KAKIMOTO & NAGASHIMA LLP

CERTIFIED PUBLIC ACCOUNTANTS
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NEWSLETTER

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Summary of Articles

Budgeting – Can You Meet Your Goals?

In the past, the preparation of a company's budget was considered as part of an required annual process – an assembly of numbers in which, one would hope, have some resemblance to the company's actual results. Today, as the U.S. economy struggles to recover, a company's immediate concern is to continue operating. The normal reaction to this is to incorporate drastic cost cuts in a company's budget as a means to counteract the effects of today's economic environment. However, it should not be a foregone conclusion that a budget's primary purpose be a cost cutting tool. Budgeting procedures should be considered as a value-added activity – an integral part of the overall planning and control process whereby corporate goals can be achieved.

Interest Payments to a Japan Parent Company

When a US subsidiary makes payments of interest and /or principal to its Japan parent company, several issues under US tax law can arise. We will briefly discuss some of the issues that might apply when these payments are made.

Maximizing the company's computer information system

While many focus on security functions and network stability when analyzing computer information systems (CIS), evaluating the system from a business perspective can be vital to improving the company's operations. Merely implementing the CIS may be ineffective; the benefits depend on how well it is utilized. Why not evaluate your current CIS?

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Inside this issue:

Any Questions?

We are committed to providing our clients with quality and excellent services. If you have any questions or comments, please let us know by either e-mail or phone.

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Budgeting For Your Success

In the past, the preparation of a company's budget was considered as part of an required annual process – an assembly of numbers in which, one would hope, have some resemblance to the company's actual results. Today, budgeting procedures should be considered as a value-added activity – an integral part of the overall planning and control process whereby corporate goals can be achieved.

"In determining strategic objectives consider historical trends, competitive analysis and future economic climate."

Budgeting is part of the financial planning process. Financial planning begins at the top of an organization and is part of a company's overall strategic plan. Strategic planning involves the establishment of long-term goals and corresponding objectives which includes an assessment of a company's internal organization as well as the effect of external factors. The budget should be designed and constructed to achieve those goals and objectives. Once, budgets were compiled by the financial or accounting departments with minimal interaction by the operational units of the organization. However, the budget process has evolved into a companywide effort with contributions and input solicited from a greater number of departmental managers and employees. Many companies are adopting a combination of the "bottom up" approach to budget preparation, in which managers prepare budgets on a departmental level that are processed into the overall organizational budget, in conjunction with the "top down" approach in which budgets are processed with focus on corporate strategic objectives.

To make budgets effective, management should consider the following:

- In determining strategic objectives consider historical trends, competitive analysis and future economic climate.
- An emphasis on the communication of the company's objectives/goals and budget preparation guidelines to managers to ensure that the departmental budgets are developed using the same assumptions used at the overall corporate level.
- Minimize time spent on data gathering by automating collection of data.
- Attain participation of and agreement with departmental managers and employees.
- Provide actual results on a reliable and timely basis.

Budget versus actual comparisons should be regularly monitored. Large differences should be promptly investigated with an appropriate course of action taken.

Advantages of maintaining an effective budgeting program:

- Requires management to plan for the future; compels management to consider, in detail, plans for achieving certain targets and goals.
- Defines areas of responsibility.
- Encourages communication and coordination between departments; promotes motivation and interaction of employees by fiscal involvement.
- Company performance can be appraised and assessed.

Most companies rely on Microsoft Excel exclusively to facilitate their budgeting process. Companies should consider and explore other alternatives such as budgeting programs which are included in accounting programs, budget-planning software or online budget-planning applications. Due to the many aspects of budget planning or different programs used to process your budget, we would be happy to assist your company in tailoring a services package suitable for your needs. ♦

Interest Payments to a Japan Parent Company

Subsidiaries of Japanese companies doing business in the US quite often receive funds from their parent company in Japan or other related parties outside the US for various reasons. Because of their relationships, it is not unusual to find situations where there are undocumented loan agreements, usage of low interest rates, or delay in the payment of interest and principal. Due to theses incidents, the Internal Revenue Service ("IRS") has been auditing many corporations. If the IRS judges a transaction to be a tax evasion or an arbitrary manipulation of income and expenses between the related parties, IRS can require making necessary corrections to properly reflect the true income of subsidiary.

To avoid adverse tax consequences associated with IRS audits, we have summarized below issues that should be considered under the US tax laws.

Matters to be attended to in relation to funding from Japan parents:

1) Issues related to thin capitalization – Internal Revenue Code ("IRC") Sec. 385
2) Appropriateness of interest rates – IRC Sec. 482
3) Interest payments expensed on cash basis – IRC Sec. 267
4) Interest expense limitation - IRC Sec. 163(j)
5) 10% withholding tax on interest paid – IRC Sec. 1442 and US-Japan tax treaty Article 13 (Article 11 effective July 1, 2004)

1) Issues related to thin capitalization – IRC Sec. 385

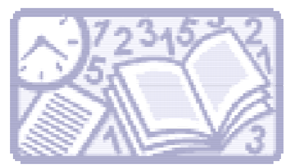
Under IRC Sec. 385, funds received can be considered a liability or an investment by the parent or other related parties depending on various factors. For instance, a subsidiary may have weak earning power at the time they receive funds, lack cash flow for payments of interest and principals, and have circumstances not allowing the subsidiary to borrow from third parties. In addition, the subsidiary may currently be delinquent in interest and/or principal payments and the parent company may not be taking proper measures to provide capital for the subsidiary. In this case, it is highly possible for the transaction to be considered a capital contribution, in which interest payments and principal payments (on certain situations) are treated as dividends or reduction of capital and are not tax deductible.

2) Appropriateness of interest rates – IRC Sec. 482

IRC Sec. 482 regulates transactions between related parties and states that an arm's length standard should be applied between related parties (whether inside or outside the US). Therefore, borrowing terms (i.e., interest rates, due dates, methods of repayments) should be set taking into consideration the standard loan agreement terms with third parties, such as banks, costs related to financing from parent and related parties, and exchange rate risks.

3) Interest payments are expensed on cash basis – IRC Sec. 267

IRC Sec. 267 indicates that interest payments are tax deductible when they are actually paid. Under the accrual basis method of accounting, interest expense is recorded when a liability is realized even if the actual payment is not made. Under the tax rules, however, interest can not be expensed until it is paid. For instance, a subsidiary may have a fiscal year ending March 31 and pay interest for the period between October and March on April 1. For accounting purposes, the subsidiary records the interest payment made on April 1 as interest payable and the interest expense on its books on March 31. Under the tax regulations, however, it is not treated as interest expense until April 1; the subsidiary must wait one year for this interest to be treated as expense. Thus, the date of interest payment should be decided with the understanding that interest expense is tax deductible on a cash basis.



4) Limitation on interest expense - IRC Sec. 163(j)

In addition to regulations on the timing of tax deductibility of interest paid to related parties outside the US under IRC Sec. 267 mentioned in 3) above, IRC Sec. 163 implements restrictions on the amount of interest that can be expensed. Generally, expense is limited to 50% of taxable income before depreciation expense for tangible and intangible assets and interest expense (net amount if there is interest income). For example, assuming that a subsidiary's income before depreciation expense and interest expense is $1,000, and depreciation expense and interest expense are $300 and $700, respectively, taxable income becomes zero before application of IRC Sec. 163(j). Upon application of IRC Sec.163 (j), however, deductible interest expense is limited to $500 instead of $700 (50% of income before depreciation expense and interest expense or $1,000). As a result, taxable income becomes $200, creating a tax due. Unless we are aware of this issue, additional tax may be imposed.

It should be noted, however, that interest expense not deducted can be carried forward to the following year and thereafter, and it is possible to include it in the calculation under IRC Sec. 163(j) as if the interest was paid in those years. Thus, the total interest expense deducted equals the total interest payments in the future.

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5) 10% withholding tax on interest paid – IRC Sec. 1442 and US-Japan Tax Treaty Article 13

Under the US-Japan Tax Treaty Article 13, in general, US entities are required to withhold tax of 10% on interest paid to Japan entities (those Japan entities not doing business in the US). This withholding tax can be considered as tax that the Japan parent pays to the US on the interest income. Therefore, the actual amount the subsidiary remits to its Japan parent is interest after the 10% withholding tax or 90% of the interest. The Japan parent, however, is taxed on the interest income before the 10% withholding tax in Japan, resulting in a double taxation, but this can be avoided by taking advantage of the foreign tax deduction or credit. Additionally, as you may already be aware of, the US-Japan Tax Treaty will be drastically revised from July 1, 2004. However, there will be no change to the 10% withholding tax on the interest.

We have summarized several issues of US subsidiaries that receive funds from Japan parent companies and related parties. We, however, recommend you consult with a tax specialist in advance prior to initializing the transactions. Should you have any questions, please feel free to contact us. ♦

Evaluating your Computer Information System

Most relate an evaluation of a computer information system (CIS) to security functions and network stability. However, determining the efficiency of the system involves evaluating how well it is utilized in a business.

A key component of CIS includes accounting software supporting fundamental business activities. Commonly used programs such as *Peachtree* and *QuickBooks* are geared for small sized companies, while midsized corporations with numerous transactions often utilize *MAS 90/200* and *Great Plains*. Although each is a high-performance software that comes with many features, how many companies are actually efficiently using and taking full advantage of them?

Since diverse software versions are available and a number of additional modules (or additional program components) are offered, the first step is deciding the software most suitable for the business. Once purchased, however, whether you maximize the software's ability depends on how well it is utilized.

Included here is a sample checklist that will be useful in determining how effectively the software is used. It may be beneficial to review your current system and determine if any of the following issues apply:

- □ Currently using an accounting software, but invoices produced by other software such as Excel or Access.
- □ Currently using an accounting software, but checks are manually prepared.
- □ Payroll and payroll taxes calculated with Excel.
- □ Depreciation maintained on Excel.
- □ Sales order, purchase orders, and inventory lists prepared using Excel or Access.
- □ Cost management performed using Excel or Access.
- □ Output reports produced from accounting software additionally modified using Excel.
- □ Custom-made business software is used in addition to accounting software.
- □ More than one software is used simultaneously to obtain similar information.
- □ Software performance is slowing due to accumulation of past year data.
- □ Inability to simultaneously access the same file by more than one computer (no multi-user option or network capability).
- □ Several unfamiliar menu options and features are present or not utilized.

If any one of the above checkpoints apply, there is a high possibility of improving your CIS.

If you are otherwise engaged by daily routines and have difficulty considering improvements, we recommend you consult with an outside specialist. By performing an analysis of your system, it is possible to improve operations tremendously, with modifications to your existing system and as a result, lower costs and make more efficient use of employee time (i.e., analyzing business strategies, marketing, developing new business and/or strengthening specialized fields).

We can provide services which range from the evaluation of your information system and offering recommendations to actual on-hand support. Should you have any interest, please feel to free to contact us. ♦

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