

Fresh out of an IRS Farm Tax Symposium in Summer 2005, Susan Post, CPA gives us a Valuable Q&A Session on Current Tax Law and the Impact on the Alpaca Investment.

The Tax Impact of Investing in Alpacas

Questions by "As You Like It Alpacas"

By Susan Post, CPA

www.spost@spostcpa.com

515-928-2138

Question: *Aren't alpacas just a pyramid scheme?*

Susan Post: *A stereotypical pyramid scheme requires recruiting representatives to market a product under your "umbrella" and then collect a royalty or commission from their sales, thereby enlarging your "base sales". I haven't seen this structure in the industry.*

If the question is, "Must I find buyers to purchase alpaca in order to make a profit?" the answer is yes. I strongly encourage potential investors to evaluate their business/marketing skills, ability to physically care for the animals and the ability to adequately capitalize the start up costs.

Question: *Will alpaca retain their value?*

Susan Post: *No one can guarantee that the animals will retain their value. The industry has a 20 year history of increasing prices, which is much longer than other exotic animal species have been able to attain. The industry also has organized a registry and a main clearing house of information, namely Alpaca Owners and Breeders Association (AOBA). Several items could impact the price of the animals including the inability to establish a textile market, change in tax law, inability to find new buyers, a severe economic down turn or animal livestock identification and premise ID regulations. In 2004 and part of 2005 alpacas could not be moved across the US-Canadian border because the animals fell into the ruminant category with cattle. There is a risk factor in investing in alpaca, just like other investments.*

Question: *Does the IRS frown on this investment?*

Susan Post: *The IRS is concerned that the investment is a true business and not a hobby or lifestyle choice that is treated abusively. An activity conducted as a for-profit business is allowed to deduct the expenses that are ordinary and necessary in carrying on the trade or business. An activity is considered a for-profit business if it generates net income in three or more out of five consecutive years. The business may still qualify if the taxpayer has an actual and honest intent to make a profit and demonstrates good record keeping and business practices, continues to expend time developing the business and can demonstrate actual growth in net worth. It has been acknowledged by the IRS that there is a standard 2-4 years of building a cattle herd where losses are generated and it would be likely that the same would hold true for alpaca.*

Question: *Are the sales of alpacas treated as capital gains?*

Susan Post: *The sale of qualified breeding stock (Section 1231 property) does qualify for capital gain treatment, which is important. Currently, capital gain income is taxed at a lesser rate than ordinary income, with the maximum being 15%. Depending upon your marginal tax bracket, that can be a very significant savings. The income from the sale of cria or animals that have not been used for breeding purposes is ordinary income.*

The sale of farm animals is classified in one of two ways.

1. *The normal scenario is that animals raised or purchased for resale are reported as income on the Schedule F, or farm schedule, of your individual 1040 tax return. This would include animals that are raised and resold for the production of fiber or pet grade alpaca.*

2. *The alternative scenario is if the alpaca have been held for 12 months or more and the livestock is held primarily for breeding purposes. This distinction is important, because breeding stock used in a farming business qualifies as section 1231 property, which is a capital asset. Sales of capital assets used in a business are reported on Form 4797.*

The following examples are from the IRS Publication 225, Farmer's Tax Guide.

- *If livestock is used primarily for breeding purposes, it is section 1231 property.*
- *The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal.*
- *An animal is not held for breeding purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use by them for breeding purposes.*

Examples:

An animal is purchased for breeding purposes, and it is later determined to be sterile. When that animal is sold, it qualifies as held as breeding livestock.

You are in the business of raising alpaca for fiber. You cull breeders from the herd when they are no longer useful and sell them as pets. They were used for breeding purposes and qualify as capital assets.

You are in the business of raising show animals. The business practice is to breed the females to establish their fitness as breeding stock. Your use of the young animals is ordinary and necessary for selling them as registered stock. Such use does not demonstrate that you are holding the alpaca for breeding purposes. Animals sold under this scenario are reported as income on the Schedule F. However, those animals you hold as additions or replacements to your own herd are considered as being held for breeding stock.

Each animal sale should be classified carefully and the tax treatment should be discussed with a tax professional.

Question: *When all is said and done, would you advise your clients to invest in alpaca?*

Susan Post: *Quite honestly, I have recommended that some clients consider investing in alpaca and I have recommended to others that it was not an appropriate investment for their situation. The factors are the ones I listed above, their ability to manage/market a business, the ability to physically care for the animals effectively, their capital resources and their dependence on generating a reliable income stream from alpaca.*

Question: *What methods can be used to depreciate alpaca?*

Susan Post: *For tax purposes, farm assets are required to be depreciated under the MACRS 150% DDB method. A good resource for a description of that method is found in the Farmers Tax Guide at www.irs.gov. The lives normally used are five or seven years. Alpaca are not specifically listed as an asset type, but most closely follow the assets listed in the five year life category. Some accountants prefer to use seven years because that is the default life for assets not specifically named in a category. As breeding livestock (Section 1231 property), alpaca are also eligible for the Section 179 depreciation method. The advertised 30% and 50% bonus depreciation methods expired December 31, 2004.*

Question: *How does the Section 179 depreciation method work?*

Susan Post: *Rather than depreciating the cost of business property over several years, Section 179 allows a taxpayer to expense in the year of purchase depreciable property used in the active conduct of a business. The maximum Section 179 deduction for 2005 is \$105,000 and will be indexed for inflation through 2007. It is set to revert to \$25,000 in 2008 but there is a chance that the amounts could be extended by Congress.*

There are several limitations on the Section 179 expense election. For each dollar of purchases of eligible property exceeding \$420,000 in 2005, the \$105,000 maximum deduction is reduced (but not below zero) by one dollar. A husband and wife, whether filing joint or separate returns, are treated as one taxpayer in regard to the limit. Qualifying property must be used more than 50% for business in the year placed in service.

The most important limitation is the taxable income limitation! Section 179 expense *CANNOT* create a loss. It is limited to the amount of net income generated by a business. On an individual return Schedule C and Schedule F earnings, plus wages are allowed to be offset by Section 179 expense. Retirement income, interest, dividends, rental income and social security income is *NOT* eligible to be offset by Section 179 expense.

NOTE! A Sub S or LLC *CANNOT* pass through a loss generated by Section 179 expense. The 179 expense can only take income to zero, therefore a Sub S or LLC is limited in the losses that can be passed through to the owners. This should be an important part of any entity selection process and should be thoroughly discussed with a tax professional in regards to an investor's specific situation. I have seen some very disappointed people when they jumped into the business and made decisions that limited the depreciation options.

Question: What percentage of the animals I buy may be deducted from my income using Section 179?

Susan Post: If you are materially participating in the business, up to 100% of the purchase may be deducted, provided there are no income limitations or other restrictions.

Question: If I have made a profit this year by selling animals, can I reinvest it in another animal without tax consequence?

Susan Post: No, there are no provisions for not recognizing a sale. If another breeding livestock animal is purchased, it may be depreciated under the methods listed above to effectively offset the income; however both the income and expense items must be reported separately. You may use like-kind exchange rules to trade breeding females for breeding females or breeding males for breeding males. Trading females for males does *NOT* qualify under Section 1031 like kind exchange rules. Animals may be sold under installment sale rules, but they are subject to depreciation recapture.

Question: If I make a profit this year selling animals and it puts me in a higher tax bracket, can I use unused income brackets in the last few years to bring those up to their maximum before I have to pay the full tax at the max tax bracket for this year's sales?

Susan Post: Farm income averaging allows farm income **or** losses to be averaged over the previous three years. However, Social Security, or payroll taxes, cannot be averaged. Only the income tax is allowed to be averaged. Planning with a tax professional before year end is recommended for this strategy! There are some significant opportunities with amending returns to reallocate or rescind the Section 179 expense in prior years to take advantage of averaging opportunities. If income reported on the personal 1040 is not consistent, farm income averaging can help fill in less expensive brackets in previous years.

Question: If I take a loss this year, can I use the loss against prior year's income to get a refund for taxes paid in prior years?

Susan Post: It is unlikely that this would happen. If the loss is so large that it offsets all other wage income, you may carry back the loss five years. Normally, current year income absorbs the loss in the year it occurs, thereby limiting net operating loss carry backs. Farm income/loss averaging may be useful in this scenario.

Question: What are the differences in being an active owner or a passive investor?

Susan Post: That is not a short answer! This is from my article previously published in Alpacas Magazine.

After the Pilgrims crossed the Atlantic they faced a bitter winter and possible starvation. The rule was, "If you don't work, you don't eat"! The IRS has a similar phrase in the tax code. "If you don't work, you don't deduct" is the premise of the passive loss rules. The overwhelming question I have heard in the past few months from alpaca owners and potential investors is about passive activities and material participation.

The goal is to achieve “material participation” status. Material participation is a nice way of saying **work**. If an owner is passive, the losses generated by depreciation and other expenses can only be deducted against passive income. There are further restrictions that disallow grouping a farming loss with income from another type of trade or business, specifically oil and gas wells, portfolio income, leasing Section 1245 property and holding, producing, or distributing motion picture films or video tapes.

A classic example of a passive activity is an investor who purchases animals and then agists them at a different location. The investor does not care for the animals directly and has no daily management responsibility. The losses are calculated annually and then carried forward until such time that the business is completely disposed of or there is passive income generated to offset the losses.

In contrast, if your business meets the **work** requirements, all expenses can be used to offset earned income from wages or business income. Obviously a deduction today is worth more than a potential deduction in the future. So what does it take to meet the requirements of material participation?

One of seven criteria must be met for an individual engaged in a trade or business (not a hobby) to meet the requirements. These can be found in the Farmers Tax Guide at www.irs.gov.

1. More than 500 hours per year are spent on the activity. Both spouses may combine their hours to meet this threshold.
2. If the individual and/or spouse are the only ones who substantially participate in the business.
3. If the individual and spouse spend at least 100 hours and no one else spends more hours in the activity.
4. If the activity qualifies as a “significant participation activity” (greater than 100 hours), and aggregate participation by the individual for all significant participation activities exceeds 500 hours per year. (OK, so the IRS wrote that one. My plan entails meeting one of the other requirements!)
5. If the individual meets the material participation requirements for any five of the previous ten tax years.
6. Doesn't apply to alpaca owners because it describes personal service activities like engineering, law or accounting.
7. My paraphrase of this one, if you haven't made it by now you probably won't. The what if's in this section are too long to list. I figure that if I can barely understand the requirement I'll have a tough time explaining how I meet the standard to the IRS. Plan on hanging your hat on 1, 2, 3, or 5.

Note that certain activities don't count toward the requirements. The work should be of the type that an owner would perform. Just because an owner might go to New Zealand to look at breeding livestock does not mean that an investor can deduct travel expenses around the world and count the hours toward material participation. A 2003 tax case ruled that driving time does not count towards the 500 hours. If the animals are agisted and you drive to the farm from your location, the commute time does not contribute to your participation hours.

Any deliberate attempts to avoid the passive activity rules will be disallowed and reclassified under examination by the IRS.

Keep in mind the rules regarding a trade or business versus a hobby. The **first** threshold is meeting the business requirements and the **second** threshold is the at-risk determination and the **third** decision is whether or not the activity is active or passive.

This information is intended as a guide as you start to evaluate your situation. It would be an excellent idea to discuss your particular situation with a tax professional to make sure that you are on secure footing in defending your status to the IRS. Potential buyers have been contacting me and not all of the information received from breeders seeking to make sales is accurate. It is very important to the industry that new owners have an accurate understanding of the potential tax benefits. It is extremely uncomfortable for accountants to tell a passive owner that none of their expenses qualify for current deductions! These rules can create some stumbling blocks and some quite negative tax consequences. Make sure that your work allows a deduction!

Question: What are the benefits if I choose to remain a passive investor?

Susan Post: *A passive investor accumulates the losses from year to year to carry forward to a year that generates income. There is no current tax advantage, but the value of the herd should be growing on a tax deferred basis. When animal sales generate income in the future, the carry forward losses are allowed to offset the revenue. Passive investors actually have a better “matching principle” of income and expense recognition. I have seen some active owners enjoy great tax savings up front, but when the herd starts generating income, all of the income is gain because the animals have been fully depreciated up front.*

This method of investing is very effective when you expect your personal income to be higher in the future than it is currently.

The situation becomes somewhat analogous to owning real estate. There is no current deduction for the property, but when the appreciated asset is sold, the corresponding basis can be used to offset the gain.

If you happen to materially participate in any other farming activity, (plants or other livestock) the alpaca business can be grouped with that activity to achieve active status regardless of the number of hours invested.

Question: *What should I discuss with my tax advisor if I am a passive investor?*

Susan Post: *The first hurdle is to pass the at-risk rules. The basic rule is that you must have actually invested cash or incurred debt that you are personally liable for or pledge outside property (not the alpaca) as security for the loan. (Beware that buying an animal on an installment basis from the seller with no other pledge of assets does not qualify for at risk capital.) If the at risk rules are met, the regulations in Code Section 469 that apply to farming syndicates and limited entrepreneurs should be addressed. Publication 925 and Publication 225 at www.irs.gov are the appropriate references to further research the regulations.*

Question: *What is the difference in deductions from taking them as sole proprietorships and partnerships vs. corporations? Which is the better choice?*

Susan Post: *The types of deductions are almost exactly the same. The Section 179 income limitation and the need for asset protection within an entity are the two main points I discuss with my clients. I usually prefer to avoid forming a separate entity if the client is looking to offset wage income that would be limited in a partnership or corporation. This is an “it depends” area that should be discussed with an attorney in your state and a tax accountant.*

IRS Circular 230 Notice: To ensure compliance with requirements imposed by the IRS, we inform you that, except to the extent expressly provided to the contrary, any federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.