

9 Factors Provided by the IRS About Your Alpaca Business



9 Factors Considered by the IRS

Nine Factors Considered by the IRS to Prove a Profit Motive

Alpaca breeding allows for tax-deferred wealth building. An owner can purchase several alpacas and then allow the herd to grow over time without paying income tax on its increased size and value until he or she decides to sell an animal or sell the entire herd.

To qualify for the most favorable tax treatment as a farmer,** you must establish that you are in business to make a profit and actively involved in your business. You cannot raise alpacas as a hobby farmer, or passive investor and receive the same tax benefits as an active, hands-on, 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 you intend to be profitable. Luckily, the IRS does provide nine factors to consider in determining whether a profit motive exists. You do not need to meet all these factors, however, you should try to meet as many of them as possible. **Here's my explanation about the Nine Factors:**

1. You operate your farm in a businesslike manner.

Do you run the activity in a business-like manner? Do you keep your business funds separate from your personal funds? Do you have a separate checkbook for your business? Do you keep accurate business records? Do you operate the business to increase profits? Do you change your methods of operation in an attempt to improve profitability? Are you incorporated, or are you a limited liability company (LLC)? Or, at the least, do you have a registered Doing Business As (DBA)?

2. You or your advisors have the knowledge needed to carry on the farming activity as a successful business.

Do you have pertinent expertise to operate the business? Do you enhance your expertise with continuing education? Do you consult others with more expertise? Do you hire bookkeepers; have a business plan with a budget and cash flow projections?

3. The time and effort you spend on farming indicates you intend to make it profitable.

Do you spend time and effort on activities needed for the business to be profitable? These activities should not be purely pleasurable, but must be profit-driven. Do you document your time, effort and results as part of your business records?

4. Expectations that the assets used in the activity may appreciate.

Will the business assets appreciate with time to cover the expenses of the business? In the alpaca industry, we call it alpaca compounding as your herd value increases through breeding.

**For simplicity, the words "farm, farmer, and farming" are chosen to describe the activity. Feel free to substitute "ranch, rancher, and ranching" for your situation.

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5. You made a profit in similar activities in the past.

Do you have previous success in profitable businesses? What is your track record and ability to convert other types of businesses to profitability?

6. Your losses are due to circumstances beyond your control or are normal in the start-up phase of ranching.

Why did the business losses occur? Were the losses beyond your control? Were they due to start-up, economic downturn, breeding losses, or unforeseen circumstances? How does your business history compare to other similar businesses? Most alpaca farms do not make a profit for quite a few years due to long pregnancies.

7. You make a profit from farming in some years and how much profit you make.

Is your occasional profit significant when compared to the size of the investment? Selling a few skeins of alpaca yarn is not the same as selling an alpaca.

8. You depend on income from farming for your livelihood.

Is the business a primary source of your income? Do you have substantial income from other sources? Your profit motive is higher the more you rely on the income from this business.

9. You are not carrying on the farming activity for personal pleasure or recreation.

Although you should enjoy your work, your activities should not be predominantly for personal pleasure or recreation. Instead, the activities must be motivated by profit. A written alpaca business plan may help to convince the IRS that you have a legitimate business.

You don't have to qualify on each of these factors – the cumulative picture drawn by your answers will provide the determination. 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.

So, in conclusion, those of us with small farms must be aware about the distinction between hobby farms and farm businesses as determined by the IRS. As stated by my CPA firm, "No one factor will determine whether your alpaca business will withstand the scrutiny of an IRS examination. By understanding the tests, they use, keeping thorough and accurate records and updating business plans, and using qualified advisors, you will be more likely to successfully argue that your profit motive is genuine, thereby allowing your losses to be deducted against your other sources of income."

For even more detailed tax information for you and your accountant, please review The IRS publication #225 entitled "The Farmer's Tax Guide".

Julie Roy, aka Alpaca Julie, is an author, speaker, and business coach. She is known as a trailblazer in farm business education with monthly webinars, group programs, Done-With-You-Coaching, and one-on-one coaching services. She is the author of numerous eBooks about growing your farm business.