# Labradoodleductions

## Tax Considerations for Dog Breeders

**February 25, 2011**

Presented by:

**Granite Point Tax Group, LLC**
4710 SW Kelly Ave
Portland, OR 97239
503-208-3736

Speaker:

**Matt Bannon, EA, LTC**
matt@granitepointtax.com

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## Introdoodleduction

Dog and cat breeders (the tax code has yet to recognize the superiority of Labradoodles over all other breeds) face a number of hazards at tax time, yet also have access to a number of tax benefits. Domesticated animals are not agricultural and therefore do not enjoy the tax benefits available to farmers, but they are entitled to the same deductions as other non-agricultural businesses. Breeding dogs can be depreciated along with kennels, whelping boxes, travel carriers, office equipment, etc. On the other hand, animal breeding can be subject to pitfalls not applicable to many other businesses. This document describes some of the tax impacts, both good and bad, that are particularly pertinent to the Labradoodle breeder (or lesser canines ☺).

## 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 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.

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## Assets, Expenses, and Inventory

It is very important for any business owner to have a good understanding of the difference between assets, expenses, and inventory. The three are treated very differently for tax purposes and should be tracked separately.

Expenses are the day-to-day costs of operating a business. Dog food, vaccinations, office supplies, business phone calls, etc. are examples of expenses. Deductible expenses will be different for each business, so the tax code simply states that "reasonable and ordinary" expenses may be deducted. If the expense has a reasonable chance of helping you generate more income, it is generally deductible. Lavish or extravagant expenses, or those that are completely unrelated to the function of the business, are not deductible.

Items purchased for business use which are expected to last more than one year are considered assets. Breeding dogs, carrier crates, office equipment, and whelping boxes are examples. These items are listed individually on the business tax return and are depreciated rather than expensed (see Depreciation section for more detail). One pitfall to be aware of is that assets become depreciable when placed in service – this means that buying an immature breeding dog at the end of the year will not generate a tax benefit until the following year when the dog reaches breeding age. A dog does not necessarily need to be a breeder to be considered an asset, however. Guard dogs, companion dogs, and surrogate mothers (insert obligatory "my step-mom is such a bitch" joke here) are all assets.

*Asset*

*Inventory*

Items purchased or produced for sale are considered inventory. In the case of a dog breeder, this would include the puppies as well as supplies (collars, etc.) intended to be sold with the puppies. The puppies have no cost basis, as all the costs of producing them are deducted as operating expenses. Collars, bedding, and other items purchased for resale, however, should

be tracked separately and deducted when sold, *not* when purchased. This is why you frequently see end-of-year “inventory clearance” sales. The easiest way to track inventory is to simply track the purchases throughout the year and perform an inventory count at year-end. The difference between what you started with (last year’s end count), what you purchased, and what you end up with is the cost of what went out the door. This is known as the Cost of Goods Sold and is deducted against the income.

## Depreciation

Depreciation is a concept that takes a little getting used to. The basic idea is to spread the cost of equipment or other assets over their useful lives in order to match that cost against the income it is helping to produce. A $7,000 breeding dog with an expected useful life of seven years would be deducted $1,000 per year. This simple concept, however, has been fiddled with innumerable times over the years, to the point it is now one of the most complex areas of the tax code. But all the tinkering can be boiled down to the question of how quickly assets can be depreciated, so let’s review the current choices available:

- Alternative Depreciation – The slowest recovery method, and useful when assets are purchased in a year with little or no tax liability, thereby preserving the deduction for later years when income (and thereby tax liability) has risen.
- Modified Accelerated Cost Recovery (MACRS) – The default option, which front-loads the deduction toward the first two or three years, tapering off toward the end.
- Section 179 – Code Section 179 allows qualifying taxpayers to deduct a portion of assets in the year of purchase, subject to some restrictions. Over the past several years, the restrictions on this form of depreciation have been lessened considerably. The Sec. 179 expense limit currently stands at $500,000. Numerous restrictions apply to this code section, so always plan carefully.
- Special Depreciation Allowance (“Bonus” depreciation) – Originally introduced as an economic stimulus after the 9/11 terrorist attacks, this form of depreciation has also been expanded over the ensuing years. Under this provision, first-use assets (i.e. brand new, not “new to you”) qualify for a 50% upfront deduction if placed in service before 9/8/10 and a 100% deduction from 9/9/10 to the end of 2011. With fewer restrictions than Section 179, this provision has become a powerful tool for business owners.



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A few further notes regarding depreciation: While Section 179 is an election made asset by asset, Bonus Depreciation applies by default (you must elect *out* if preferred) and to each asset class. For example, all 5-year assets, all 7-year assets, etc. It is also important to understand that depreciation can be subject to recapture if the asset is sold for a price higher than its remaining undepreciated basis. Think of it this way: If you fully deduct an asset and later sell it, the sale price becomes taxable income in order to bring the prior depreciation deduction back in line – this is referred to as "depreciation recapture." On the other hand, if you sell an asset for less than its remaining basis you can deduct that balance in full. So, if you originally purchased an asset for $10,000 and have taken $6,000 of depreciation deductions, any sale price below $4,000 (the remaining cost basis) generates a deductible loss and any sale price above $4,000 generates depreciation recapture. A sale price above the original $10,000 purchase price would generate $6,000 of depreciation recapture and capital gain on the rest. The IRS has devised a special form of torture called Form 4797 to calculate all this.

Depreciation can certainly be difficult to comprehend, but as long as you understand the basic premise you can always brush up on the latest rules. Once you do that, you will have an extremely versatile and powerful tool in your tax-saving toolbox.

## Business Use of Home

Under certain circumstances, the Business Use of Home deduction can provide a significant tax reduction. There are a couple pitfalls to avoid, though, so we will review those carefully after looking at the benefits.

Owning or renting a home is expensive. And while the tax code allows a deduction to be taken for mortgage interest and real estate taxes, other costs such as rent, utilities, and maintenance are generally non-deductible. If a portion of your home is used for business purposes, however, you may be able to claim some of those costs as business expenses, thereby saving not only income tax but also Self Employment tax. The area must be used regularly and exclusively for the business and this has tripped up many a taxpayer, so let's explore these requirements a little further.

The exclusive use requirement is fairly intuitive – the area being deducted for business must be used *solely* for the business. No spare bed for visiting relatives, no storage of outgrown children's clothing, no bookshelves stuffed with dusty old novels and trinkets. The other

requirement, regular use, is a little more obscure but no less important. The area claimed as a business expense must be used on a regular basis – this rules out the 900 square foot basement that sits empty for weeks or months at a time, only to be used once or twice a year as a temporary work area. The area must meet BOTH requirements – exclusive business use AND regular business use.

Little known fact: There is no requirement that the business portion of the home be a separate room or even be partitioned off. As long as the area claimed meets the use tests, it qualifies (caveat – areas used for administrative functions do not qualify if you have an office elsewhere). This means that *half* of a bedroom, for example, can be claimed as a business expense as long as that half meets the tests. So put your mother-in-law, your musty old books and your kids' worn shoes on one side of the room and your desk, filing cabinet, and inventory on the other and reap the tax benefit. And who wouldn't want their mother-in-law watching them work from across the room??

Allowable business-use-of-home expenses include all the costs of keeping up the home (pro-rated by area used, of course) such as:

- Mortgage interest or rent
- Real estate taxes
- Homeowners or renters insurance
- Utilities
- Security system
- Repairs and maintenance
- Depreciation (if you own the home)

Be sure to keep a separate tally of expenses related directly to the business area, as these are not subject to the proration formula. For example, painting an office that occupies 15% of your home would be fully deductible, while painting the entire house would be 15% deductible.

## Audit Considerations

If your breeding operation is profitable, your risk of audit is quite low (depending on what else is on your tax return, of course) and will likely focus on substantiating business income and expenses with receipts and other records. If your operation generates a loss, however, your

audit risk is higher and will probably begin by determining whether or not a profit motive exists before moving on to the substantiation phase. Profit motive is a key issue and not always easily determined or substantiated. Let's take a closer look at the issue and how you can avoid the pitfalls.

All income is taxable unless specifically exempt by law. Expenses, however, are the reverse – they are generally not deductible unless allowed by law. Even when allowed, expenses are often subject to restrictions and limitations. For example, expenses related to a hobby are limited to the income generated by the hobby. In other words, a hobby is not allowed to generate a loss on your tax return. Business expenses, on the other hand, are not limited to the income generated – a business loss can be used to offset income from other sources such as wages or investment income. Determining the difference between a business and a hobby, therefore, is often of crucial importance. The tax code defines the difference this way: A business is an activity in which a profit motive exists and a hobby is anything else. So you do not have to be profitable to be considered a business, but you do have to *try* to be profitable.

Nine factors are used to determine whether a profit motive exists:

- The manner in which you carry on the activity – Do you *act* like a business?
- Your level of expertise – If you are not knowledgeable, are you at least getting the advice of consultants who are?
- Time and effort – How hard are you really working at this?
- Expectation of asset appreciation – Are you buying or generating assets which can be reasonably expected to become more valuable over time (real estate, etc)?
- Success in other business activities – Have you proven yourself before?
- History of your income or loss in the activity – How many good years, how many bad?
- Amount of occasional profits – Does one good year make up for many bad years?
- Your financial status – How dependent are you on the success of the activity?
- Elements of personal pleasure – Is this just a way to deduct something you enjoy doing?

No single element is conclusive; all must be weighed together and taken as a whole. It is not uncommon for a business to sustain a loss for the first year or two of operations, but with each loss year it becomes more important to be able to prove the profit motive. And because Labradoodles are so darn enjoyable to be around, the "elements of personal pleasure" test takes on particular relevance here and should not be underestimated. You will want to distinguish your breeding operation from the many the IRS sees where there is no real expectation or intent of ever turning a profit.



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Good ways to substantiate profit motive include building and maintaining a quality website, generating and updating a business plan (make sure it is realistic and shows a profit!), keeping a business journal of time spent, and working hard to increase revenue and decrease expenses. Almost sounds like work, right? Well guess what – that's the idea!

To see the tax impact of the business vs. hobby discussion, consider a hypothetical scenario of a married couple with $80,000 of combined wages and a dog breeding operation. To see the effect in a loss year, assume $15,000 of dog sales and $25,000 of dog expenses (including depreciation). In a profitable year, assume $25,000 of sales and $15,000 of expenses. As you can see, the hobby operation generates more income tax in both scenarios. Note, however, that in many cases a business profit is also subject to Self-Employment tax (FICA), so plan carefully.

| | Business Loss | Hobby Loss | Business Gain | Hobby Gain |
|---|---|---|---|---|
| **Income** | | | | |
| Wages | 80,000 | 80,000 | 80,000 | 80,000 |
| Dog Business | -10,000 | | 10,000 | |
| Dog Hobby | | 15,000 | | 25,000 |
| | | | | |
| Gross Income | 70,000 | 95,000 | 90,000 | 105,000 |
| | | | | |
| **Deductions** | | | | |
| Mortgage Interest | 15,000 | 15,000 | 15,000 | 15,000 |
| Taxes | 2,500 | 2,500 | 2,500 | 2,500 |
| Dog Hobby Expenses | | 15,000 | | 15,000 |
| Personal Exemptions | 7,300 | 7,300 | 7,300 | 7,300 |
| | | | | |
| Taxable Income | 45,200 | 57,100 | 64,493 | 67,300 |
| | | | | |
| **Federal Income Tax** | 5,946 | 7,080 | 8,834* | 9,261 |
| | | | *(plus $1,413 FICA | |
| | | | if applicable) | |

The question of whether your dog breeding operation is a business or a hobby is likely the single most important one you will face if you are audited. That and the $10,000 tax credit you claimed for kickbacks paid to foreign officials for your drug smuggling operation.



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## Record Keeping

An endless number of record-keeping systems exist, from the shoebox full of random receipts to full-blown double-entry accounting software. No single system is right for every business, but finding the right system for *your* business can be a make-or-break decision. If your breeding operation is a hobby, the shoebox of receipts is perfectly viable. But if you are treating your operation as a business and treating it that way on your tax return, you will need something a bit more robust. Partly this is to aid in substantiating expenses in an audit, but mostly it is to help you run your business properly – you can't make sound business decisions if you don't have ready access to your income and expense records. Let's review a few of the more viable options for small- to mid-size businesses:

- **Spreadsheet** – Whether on paper or computer (Excel, etc), a spreadsheet is a very simple system of listing categories along one axis (typically across the top) and the date along the other. Income and expenses are then plugged into the appropriate date and category with a running tally at the bottom of each category. This system works well for very small activities, but tends to grow unwieldy when the number of transactions forces the spreadsheet onto more than half a dozen pages or so. It still works, but is difficult to read or retrieve data from, which is the whole point of any accounting system.
- **Quicken, Money, etc.** – These are small accounting programs, generally marketed toward home finance and small businesses. Used properly, these programs work quite well. Using them properly, however, is not always easy – these programs typically have few if any safeguards against incorrect or one-sided entries. A basic understanding of accounting principles can come in very handy.
- **QuickBooks, PeachTree, etc.** – These programs are considerably more robust than their smaller counterparts, and can generally accommodate businesses with annual revenue from a few thousand to several million dollars. Some accounting knowledge can be helpful, but the programs include safeguards to at least minimize or contain irregularities.

At a minimum, every business owner should try to maintain a statement of income and expenses (the Profit and Loss statement, or "P&L") and a statement of assets and liabilities (the Balance Sheet, which for certain companies whose names we won't mention can be safely abbreviated as the "BS"). These two statements provide a pulse of the company and are universally understood in the accounting world. Don't let all the fancy names and terms fool you, though – it's really just a way to show what the company has earned, what it has spent,



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what it owns, and what it owes. Good things for any business owner to know, wouldn't you agree?

Many new business owners ask what categories they should be tracking, but the answer will be different in every case. The appropriate categories are those that are the most pertinent to each individual business; a company that relies heavily on mailing campaigns should be tracking postage while a company with little or no mail activity might simply include postage costs in the broader category of office expenses. Whichever categories *need* to be tracked in order manage expenses and compare revenue sources, those are the appropriate categories to track. At a minimum, a dog breeder would want to track food costs, bedding supplies, vet fees, etc.

## A Brief Word on Guardian Homes

Guardian home arrangements, wherein a dog is given to and cared for by a new owner in exchange for the breeder retaining the breeding rights, should be treated by the breeder as a sale of the dog at fair market value for equivalent pet-quality dogs. The breeder has essentially sold the guardians a pet and they are paying for it by providing for its maintenance and well-being, thereby preserving the value of the breeding rights. Assuming the guardians have no commercial interest in the dog, there should be no tax impact to them. The breeder reports the sale as either the sale of an asset or the sale of inventory, whichever is appropriate (see earlier discussion regarding assets vs. inventory).

**Disclaimers:** Every tax scenario is unique; please consult with your tax advisor *before* making any significant decisions. Information in this packet is believed to be accurate, but is not guaranteed. If you call us we will try to answer all your questions, but can't always promise you will like the answers. This document may cause drowsiness – do not read while operating heavy machinery.

**Q:** What do you get when you cross a Newfoundland and a Basset Hound?

**A:** A Newfound Asset Hound. Our kind of dog!

(Joke swiped from www.travelingdogs.com, hope they don't mind)



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