



## Equity-Based Compensation Awards



*Prior to 1970, executives received wage income similar to other employees of a company.*

However, a change in paradigm indicated that aligning top executives' interests with those of the company and its shareholders could be a more efficient way to retain top talent and increase the profitability of the company. Thus began the era of equity-based compensation.

Executives today can be offered various types of stock-based compensation that are either qualified or nonqualified.

The difference impacts the timing of the realization of the compensation and therefore, the associated tax liability. Four characteristics are important in determining realization and cash receipt:

1. **Grant Date** - The date the options/share awards are granted.
2. **Vesting Date** - The date the award recipient can actually exercise their right to receive the security.
3. **Date of Exercise** - Date that the right is actually exercised and the holding period for long term capital gain treatment begins.
4. **Date of Sale** - The date the shares are sold and the type of gain (short or long term) is determined.

## Qualified Plans

Securities received via a qualified plan are granted special tax treatment as prescribed by the tax code. To be considered qualified, equity awards can only be granted to employees but are limited in the amount that can be granted each year. They are not taxable at either the time of grant or exercise and if held a year are subject to the more beneficial capital gain rate.

Qualified plans include:

- Incentive Stock Options ("ISOs") and
- Employee Stock Purchase Plans ("ESPPs")

To qualify for the beneficial tax treatment of either of these two plans, the recipient must not sell the stock within two years of grant or within one year of exercise of the option. The benefit of adhering to this holding period is to receive capital instead of ordinary treatment on the income.

ISOs can be exercised in the future at a price equal to the fair market value ("FMV") as of the date of grant. The difference between the FMV on the date of exercise and the exercise price ("the spread") is not included in regular income on the date of the exercise. However, it is treated as a tax preference item that increases income for alternative minimum tax ("AMT") purposes even though no money is actually received. Typically, this will trigger the AMT tax. Of course, an executive could exercise and sell sufficient amounts of the stock to cover the AMT tax, but the income would then be ordinary instead of capital. Awards are limited to \$100,000 per year.

In general, ESPPs allow an employer to grant its employees the right to purchase stock in most cases at a discount on the then-current FMV and sell it at some time in the future, with any increase being treated as a capital gain. Since contributions to these plans are completed through payroll deductions, it is a simple way for employees to purchase equity in their employer's company. However, since this form of compensation is only allowed up to \$25,000 per year, it would not be a large component of the executive's compensation package.

## Nonqualified Plans

Nonqualified plans are those that do not receive beneficial tax treatment. These plans include Nonqualified Stock Options, Restricted Stock, Restricted Stock Units and Stock Appreciation Rights.

**Nonqualified Stock Options ("NSOs")**, give the executive the right to purchase the company's stock at a fixed price within a fixed period of time subject to a vesting schedule. There is no limit on the dollar value of the NSOs that can be granted to an executive. In general, there is no income realization on the date of grant. Ordinary income is realized for "the spread" on the date of exercise.

**Restricted Stock (“RS”)** is non-transferable and must be traded in compliance with SEC Rule 144. Vesting periods generally range from three to five years.

There is no cost associated with these shares as with ISOs and NSOs. When the shares vest, the executive recognizes wage income equal to the FMV of the shares on that date. Since vesting triggers taxable income even though the executive receives no cash, they can either remit the required tax from other funds or the company can withhold sufficient shares to cover the tax. Most executives opt for the latter.

An RS recipient can make a Section 83(b) election to include the FMV of the restricted shares in income in the year granted and pay the associated tax. This would effectively set the holding date for capital gain purposes. If the recipient sells the shares for a higher value after a year, they will receive long term capital gain treatment for the difference between the FMV on the date of the election and the value upon sale. However, because the shares are still subject to a substantial risk of forfeiture (i.e. there is no guarantee the award recipient will actually receive the shares) making the election should be considered carefully with an eye on the forfeiture period, the employment requirements and the executive’s belief of the future value of the shares.

**Restricted Stock Units (“RSUs”)** are an unsecured promise from the company to pay the executive a set number of shares at some point in the future so long as the executive meets certain vesting criteria.

Unlike holders of RS, holders of RSUs do not have voting rights. Also, an 83(b) election is not available. Thus, the executive will include as wage income the FMV of the stock on the date the units vest. Similar to RS, the executive can hold onto the stock after it vests and any gain upon sale will be capital. However, the executive is required to pay the appropriate withholding tax in similar fashion as Restricted Stock.

**Stock Appreciation Rights (“SARs”)** are treated like a bonus equal to the amount of the increase in the share price during a specified period of time. This form of compensation is much simpler for the executive because the executive is not required to pay for the underlying stock, but merely receives the value of the increase as additional wage compensation that can be paid in stock or cash.

<b>Form of Compensation</b>	<b>Type of Income</b>	<b>When Recognized</b>	<b>Limitations/Tips</b>
<i>Incentive Stock Options</i>	Capital Gain/ Ordinary for AMT purposes	Sale (Regular Tax)/Exercise Date (AMT)	Two years from grant, one year after exercise; limited to \$100,000/year
<i>Employee Stock Purchase Plan</i>	Capital Gain	Sale	Two years from grant, one year after exercise; \$25,000/year
<i>Nonqualified Stock Options</i>	Wage (then) Capital Gain	Exercise (then) Sale	N/A
<i>Restricted Stock</i>	Wage or Capital Gain (then) Capital Gain	Vesting (then) Sale	Sec. 83(b) Election
<i>Restricted Stock Units</i>	Wage (then) Capital Gain	Vesting (then) Sale	No voting rights; no section 83(b) election
<i>Stock Appreciation Rights</i>	Wage	Vesting	N/A

## Conclusion

Receipt of equity-based compensation awards can incentivize executives and assist a company in retaining its best talent. However, each type of award must be considered carefully when negotiating a compensation package. Consideration must be given to the vesting period, AMT effects and the character of the income once received. Also, there are complex state sourcing rules that can cause unexpected tax consequences to executives living in one state and working in another or who move to a different state between time of grant, vest and exercise. A trusted tax professional can help you understand the tax consequences of various forms of executive compensation and guide you through the maze of exceptions and requirements of these plans.



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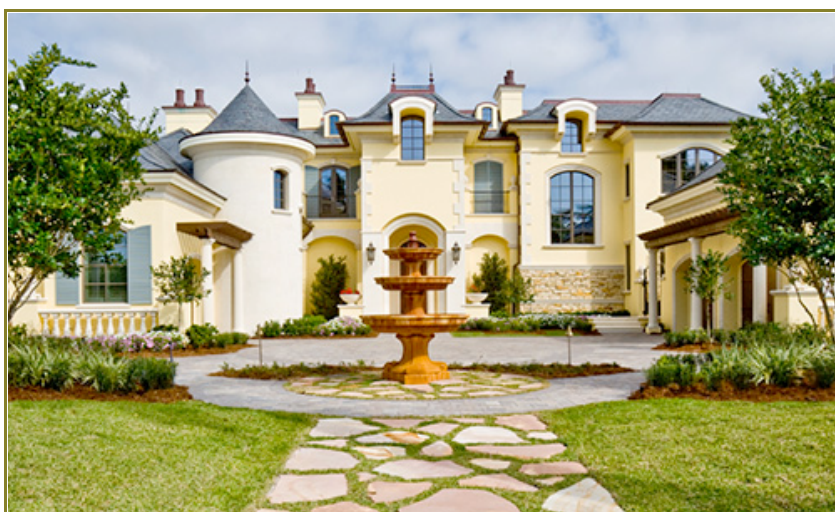
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## Importance of Substantiating Value for Charitable Contribution, Estate Tax, and Gift Tax Positions



*In July 2012, we published an article stressing the importance of properly substantiating a charitable contribution with a qualified appraisal prepared by a qualified appraiser.*

As detailed in [that article](#), the tax law is complex and when the taxpayers in the highlighted cases argued that their compliance was sufficient, IRS and the Tax Court (the “Court”) disagreed and consequently, disallowed the deductions. As such, the Court continues to challenge taxpayers for their charitable contribution, estate tax, and gift tax positions.

For charitable contribution purposes, a qualified appraisal must include the following: certain information about the contributed property; the terms of any agreement or understanding that relates to the use, sale, or disposition of

the property; the date of the contribution; certain information and declarations related to the appraiser; a statement indicating the appraisal was prepared for income tax purposes; and the method and basis used for the valuation. The report must be made effective no more than 60 days before the contribution date and must also be prepared by a qualified appraiser, whose qualifications should be included in the qualified appraisal report.

The following highlights two recent cases that reiterate the importance of obtaining a qualified appraisal.

*Ben Alli & Shaki Alli v. Commissioner*

In 2008, BSA Corp., a Michigan Subchapter S corporation owned by two Alli siblings, contributed a 34-unit apartment building to a qualified Section 501(c)(3) organization and claimed a \$499,000 charitable deduction. The Court disallowed the charitable deduction, stating that it did not comply with the qualified appraisal and qualified appraiser requirements of Internal Revenue Code (“IRC”) Section 170.

In support of their deduction, the Allis submitted two appraisals. The first appraisal was completed more than ten years prior to the date of the donation, and only presented a conclusion as to the income-generating potential of the property rather than determining a fair market value. The Court noted that the first appraisal failed to include a number of the requirements, including the “date or expected date” of the contribution.

The second appraisal, also not compliant, was completed five months prior to the date of donation. That report concluded as to the hypothetical value of the property after renovation and remodeling and did not appraise the property in its current condition, nor did it provide a description of the current condition of the property. Further, the report excluded several other key requirements of a qualified appraisal including the fact that the standard used by the appraiser was not “fair market value.”

Neither appraiser included his qualifications, tax identification number, the date or expected date of the contribution, the income tax purpose for the appraisal, or provided an appraisal with a valuation date within 60 days prior to the contribution date. In the end, the Court denied the deduction.

*Estate of Helen P. Richmond, et al. v. Commissioner*

Ms. Richmond held a 23.44% interest in a 76-year-old family-owned investment holding C corporation at the time of her death. The securities held by the entity were worth \$52,159,430, with Ms. Richmond’s indirect interest worth \$12,226,170. Assuming a sale at the date of death, the securities would be subject to a built-in gain (“BIG”) tax of \$18,113,083. The entity’s investment philosophy had been to hold the investments for future gains.

The Estate engaged an accounting firm to perform the valuation. The expert utilized a single approach, the capitalized dividend approach, in arriving at a value of \$3,149,767. Although this expert was not a certified valuation expert and provided the Estate with an unsigned draft report documenting his conclusions, the Estate used the draft report’s value conclusion for its estate tax filing.

At trial, the Estate employed a different expert who also primarily relied upon the capitalized dividend approach and arrived at a higher value of \$5,046,500. As a reasonableness check, the trial expert utilized a net asset value (“NAV”) approach, and applied an 8% discount for lack of control and a 35.6% discount for lack of marketability. The Estate’s trial expert incorporated a dollar-for-dollar reduction for the unrealized BIG tax in the NAV approach.

The IRS expert utilized an NAV approach, incorporating a 6% discount for lack of control and a 36% discount for lack of marketability (comprised of a 15% BIG tax liability discount and a 21% discount for lack of marketability). The expert arrived at a value of \$7,330,000.



The Court had several theoretical issues with the appraisals:

- The Court rejected the use of the capitalized dividend approach and relied solely on the NAV approach. The Court stated that the method ignores the most concrete and reliable data available – the actual market prices of the publicly traded securities that constituted the entity's portfolio.
- The Court rejected the use of the dollar-for-dollar reduction in value for the unrealized BIG tax liability (despite prior Court decisions to the contrary), as well as the IRS expert's 15% discount. The Court compared the BIG tax liability to a zero-interest note whose payment could be deferred indefinitely, to a note where the full payment was due tomorrow, stating, "It stands to reason that a potential buyer would be willing to pay more for a company with a contingent liability of \$18.1 million than he would pay for a company otherwise equivalent but that had an unconditional liability of \$18.1 million payable now."
- The Court also took issue with the Estate expert's approach in quantifying the discount for lack of marketability as it did not constitute an independent analysis and merely selected the high end of the range of restricted stock and pre-IPO study discounts.

Finally, in considering an accuracy penalty, the Court considered whether the taxpayer acted reasonably and in good faith. Factors to be considered include: (1) the methodology and assumptions underlying the appraisal, (2) the appraised value, (3) the circumstances under which the appraisal was obtained, and (4) the appraiser's relationship to the taxpayer or to the activity in which the property is used. Additionally, as part of the process, the Court noted that the appraiser did not demonstrate that he was qualified as a valuation expert. As a result, the Commissioner's imposition of a 20% accuracy-related penalty under IRC Section 6662 was sustained.

As evidenced by these recent cases, it is now more critical than ever to obtain a qualified appraisal from a qualified appraiser to properly support tax filings.



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## Financial Accounting for Income Taxes in a Changing Tax Environment



*The primary source of funding for governments is derived through the collection of taxes and as economic pressures arise, governments look for avenues to increase the collection of tax revenue.*

As U.S. federal, state and foreign tax laws are subject to continual updates, companies are faced with the challenge of analyzing and accounting for the impact on their financial statements. Collectively, company tax, financial reporting, and operations personnel must address these impacts to ensure that the financial statements clearly and materially reflect the company's current and future tax liabilities, opportunities and potential exposures. This task has been further complicated with the continually expanding expectation for precision, being promulgated by the SEC, Public Company Accounting Oversight Board ("PCAOB") and the Company's auditor, on behalf of the financial statement users, related to the computation and disclosure of tax matters.



## Exploring Recent History of Accounting for Income Taxes

Over the past eleven years, we have experienced a monumental shift in the expectations regarding the financial accounting and reporting of a company's income tax asset or liability. There has been increased focus on the consistency, comparability, and disclosure surrounding income taxes within the financial statements. The genesis of the increased complexity in accounting for income taxes can be traced back to the release of FAS 109 which was issued in 1992, and replaced APB 11, which had previously been the U.S. GAAP Standard for Accounting for Income Taxes. FAS 109 changed the perspective from an income statement approach to a balance sheet approach with a heavier emphasis on the future tax treatment of items of income and expense that are recognized in different periods for book and tax return reporting. The expectations were greatly enhanced with the enactment of Sarbanes Oxley legislation in 2003, followed by the issuance of Financial Interpretation Number 48 ("FIN 48"), in 2006 – both of which increased the pressure on documentation expectations and narrowed the scope for the application of judgment. The current trend continues along the path of expanding the expectations regarding documentation of tax processes and income tax positions within the company's work papers, coupled with the pressure for more expansive disclosures surrounding the judgments inherently required in the area of income tax conclusions.

The expanding expectations for documentation and detail disclosures surrounding judgments applied to accounting for income taxes can be contrasted with the historical approach taken by companies, whereby it was generally accepted, without explicit disclosures, that there would be inherent judgments assumed within the financial reporting for income taxes. It was generally acknowledged that the determination of a company's income tax liability could be quite intricate due to the complexity of applying the tax laws of multiple jurisdictions to the company's financial results. While the complex nature is still an acknowledged factor, the desire for transparency within financial reporting is the driving factor in the increased emphasis on documentation and disclosure.

## Reporting Challenges when Tax Laws Change

A key element of ASC 740 requires a company to provide for income taxes based upon enacted tax legislation as of the last day of the financial statement reporting period. Companies must have procedures in place to not only compute the impact of an enacted tax law change, but also to be able to monitor the actual enactment of new legislation within all tax jurisdictions in which the company operates. Further, a company needs to understand the legislative process within each jurisdiction to properly determine whether legislation is considered enacted under ASC 740. For example, over the past few years the United Kingdom has systematically been reducing the Corporate Income tax rates each year. The history has been that the expected rate reductions have been announced in budget resolutions issued early in the calendar year; however, the final step in the enactment process is not completed until August. Thus under ASC 740, these tax rate changes would be accounted for in the financial statements issued for the period that includes the August enactment date. Note that under International Financial Reporting Standards ("IFRS") the requirement is to include income tax law changes when they are substantially enacted, which could be an earlier date. Another example would include the U.S. enactment of legislation in early January 2013, which retroactively extended the R&D credit for years beginning January 1, 2012. Because the legislation was not signed into law by President Obama until January 2013, a company with a December 31 year end could not recognize R&D credits earned for activity in 2012 as an income tax benefit until the first quarter of 2013.

In addition to reflecting tax law changes in the proper accounting period, the financial reporting team needs to focus on the impact of the tax law change on the balance sheet and income statement. A company's income tax expense includes a provision for taxes currently payable and a deferred provision for the tax impact of items recognized in different periods for book and tax return reporting. Most often, the current portion of the income tax

provision is straight forward since it is based purely on the amounts currently payable or refundable. The deferred income tax provision is based upon the reversing temporary differences created from book and tax income/expense for a particular transaction or series of transactions being reporting in different periods. When temporary differences exist as of a reporting period, a company is required to determine the tax impact of these items based upon the income tax rates that are currently enacted and expected to apply in the period in which the temporary differences are expected to reverse. Therefore, a company needs to estimate when the differences will reverse. For example, assume that a company has taken an accelerated rate of depreciation, as provided by the tax statutes in a particular jurisdiction, that is in excess of the amount recorded for financial statement reporting purposes in the amount of \$1 million. Further, assume that the jurisdiction(s) in which this deduction is being reflected enacts legislation that will reduce their corporate income tax rate from the current rate of 25% by 1% per year for the subsequent three years until it reaches the final new rate of 22%. The company would have recorded an initial income tax expense of \$250,000 and deferred tax liability ("DTL") of \$250,000, (25% of \$1 million). When the new legislation is enacted the company would need to estimate what years the \$1 million will reverse and apply the rate for that year. The table below demonstrates the computation of revised DTL of \$226,000. The \$24,000 difference would be recorded as an income tax benefit in the period of enactment.

Computation of Deferred Tax Liability at Date of Enactment						
Deferred Tax (Liability)/Benefit <i>Tax Rate Decreasing from 25% to 22% (1% each year):</i>	(\$250)	Initially Recorded				
	Revised DTL	Y1	Y2	Y3	Y4	Y5
Gross DTL	(\$1,000)	\$200	\$200	\$200	\$200	\$200
Tax Rate	22.6%	24%	23%	22%	22%	22%
Deferred Tax (Liability)/Asset	(\$226)	\$48	\$46	\$44	\$44	\$44
Reduction of Deferred Tax (Liability)	\$24	Tax Benefit on Date of Enactment				

A single tax law change in any one jurisdiction may not result in extensive complexity; however, changes in multiple jurisdictions could cause significant complications. This struggle is being experienced by multi-national companies as well as companies operating in multiple state jurisdictions since a number of states have been quite active in enacting tax rate changes, as well as their methodologies of apportioning taxable income within their jurisdiction.

## Potential U.S. Tax Reform

There currently is a continuous narrative regarding the perceived need and desire to implement significant U.S. tax reform, in particular to the taxation of multi-national corporations. While the probability of extensive tax reform can be a subject of great debate, if enacted, it has the potential to provide significant income tax accounting and reporting complexity for many companies. Some of the significant questions for consideration are: (1) will significant reform be enacted; (2) what would it look like; (3) what would the impact be? Currently, the "if enacted" question is the focal point. However, the other two questions are topics that are clearly worthy of discussion.

Prior to the enactment of any applicable legislation, companies should consider the following:

- Are you equipped to analyze and communicate the impact on your financial statements in an effective and efficient manner?
- What impact would tax reform have on your effective tax rate in the current and future years?
- What would the immediate impact be on your balance sheet and income statement?
- Will you now need to establish a deferred tax liability on a portion of foreign earnings that were previously

considered to be essentially permanently reinvested?

- What would be the impact of now having a portion of your worldwide income subject to U.S. tax each year?
- What would the impact be on your foreign tax credit position?
- Would it be advantageous to make or postpone distributions from a foreign operation?
- Would you be prepared to make pre-emptive disclosures regarding potential impacts on your expected future effective tax rate as any proposals reach a stage of possibility?

Much of the discussion surrounding potential tax reform is centered around the lowering of the U.S. statutory tax rate of 35% to be more competitive, coupled with some form of taxation on worldwide earnings. While this is all speculative, there is one simple guideline to keep in mind when it comes to a statutory tax rate being reduced. When a statutory rate is reduced, it is obviously a positive for future cash taxes payable; however, the deferred tax position at the date of enactment will have an immediate impact on your balance sheet and income statement. When a company has an overall net deferred tax asset in a jurisdiction in which the statutory tax rate is being reduced, a reduced statutory rate will result in a current year charge to income tax expense since the asset will now be less valuable as it will be realized at a lower rate than originally expected. For example, assume a deferred tax asset for net operating loss carry forwards of \$1 million, which were valued at 35% at the date they were incurred. If tax reform were to reduce the statutory rate to 25%, the value of the deferred tax asset will be reduced by \$100,000 (10% of \$1 million), resulting in an immediate charge to earnings.

The inherent complexities contained within multi-jurisdictional tax laws and their application, coupled with the increasing expectation for transparency and precision, continue to present many challenges to those responsible for the financial reporting for income taxes.



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## The Case for Emerging Markets Equities



*While quite popular during the 1980-2000's due to outsized relative returns, emerging market ("EM") equities have recently suffered amidst much-publicized headwinds including geopolitical tensions in Russia, policy uncertainty in India, and a growing Chinese asset bubble.*

Better-known developing economies such as Brazil, Russia, India, and China tend to dominate the headlines; but, the term "emerging markets" actually refers to a much broader range of constituents. The MSCI Emerging Markets Index currently lists 21 countries with highly varied economic, demographic and cultural profiles, which represent an increasing proportion of the world economy. Despite the recent negative attention, EM securities remain compelling due to historically strong performance, attractive valuation levels, robust diversification benefits, and growth potential.

EM equities, when viewed as an asset class, may appear highly volatile over short time periods relative to more

placid markets. Despite this greater level of risk, EM has outperformed both the U.S. and developed international equity markets over the longer term. While EM is susceptible to prolonged busts and high volatility, over the last 10 years average returns (14.0%) have outperformed the S&P 500 (7.3%). After a heavy downturn in 2008, flows into EM were particularly strong during 2009-2013, boosting performance and dampening volatility. Massive asset purchase programs from large, developed central banks pumped liquidity into the markets while driving interest rates to all-time lows, providing investors with both the means and motivation to search for yield in other markets. The current volatility in EM equities contrasts to the unusual period of calm in the markets brought on by quantitative easing. However, risk-adjusted returns should continue to compensate long term investors who are willing to accept the additional volatility during the transition to a more normal environment.

Many EM countries have undertaken vast structural improvements in recent years, attracting both international and domestic investors through stronger legal and capital-market frameworks. Of the total global market capitalization, the EM portion nearly tripled from the end of 2002 to mid-2013 while the U.S. and developed international markets percentage contracted over the same period. Ongoing economic development and reform programs are creating greater financial transparency in the shift to open market economies. Against a backdrop of rising rates in the U.S. and volatile currency exchange rates, several EM currencies have already staged large corrections, potentially limiting further downside. More proactive EM central banks have dramatically raised rates to curtail currency declines. The consensus outlook for rate of growth remains positive and is projected to continue, with potential shorter-term pullbacks along the way.

In terms of growth, World Bank consensus has predicted 90% of the world's middle class will be in emerging markets in less than 20 years. The emergence of a genuine middle class in these regions can create a spending power shift from an export-oriented economy toward a domestic consumer-driven model. With a growing consumer base, spending in EM is on track to outpace the U.S., driving greater economic growth. Certain EM governments are also taking steps to boost trade within EM, creating flexible terms and currency settlements in an effort to mitigate foreign risk aversion.

In addition to growth potential, EM equities can provide diversification as suggested by lower correlations relative to broad U.S. equities and varying characteristics within specific countries, sectors and stocks. Lower correlations coupled with higher expected returns are supportive of a strategic allocation with EM equity exposure. However, due to the varied characteristics of EM countries and the fact that these stocks get far less analyst coverage than U.S. stocks, portfolio managers with specific skills in this asset class are best apt for exploiting the opportunities created by mispriced markets.

Despite recent headlines and extreme short-term market movements, the qualities present in EM equities remain attractive over longer periods. EM equities currently trade both below their long-term average and at a steep discount to U.S. price multiples. Some caution is warranted, as the recent inflows of liquidity that have buoyed this market could begin to recede. However, with its potential for growth, diversification benefits, and strong fundamentals, EM equities as an asset class remain an integral piece of a well-diversified portfolio for those whose risk tolerance and time horizon can tolerate greater short-term volatility.

*Please feel free to reach out to a WTAS investment consultant should you have any questions relating to this newsletter article or your investment portfolio.*





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