# Tax Considerations

**For**

# Alpaca Breeders

Presented to Alpaca Ranchers of the Northwest
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## Introduction

The alpaca breeder faces a host of complicated tax compliance and accounting issues. This document is intended to introduce some of these issues, both good and bad. It is not intended to be exhaustive, but hopefully can be used as a starting point in preparing an alpaca tax return or hiring a tax professional.

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## About The Speaker

Matt Bannon is an Enrolled Agent and Licensed Tax Consultant in Portland, Oregon. He has been preparing tax returns since early 2000 and is one of the founding members of Granite Point Tax Group, LLC. When not preparing individual and business tax returns for clients across the Pacific Northwest and beyond, he helps clients with tax planning issues, general bookkeeping, and QuickBooks applications. Outside interests include amateur triathlon racing, mountain sports, and raising his family (not necessarily in that order).

## About Our Company

The Granite Point Tax Group brings together dedicated, experienced tax professionals that are committed to high quality, personalized services. We focus on understanding our clients' needs and excel at strategic problem solving, and we do it all in a format we think you will find very refreshing.

Our areas of practice include the preparation of tax returns for individuals, businesses, trusts, estates, and tax exempt organizations. We offer full-service bookkeeping, small account payroll, and office management services, as well as consulting and tax planning assistance in all areas of taxation.

## Hobby Loss Rules

Many farms begin their lives generating limited amounts of income while incurring lots of expenses. Expenses in excess of income will create an operating loss. Whether or not you can use this operating loss to offset other taxable income depends on whether your farm is a hobby or a business. If your farm is a hobby you can only deduct your expenses up to the amount of your income and, because of how they are reported, hobby expenses are subject to other limits on their deductibility. This raises the obvious question of just what is and what is not a hobby. The essential issue comes down to the intent to make a profit. A person operating a business has a reasonable expectation of making a profit. A person enjoying a hobby does not. Nine factors are used by IRS to make this determination:

- The manner in which the taxpayer carries on the activity – essentially, do you act like a business? Do you keep records? Do you change your methods of operation to improve profitability? Do you promote yourself?
- The expertise of the taxpayer or advisors – do you know what you are doing? If not, do you hire professionals who do?
- Time and effort by the taxpayer in carrying on the activity – do you spend a reasonable amount of time conducting the activity? Are you involved on a continuous basis?
- Expectation of asset appreciation – Can you reasonably expect that the assets used in the business (e.g. breeding animals) will appreciate in value over time?
- Taxpayer's success in other similar or dissimilar activities – have you proven yourself in other business ventures?
- Taxpayer's history of income or losses with respect the activity – is a string of losses just a slump, or has the activity always lost money?
- Amount of occasional profits, if any – a small profit in one year will be disregarded if preceded by many years of substantial losses.
- Financial status of the taxpayer – how dependent are you on the income of the activity? Is this just a tax shelter?
- Elements of personal pleasure or recreation – are you using the activity simply as a means of deducting travel or other recreation?

No single factor will determine the outcome of this analysis, and the list is not meant to be exhaustive – all facts and circumstances are considered and weighed to determine whether a profit motive is present. A farm that sustains losses over a significant period of time is at risk for audit selection and scrutiny on whether it is a business or a hobby. There is a safe harbor provision that applies to this analysis. If you make a profit for three out of five consecutive years your farm will be presumed to be conducted for profit for that five-year window, although even this presumption can be overridden if facts and circumstances warrant. Below is an example illustrating the impact the hobby loss rules can have on a farm.

| | Business | Hobby |
|---|---|---|
| **Income** | | |
| Wages | 120,000 | 120,000 |
| Interest | 500 | 500 |
| Business Income | 10,000 | 0 |
| Business Expenses | -25,000 | 0 |
| Hobby Income | 0 | 10,000 |
| **Total Income** | 105,500 | 130,500 |
| | | |
| **Deductions** | | |
| Exemptions - 3 | 11,400 | 11,400 |
| Itemized Ded. | 21,500 | 21,500 |
| Hobby Expenses | | 10,000 |
| 2% AGI Limitation | | -2,610 |
| **Taxable Income** | 72,600 | 90,210 |
| | | |
| **Total Federal Tax** | **10,216** | **14,616** |

As you can see from the chart, the two scenarios report the same amount of income, but the hobby expenses are shifted down to the deductions section and limited to the amount of hobby income. Then they are further reduced by 2% of total income (AGI) with the net result being a $4,400 difference in total tax liability.

## Passive Activity Loss Limitations

If a taxpayer's activities in the day-to-day operation of a business are limited, passive activity loss rules will kick in and any losses generated by the activity can only be used on the tax return to offset other passive income; any excess must be suspended to a future year when income is generated or the business is sold.

Generally, if you spend more than 500 hours during the year performing work directly related to the daily activities of your farm you will be deemed to have materially participated in the farm's activities and it will not be considered a passive activity. You will then be able to use farm losses to offset other types of income on your tax return. The activities typically considered when counting your participation hours include halter-training, shearing, showing, cleaning, equipment maintenance, business travel and time spent clearing pastures and building fences or making other improvements to your farm property. It does not include activities of a managerial or marketing nature, such as internet research or breeding decisions.

For husbands and wives both their hours of participation count toward the 500-hour threshold. There are other ways to measure participation to avoid the passive activity rules, most notably the 100 hour test which requires you spend at least 100 hours on the business during the year and no other person spends more time than you.

Most farmers have no trouble meeting the participation hours (think of all those mornings spent mucking stalls or cleaning your pastures using your new vacuum). However, the breeder whose animals are boarded at another farm may need to look carefully at their participation hours to make sure they are meeting the material participation rules if they hope to utilize a loss on their tax return.

## At Risk Rules

Business losses are deductible only to the extent the owner(s) is at risk of financial loss. Although this seems on the surface to be an obvious point and the at-risk rules are often overlooked, they can have a real impact on the unwary alpaca breeder. Example: Let's say you purchase a nice breeder on December 31 for $25,000 with a down payment of $5,000 and the balance payable over the course of the following year. Assuming the animal is placed in service (i.e. bred) that day, you are entitled to a depreciation deduction of up to the full $25,000. Under the at-risk rules, however, if the farm incurs a loss for the year, that loss is likely to be limited since you are only "in the game" for $5,000 at this point.

Basis for the at-risk rules is limited to the amount of cash put into the activity plus any recourse debt (personally liable and collateralized) used as financing. Non-recourse debt such as unsecured loans (e.g. credit cards) does not qualify. Furthermore, any collateral pledged must consist of assets not used in the activity. In the example above, pledging a personal vehicle as collateral for the alpaca purchase would generate the basis needed to avoid the at-risk loss limitation, but pledging only the alpaca itself (or other alpacas) would not qualify since they are used in the activity.

Other forms of financing a business which would not create basis under the at-risk rules include non-recourse lines of credit, informal family loans, and the famous "handshake pledge" that farmers are so famous for.

## Immature Livestock

Assets used in a trade or business, including farms, are eligible for depreciation when placed in service. This includes breeding animals, but take note of the last portion of that sentence; "when placed in service." A breeding animal is generally considered placed in service when you actually begin breeding it. Immature breeding animals must be held for tax purposes until bred, at which point depreciation can begin. IMPORTANT: This can lead to a huge tax trap! Although depreciation begins when an asset is placed in service, the Section 179 election (see depreciation next) is available only in the *year of purchase*. If you need a big write-off and are counting on Section 179 to provide it, be sure to buy animals you can breed by year-end!

## Farm Depreciation

In order to match expenses with income, the cost of purchasing business assets (items costing more than $100 and with an expected useful life of more than a year) is deducted over a number of years based upon the asset's classification through a process called depreciation. The asset classes make a rough estimation of how many years a particular type of asset will last. For instance, under the depreciation rules farm fencing is assumed to last 7 years. The cost of installing new fencing, then, is expensed over 7 years of tax returns. Under the original depreciation rules you would expense the fencing ratably at one seventh per year. These days, however, the formula has been modified to accelerate the bulk of the depreciation into the first few years, trailing off toward the last few years. This is known as the "Modified Accelerated Cost Recovery System" or MACRS.

The tax rules on depreciation have been liberalized over recent years to help stimulate the economy through increased spending. These rules are found in Code Section 179 and in newer, special bonus depreciation rules. These rules allow more immediate use of the cost of assets as a deduction, but they do not avoid complex recapture rules that apply to all depreciable assets. In simple terms, these recapture rules may require you to recognize the depreciation expense taken in a prior year as ordinary income on the sale of an asset, or for certain assets when their business use drops below 50%.

Most farmers are familiar with Section 179, which allows you to expense a portion of assets in the year of purchase, up to $139,000 total (note: this amount was $500k for 2012 and could be retroactively reinstated for 2013) . Assets that qualify for this treatment may be new or used, but must be placed in service during the tax year and used more than 50% for business. There are certain types of assets that do not qualify for Section 179, most notably buildings. You do not have to take a deduction for the entire cost of an item in the year of purchase; instead, you can take a partial Section

179 deduction and regular depreciation expense for the rest of the asset's cost. There are business income limitations for the use of Section 179, so the expense is not always available and will generally not be available to create a net operating loss deduction (discussed in another of our publications).

Substantial changes were made in 2010 to the newer special bonus depreciation rules. For 2013 bonus depreciation is available for up to 50% of an asset's basis after any Section 179 deduction taken . These rules allow you to accelerate the depreciation expense for an asset into the year of purchase. They only apply to new, first-use assets. It is our opinion that an unproven animal will qualify for special bonus depreciation, but remember that depreciation begins when assets are placed in service. Unlike Section 179, however, bonus depreciation can be claimed in the year the asset is first placed in service regardless of when it was purchased.

The chart below illustrates the impact of four different depreciation methods on the same tax return. In this case, $50,000 of new farm assets placed in service in 2012 are depreciated over seven years using straight line depreciation, regular MACRS depreciation, 50% bonus depreciation with the balance seven year MACRS, and fully expensed under Section 179.

| 2012 MFJ | **Straight-Line** | **MACRS 7-Yr** | **50% Bonus** | **Sec. 179** |
|---|---|---|---|---|
| | | | | |
| Wages | 160,000 | 160,000 | 160,000 | 160,000 |
| Farm Income | 10,000 | 10,000 | 10,000 | 10,000 |
| Farm Expenses | 35,000 | 35,000 | 35,000 | 35,000 |
| Depreciation | 3,570 | 5,355 | 27,678 | 50,000 |
| **Total Income** | 131,430 | 129,645 | 107,322 | 85,000 |
| | | | | |
| Exemptions - 3 | 11,400 | 11,400 | 11,400 | 11,400 |
| Itemized Ded. | 21,500 | 21,500 | 21,500 | 21,500 |
| **Taxable Income** | 78,530 | 76,745 | 54,422 | 32,100 |
| | | | | |
| **Total Federal Tax** | **11,691** | **11,241** | **7,294** | **3,949** |
| | | | | |

As you can see, the depreciation deduction ranges from $3,570 to $50,000 generating a total tax savings of $7,742 under this scenario. The default depreciation method is 50% bonus depreciation for qualified assets and MACRS for the balance, plus MACRS for all other assets. Any other form of depreciation you wish to use (straight line, Section 179, or opting out of bonus depreciation) requires an election to be made on the tax return. Some of these elections are revocable and some are not, so plan carefully and do your homework!

## Tax Treatment of Alpaca Sales

The question of how an alpaca sale is taxed can be remarkably complicated. Alpacas and other agricultural animals used for breeding are farm assets and upon their sale are taxed as capital gain (although see “depreciation recapture” later in this section). This is good news for the alpaca breeder, as long term capital gains are afforded preferential tax treatment; under current law the maximum capital gains tax rate is just 20% compared to the top regular income tax rate of 39.6%. Long term gains are those generated by assets held for more than a year, but even short term capital gains escape self-employment tax. Furthermore, assets sold on the installment method can be reported and taxed as the income is received, thereby spreading the tax impact over multiple years (once again, however, beware of depreciation recapture).

Animals *not* held as assets are considered inventory. Sales of these animals should be reported on Schedule F and are taxed as ordinary income. Additionally, any gain on Schedule F is subject to 15.3% self-employment tax (Social Security and Medicare) on top of the income tax. Note that an alpaca does not necessarily have to be a breeder in order to be considered a farm asset; a companion male, a fleece producer, or a friendly “PR” boy could all be considered assets as they are being held for use not resale.

The last category of income that can be produced by selling alpacas is depreciation recapture. If you sell a business asset which you have deducted through depreciation and the sale price exceeds the remaining basis in the asset, that generates taxable gain. And since you originally claimed a deduction at ordinary tax rates, the gain which otherwise would have qualified for capital gains rates is now subject to ordinary tax rates. You are “recapturing” some or all of the depreciation you claimed as a deduction in an earlier year. Any gain in excess of *that* is taxed as capital gain. The IRS has developed a special form to split business asset sales into appropriate types of income – Form 4797.

One final word of caution regarding depreciation recapture: The recapture income is fully taxed in the year of sale, even on installment sales. This can present quite a tax trap for the unwary alpaca breeder. Consider the following comprehensive example:

> Farmer Bob buys a stud in 2011 for $30,000. He claims a depreciation deduction in the year of purchase of $15,000 and another $5,000 the following year. The alpaca’s remaining tax basis is $10,000 at this point. In 2013 he sells the animal for $35,000. His total gain on the sale is $25,000 of which $20,000 represents depreciation recapture and is taxed as ordinary income in the year of sale. The remaining $5,000 is long term capital gain taxed at the lower capital gains rate and is eligible to be deferred under the installment method.

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## Business Entity Selection

The form of business entity you choose for your farm can have profound legal and tax implications. Entity selection and formation is complicated; although we are providing a broad overview of the issues involved, working with a competent business attorney is highly recommended.

The simplest business format, and probably the most common among small farmers, is the sole proprietorship. One owner, no separate legal structure, very clean and simple. A sole proprietor reports business income and expenses on Schedule C or Schedule F (farmers) and the net profit or loss is carried to the front of their personal tax return. Profits are taxed as ordinary income and are subject to self-employment tax (Social Security and Medicare), losses can be used to offset other ordinary income such as wages (subject to passive activity and at-risk rules discussed earlier). The owner is fully liable for all aspects of the business and should always consider liability insurance for protection.

When two or more people decide to operate a business as co-owners, a partnership is born. Because the possible ownership scenarios are endless, the rules governing partnerships are voluminous and complicated. In general, though, a partnership reports income and loss on a separate tax return (Form 1065) and issues a K-1 at year-end to each partner reporting that partner's share of gain or loss for the year. Each partner then includes their K-1 information on their personal tax return. The partnership itself pays no income tax; this is referred to as a "pass-through" entity since the income passes through the partnership and is taxed at the individual level. Like sole proprietorships, partnership gains are taxed as ordinary income, are subject to self-employment tax, and losses can offset other ordinary income (still subject to passive activity and at-risk rules).

Husband-wife co-owners are technically a partnership and must file a partnership tax return. Because Washington is a community property state, however, married couples may file a joint Schedule C or F under Revenue Procedure 2002-69 unless operating as a Limited Liability Company (see LLC later). This set of rules has the potential to create a significant tax trap for new businesses, especially those with large initial asset purchases such as a foundation alpaca herd. One of the most powerful tax tools available to the business owner is the Section 179 deduction. This code section does have some limitations, though, and one of these is that it is limited to the net income reported on the tax return. For a sole proprietor the net income on the return includes wages (and the spouse's wages if applicable), which often allows Section 179 to be used even when the farm itself generates a loss. On a separate return such as Form 1065, however, if operating expenses exceed income on their own, Section 179 will be disallowed. In this scenario, it might be smart to consider operating as a sole proprietor in the initial years when assets are being purchased and convert to a partnership or other format later.

A more formal business choice is the corporation. In this arrangement a separate legal entity is created which sells shares to one or more owners. This can help shield the owners from legal liability,

but does come with the downside of greatly reduced flexibility; in order to add or remove owners or change ownership ratios, shares of the corporation must be bought or sold. A corporation is also a taxpaying entity, meaning profits are taxed on the corporate return (and again when distributed out to the owners) and losses are unavailable for use by the shareholders. If that weren't enough, corporations do not enjoy the special long term capital gains tax rates of individuals; this can make a substantial difference in tax liability for an asset-heavy business such as alpaca breeding. Certain small corporations can elect to become S-Corporations, which avoids the double taxation issue by passing income or losses through to the shareholders on Form K-1 the same way a partnership does. This also affords the capital gains tax rates, but does not avoid the Section 179 trap discussed above. One other factor for the small farmer to consider before incorporating is that the legal shield provided by the corporate structure is neither automatic nor unassailable. If the owner(s) doesn't respect the corporation's rights and boundaries, the legal shield can be pierced by a creditor or other adversary. In the case of a small farm, it is often difficult or impossible to maintain those boundaries. For example, if the purpose of the corporation is to breed and sell alpacas, it needs barns and fencing. But barns and fencing are attached to land, and who owns the land? Generally not the corporation. The corporation could rent the land from the farmer, of course, but why would it do that when the well is also used for the farmer's house and the access road doubles as a personal driveway?

The final entity choice is a chameleon and in fact doesn't even exist for tax purposes. The Limited Liability Company is a legal structure that is essentially placed atop another structure but files tax returns based on its underlying nature. A single-member LLC is treated as a sole proprietorship for tax purposes. A multi-member LLC files a partnership return…unless it elects to be taxed as a corporation. In that case it files a corporate tax return, and can even elect S-Corporation status. More than any other business format, the LLC should be discussed first and foremost with a business attorney.

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## Building the Business Plan

A business plan serves many purposes. Besides being the best way to pitch a business to potential investors or bankers, it also helps keep the owner(s) from losing sight of the overall objective of the business; to make money! The business plan should be a living document that changes as the needs of the business change – but be sure to keep copies of the old plans, as they could be worth their weight in gold during a tax audit.

**Elements of a good business plan:**

- Clear and concise description of the purpose of the business
- Analysis of similar businesses with reasonable estimates of performance
- In depth discussion of how the business will be similar and dissimilar to competitors and why
- Analysis of current and future finances (initial funding, ongoing cash flow, etc.)
- Review of previous versions of the plan and discussion of revisions

Keep in mind that a decision which may seem silly or illogical now may have been perfectly reasonable under the conditions that existed when it was made. Should you ever need to justify your decisions to an auditor or investor, those outdated versions of your plan could come in very handy.

## Adding Children to Payroll

Quick tax tip: For the sole proprietor or husband-wife partnership, adding your children to the farm payroll can result in significant tax savings. The gross salary is a deductible farm expense while the income can potentially be tax-free to the kids. If total wages are kept below the annual filing requirement ($5,950 per person in 2012), no tax return is necessary and yet the earnings still qualify for purposes of contributing to a retirement plan. This means you can open a Roth IRA account for your child, pay them a salary of (for example) $5,000 and contribute the entire amount to the retirement account, deduct the salary as a farm expense, and (if the child has no other income) avoid filing a tax return for the child.

Payroll reports and W-2s are required, so it's not entirely free of effort, but no taxes need be withheld if you are paying your own children under the age of 18. It is important the kids actually provide real services to the farm and the salary be reasonable for the services performed. In case of audit, be sure to keep time logs and good records of payments. Also, be sure to work closely with your tax preparer or a payroll specialist in order to comply with all reporting requirements.

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# Notes



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