

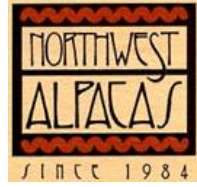


## ALPACA TAXES 2007

### Why Not Have Uncle Sam Help You Buy Your Alpacas?

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**By Mike Safley**



### **ALPACA TAXES 2007** **WHY NOT HAVE UNCLE SAM HELP YOU BUY YOUR ALPACAS?** By Mike Safley

To begin I want you to know that the idea of taxes is not new nor the exclusive sin of the United States Government. In Roman times, Caesar Augustus decreed, "that all the world should be taxed." Politicians have taken taxation to heart for centuries. We have, on occasion, been given good advice about our responsibility to pay tax. The Honorable Supreme Court Justice Learned Hand instructed the IRS, in a high court decision, that it was not a citizen's duty to conduct himself so as to pay the maximum tax possible, but that a common man might arrange his affairs so as to pay the least amount of tax possible. God bless the judge, and God bless our alpacas and their tax advantages.

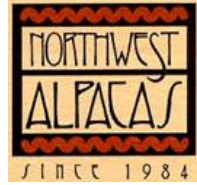
I must confess, I don't like to pay taxes; I always do, but I'm never happy about it. I inherited this bias, I believe, from my father. Dad was always fully convinced of his beliefs, and he believed that IRS agents were the bad guys.

Dad was one of the first full time llama farmers in the U.S. to be audited by the IRS. It was quite a task to prove to the agent who conducted Dad's audit that llamas were in fact a profit making enterprise. The agent decided that before he completed his review of Dad's tax return, he wanted to see these llamas with his own eyes; just to make sure, of course, that everything was on the up and up.

After much negotiating between my dad's accountant and the agent, it was agreed that the agent could view the llamas from the road in front of Dad's farm; he wasn't to be allowed on the property. When the fateful day arrived, Sam, the IRS agent, appeared at the fence in front of Dad's ranch. It wasn't long before Bonnie, his big black llama, wandered up to the fence and offered Sam a kiss. I still to this day believe that my dad's audit was the only one ever closed as a result of a llama's kiss. Thank God, she didn't spit!

Raising alpacas can offer the farmer some very attractive tax advantages. In 2003 those benefits got a lot better due to the "Jobs and Growth Reconciliation Tax Act." which was enacted into law on May 28, 2003. It was amended for the 2007 tax year. The new rules added several powerful incentives for people who buy alpacas. The 179 deduction has been raised to \$108,000. These benefits are for assets placed in service after May 5, 2003 and they expire in December 2009.

If alpacas are raised for profit, all the expenses attributable to the endeavor can be written off against your income. Expenses would include not only feed, fertilizer, veterinarian care, etc., but depreciation of such tangible property as breeding stock,



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barns and fences, all of which can help shelter current cash flow from tax. Beyond these basics there are several strategic tax advantages for the alpaca farmer.

The fact is that Uncle Sam will pay for a portion of the cost of acquiring your herd, assuming you are currently paying income tax and plan to continue paying income tax over the next six years. You can write 100% of your original purchase price off, up to a maximum of \$108,000, in the year of purchase. If you are in the 45% tax bracket, the deductions for depreciation that the animals are eligible for may save you up to 45% in cash, of your original purchase price.

If you were to buy ten females for \$108,000, pay \$36,000 down, and take advantage of IRS code section 179, insure the animals and finance the balance over 4 years, the government would give you a tax refund of \$50,607 and you would have cash out of pocket of (\$7,582) in the first year. In other words in the year of purchase you would pocket \$7,582 in net cash, after tax. This assumes you are in a 45% tax bracket (state & federal). (See page 8 for the complete details.)

If you would like Northwest Alpacas to compute the after-tax cost of your prospective alpaca purchase according to the 2007 tax law update, please email Fred Kraft at [Fred@alpacas.com](mailto:Fred@alpacas.com). He will be glad to do a six-year projection that calculates the after-tax cost of your alpacas.

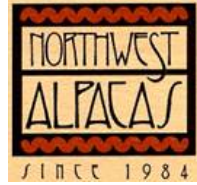
I recommend that you engage an accountant for advice in setting up your books and determining the proper use of the concepts discussed in this article. The aim of this discussion of IRS rules is to make you more conversant with the issues of taxation.

### **TAX DEFERRED WEALTH BUILDING**

Alpaca breeding also allows for wealth building, while deferring tax on your investment's increased value. A small farmer can purchase several alpacas and then allow their herd to grow over time without paying tax on its increased size and value. If the same amount of money was invested in a Certificate of Deposit, any interest earned would be currently taxable. In addition, the C.D. could not be depreciated, thereby offsetting the amount of tax due.

### **IRS CODE SECTION 179 DEDUCTION**

This deduction is available every year when you purchase IRS code 1245(a) (3) assets that are acquired for use in an active business [(Code Section 179 (d) (1)], assuming that you have not used the deduction on a computer or some other qualifying asset. Many people do not understand that you can use this deduction to write off your purchase of up to \$108,000 worth of alpacas this year and that they can take another \$112,000 deduction next year. The following example takes into consideration IRS



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code section 179. (If you would like a copy of the code section, please give us a call 503-628-3110 or email [Fred@alpacas.com](mailto:Fred@alpacas.com).)

Purchase price (one or more alpacas):	\$108,000
Section 179 tax deduction	(\$108,000)
Tax savings 45% (tax bracket 45%)	<u>(\$48,600)</u>
Actual after tax cost out of pocket	<u>\$59,400</u>

In other words, if you are in the 45% tax bracket (state & federal) the government will reduce your taxes by 45% of the cost of \$108,000 worth of alpacas. This deduction is available for all taxpayers. To see how much this will benefit you, simply calculate your state and federal tax bracket and multiply it by the amount of your purchase up to \$108,000.

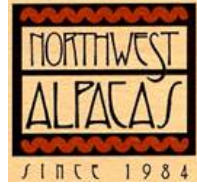
**Please Note:** 1) that you must have sufficient income to use the deduction. If you have no ordinary income then the deduction will be limited, 2) the unused portion of the deduction can be carried forward to subsequent years, 3) you may want to forgo electing to take the deduction and simply depreciate the cost of your alpacas. This approach would allow you to create a net operating loss which could be carried back two years and you may obtain a refund of previously paid tax, and 4) to benefit from the 179 deduction the tax payer can not place more than \$430,000 of qualifying assets in service in the year that the deduction is taken.

## HOBBY FARM RULES

The first step in qualifying for favorable tax treatment as a farmer is establishing that you are in business to make a profit. You can not raise alpacas as a hobby farmer and receive the same tax preferences as a for-profit farmer. A farming operation is presumed to be for profit if it has reported a profit in three of the last five tax years, including the current year.

If you fail the three years of profit test, you may still qualify as a “for profit” enterprise *if your intention* is to be profitable. Some of the factors considered when assessing your intent are:

1. You operate your farm in a business-like manner.
2. The time and effort you spend on farming indicates you intend to make it profitable.
3. You depend on income from farming for your livelihood.
4. Your losses are due to circumstances beyond your control or are normal in the start-up phase of farming.
5. You change your methods of operation in an attempt to improve profitability.



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6. That you make a profit from farming in some years and how much profit you make.
7. You or your advisors have the knowledge needed to carry on the farming activity as a successful business.
8. You made a profit in similar activities in the past.
9. You are not carrying on the farming for personal pleasure or recreation.

You don't have to qualify on each of these factors – the cumulative picture drawn by your answers will provide the basis for the determination.

### **FARMERS TAX GUIDE**

One of the frustrating factors in dealing with the IRS rules is getting to a definitive answer. The code is often more grey than black or white; consider the following statement which is found in IRS publication 225, *Farmers Tax Guide*:

“This publication covers some subjects on which a court may have made a decision more favorable to taxpayers than the interpretation of the Service. Until these differing interpretations are resolved by higher court decisions or in some other way, this publication will continue to present the interpretation of the Service.”

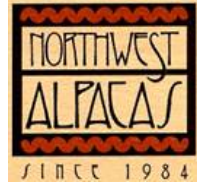
I recommend everyone who farms alpacas obtain a copy of this handy guide at your local IRS office or at the IRS website at [www.irs.gov](http://www.irs.gov). It is very informative.

Once you've established that you are farming alpacas with the intent to make a profit, you can deduct all qualifying expenses from your gross income. The discussion from here forward presumes you are a cash basis taxpayer and you keep good records. Accrual basis tax payers would also be allowed the same tax treatment, but their timing might be different.

First, the following items must be included in your gross income calculations:

1. Income from the sale of livestock
2. Income from sale of crops, i.e., fiber
3. Rents
4. Agriculture program payments
5. Income from cooperatives
6. Cancellation of debts
7. Income from other sources, such as services
8. Breeding fees

Then the following expenses may be deducted from this income:



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1. Vehicle mileage at .48 ½ cents a mile for all farm business miles
2. Fees for the preparation of your income tax return farm schedule
3. Livestock feed
4. Labor hired to run and maintain your farm (remember, you must not deduct the expense of maintaining your personal residence)
5. Repairs and maintenance
6. Interest
7. Breeding fees
8. Fertilizer
9. Taxes and insurance
10. Rent and lease costs
11. Depreciation on animals used for breeding, real property improvements, barns and equipment
12. Farm-related travel expenses
13. Educational expenses, which improve your farming expertise
14. Advertising
15. Attorney fees
16. Farm fuel and oil
17. Farm publications
18. AOBA dues and registry fees
19. Miscellaneous chemicals i.e. weed killer
20. Vet care
21. Small tools having a useful life of less than one year

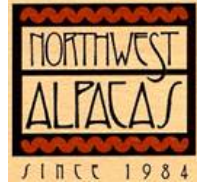
Please note: Personal and business expenses must be allocated between farm use and personal use, for instance, with such expenses as utilities, property taxes, accounting, etc. Only the farm use portion can be expensed.

### **AT RISK RULES**

Once you've determined your net income or loss, it is included on your tax return as an addition to or a deduction from your ordinary income. Losses can be carried back for two years and forward for twenty years. To deduct any loss, you must be at risk for an amount equal to or exceeding the losses claimed. The "at risk" rules mean that the deductible loss from an activity is limited to the amount you have at risk in the activity. You are generally at risk for:

1. The amount of money you contribute to an activity
2. The amount you borrow for use in the activity

You must establish the cost basis of your assets for tax purposes. This basis is used to determine the gain or loss on sale of an asset and to figure depreciation. In determining basis, you must follow the uniform capitalization rules found in the IRS code. Animals raised for sale are generally exempt from the uniform capitalization rules,



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and there are other exceptions for certain farm property. You need to become familiar with these rules.

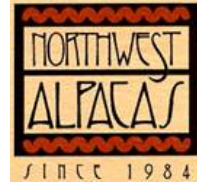
Once you've established the cost basis of your various assets, you take a charge for depreciation against your annual income. This process allows you to expense the historic cost of an asset to offset present income. The effect is to create non-taxable cash flow on a current basis. This benefit is especially attractive in an environment of higher taxes.

### **ALPACAS SIX YEAR WRITE-OFF**

There are several methods of writing alpacas off, beginning with the straight line method which allows you to deduct one-fifth of their cost each year, except the first year, in which the code allows for a prorated write off based on the month of your purchase. The net result of this method is that it takes six years to write off your alpacas, unless you buy them in January. The straight line system can only be used by making an election. There is also the modified accelerated cost recovery system using 150% declining balance and the half-year or mid-quarter convention (MACRS) which allows animals to be written off as follows: 15% year 1, 25.5% year 2, 17.85% year 3, 16.66% years 4 and 5, and 8.33% year 6. This is an accelerated schedule allowing for a larger percentage of the asset to be written off early. The MACRS system is the system preferred by the IRS since it does not require an election. Alpacas born at your ranch have no cost basis and cannot be written off, although they may qualify for capital gain treatment on sale. The costs related to financing or interest on your purchase is also deductible. Many people pay cash for their animals so writing off the interest is not an issue. The following examples articulate the benefits of tax deductions derived from an investment in alpacas. The examples do not include expenses for feed, veterinarian care, supplies, and transportation.

### **FINANCING**

Let's consider what would happen if you purchased a herd of six alpacas for \$108,000. In this scenario we will assume you are in the 45% overall tax bracket (state and federal), use the section 179 deduction in year one, use the MACRS depreciation method, finance the herd at 8% interest for four years, and insure the herd for the balance owed after a 30% down payment. If you would like to receive a customized projection, similar to the following, for your purchase, please email Fred Kraft at [Fred@alpacas.com](mailto:Fred@alpacas.com). All purchases of less than \$108,000 are 100% expensable in the year of purchase. (Please consult your accountant to determine how these benefits pertain to your actual taxable circumstances.)



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### FIVE YEAR AFTER TAX PURCHASE PROJECTION

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	YEAR 6
<b>Purchase Price:</b>	108,000					
<b>Down Payment</b>	36,000					
<b>Section 179 Deduction</b>	(108,000)					
Interest Payments:	(951)	(4,972)	(3,634)	(2,185)	(628)	0
Insurance:	(3,510)	(3,510)	(3,510)	(3,510)	(3,510)	(3,510)
Principle Payments:	(2,564)	(17,458)	(17,458)	(18,907)	(16,950)	0
Total Tax Deduction:	(112,461)	(7,144)	(7,144)	(5,695)	(4,138)	(3,510)
Total Tax Savings:	(50,607)	(3,215)	(3,215)	(2,563)	(1,862)	(1,580)
Total Cash Invested:	43,025	24,602	24,602	24,602	21,088	3,510
Cash Out-of-Pocket						
Net After Tax Each Year:	<u>-7,582</u>	<u>21,387</u>	<u>21,387</u>	<u>22,039</u>	<u>19,226</u>	<u>1,930</u>
Cumulative After Tax Cost:	<u>-7,582</u>	<u>13,203</u>	<u>34,591</u>	<u>56,630</u>	<u>75,856</u>	<u>77,786</u>
Principal Balance-End		<b>End of Yr 1</b>	<b>End of Yr 2</b>	<b>End of Yr 3</b>	<b>End of Yr 4</b>	<b>End of Yr 5</b>
of Year on Contract:		<u>\$ 69,436</u>	<u>\$ 53,316</u>	<u>\$ 35,858</u>	<u>\$ 16,951</u>	<u>\$ 1</u>
<b>ASSUMPTIONS:</b>						
<b>INTEREST RATE</b>	8.00%					
<b>INSURANCE RATE</b>	3.25%					
<b>LENGTH OF LOAN</b>	4 YEARS					
<b>TAX BRACKET</b>	45.00%					

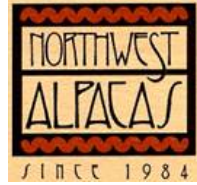
The total after tax cost of purchasing a \$108,000 herd for taxpayers in the 45% bracket (state and federal) is \$77,786, spread over six years, including principal, interest, and insurance.

### **CAPITAL IMPROVEMENTS**

Capital improvements to your ranch can also be written off against income. Barns, fences, pond construction, driveways, parking lots all can be expensed over their useful life. Equipment such as tractors, pickups, trailers and scales each have an appropriate schedule for write off. The depreciation schedule for each asset class varies from three years to forty years. A barn or special purpose agricultural building can be written off pursuant to Section 179 in the year it is put in service. If you do not chose to write the barn off as a Section 179 asset then you can depreciate it. To qualify for a 179 deduction it must be put in service after May 5, 2003 and before 2010.

The original cost basis of an asset is reduced by the annual amount of depreciation taken against the asset. Other costs add to basis, such as certain improvements or fees on sale. The changes to basis result in the adjusted cost basis of the asset. Upon sale excess depreciation, previously expensed, must be recaptured at





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ordinary income rates. The recapture rules are a bit complex, as are most IRS rules, but the IRS Farmers Publication I've mentioned explains them well.

### **CAPITAL GAINS VS. ORDINARY INCOME**

When an asset is sold, say for instance a female alpaca, which was purchased for breeding purposes and held for several years, the gain or loss must be determined for tax purposes. If this alpaca was purchased for \$20,000 depreciated for two and a half years or, say, 50% of its value, and then resold for \$20,000, there would be a gain for tax purposes of \$10,000. In other words, your adjusted costs basis is deducted from your sale price to determine gain or loss.

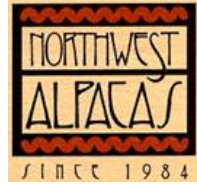
Once you've determined the amount of a gain, you must classify it as either ordinary income or capital gain. This year ordinary income will be taxed at a maximum rate of, up to, 35% and capital gains are taxed at rates of, up to, 15%. Previously these rates were 39% and 20% respectively. The sale of breeding stock qualifies for capital gains treatment (excepting that portion of the gain which is subject to depreciation recapture rules). Any alpacas held for resale, such as newborn cria which you do not intend to use in your breeding program, would be inventory and produce ordinary income on sale. Animals born on your ranch and held for breeding purposes, which usually involves holding them for more than two years, can be taxed at capital gain rates on sale. The capital gains treatment of sale proceeds are an attractive benefit of raising alpaca breeding stock.

### **CHARITABLE DEDUCTIONS AND EXCHANGES**

There are other tax-saving strategies that can be utilized in concert with operating your farm. For instance, you are entitled to claim a charitable deduction for the fair market value of a capital asset, which you contribute to a qualifying charity or institution. You can also exchange like for like (Section 1031) assets and avoid the tax of a sale. An example of this strategy would be a breeder who wanted to diversify his bloodstock. If he sold his alpacas and simply bought more, he would be required to pay tax on his gains. If he exchanged his alpacas for others, there would be no tax due. Employing the exchange concept can be very beneficial; for it to work efficiently; a third-party buyer is usually introduced into the transaction. The model for this type of transaction would be a real estate exchange. I'm sure your C.P.A. would be familiar with the use of like kind exchanges and how it might benefit you.

### **INSTALLMENT SALES**

Installment sale rules allow you to defer income to future years. If you sell an alpaca with credit terms, you can defer your gain until you receive payment (excepting that portion of the gain which is subject to depreciation recapture rules). If an animal



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dies of disease and is insured, you can use the involuntary conversion rules in the code. These rules allow tax-free replacement of your animal.

### **CONCLUSION**

Please bear in mind that I am not an accountant. This discussion of tax issues omits a number of rules which will impact your taxes. I did not discuss tax preference items, alternate minimum taxes, employment taxes and other concepts of importance. Whether we like it or not, this is a complicated world we live in; it often requires CPA's and on occasion an attorney. Whatever happened to the days when all you needed to farm was a mule, a plow, and a strong back?

In summary, the major tax advantages of conducting an alpaca business include the employment of expensing capital assets depreciation, capital gains treatment, and the benefit of offsetting your ordinary income from other sources with losses from your farming business. Wealth building by deferring taxes on the increased value of your herd is also a big plus. It pays to keep your eye on the tax law changes instituted by Congress. On occasion, like in the year 2007, you may find a silver lining in the clouds of government.