TAX AND ACCOUNTING GUIDELINES

FOR THE ALPACA BREEDER

The alpaca breeder faces a host of complicated tax compliance and accounting issues. Anyone who works on a farm return must understand special tax rules that determine how the farmer recognizes income from operations, breeding and the sale of livestock as well as limitations on the deductibility of expenses. The following will help you understand the basic tax and accounting rules that apply to your alpaca farm. It will also help you determine whether you are reporting the farm's activities correctly and whether you are taking advantage of the available tax benefits your farm can utilize.

We will start by analyzing how your farm reports and recognizes its income. We then look at what expenses are deductible, paying special attention to the depreciation of farm assets. Finally, we look at using the loss limitation rules to your advantage with an analysis of the hobby loss and passive activity rules.

INCOME

Under current law there are significant differences in the way ordinary income and capital gains are taxed. The capital gains tax rates are much lower than those applied to ordinary income so it is very important that your farm's income be properly characterized.

The sale of animals held as inventory (whether raised or acquired by purchase) is taxed as ordinary income as is the sale of animal fiber and other miscellaneous farm products. Ordinary income

from your farm operations will also include income from the provision of any services such as boarding, breeding, consulting and judging, whether you are paid in cash or through a barter arrangement. If you are engaged in barter transactions you should report the fair market value of the services you receive as well as all expenses associated with the barter activity. Trading services and trading animals or other business assets (like trading in a farm vehicle) are treated differently. These transactions may fall within the tax deferred exchange rules and require special attention from your tax preparer.

The sale of animals can be taxed as capital gains if they are held as breeders or are used in the farm's operations. As your herd nears its optimum size and quality, fewer animals will qualify as breeders, but they could still qualify as an asset if you are using them in the farm's operations, such as to create fleece for sale. Other examples of animals used as farm assets include those kept as companions for breeders and those displayed to the public in your front pasture.

Animals held as business assets can be granted special tax treatment garnering the best of both worlds. When business assets are sold at a gain they can be accorded capital gain tax treatment. When sold at a loss they receive ordinary loss treatment and offset ordinary income dollar for dollar. There are some complications here related to depreciation, but more on that later. Timing for the sale of an animal held as an asset can be crucial because the animal needs to be held for more than one year to receive the favorable capital gain treatment.

The example on the next page illustrates the difference in taxation of capital gains and ordinary income. The example is for a farmer with $120,000 of outside wages, $500 interest income and $30,000 of farm income.

	Ordinary Income (SE)	Short Term Capital Gain	Long Term Capital Gain
Income			
Wages	120,000	120,000	120,000
Interest	500	500	500
Farm	30,000	30,000	30,000
Total Income	150,500	150,500	150,500
SE Tax Adjust.	-2,120		
Adj. Gross Income	298,880	301,000	301,000
Deductions			
Exemptions - 3	10,950	10,950	10,950
Itemized Ded.	21,500	21,500	21,500
Taxable Income	115,930	118,050	118,050
Regular Tax	21,345	21,875	18,881
Capital Gains			
SE Tax	4,240		
Total Federal Tax	**25,585**	**21,875**	**18,881**

INCOME AVERAGING

Farm income can vary considerably from one year to the next. The sale of a single champion alpaca can send your farm income and your tax liability soaring. This abnormal increase in income can put you into a higher than normal tax bracket. Congress took notice of this problem and passed a law allowing farmers to spread their income over the three previous years in order to even out the spikes in income. The law allows the farmer to pick and choose which income to include within the carry back calculations. The income eligible for averaging includes all types of farm income such as capital gains, ordinary income and depreciation recapture. You should consider income averaging any time your farm-related income spikes upward in a given year.

FARM DEDUCTIONS AND RECORD KEEPING

Now that you have a sense of how your farm income is taxed, we want to turn your attention to how the tax code allows you to offset taxable income with farm and business related deductions. In its early years your farm will require a substantial amount of invested capital to build barns and fences and acquire equipment and animals. Even after your farm matures and grows into a functioning enterprise you will have ongoing expenses such as breeding fees, travel and show expenses, vet bills, etc. You will need to have a basic understanding of how the tax code treats the various types of business expenditures, but first let's talk about how to keep track of all the money you spend on your farm.

A good system for tracking and documenting your farm expenses can be centered around the use of a separate business account, but many farmers find it difficult to use the business account for the payment of all farm expenses. The disciplined use of a software program can be an excellent solution. Readily available off-the-self programs such as AlpacaEase, QuickBooks, or Microsoft Excel are all used successfully by farmers. For larger operations or any farm wanting to share accounting data electronically with their tax accountants, we recommend the use of QuickBooks. Regardless of the system you use for tracking expenses, you must maintain accurate and retrievable documentation for all of your business expenses. You should work out a filing system that allows you to organize and save your receipts throughout the year and, once your tax returns are completed, allows for appropriate archiving. We recommend you save documentation of both income and expenses for your farm for at least 4 years. We feel paper files (instead of electronic archiving) should be maintained during this time period as original documentation is most persuasive in an audit. Please keep in mind that the IRS will not accept expense summaries or bank/credit card printouts as evidence of your expenses. An original receipt and proof of payment is the best documentation you can have.

Here is an example of a rudimentary, but functional spread sheet you can use to keep track of your farm expenses. It could be maintained with pencil or paper or using a computer program such as Microsoft Excel:

Date	Hay/Grain	Vet/Meds	Assets	Repairs/Maint	Mileage	Description
1/10/2011		450.00			170.3	Vet visit
1/25/2011	220.00					
2/4/2011			4,700.00			New fencing installed
2/5/2011					450.0	Transport for breeding
2/5/2011				675.00		Barn roof repair
2/22/2011	2,500.00				35.5	Hay purchase
3/1/2011			10,000.00			Purch. Alpaca SuperStar
3/16/2011		180.00			60.0	
Totals	2,720.00	630.00	14,700.00	675.00	715.8	

There is another set of documents and data we encourage our clients to carefully maintain. Every farm should have a list of alpacas and a separate file for each animal containing purchase and other relevant information about the animal's birth, pedigree, etc. This list should provide the name of the animal, the date of its purchase or birth, note whether it is a raised animal, the purchase amount if any and indicate if it is kept as a farm asset (explained below) or considered inventory. This list should be updated regularly to indicate any animal deaths, sales, trades, etc. and should be provided to your tax preparer each year. A livestock program such as AlpacaEase or Llama Logic can be a tremendous help with this task.

To understand what farm costs are deductible and how the tax code allows you to use them, we first have to separate them out into three distinct categories: expenses, assets and inventory.

EXPENSES

Expenses are everyday costs of operating your business. Under the tax code deductible business expenses must be *ordinary and necessary*, meaning they must be typical for the type of business being conducted and appropriate and helpful for the conduct of your business. Attached as Appendix B is a list of expenses frequently overlooked by farmers as well as some that are deemed non-deductible by IRS. In general, expenses are the day to day costs paid to operate the farm such as feed, vet bills, equipment and fence repairs, business use of your phone, etc.

ASSETS

Any item you purchase for use on the farm that is expected to last more than one year is considered an asset and is subject to the depreciation rules. Examples are fencing, tractors, breeding animals and computers. We have provided a separate section describing the depreciation rules that apply to your farm. It is important that your asset purchase costs be tracked separately from expenses because each asset is listed on a depreciation schedule used for your tax return and the preparation of financial statements if you use them. You will need to list the purchase date, price and a description of each asset you purchase.

INVENTORY

Items you purchase or produce for resale are considered inventory. This includes fleece and fiber as well as animals held for sale to the public. Breeding animals and animals that otherwise are used in the conduct of the farm's operations are not considered inventory. The cost of inventory is not deducted when paid. Instead inventory is deducted when it is sold. This deduction is called "cost of goods sold." The idea here is to match expenses with income. The inventory rules prevent a business

from purchasing large amounts of inventory in one year to create an expense deduction and holding the inventory for sale in later years.

It is important to understand the difference between these three deduction categories. If you expense something that should have been depreciated or deduct an inventory cost without a matching sale, the IRS may adjust your return during an audit, resulting in an assessment of additional tax, interest and penalties.

FARM DEPRECIATION

The concepts behind our depreciation rules are difficult for many farmers to understand. The basic idea is to match expenses with income much like the inventory rules do. The theory used to justify this assumes any asset that will last more than one year will be used for the creation of income over a useful life. The cost of purchasing this type of asset is then deducted over a number of years based upon the asset's classification. The asset classes make a rough estimation of how many years a particular type of asset will last. For instance, under the depreciation rules a fence is assumed to last 7 years.

The tax rules on depreciation have been liberalized over recent years to help stimulate the economy through increased spending. The result has been a blurring of the distinction between depreciation and other, current farm expenses. These expensing 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 an asset up front. For 2010, these rules can be used if you purchase up to $2 million in Section 179 assets. At this level of purchasing you can deduct in the current year up to $500,000 of asset purchases. Assets that qualify for this treatment must be new to you (used assets purchased by you qualify, but not assets with prior personal use) and placed in service during the tax year. There are certain types of assets that do not qualify for Section 179. 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 2011 bonus depreciation is available for up to 100% of an asset's cost. 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. This means that if you want to fully deduct a new alpaca, you must purchase and breed it within the same calendar year.

DEPRECIATION RECAPTURE

If you sell an asset that has been partially or fully depreciated, you may need to "recapture" a portion of the depreciation taken as ordinary income. The recapture rules basically prevent you from "tricking" the IRS by taking an expense deduction which offsets ordinary income based upon the incorrect assumption that an asset will become useless and worthless over time. You will have tricked the IRS if you later sell that asset for a gain. The normal sale rules require that you pay capital gains tax

on any amount of gain you realize on the sale of an asset. Gain is computed by subtracting from the sale price your adjusted basis. Adjusted basis is original cost less depreciation deducted. The recapture rules require you treat the portion of your gain equal to the depreciation recovered as ordinary income. This means that you are recapturing as ordinary income the depreciation expense you previously used to offset ordinary income correcting, if you will, the grave injustice done to the IRS.

Section 179 also has a 50% recapture rule which can be particularly harsh. This rule creates recapture income when an asset's business use falls below 50%. The recapture amount is the difference between the Section 179 expense taken and the amount of depreciation you would have been entitled to if you had taken straight line depreciation. There is a cautionary tale to be told here. When you are tempted to take a large Section 179 deduction for a truck, for instance, you should think about the possibility that your business use will drop to less than 50% and what your taxable income will look like in the year it does if you have to add back, as ordinary income, a substantial part of the Section 179 deduction. This will likely result in income tax owed with no dollars in the door to pay it!

The 50% rule does not apply to special bonus depreciation. The rules on income limitation also do not apply to bonus depreciation which means they can be used to create a net operating loss in instances where Section 179 will not. We have created a separate summary explaining the net operating loss deduction.

This chart illustrates how the three types of depreciation impact taxable income and tax owed.

	None	Regular	Bonus	Sec. 179
Income				
Wages	120,000	120,000	120,000	120,000
Interest	500	500	500	500
Farm Loss	-15,000	-15,000	-15,000	-15,000
Farm Depreciation	0	-2,142	-11,071	-20,000
Total Income	105,500	103,358	94,429	85,500
Deductions				
Exemptions - 3	10,950	10,950	10,950	10,950
Itemized Ded.	21,500	21,500	21,500	21,500
Taxable Income	73,050	115,930	115,930	115,930
Total Federal Tax	**10,631**	**10,094**	**8,459**	**7,124**

Both Section 179 and special bonus depreciation can be used for assets purchased on credit. This creates the ability to use leveraged purchases to create substantial tax savings. For example, if you purchase a herdsire for $50,000 on December 31, 2010 on an installment sale calling for $5,000 annual payments over ten years, you will pay $5,000 in the year of purchase and take a $50,000 deduction. Be sure to review the “At Risk” rules, though, as they are designed to prevent this type of leveraging in some cases.

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 income taxed on your return depends on whether your farm is a hobby or a business operated with an intent to make a profit. 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:

1. 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?
2. The expertise of the taxpayer or advisors – do you know what you are doing? If not, do you hire professionals who do?
3. 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?
4. 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?
5. Taxpayer's success in other similar or dissimilar activities – have you proven yourself in other business ventures?
6. 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?
7. Amount of occasional profits, if any – a small profit in one year will be disregarded if preceded by many years of substantial losses.
8. Financial status of the taxpayer – how dependent are you on the income of the activity? Is this just a tax shelter?

9. 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, although even this presumption can be overridden if facts and circumstances warrant. Here 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	10000
Total Income	105,500	130,500
Deductions		
Exemptions - 3	10,950	10950
Itemized Ded.	21,500	21500
Hobby Expenses		10000
2% AGI Limitation		-2610
Taxable Income	73,050	90,660
Total Federal Tax	**10,631**	**15,031**

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 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.

PULLING IT ALL TOGETHER

You now have a good idea how your farm's income will be taxed and what expenses you can use to offset income and how each of the three types of expenses are used. We know that the depreciation expense can be a wonderful tax deduction, but has its hazards in the form of future recapture income. It is beneficial to be able to use current losses to offset other income on your tax return, if for no other reason than to free up money for investment in the farm that would otherwise be paid in taxes, but you now know you have to be careful that you do not run afoul of the hobby loss and material participation rules or your losses will be of limited or no use.

The tax code changes constantly, so keep in mind that this information could be quickly outdated. You should always consult with your tax adviser about any specific tax and accounting decisions you would like to make regarding your farm.

Starting and running your alpaca farm can be a daunting and expensive undertaking. We want our alpaca farm clients and others in the industry to use and enjoy every tax benefit available to reduce the financial burdens of business ownership and increase their potential for success. We hope this information helps you down this path. Please feel free to call us, anytime, to discuss the information we have provided and any questions you may have or to schedule a consultation.

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