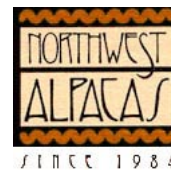




Why not let Uncle Sam help you buy your Alpacas?

By Mike Safley



Why not let Uncle Sam help you buy your Alpacas?

Raising alpacas can offer the farmer some very attractive tax advantages. If they 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, barns and fences, which help shelter current cash flow from tax. Beyond these basics there are several strategic tax advantages for the alpaca farmer.

In fact, 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. If you are in the 50% tax bracket, the deductions for depreciation that the animals are eligible for may save you 40% or more, in cash, of your original purchase price, over six years. There is also an additional 30% depreciation (see below) available in the first year of your purchase as a result of the recent tax bill passed by congress. In the example found later in the article, a person purchasing a herd for \$100,000 would have an after tax cost of only \$58,999 if they paid cash for their animals and owned them for six years.

If you were to buy two females for \$30,000, pay \$10,000 down, and take advantage of IRS code section 179 and the 30% additional tax saving, your first year cash out-of-pocket cost after taxes would be only \$629.00. This assumes you are in a 50% tax bracket. The total cost, after tax over six years, would be \$19,193. This is after paying for interest on your purchase and full mortality insurance.

If you would like Northwest Alpacas to compute the after-tax cost of your prospective alpaca purchase, please email Alan Cousill at alan@alpacas.com. He will be glad to do a six-year projection that calculates the after-tax cost of your alpacas.

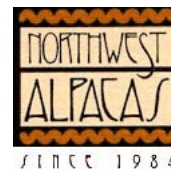
I recommend that you engage an accountant for advice in setting up your books and determining the proper use of the concepts discussed in this article. The aim of this discussion of IRS rules is to make you more conversant with the issues of taxation

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 certain assets, 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 \$24,000 worth of alpacas annually. This following example takes into consideration IRS code section 179. (If you would like a copy of the code section, please give us a call 503-628-3110 or email alan@alpacas.com.)



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Purchase price (one or more alpacas):	\$24,000
Section 179 tax deduction	(24,000)
Tax savings 50% (tax bracket 50%)	<u>(12,000)</u>
Actual after tax cost out of pocket	\$12,000

In other words, if you are in the 50% tax bracket the government will reduce your taxes by 50% of the cost of \$24,000 worth of alpacas each year. This deduction is available for all taxpayers. To see how much this will benefit you, simply calculate your tax bracket and multiply it by the amount of your purchase up to \$24,000. The amount of this deduction is scheduled to go higher in future years.

AN ADDITIONAL 30% FIRST YEAR DEPRECIATION

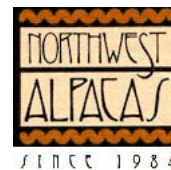
There are important changes for alpaca breeders in the recently enacted Job Creation and Worker Assistance Act of 2002. In an effort to stimulate the economy, Congress is giving taxpayers an extra 30% first-year depreciation writeoff for most new capital assets (other than buildings) acquired after September 10, 2001, and before September 11, 2004, and placed in service before 2005. In effect, this additional writeoff means that you can recover more of the cost of a business asset, such as an alpaca, in the year you place it in service.

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.
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.



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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 255, 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. It is very informative.

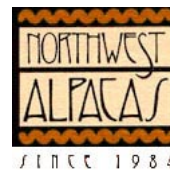
I must confess, I don't like to pay taxes; I always do, but I'm never happy about it. I inherited this bias, I believe, from my father. Dad was always fully convinced of his beliefs, and he believed that IRS agents were the bad guys.

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!

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

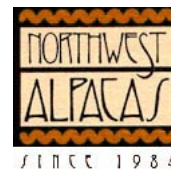


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Then the following expenses may be deducted from this income:

1. Vehicle mileage at 34.5 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 such as 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.



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

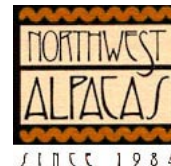
Once you've established the cost basis of your various assets, you take a charge for depreciation against your annual income. This process allows you to expense the historic cost of an asset to offset present income. The effect is to create non-taxable cash flow on a current basis. This benefit is especially 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 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 of 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 \$100,000. In this scenario we will assume you are in the 50% overall tax bracket (state and federal), use the section 179 deduction in year one, use the MACRS depreciation method, finance the herd at 7% 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 Alan Cousill at alan@alpacas.com.

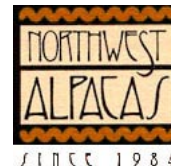


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FIVE YEAR AFTER TAX PURCHASE PROJECTION

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Purchase Price:		100,000	-	-	-	-	-
Down Payment:		30,000	-	-	-	-	-
Section 179 Deduction:		(24,000)	-	-	-	-	-
Special Depreciation:	30%	(22,800)					
Interest Payments:		(2,675)	(4,412)	(3,076)	(1,629)	(235)	0
MACRS Depreciation:		(7,980)	(13,566)	(9,496)	(8,863)	(8,863)	(4,432)
Insurance:		(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Principle Payments:		(7,579)	(16,095)	(17,431)	(18,877)	(10,018)	0
Total Tax Deduction:		(60,455)	(20,978)	(15,572)	(13,492)	(12,098)	(7,432)
Total Tax Savings: (50% bracket)		(30,228)	(10,489)	(7,786)	(6,746)	(6,049)	(3,716)
Total Cash Invested:		43,254	23,507	23,507	23,506	13,253	3,000
Cash Out-of-Pocket							
Net After Tax Each Year:		13,026	13,018	15,721	16,760	7,204	(716)
Cumulative After Tax Cost:		<u>13,026</u>	<u>26,044</u>	<u>41,765</u>	<u>58,526</u>	<u>65,730</u>	<u>65,014</u>
End Of Year		Year 1	Year 2	Year 3	Year 4	Year 5	
Principal Balance – End of Year on Contract:		<u>62,421</u>	<u>46,326</u>	<u>28,895</u>	<u>10,018</u>	<u>0</u>	

The total after tax cost of purchasing a \$100,000 herd for taxpayers in the 50% bracket (state and federal) is \$65,014, spread over six years, including principal, interest, and insurance.



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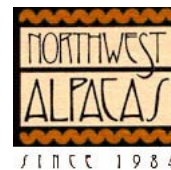
CASH PURCHASE

This scenario assures you pay cash and make the same assumption on depreciation and insurance as above.

FIVE YEAR AFTER TAX PURCHASE PROJECTION

		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Purchase Price:		100,000	-	-	-	-	-
Down Payment:		100,000	-	-	-	-	-
Section 179 Deduction:		(24,000)	-	-	-	-	-
Special Depreciation:	30%	(22,800)					
Interest Payments:		-0-	-0-	-0-	-0-	-0-	-0-
MACRS Depreciation:		(7,980)	(13,556)	(9,496)	(8,863)	(8,863)	(4,432)
Insurance:		(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
Principle Payments:		-0-	-0-	-0-	-0-	-0-	-0-
Total Tax Deduction:		(57,780)	(16,566)	(12,496)	(11,863)	(11,863)	(7,432)
Total Tax Savings: (50% Bracket)		(28,890)	(8,283)	(6,248)	(5,932)	(5,932)	(3,716)
Total Cash Invested:		103,000	3,000	3,000	3,000	3,000	3,000
Cash Out-of-Pocket							
Net After Tax Each Year:		74,110	(5,283)	(3,248)	(2,932)	(2,932)	(716)
Cumulative After Tax Cost:		74,110	68,827	65,579	62,647	59,715	58,999

The after tax cost of the same six alpacas costing \$100,000 is \$58,999, after five years, if you pay in



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cash. In other words, the government pays you back \$41,001 of your initial \$100,000 investment plus insurance in the form of tax savings.

The one thing to keep in mind is that you only receive the tax benefits of a \$41,001 write-off if you are a tax payer in the 50% bracket for each of the six years. For the same analysis of the 30% and 40% tax brackets, email Alan Cousill at alan@alpacas.com.

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.

The original cost bases 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 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.

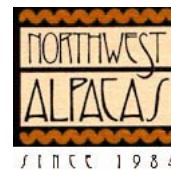
CAPITAL GAINS VS. ORDINARY INCOME

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 is currently taxed at a maximum rate of, up to, 39.1 percent and capital gains are taxed at rates of, up to, 20 percent. In 2002 the income tax drops slightly. 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 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



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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 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 CPAs 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 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, you may find a silver lining in the clouds of government.

In closing I wanted to let you know that the idea of taxes is not new nor an exclusive sin of the United States Government. Caesar Augustus decreed, in Roman times, "that all the world should be taxed," The politicians have taken taxation to heart for centuries. We have, on occasion though, been given good advice about our responsibility to pay tax. The Honorable Supreme Court Justice Learned Hand had the opportunity to instruct 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!