital gain. Initially, Investor's tax basis in her QOF investment will be US\$0.

At the end of 2023, when Investor has held her interest in the QOF for at least five years, Investor is permitted to increase her tax basis in her QOF investment by an amount equal to 10% of the deferred gain, thereby permanently excluding US\$10 of the deferred US\$100 capital gain from taxation.

At the end of 2025, when Investor has held her interest in the QOF for at least seven years, Investor is permitted to increase her tax basis in her QOF investment by an amount equal to 5% of the deferred gain, thereby excluding an additional US\$5 of the deferred US\$100 capital gain (for a total of US\$15) from taxation.

At the end of the deferral period on December 31, 2026, Investor recognizes gain equal to the excess of (i) the lesser of the original deferred gain amount or the fair market value of the QOF interest, over (ii) Investor's tax basis in her interest. The recognized gain will be treated as having the same character as the original deferred gain (*i.e.*, long-term capital gain in this example).

For example, assume Investor's QOF interest is worth US\$150 on December 31, 2026, when Investor's basis in the interest is still US\$15. Investor will recognize US\$85 of long-term capital gain (the excess of the US\$100 deferred gain over her US\$15 tax basis). Alternatively, if the QOF interest is worth US\$90 on December 31, 2026, Investor would only recognize US\$75 of long-term capital gain because the fair market value of the QOF interest is lower than the US\$100 deferred gain.

Sale of QOF interest in 2030: Investor sells the QOF interest for US\$200 in 2030, when Investor's basis in her interest is US\$100. Because Investor has held the QOF interest for longer than 10 years, Investor can elect to step up her tax basis in the QOF interest to its fair market value on the date of sale, resulting in no gain recognition on the sale.

### Comparison of QOF Tax Benefits in the Example

With QOF Tax Benefits	Without QOF Tax Benefits
Tax on US\$85 of deferred gain in 2026 at 20%: US\$17	Tax on US\$100 of gain in 2018 at 20%: US\$20
Tax on US\$100 of future sale gain in 2030: US\$0	Tax on US\$100 of future sale gain in 2030 at 20%: US\$20
Total tax (not including value of deferral): US\$17	Total tax: US\$40
Equivalent to US\$11.5 in 2018 (assuming 5% discount rate)	Equivalent to US\$31.1 in 2018 (assuming 5% discount rate)

### What Is the Timing and Process for Deferring Gain Through a QOF Investment?

Investors generally must invest in a QOF within 180 days of recognizing the eligible capital gain. Investors make the deferral election by filing a form with their US federal income tax return for the year in which the deferred gain would otherwise have been recognized.

- The recognition of capital gain must occur *before* making the QOF investment. An investment in a QOF without prior recognition of a capital gain eligible to be deferred (or an investment to the extent it exceeds the amount of capital gain to be deferred) will *not* qualify for any of the special QOF tax benefits, including the exclusion of gain on future appreciation.
- An “investment” in a QOF generally means the acquisition of an equity interest in a QOF for cash or property. A loan to a QOF or a contractual commitment to contribute capital in the future will not qualify as an investment. Although the proposed regulations are not explicit on this point, it seems unlikely that carried interest in a QOF that is received by a QOF manager in exchange for services would qualify as an investment that is eligible for the QOF tax benefits.
- The cash invested in a QOF by an investor does not have to be “traceable” to any proceeds giving rise to the deferred gain. For example, an investor that recognizes a “phantom” capital gain through a partnership may defer the gain by contributing the investor’s own funds (including funds obtained through borrowing) equal to the amount of the gain to a QOF within 180 days.
- All or any portion of a capital gain may be deferred through an investment in a QOF. An item of capital gain may also support investments in multiple QOFs or multiple investments in a single QOF (up to the total amount of gain) as long as the investments are made within 180 days of recognizing the eligible capital gain.

### What Special Timing Rules Apply for Partnerships?

A partnership that recognizes an eligible capital gain may defer recognition of the gain for US federal income tax purposes by investing such gain in a QOF within 180 days of recognition. If a partnership does not elect to defer the gain by investing in a QOF, the partners in the partnership may make their own deferral elections with respect to their allocable shares of the capital gain by investing in a QOF outside the partnership. In such a case, for the purposes of the 180-day rule, the partner may treat its allocable share of the capital gain as recognized under one of two timing rules. Under the general rule, the partner may treat the capital gain as recognized on the last day of the *partnership’s* taxable year in which the capital gain is recognized. Thus, if a calendar year partnership recognizes a capital gain on January 1, 2018, and does not elect to defer the gain by investing in a QOF, each partner would have until June 30, 2019 to elect to defer their distributive share of the capital gain by investing in a QOF. Alternatively, a partner may elect to treat the capital gain as recognized on the date the partnership recognizes the gain, which could facilitate an earlier investment in a QOF.

### Example of QOF Tax Benefit for Investors That Are Partners in a Partnership

Facts: Investor (an individual calendar year taxpayer) is a partner in a real estate fund organized as a partnership (a calendar year partnership). On March 4, 2018, the fund sells a building and recognizes US\$1,000 of capital gain. Investor's distributive share of the capital gain is US\$100.

#### Eligibility for deferral:

Alternative 1 – The real estate fund can elect to defer the US\$1,000 gain by investing US\$1,000 in a QOF by August 31, 2018 (within 180 days from when the partnership recognized the eligible gain).

Alternative 2 – Upon selling the building, the real estate fund notifies its partners that the real estate fund does not intend to elect to defer the gain by investing in a QOF. Investor's US\$100 distributive share of the real estate fund's capital gain is eligible capital gain in Investor's hands, and Investor may elect to defer his US\$100 capital gain by investing in a QOF within 180 days of December 31, 2018 (the last day of the real estate fund's taxable year).

Alternative 3 – Upon receiving notice of the real estate fund's intention not to make a QOF investment, Investor may elect to defer his US\$100 distributive share of the gain by investing in a QOF by August 31, 2018 (within 180 days from when the partnership recognized the eligible gain).

\* Investors that are partners in a fund or other partnership may require additional transparency and reporting requirements from the partnership. These additional requirements are necessary to determine whether the partnership will elect to defer eligible capital gains by investing in a QOF, as well as the gross amount of capital gains allocated to a partner. A partnership may have difficulty accurately determining each partner's share of an eligible capital gain prior to the end of its taxable year if the partnership's allocations are contingent on future performance or other factors.

## Other Tax Consequences of Investing in a QOF

### Operating Income

Operating income generated by a QOF (e.g., rental income from real estate) generally will be taxed according to ordinary US tax rules based on the QOF's structure. For example, rental income derived by a QOF structured as a partnership will be reported to the QOF investors on their Schedule K-1s and includible in their taxable income.

### Investor's Basis in QOF Interest

QOF investors are generally required to take a zero basis in their QOF interest for which the deferral election is in effect. An investor's basis generally will be increased by the amount of gain recognized at the end of the deferral period in 2026, in addition to any other basis increase under ordinary US tax rules.

The zero basis could reduce the ability of an investor in a partnership QOF to utilize net losses generated by the QOF during the deferral period because an investor in a partnership generally may not deduct losses in excess of its basis in the partnership interest. The zero basis could also increase the likelihood that an investor may recognize gains from QOF distributions in excess of its basis, including return of capital distributions from a QOF organized as a corporation or REIT.

## Sale of Assets by QOF

Currently, under the statute, the exclusion for future gain from the sale of QOF interests held for at least 10 years likely applies only to the sale *by the investor* of its interest in the QOF. The tax consequences of a sale of *assets* by a QOF is not entirely clear. Under regular US income tax rules, those gains may give rise to taxable income for the QOF or the QOF investors (e.g., as a Schedule K-1 gain item in the case of a partnership QOF, or as a dividend in the case of a QOF taxed as a corporation, including a REIT). Treasury is required to issue regulations to ensure that a QOF has adequate time to reinvest proceeds attributable to the disposition of interests in QOZ Property (defined below). The recent guidance acknowledges this mandate, but specific rules remain to be provided. Whether this guidance may also permit QOFs and/or QOF investors to treat gain reinvested by a QOF as a non-recognition transaction remains uncertain. If not, under existing guidance, QOF investors in a QOF structured as a partnership or a REIT may still be able to roll over their share of any eligible capital gain from the sale of a QOF asset prior to 2027, by making a new deferral election with respect to the gain.

### Example of Possible Rollover Under Proposed Regulations

**Facts:** Investor (an individual calendar year taxpayer) holds an interest in a QOF organized as a partnership (a calendar year partnership), which owns real property. On May 1, 2019, the QOF sells the real property for US\$1,000 and recognizes US\$100 of capital gain, of which US\$10 is allocable to Investor. The QOF cannot elect to defer its US\$100 capital gain by investing in another QOF because a QOF cannot own an interest in another QOF.

**Eligibility for deferral:** The QOF's capital gain is eligible capital gain in Investor's hands and Investor can elect to defer its US\$10 distributive share of the gain by making a QOF investment within 180 days of December 31, 2020 (the last day of the QOF's taxable year). Presumably, this investment could take the form of an additional investment in the same QOF, in which case the subsequent investment will be treated as a separate interest in the QOF (distinct from Investor's original QOF investment). Investor must meet the holding period requirements for this separate interest, measured from the date of Investor's subsequent investment, to qualify for the QOF tax benefits with respect to that interest.

## Sale of Interest in a QOF

An eligible investor that holds its QOF interest for at least 10 years generally will not recognize any gain on the disposition of that interest.

- Under the statute, this result is achieved by providing that the investor's basis in its QOF interest will equal its fair market value on the date of disposition. Because of complex tax rules addressing basis and leverage in partnerships, these rules may not — as a technical matter — provide a complete exclusion for gain in the case of an investor in a QOF structured as a partnership that leverages its investments. Hopefully, future guidance will clarify that the complete exclusion should also apply to the sale of a QOF partnership interest, which would appear to be consistent with the intent of the legislation.
- **Rolling over gain to a new QOF:** If an investor sells *all* of its interest in a QOF before 10 years, the gain will not be excluded from income as a general matter. However, the investor may elect to defer the gain from the sale of the QOF interest by re-investing the gain in another QOF within 180 days of the sale of the first QOF. The investor's interest in the new QOF should also be eligible for the gain exclusion on future appreciation if the new QOF interest is held for 10 years and disposed of prior to 2048.

### **“Mixed” Investments in a QOF**

An investor is not limited in the amount it is permitted to invest in a QOF. However, if the amount invested exceeds the amount of the investor's eligible capital gains, the investor generally will be required to treat its investment in the QOF as two separate interests corresponding to the portion of the investment that qualifies for the QOF tax benefits and the portion that does not.

### **Considerations for Structuring a QOF**

For investors to achieve the tax benefits discussed above, investors must acquire equity in an entity that qualifies as a QOF. In general, a QOF is an investment vehicle that holds 90% of its assets in the form of “qualified opportunity zone property” (QOZ Property), which includes: (1) qualified opportunity zone business property (QOZ Business Property), (2) qualified opportunity zone stock (QOZ Stock) and (3) qualified zone partnership interests (QOZ Partnership Interests). Different rules may apply to different types of QOZ Property, as discussed below.

#### **Choice of Entity**

A QOF may be organized as any entity treated as a partnership or corporation for US federal income tax purposes.

- A QOF may be organized as an LLC treated as a partnership for tax purposes.
- A QOF could elect to be taxed as a REIT, if otherwise eligible.
- A single member LLC treated as a disregarded entity for tax purposes cannot be a QOF.

#### **Type of Investor Interests in a QOF**

To qualify for the QOF tax benefits, investors must acquire equity in a QOF.

- The proposed regulations clarify that preferred equity interests, as well as partnership interests that provide for special allocations, may qualify.
- Acquiring debt of a QOF will not, by itself, allow an investor to claim the QOF tax benefits.

#### **Qualifying as a QOF**

##### **90% of Assets in QOZ Property**

90% of a QOF's assets must consist of QOZ Property, which includes: (i) QOZ Business Property, (ii) QOZ Stock and (iii) QOZ Partnership Interests. QOZ Property does *not* include an interest in another QOF.

### Summary of QOZ Property Requirements

QOZ Business Property	QOZ Stock	QOZ Partnership Interest
<ul style="list-style-type: none"> <li>Tangible property used in a trade or business of the QOF</li> <li>Acquired by the QOF for cash or property in a taxable transaction from an unrelated party</li> <li><u>Either</u> original use of the property commenced by the QOF <u>or</u> the QOF “substantially improves” the property (by doubling its basis within a 30-month period)</li> <li>“Substantially all”<sup>*</sup> of the property is used within a QOZ for “substantially all”<sup>*</sup> of the QOF’s holding period for the property</li> </ul>	<ul style="list-style-type: none"> <li>Stock of a domestic corporation</li> <li>Acquired by the QOF for cash in an original issuance</li> <li>Corporation is a <u>QOZ Business</u> (see below) at time of acquisition and remains so for “substantially all”<sup>*</sup> of the QOF’s holding period for the stock</li> </ul>	<ul style="list-style-type: none"> <li>Equity in a domestic partnership</li> <li>Acquired by the QOF for cash in an original issuance</li> <li>Partnership is a <u>QOZ Business</u> (see below) at time of acquisition and remains so for “substantially all”<sup>*</sup> of the QOF’s holding period for the partnership interest</li> </ul>

\* While recent guidance clarified how to determine whether “substantially all” of a QOZ Business’ tangible assets are comprised of QOZ Business Property, other uses of “substantially all” have not yet been clarified and remain a significant source of uncertainty regarding the application of the QOF rules. Treasury has requested comments regarding potential guidance on those terms.

### QOZ Business Requirements (to qualify as QOZ Stock or QOZ Partnership Interest)

- “Substantially all” (*70% under the proposed regulations*) of the tangible property of the business is QOZ Business Property.
- At least 50% of the entity’s gross income is derived from the active conduct of the business.
- A “substantial portion” of the entity’s intangible property is used in the active conduct of the business.
- Less than 5% of the entity’s average adjusted basis in its property is attributable to certain financial assets, including debt, stock, partnership interests, and certain financial instruments, but *not including* (i) reasonable amounts of working capital held in cash or cash equivalents and (ii) certain short-term debt instruments (*i.e.*, terms of 18 months or less).

**Special rule for working capital:** The proposed regulations provide that cash and cash equivalents will generally not count towards the 5% financial asset limit, if the entity has a written schedule documenting how the cash will be deployed to acquire eligible assets in the QOZ and the cash is deployed in a manner “substantially consistent” with the schedule.

This rule is only available for QOZ Businesses held as QOZ Stock or QOZ Partnership Interests.

- Certain businesses are excluded, such as golf courses, liquor stores, massage parlors, country clubs, tanning salons, and gambling establishments.



### **How Does a Fund Elect Its Status as a QOF?**

A qualified investment vehicle may self-certify its status as a QOF by filing IRS Form 8996 with the entity's tax return. If an entity that has elected to be treated as a QOF fails to meet the criteria for QOF status, penalties may apply, although the specific consequences of failing to meet such criteria are unclear in some respects.

### **What Are the Testing Dates for Determining Compliance With the 90% Test?**

Generally this is an annual test based on the QOF's average asset composition on the last day of the sixth month of its taxable year and the last day of its taxable year. For its first year, a QOF may designate the month in which it will qualify as a QOF, and the first testing date will be six months from that date (or the end of the taxable year if the QOF's first taxable year is six months or less).

### **How Is the Value of the QOZ Property Determined for Purposes of the 90% Test?**

Under the recent guidance, the QOF generally will use the valuations reflected in an "applicable financial statement," which generally means an audited GAAP financial statement. This rule could pose challenges for QOF's and QOZ Businesses holding QOZ Property that reflects depreciation under GAAP. If the QOF does not have an applicable financial statement, the QOF's assets will be valued equal to the QOF's original cost basis. Treasury has requested comments on this rule.

### **How Is Land Treated for Purposes of the 90% Test?**

Recent guidance generally clarified that land will not fail to be treated as QOZ Business Property merely because its original use does not commence with the QOF. The guidance also clarified that when a QOF purchases land with an existing building, only the cost of the building is relevant for determining whether the asset meets the substantial improvement test for QOZ Business Property (*i.e.*, the basis of the building must be doubled). Although the answer is not entirely clear, an example in the proposed regulations suggests that land may qualify as QOZ Business Property if a QOF purchases undeveloped land and constructs a new building on the land.

The practical limits of the rule regarding the treatment of land have not been clarified. For example, it might be possible to take the position that a QOF can acquire valuable land in a QOZ and construct a building with a value that is very low relative to the value of the land. Whether this fact pattern was intended to be eligible for the QOF tax benefits is unclear.

## **Some Practical Implications in Light of Recent Guidance**

### **QOFs May Tend to Favor Real Estate**

By virtue of their immobility, real estate projects may in many cases be easier to qualify as good QOZ Businesses. While QOFs targeting non-real estate businesses are certainly possible, those strategies may be more limited until future guidance provides greater clarity on when the various requirements of a QOZ Business (which generally look to assets and activities *within* a QOZ) would be satisfied in a non-real estate context.

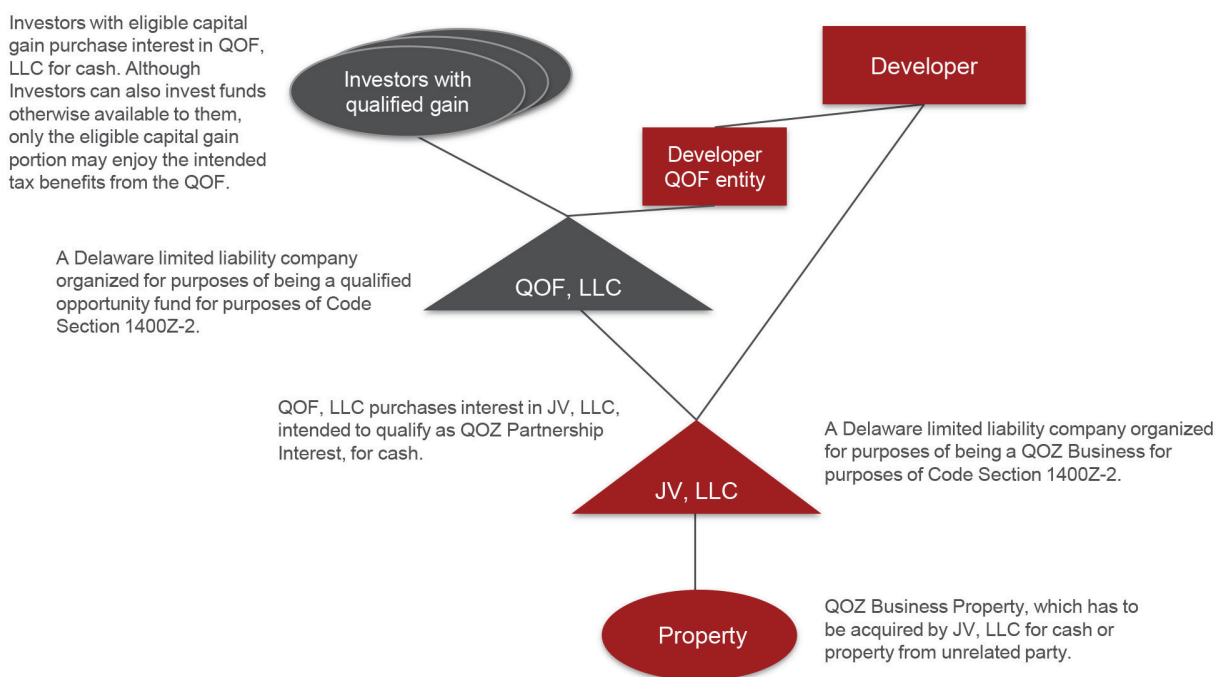
### **Single Versus Multi-Asset / Blind Pool Strategies**

Pending further guidance, single-asset QOFs may be easier to structure and operate. For QOFs that need to call capital for development, the current working capital safe harbor appears to require a written plan detailing the deployment of the capital. Moreover, the requirement that investors acquire their QOF interests within 180 days of recognizing gain could lead to a preference by investors for greater certainty regarding the timing of capital calls as well as a limited number of capital calls. Although the use of

leverage and other techniques by funds with multiple assets or blind pool strategies may mitigate these concerns, single-asset strategies could be easier to manage. In addition, because the gain exclusion for QOF interests held for at least 10 years currently applies to a sale by an investor of its interest in a QOF (as opposed to a sale of QOZ assets by the QOF), structuring a potential exit as a sale of a QOZ interest, without triggering additional asset-level gain during the holding period, may be important to achieving the full tax benefits offered by the QOF rules. Unless future guidance provides more flexibility, these considerations regarding timing and structuring of exit opportunities may also be more easily addressed in a single-asset QOF.

### More Rigid Fund Structures for QOFs

Unlike traditional investment fund structures, various aspects of the QOF rules may limit flexibility regarding how investors structure their investment into a QOF and how QOFs hold their investments. For example, a QOF must hold directly (or through wholly owned disregarded entities) either QOZ Business Property, QOZ Stock, or a QOZ Partnership Interest. A QOF may not own an interest in another QOF. Similarly, the issuer of the QOZ Stock or QOZ Partnership Interest held by a QOF must directly (or through disregarded entities) own QOZ Business Property. Additional tiers of subsidiary partnerships are apparently not permitted. Moreover, it appears that investors deferring gain generally must invest directly in a QOF. Absent further guidance, it is not clear that investors could pool their capital in an investment vehicle, such as a partnership, to invest in a QOF, unless that pooling vehicle itself recognized the capital gain that is being deferred by investment into the QOF. The chart below shows an example of the structure of a QOF that closely tracks the current rules and regulations.



## Key Takeaways

The recent guidance provides helpful direction and clarifies fundamental aspects regarding the investment of deferred capital gains in QOFs. Future guidance is expected to address important remaining questions regarding the qualification and operation of a QOF, including:

- How QOFs may reinvest gain from the sale of QOZ Property and the resulting tax consequences to QOF investors
- Questions relating to the specific qualifications for QOZ Property, including the meaning of “substantially all” in other contexts where the term appears
- How the QOF rules and existing partnership tax rules interact in a variety of contexts

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