

LOS ANGELES HEAD OFFICE  
1515 West 190<sup>th</sup> 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](mailto:kaco@kakimoto.com)

ORANGE COUNTY OFFICE  
940 South Coast Drive, Suite 250  
Costa Mesa, CA 92626-7781  
TEL (714) 436-2676  
FAX (714) 436-2688

September 1999

To All of Our Valued Clients and Friends:

We are pleased to be able to send you our September 1999 newsletter. Our topics for this newsletter are as follows:

- TRANSFER PRICING STUDY MAY BE BENEFICIAL
- COMPUTER VIRUSES
- EMBEDDED SYSTEMS
- STAFF INTRODUCTION – MICHAEL POLASHEK, TAX MANAGER

### Our Services

**Kakimoto and Co. provides a wide-range of services for reasonable fees.**

- ***Tax Services*** – Conducting business in today's international environment can be complex and demanding. So too are the ever-changing federal, state and local tax laws. We can assist you in confronting difficult tax issues, including those faced by multinational corporations, such as transfer pricing issues (see below). We can also assist you in complying with the various federal and state reporting requirements—we can handle from simple to very complex tax returns. For more information about our tax services, please contact our Tax Manager, Michael Polashek.
- ***Transfer Pricing*** – As the IRS becomes more assertive in the transfer pricing area, and the risk of transfer pricing adjustments increases, multinational taxpayers must take steps to minimize their transfer pricing exposure. We can assist you in doing so, by conducting a transfer pricing exposure analysis and, if warranted, a transfer pricing study for your company. In this issue, we provide an overview of the transfer pricing area, and discuss the benefits of a study. Please see the article inside.
- ***Employee Benefit Plan Audits*** – 401(k) plans are a popular way for employers to provide retirement benefits for employees. The Employee Retirement Income Security Act of 1974 (ERISA) contains a requirement for annual audits of plan financial statements that meet certain criteria. We are available to help you determine whether you are required to provide such financial statements, and if necessary, conduct the audit of your 401(k) plan.

### Reminder!

When testing for Y2K compliance, don't forget about embedded systems within your organization. Embedded systems are equipment and systems, which include elevators, telephone, voice mail, faxes copiers, thermostats, utility meters, security systems, time clocks, internal sprinklers, and lighting, to name a few. These types of equipment must also be tested for their ability to function in the new millennium. For further information, please call us.

If you are interested or have any questions, please call Gerald W. Kakimoto or Michael Polashek at (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, September 1999

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## **TRANSFER PRICING STUDY MAY BE BENEFICIAL**

Internal Revenue Code (IRC) section 482 authorizes the Internal Revenue Service (IRS) to allocate income and/or deductions between related entities. The IRS uses section 482 to discourage multinational entities doing business in the U.S. from shifting outside of the U.S. profits that would otherwise be properly taxable in the U.S. The method the IRS uses to achieve this result is to adjust, if necessary, the prices the U.S. entity charges, or is charged, for goods, services or intangibles transferred to, or from, its foreign affiliate (“transfer prices”).

The income tax regulations provide that, in order to avoid adjustment, a taxpayer must set its transfer prices at an amount that falls within an “arm’s length range” of prices. The challenge in complying with section 482 is determining this arm’s length transfer price range. The regulations set forth various economic methods that taxpayers are permitted to use to determine the arm’s length range; however, the taxpayer is required to determine and use the “best” method.

Generally, the arm’s length range is determined based on *transactions* between unrelated entities or on the *financial results* of unrelated entities. If the taxpayer engages in the same type of transactions with unrelated entities as it does with its foreign affiliate, the *transactions* with the unrelated entities may be used to determine an arm’s length range of prices. If not, then the *financial results* of unrelated entities sufficiently comparable to the taxpayer may be used to determine an “arm’s length” range of financial results, within which the taxpayer’s financial results must fall.

The process of determining the arm’s length range, and whether the taxpayer’s related-party transactions fall within that range, is typically referred to as a “transfer pricing study.” A transfer pricing study performed by a qualified professional can assist the client in complying with section 482 and in avoiding transfer pricing adjustments by the IRS. Among other things, a transfer pricing study determines which transfer pricing method the client is required under the regulations to use, properly applies that method to the client’s related-party transactions and documents the application of the method.

In order to encourage compliance with the requirements of section 482, Congress has established a rather onerous penalty for noncompliance. The penalty is 20% of the additional tax due where:

1. The transfer price reported on the tax return is 200% or more, or 50% or less, of the amount determined to be the correct amount (the “transactional penalty”), or
2. The net section 482 adjustment for the year exceeds \$5 million or 10% of the taxpayer’s gross receipts (the “net adjustment penalty”).

The penalty is doubled, to 40% of the additional tax due, if the reported transfer price is 400% or more, or 25% or less, of the correct amount, or if the net section 482 adjustment is at least \$20 million or 20% of gross receipts.

The penalty will not apply, however, if the taxpayer:

1. Selects and applies a transfer pricing method specified in section 482 in a reasonable manner,
2. Maintains certain documentation, and
3. Provides such documentation to the IRS within 30 days of the IRS’s request for it.

## TRANSFER PRICING STUDY MAY BE BENEFICIAL (Continued)

If a taxpayer has had a transfer pricing study prepared by a qualified professional, the IRS will take this into account in the taxpayer's favor in determining whether the taxpayer has met the first of these requirements. Also, one of the purposes of a transfer pricing study is to provide the client with much of the documentation needed to meet the second requirement. This documentation must be in existence by the time the taxpayer's tax return is filed. Therefore, in order to avoid the penalty, the taxpayer must have its transfer pricing study for a given year completed no later than 8½ months after the close of that year.

Lately, we have seen an increase in the frequency of IRS transfer pricing examinations, and a decrease in the size of the taxpayers subject to such examinations. Because of this apparent increase in exposure to U.S. affiliates of foreign entities, a transfer pricing study has become cost beneficial to many such entities. A qualified professional can assist in determining the need for a transfer pricing study by conducting an "exposure analysis," to determine the client's exposure to a transfer pricing adjustment and, in turn, the anticipated benefits of a study.

If you are interested in having Kakimoto and Co. conduct a transfer pricing study or exposure analysis for your company, or if you have questions about the transfer pricing area, contact Michael Polashek, our Tax Manager.

## COMPUTER VIRUSES

Over the last couple of decades the personal computer has become an essential part of life in both the business and personal worlds. Computers are called upon to do everything from totaling last quarter's sales figures to making stock trades. Due to our dependence on computers, any loss of data or extended periods of downtime can be both inconvenient and costly. One of the greatest threats to the security of our computers comes from computer viruses. Viruses, as programs that can replicate themselves are called, can have effects that range from mildly annoying to totally destructive. After infecting one computer a virus will replicate itself and look for other computers to infect, thus spreading its effects.

The recent explosive increase in the use of the Internet and Local Area Networks (LANs) has created an excellent breeding ground for computer viruses. In the past, the sharing of floppy disks was the main method of virus transmission. Today viruses take advantage of the connectivity that LANs and the Internet to spread. Viruses no longer have to be physically transported on disks from computer to computer. Now they can be downloaded or e-mailed around the world in a matter of seconds.

Here are some tips to help you avoid viruses and the trouble associated with them:

- Buy anti-virus software. Use it to run regular checks on your computer. Most current anti-virus software can check your system automatically.
- Update your anti-virus software. Most anti-virus software vendors offer monthly and even weekly updates. Without these updates your anti-virus software becomes much less effective, especially against new types of viruses.
- Be careful when dealing with e-mail attachments. If you receive an attachment that you were not expecting or from an unknown source, delete it or call the sender. Many of the newest viruses take advantage of e-mail to spread themselves.
- Scan all diskettes that you insert into your computer
- Don't download programs from unknown sources such as newsgroups.

Following these tips will not ensure that your computer system will not contract a virus, but it certainly reduces the chances greatly.

## **EMBEDDED SYSTEMS**

Most businesses when evaluating whether or not their systems are Y2K compliant are considering mainly their computer systems. While the computer system is an important part of most businesses, embedded systems should also be considered when testing for Y2K compliance. Embedded systems are equipment and systems containing integrated circuits, such as:

Elevators	Thermostats	Telephone systems
Voice mail systems	Faxes	Copiers
Utility meters	Security system	Time clocks
Internal sprinkler systems	Lighting	Appliances

Many of the manufacturers of embedded systems have web sites containing their Y2K plans and also include a list of their products confirming their compliance. Also letters to the manufacturers, and or vendors can be sent to verify if a specific brand of equipment will be able to handle the New Year.

Any company can become Y2K compliant by starting corrective action soon enough and devoting sufficient resources to the effort. However, we recommend starting as soon as possible before there is not enough time left to complete the necessary steps to ensure Y2K compliance. If you need help evaluating your systems, please contact us. But you will need to do so now before time runs out.

## **STAFF INTRODUCTION**

We will be introducing staff members in each newsletter so that you may become acquainted with each individual skills and abilities to better serve your needs. In this issue, the firm is pleased to introduce Michael Polashek, our Tax Manager.

### **MICHAEL POLASHEK, TAX MANAGER:**

Michael joined Kakimoto and Co. in March 1998. He is an attorney and CPA and has over 10 years tax experience. He earned his bachelor's degree in accounting from the University of Arizona, and graduated *cum laude* from Arizona State University College of Law in 1995.

Prior to joining the firm, Michael practiced law in Arizona with Gust Rosenfeld, P.L.C. There, Michael represented several institutional clients with regard to income and sales tax matters, and appeared in Arizona Tax Court. Prior to that, Michael worked for over six years with the Arizona Department of Revenue, in the areas of income tax and sales tax. During his last two years with the Department of Revenue, Michael represented the Department in administrative hearings with respect to corporate income tax issues. In addition, Michael has worked in the tax departments of Deloitte & Touche and Arthur Anderson.

Since joining Kakimoto and Co., Michael has successfully represented several of our clients, both corporate and individual, in IRS audits, including international audits. Michael has also been very involved in the transfer pricing area, and has conducted transfer pricing analysis for many of our clients.

The firm is pleased to have Michael's background and skills available to its clients. His talents are especially valuable for purposes of tax planning, transfer pricing analysis and representation before the taxing authorities.

If you would like to have additional information or have any questions, please do not hesitate to contact us.