



**Kakimoto & Nagashima LLP**  
Certified Public Accountants  
Consultants

## NEWSLETTER

Volume 5, Issue 4

October 2007

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### 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. Our company profile is available on the internet at:

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## Summary of Articles

### **FIN 48 - Uncertainty in Income Tax Positions**

In July 2006, the Financial Accounting Standards Board ("FASB") released FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109" ("FIN 48"); this interpretation is effective for fiscal years beginning after December 15, 2006. In an effort to promote increased transparency in financial statement reporting, FIN 48 provides certain clarification and guidance on the recognition, measurement and disclosures of uncertain tax positions. Companies affected by FIN 48 will need to address the adequacy of their processes for identifying and monitoring their uncertain tax positions. Management will be expected to provide its auditors and/or accountants with its analysis and assessment of tax positions and outcome probability.

### **U.S.-Japan Withholding Tax: How Much Tax Should Be Withheld?**

After three and a half years since the U.S.-Japan Income Tax Treaty was ratified in March 2004, there still appears to be some confusion over the proper amount of withholding with respect to certain transactions. Is the transaction exempt from withholding? Is it subject to 5%, or 10% withholding? In this newsletter, we would like to recall and cover in further depth some of the major changes of the treaty which often apply in practice to transactions across the border between Japan and U.S.

### **Firewalls – How to Protect Your Intranet from the Internet**

If you look up firewall in the dictionary, you will see an entry similar to this:

*fire wall – noun*

- 1. a partition made of fireproof material to prevent the spread of a fire from one part of a building or ship to another or to isolate an engine compartment, as on a plane, automobile, etc.*
- 2. an integrated collection of security measures designed to prevent unauthorized electronic access to a networked computer system.*

Essentially, a firewall is level of security, protecting the "good" from the "bad". Inside this issue, we will explain to you how this applies to your companies computer networking infrastructure.

Questions or comments about this issue or inquiries about our newsletter by e-mail subscription service can be sent to:

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## FIN 48 - Accounting for Uncertain Tax Positions

In July 2006, the Financial Accounting Standards Board ("FASB") released FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No. 109" ("FIN 48"); this interpretation is effective for fiscal years beginning after December 15, 2006. Tax law is often complicated and ambiguous and the application to certain situations may be difficult. Due to varying interpretations of the law and aggressive tax planning, tax positions, such as claiming deductions or credits (tax benefits), could be subsequently challenged and ultimately be denied. The FASB issued FIN 48 to reduce the diversity in accounting practice related to the accounting for the uncertainty in income taxes. In an effort to promote increased transparency in financial statement reporting, FIN 48 provides certain clarification and guidance on the recognition, measurement and disclosures of uncertain tax positions. Certain key elements of FIN 48 are summarized as follows:

### Recognition/Measurement

FIN 48 utilizes the following two-step process in the evaluation of tax positions:

1. The Company determines if its tax positions, based on technical merits, meet the "more likely than not" (likelihood of more than 50 percent) threshold of being sustained upon examination by a taxing authority or appeals process. In the evaluation, a presumption is made that the tax position will be audited by the appropriate taxing authority who has full knowledge of all relevant information. If the tax position does not meet this threshold, none of the tax benefit can be recorded in the financial statements.
2. A tax position that meets the "more likely than not" criterion should be measured at the appropriate amount of tax benefit to be recognized. Under FIN 48 the proper amount of tax benefit to be recognized is the largest amount of benefit that has a more than 50 percent chance of realized upon ultimate settlement.

Although the term "tax position" itself is not specifically defined within FIN 48, it does encompass:

- a decision not to file a tax return
- an allocation or shift of income between jurisdictions (including foreign countries)
- different characterization of taxable income or the decision not to include taxable income in the tax return

Interest and penalties are required to be accrued if an uncertain tax position will not be ultimately sustained. The accrual of interest and penalties would begin in the period in which it would begin accruing under the relevant tax law.

### Classification/Disclosures

The liability that results from the application of FIN 48 should be classified separately from other tax balances on the balance sheet. In addition, the resulting liability cannot be aggregated

with either deferred tax liabilities or assets. Nor does FIN 48 allow the recognition of a tax benefit related to an uncertain tax position to be offset with the valuation allowance.

FIN 48 requires a significant amount of disclosure in the following areas:

- a tabular presentation reconciling the aggregated beginning and ending amounts of unrecognized tax benefits
- affect on the effective tax rate of unrecognized tax benefits if recognized
- interest and penalty amounts recognized in the financial statements
- foreseeable significant increases and decreases of unrecognized tax benefits within 12 months of the reporting date
- open tax years by major tax jurisdictions

### Adoption of FIN 48/Documentation

In the adoption of FIN 48, companies will need to identify its open tax positions and comply with the recognition, measurement and disclosure requirements. Due to the number of possible exposures and taxing jurisdictions, FIN 48 could not provide a specific documentation model to refer to. Management will be expected to provide its auditors and/or accountants with its analysis and assessment of tax positions and outcome probability. Management should consult its outside auditors and tax advisors to coordinate its FIN 48 analysis.

### KNLLP FIN 48 Services

FIN 48 poses several challenges that companies must overcome in order to properly implement and subsequently follow to comply with financial statement reporting standards. Tax laws are often complicated and ambiguous, and coupled with the compliance requirements of FIN 48, can be an insurmountable process to perform and complete. We can help you to decipher the complexities from both an accounting and/or tax perspective. Our services can be tailored to assist in the entire FIN 48 process or be limited to specific components/areas, such as:

- identification and inventory of tax positions
- evaluation/measurement of tax positions
- interest and penalty amounts
- financial statement recording and presentation issues
- disclosure preparation

In performing FIN 48 evaluations, we also anticipate many of these companies will need to address several tax matters including the following:

- mergers and acquisitions
- reserves - inventory/account receivable
- inventory costing/valuation; IRC Section 263A - inventory capitalization
- compensation vs. dividend issues
- foreign tax credits
- thin capitalization

(Continued on page 3)

## U.S.-Japan Withholding Tax: How Much Tax Should Be Withheld?

It has been over three and a half years since the U.S.-Japan Income Tax Treaty was ratified in March 2004. The new treaty has stimulated economic activity between U.S. and Japan, and it has promoted stronger and closer business relations than ever between the two countries. Some of the major changes of the treaty, including withholding taxes on dividends, interest, and royalties which often apply in practice to transactions across the border between Japan and U.S. are as follows:

### Withholding Tax on Dividends (Article 10)

Article 10 allows the country where the recipient of a dividend resides, to tax the dividend and limit the other country, where the payor of the dividend resides, to tax the dividend. The withholding tax rate applicable in the country of the payor generally varies depending on the ownership percentage (direct and indirect) of the payor's voting stock, as well as other conditions of ownership. The categories of ownership can be divided into 3 groups: more than 50% of voting stock ownership; 10 to 50 % ownership; and less than 10 % ownership.

When more than 50% of the payor's voting stock is directly or indirectly owned by certain recipients for a period of 12 months or more ending on the date the dividend is declared, such dividend is not taxed in the country where the payor resides if any of the following conditions are met: (1) stock of the recipient is listed and regularly traded on a recognized U.S or Japan stock exchange; (2) 50% or more of the recipient's stock is directly or indirectly owned by 5 or fewer shareholders, each of whom meets condition (1) above; or (3) 50% or more of the recipient's stock is owned by individuals, the government, local government, the Bank of Japan or the Federal Reserve Bank, publicly-traded companies, a pension fund, or organizations which are established under the laws of the country for religious, charitable, educational, scientific, artistic, cultural or public purposes, and less than 50% of the gross income of the recipient for the taxable year is paid or accrued directly or indirectly to individuals or entities who are not residents of either U.S or Japan as payments that are deductible in computing taxable income.

When the percentage of voting stock owned by a company is at least 10%, but less than 50% on the date the dividend is declared, the withholding rate in the country of the payor is limited to 5% of the gross amount of the dividend paid.

When the voting stock percentage is less than 10% or when none of the above conditions are satisfied, the withholding rate is limited to 10% of the gross dividend amount.

### Withholding Tax on Interests (Article 11)

Interest is taxed in the country of its recipient according to the law of that country. Such interest may also be taxed at 10 percent, and the tax should be withheld in the country of the

payor. However, such interest is exempt from tax if paid to the government of the other country, including the local government, the central bank of the other country, and financial institutions including banks, insurance companies, and registered securities dealers.

### Withholding Tax on Royalties (Article 12)

Royalties are taxed in either the U.S. or Japan, where the beneficial owner of the royalties resides. The royalties are exempt from tax at the source country. The term "royalties" is defined in Article 12 as any consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark, design or model, plan or secret formula or process, or for information concerning industrial, commercial or scientific experience.

The withholding rules covered here are brief and provide only a general explanation of the withholding tax on dividends, interest, and royalties. More detailed information is provided in Articles 10, 11, and 12 of the 2003 U.S.-Japan Treaty, and the technical explanation is available on the website of the Ministry of Finance Japan and the U.S Department of Treasury. Exceptions which are not covered in this issue of the newsletter may apply in the withholding rules depending on the details of the transaction. It is strongly recommended that you consult your tax accountants regarding the specifics of the withholding requirements.♦

*(Continued from page 2)*

- IRC Section 163j - interest expense limitations
- income tax treaties
- state nexus issues
- state apportionment and allocation methods
- state and local filing methodologies
- unusual transactions
- statutes of limitation

Most U.S. subsidiaries of Japanese companies are also faced with uncertainties in the transfer pricing area (IRC Section 482). Transfer pricing studies could be used as a possible source to supplement management's evaluation and measurement in the FIN 48 analysis process.

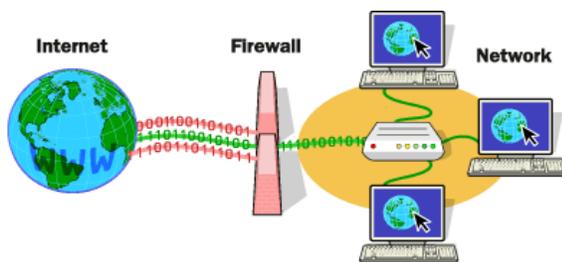
Due to the unique composition of our clientele and numerous years of servicing U.S. subsidiaries of Japanese companies, we are able to draw upon a large reference and resource base which will address your specific needs. With the combination of solid expertise and talent from both our assurance and tax professionals, we will be able to provide an integrated level of service for your FIN 48 requirements. Please consult us to discuss the possibilities of adapting a services package suitable for your company.♦

## Firewalls – How to Protect Your Intranet from the Internet

If you have been using the Internet for any length of time, and especially if you work at a large corporation and browse the Web while you are at work, you have probably heard the term firewall being used. For example, you often hear people in companies say things like, "I can't use that site because they won't let it through the firewall."

### But what are Firewalls?

Firewalls provide important network and computer-system protection for businesses and home users alike. Think of it like this, just as your local farmer makes quality control checks of the tomatoes that were just picked. The workers there identify and sort each and every tomato that will be sold, allowing only the freshest and ripest to be shipped out. All rotten ones will be discarded. A firewall does essentially the same thing, they examine each and every transmission packet from the internet and only allow the "good" packets to come in and block out all of the "bad".



Today's firewalls come in two distinct flavors: host-based firewalls that protect individual computers and network-based firewalls that you place at strategic points on your internal network. Most large organizations use network-based firewalls. However, even in large, well-protected enterprises, host-based firewalls can provide a solid secondary level of defense from worms or other malicious traffic that might breach your primary network firewall. The following describes some of the features to look for when considering a host- and network-based Windows firewall software.

### Network-Based Firewalls

Firewall rule sets detect and block anomalous and unwanted traffic. The rule sets consist of individual ACL's (Access Control List) that define the traffic that's permitted through the firewall. Be sure to examine how the firewall constructs ACL's and how you make changes to them. For example, does the firewall use a GUI (Graphical User Interface) or command-line syntax? Which tools and protocols, such as HTTP Secure (HTTPS) or Secure Shell (SSH), does it use for remote management? Does the firewall support real-time logging of dropped packets, which helps you troubleshoot firewall operations and detect rogue activities? If the log events are exportable to a common (i.e., SNMP or syslog) or delimited format, you'll be able to use the plethora of log-analysis tools that are freely available.

Most modern firewalls include Intrusion Detection System (IDS) functionality. IDS identifies (and usually blocks) known exploits before the rule set processes them. For example, IDS might drop a Denial of Service (DoS) attack that's embedded within a protocol that your rule set would have allowed. IDS sophistication and features vary by vendor.

Several network firewall architectures exist—from simple single firewalls to dual back-to-back firewalls that create a perimeter net-

work to triple firewalls that have legs for demilitarized zone (DMZ), private, and public networks. Do some research before you decide which architecture you want to deploy, then compare firewalls that support that design. Firewalls route packets from one network to another and most can perform Network Address Translation (NAT), which hides a larger number of private IP addresses behind a few public IP addresses. Some network firewalls also provide VPN (Virtual Private Network) server functionality. Several VPN technologies (e.g., IP Security—IPSec, PPTP) are available, so consider which solution is most compatible with your environment. VPN's historically have had problems crossing firewalls that are configured for NAT. If you're a small office/home office (SOHO) user, look for firewalls that support IPSec or PPTP pass-through to ensure that you can connect to your company from behind your home firewall.

Some firewalls provide more sophisticated control—such as anti-virus scanning, Web-content filtering, or other application-layer filtering—over the traffic that passes between networks. To enable these features, vendors often charge extra subscription fees that add to the recurring cost of the software, so be sure to check the details.

Consider where to deploy your dedicated network firewalls and whether you need high availability. Redundant hardware and software licenses for firewalls that are clustered for failover or load balancing can add to your cost.

### Host-Based Firewalls

Because of the proliferation of remote users and worms, host-based firewalls play an increasingly important role in securing workstations from internal attacks that bypass the network firewall. Host-based firewall software must co-exist with users' day-to-day tasks, such as using Microsoft Office or surfing the Web.

Because host-based firewalls are installed on client computers, many products control which applications can access the network. Some products profile computers by building up a rule list as programs attempt to access the network. For enterprise deployments, look for centralized management capabilities, which aggregate workstation data into reports and let you push host-based firewall policies to remote computers. Also, consider location-detection features that assign additional rules to protect laptop computers when they're connected to remote networks.

Host-based firewalls typically assign ACL's on a per-user basis, which provides additional flexibility and security. Instead of basing ACL's on individual IP addresses (which an attacker can spoof or change), host-based firewalls authenticate users at any location and apply ACL's based on user roles.

Most reputable firewalls provide solid protection—if they're configured correctly. But an incorrectly installed firewall can cause a false sense of security or a disruption in your business service. Carefully scrutinize the literature, product manuals, and other information to ensure that you're truly guarding what you've set out to protect.

A secure firewall is essential for everyone, from the home-user to the local doctor's office, and even up to the multi-million dollar enterprises of the world. Protecting your data is vital to keep your business running in this digital age of time. Please contact the professionals at Kakimoto and Nagashima, if you seek to have your network analyzed for proper security and protection.♦