LOS ANGELES HEAD OFFICE
1515 West 190th Street, Suite 400
Gardena, CA 90248-4328
TEL (310) 715-9100
FAX (310) 715-9830

KAKIMOTO AND CO.
CERTIFIED PUBLIC ACCOUNTANTS
CONSULTANTS
http://www.kakimoto.com
e mail: kaco@kakimoto.com

ORANGE COUNTY OFFICE
4199 Campus Drive, Suite 550
Irvine, CA 92612-4684
TEL (949) 725-2970
FAX (949) 509-6599

January 2002

To All of Our Valued Clients and Friends:

We are pleased to be able to send you our January 2002 newsletter. Our topics for this newsletter are as follows:

- ***Accumulated Earnings Tax Prevention : The Long-term Debt Option*** - Although it is important to reserve profits for the corporation's working capital, and for long-term business plans, reservation of too much profit becomes a target for accumulated earnings taxation. A company needs to take measures to avoid unnecessary taxation. At Kakimoto and Co., accumulated earnings taxation is studied from various angles, and appropriate tax saving measures can be proposed to the clients considering each company's situation. (See report)

- ***MICROSOFT WINDOWS XP*** **–** Recently, Microsoft released the next generation's operating system, Windows XP. While marked improvement is found on its functional side, such as user interface enhancement, increased system stability, and multi-language capabilities, there is a greater hardware requirement for memory and hard disk. Kakimoto and Co. has been gaining popularity proposing a more efficient information processing system apt for the client's corporate activity through combining professional accounting and computer services using the latest technology such as Windows XP. (See report)

Kakimoto and Co. offers reliable services in the area of audit, accounting, tax, computer related with accounting, and management consulting at substantially reasonable charges. If you are interested or have any questions, please contact Adam Karp or Jess Nakasuji @ (310) 715-9100. For more information about our firm, please visit our website at *http://www.kakimoto.com.*

The Japanese version of this newsletter is available by request or through our website.

Kakimoto and Co.

enc. Newsletter, January 2002

January 2002

Accumulated Earnings Tax Prevention : The Long-term Debt Option

Introduction:

When operating a multinational business that includes a US Subsidiary, preventing application of the accumulated earnings tax can be a high priority. The critical issue in most accumulated earnings tax cases is whether the earnings and profits have been accumulated beyond the "reasonable needs" of the business.

To determine a businesses reasonable needs, most cases have used an operating cycle approach ("The Bardahl Formula"), thereby determining the amount of the corporation's working capital requirements by determining the amount needed for one full business cycle. The corporation must generally explain any excess beyond its working capital requirements by indicating, for example, long-term indebtedness, expansion plans, contingencies, or other commitments that constitute reasonably anticipated needs of the business.

Using long-term indebtedness has been approved, in many cases, as a legitimate excuse for excessive accumulated earnings. The following paragraphs describe some of the important factors of which to be aware when using debt instruments as funding vehicles for US subsidiaries of Japanese Corporations.

The Long-Term Debt Excuse:

Regulations and Audit Guidelines have explicitly provided that funds can be legitimately retained to provide for the retirement of bona fide indebtedness made in connection with a trade or business. Tax Court and the IRS itself have repeatedly affirmed that a corporate taxpayer may apply or set aside profits to repay debts, and that the corporation need not pay dividends out of borrowed money. Most important, in qualifying this excuse is that the debt be sufficiently "bona fide" and "business related."

Debt Re-characterization as Equity:

U.S. tax law also provides U.S. enforcement authorities the power to re-characterize debt as equity. If debt takes on too much of the benefit of success or the risk of failure of the enterprise, it may be deemed an ownership shareholding rather than a loan. Answering the question of whether debt is really equity for tax purposes, depends on contract terms, like: length of repayment period, existence of fixed interest rates, existence of an unconditional promise to pay on demand, subordination clauses, the ratio of debt to equity, and convertibility to ownership share.

Interest Income and Withholding:

The Treaty diminishes the income tax rate for interest to 10%, as long as the Japanese recipient of the interest has no permanent business establishment in the U.S. to which the interest payment is effectively connected. Additionally, interest paid on debt obligations by the Bank of Japan or the Export-Import Bank of Japan, or by any resident of Japan, which are guaranteed or indirectly finance by such banks, are free from U.S. tax. Bear in mind, also, that excessive payments of interest by related parties may be re-characterized, and taxed accordingly.

Withholding of taxes on interest income received by foreign entities occurs, when appropriate, before the payment is actually sent out of U.S. jurisdiction. This operates by placing a duty to withhold, as well as, the threat of penalties for failure to properly withhold, upon the U.S. payer. In other words, a U.S. subsidiary to a Japanese parent corporation may be required to withhold 10% of its interest payment, for U.S. taxation of the Japanese parent corporation. In addition, U.S. authorities may "impute" a payment of interest, even though little or none is actually paid, where the interest percentage is below the market rate.

Interest Deduction Allocation and Apportionment:

The interest deduction that the US subsidiary will wish to take on its indebtedness can be limited. Interest will be tied to the class of income for which the debt was acquired, and if the debt was acquired for general business purposes, it will be allocated according to the basis of all the corporation's assets or liabilities. This allocation serves the purpose of apportioning interest paid between U.S. and foreign sources. Interest connected to U.S. sources can only be used as a deduction from U.S. source income, while that apportioned for foreign income can only be deducted from Foreign source income.

The Treaty generally prohibits the treating of a U.S. corporation controlled by Japanese shareholders differently than a U.S. corporation controlled by U.S. shareholders. As such, many have argued that the, above described, allocation of deductions violates the Treaty. This argument, however, has failed in U.S. courts, which have applied the Treaty provisions to "similarly situated" taxpayers, rather than as a general rule.

Note, in addition, that both the Treaty and the Internal Revenue Code assign enforcement bodies the power to re-allocation of income, deductions, credits or allowances between related parties to more accurately reflect "arms-length" arrangements (i.e. the arrangements of unrelated parties).

Conclusion:

With tax planning you can often avoid application of the accumulated earnings tax by issuing long-term debt. However, the debt instrument should be carefully constructed. If you have any questions about the use of long-term debt, or would like to discuss the impact this area of law may have on your U.S. operations, please feel free to contact us.

MICROSOFT WINDOWS XP

For the last couple of months Microsoft has inundated America with advertisements for its new operating system, Windows XP. While most new PCs you buy will come with Windows XP pre-installed, what about the PCs you already have? Should you upgrade to Windows XP? Can you?

Windows XP has many new features such as a new user interface, Remote Assistance system utility, and new Internet tools and multimedia programs. The most noticeable difference is the user interface. The redesigned interface is simpler and cleaner. Almost all the default desktop icons are gone except for the recycle bin, taskbar and start menu. Programs are accessed from the start menu, which show the most recently used programs. Performing tasks for the novice user is easy, however the experienced user will need some patience at first, since many familiar items have been moved.

While working with our clients, we have found that Windows XP's stability and multi-language capabilities are the primary reasons to upgrade from Windows 95, 98, or NT 4.0. Windows 95 and 98 users will find that Windows XP offers a level of stability that they had previously only dreamed about. However, Windows 2000 offers similar stability and multi-language capabilities so users may find little reason to upgrade. Windows XP users can go for longer periods of time without experiencing system crashes or having to reboot their system. This is probably the most important reason to upgrade your operating system to Windows XP.

The new operating system also allows users to view and create documents in a variety of different languages, including Japanese. When combined with Office XP, Windows XP almost eliminates the need to have a separate operating system for languages other than English. More information on Windows XP's multilingual capabilities is available on Microsoft's website at this address:
http://www.microsoft.com/windowsxp/pro/techinfo/planning/multilingual/default.asp.

If you determine that you would like to upgrade to Windows XP, you will need to verify whether your current hardware and software is compatible with Windows XP. Microsoft recommends that your PC has at least the following specifications: 300 MHz CPU, 128 MB RAM, and 1.5 GB of free space on your hard disk drive. However, our experience with Windows XP indicates that the following specification are more realistic: 600 MHz CPU, 256 MB RAM, and 15 GB of free space on your hard disk drive. In addition, you should verify with your software vendors to make sure the applications you currently use are compatible with Windows XP. Microsoft has a useful utility that will help you check to see if your PC's current hardware and software are ready to run Windows XP. You can download this utility for free from this address:
http://www.microsoft.com/windowsxp/pro/howtobuy/upgrading/advisor.asp.

This utility is approximately 30 MB so it may take some time to download it. If downloading it is impractical for you, let us know and we will be happy to assist you with this process.

Kakimoto and Co.
Certified Public Accountants

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