

Memorandum

To:

From: GIRCOM

Subject: Capital Gain Tax Treatment of Alpacas

Purpose:

The purpose of the memorandum is to raise awareness of the various tax treatments for the sale of alpacas, the complexities of such sales, and to hopefully create a data base in order that alpaca owners may draw upon this collective knowledge and best practices within the industry. This memorandum is NOT intended to give tax advice and alpaca business owners are encouraged to consult their tax advisor or accountant for individual farm business tax purposes.

Guidance:

Internal Revenue Service (IRS) has the following guidance available for consideration:

1. Farmers Tax Guide Publication 225
2. Memorandums and Revenue Rulings
3. Market Segment Specialization Program, (MSSP) , General Livestock
4. Farmers Audit Tax Guideline
5. IRS Tax Code Sections 167, 1231, and regulations

Example #	If you sell the following alpaca:	The understanding is that the income from the sale, qualifies as:		
		Ordinary Income	Depr. Recapture/Ordinary Income	Capital Gain
1	Crias held for less than 12 months	✓		
2	Crias held for more than 12 months:			
	a) Unproven Male (no breeding attempts made)	✓		
	b) Unproven Female (no breeding attempts made)	✓		
3	Unproven female with a pre-contracted breeding to a herd sire selected by the buyer	Indeterminate		Indeterminate
4	Maiden Female (no breeding attempts made)	✓		
5	Bred Female with a Confirmed Pregnancy			✓
6	Maiden Female without confirmed Pregnancy, but was attempted to be bred (and attempt can be proven with accurate records)			✓
7	Female who has been bred but not yet delivered a live cria (crias miscarried, aborted, etc.)			✓
8	Unproven Male:			
	a) No breeding history	✓		
	b) Yet has attempted breeding (no confirmed pregnancies)			✓
9	Proven Male:			
	a) Has confirmed pregnancies through ultrasounds			✓
	b) Crias on the ground			✓
10	Foundation Herds		✓	✓

Analysis:

Based upon the success of the GIRCOM initiatives, alpacas were recognized as “livestock” as compared to exotic animals, in the Food, Conservation and Energy Act of 2008, better known as the “Farm Bill.” The IRS gives the term “livestock” a broad definition that includes sheep, goats, fur-bearing animals...etc. This is in contrast to birds, fish, frogs and other reptiles. The IRS also has an interesting memo dated 08/02/1995, Treatment of Ostriches, Emus and Rheas as Section 1231 property. Alpaca owners should by definition determine how their particular alpacas will be “placed into service” and based upon a “facts and circumstance test,” these alpacas will either be held for “resale” or held for “breeding.” The intent of the alpaca owner will help to determine the correct classification of the alpaca when sold. This analysis should be considered if the alpaca owner purchased an alpaca, or if the cria was born on the farm.

SECTION 1231

In helping the alpaca owner in determination the character of the business property, IRC Section 1231 has some special requirements applicable to livestock.

The regulations contemplate a “facts and circumstances” test.

Treasury Reg. § 1.1231-2(a) (1) provides as follows:

(1) In the case of cattle, horses, or other livestock acquired by the taxpayer after December 31, 1969, section 1231 applies to the sale, exchange, or involuntary conversion of such cattle, horses, or other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him:

(i) For 24 months or more from the date of acquisition in the case of cattle or horses, or

(ii) For 12 months or more from the date of acquisition in the case of such other livestock.

[Emphasis added]

Treasury Reg. § 1.1231-2(b) (1) provides as follows:

(1) Whether or not livestock is held by the taxpayer for draft, breeding, dairy, or sporting purposes **depends upon all of the facts and circumstances in each case. The purpose for which the animal is held is ordinarily shown by the taxpayer's actual use of the animal.** However, a draft, breeding, dairy, or sporting purpose may be present if an animal is disposed of within a reasonable time after its intended use for such purpose is prevented or made undesirable by reason of accident, disease, drought, unfitness of the animal for such purpose, or a similar factual circumstance. Under certain circumstances, an animal held for ultimate sale to customers in the ordinary course of the taxpayer's trade or business may be considered as held for draft, breeding, dairy, or sporting purposes. **However, an animal is not held by the taxpayer for draft, breeding, dairy, or sporting purposes merely because it is suitable for such purposes or merely because it is held by the taxpayer for sale to other persons for use by them for such purposes.** Furthermore, an animal held by the taxpayer for other purposes is not considered as held for draft, breeding, dairy, or sporting purposes merely because of a negligible use of the animal for such purposes or merely because of the use of the animal for such purposes as an ordinary or necessary incident to the other purposes for which the animal is held.

[Emphasis added]

TAX COURT DECISIONS

An early Tax Court decision, McDonald v. Commissioner, 23 T.C. 1091 (1955), interpreted a predecessor to current Code Section 1231, Section 117(j), and suggests the following basic principles:

- it is not necessary that an animal reach maturity and produce offspring for the animal to be held for breeding purposes.
- it is not fatal to a taxpayer's case that the greater part of the income from a farm's operations be derived from sales of the animals in question.
- it can be meaningful if animals are sold at different ages, rather than at earlier ages only, as this can show that their disposal was not motivated by a desire for profit from such sales, but rather because of their unfitness of breeding purposes.
- It is important to look at the taxpayer's complete method of operation, even though it may be clear and predictable that each year substantial numbers of animals will be eventually be culled and sold.

McDonald was a victory for the taxpayer, an earlier Tax Court decision dealing with the same taxpayer having been overruled by the Court of Appeals for the Second Circuit.

A subsequent Tax Court decision, Clark v. Commissioner, 27 T.C. 1066 (1957) was a victory for the Service. The key factors in Clark were:

- there were substantial volumes of sale during the years at issue.
- the taxpayer engaged in extensive advertising.
- a prospective purchaser who came to the farm was free to select from the herd any animal that he wished.
- the taxpayer's inventory of animals continually declined during the years at issue.

Placed into Service:

The second factor that should be considered in determining capital gains treatment or ordinary income is when an alpaca is considered "placed in service." This rule is a timing rule, however, and does not change the characterization of the business property. For example, the depreciation sections of the Internal Revenue Code are tied to the concept that "immature livestock acquired for ...breeding purposes, is eligible for depreciation when it reaches maturity." This means the characterization of 1231 remains available, but depreciation will begin when the livestock can be worked, milked or bred. Audit Tax Guideline Chapter 7@6. (Emphasis added). The key word is "can" and the industry concepts that the maturity of breeding livestock is based on age, sufficient growth and behavioral factors.

The concept of maturity is also tied to the analysis of when the livestock can actually be considered "placed in service." Although the subject is of some debate, recent revenue rulings have relied on the following statement:

"In general, property is placed in service in the tax year the property is placed in a condition or state of readiness and availability for a specifically designed function."

The determination is based on facts and circumstances with the recognition that the "asset" is deemed placed in service when it is ready and available for use should the occasion arise. In this particular instance, the assumption is that all the males were old enough and demonstrating behavior consistent with a determination that they were in a "condition of readiness." Sec Rev. Rules 76-256; 84-85 and LTR 200334031 citing Reg. Sec. 1.46-3(d) (2). Similarly, there is case law available that does not rely on "actual use" as a prerequisite for making the determination of "placed in service." Age as a primary factor indicating maturity and "readiness to function" is supported by the IRS's use of the unit-livestock method. The unit livestock method is one way to deal with the economic value of immature versus mature livestock. In this particular instance, maturity and valuation are tied directly to the age of the livestock.

Practical Considerations:**Alpacas born on the farm:**

Where the alpacas are born on the farm raised for breeding purposes and sold, the characterization as Sec. 1231 business property is still available assuming it was the intent of the owner to use the animal in the trade or business of breeding (*Emphasis added*). Additionally the following result is that the alpaca may have a zero basis depending on how the costs of raising the alpaca have been treated in prior tax years. Support for this position may be found at MSSP @ 3-3. The IRS defines breeding livestock as, "...mature male and female animals that are used to reproduce offspring."

This can be contrasted, however and must be distinguished, from an alpaca that is born on the farm and from the beginning has been raised "for sale as a breeder." The support of which may be found at Farmers Audit Tax Guideline, Chapter. 7 @ 5. In this instance, the risk is that the IRS will view this as "offspring raised for sale as a breeder" and represent an ordinary income asset, per Market Segment Specialization Program @ 3-3. The factual criteria in support of the "purpose for which the alpaca was held" and the breeder's use of the asset includes such activities as participation in the show system, advertising and promotional activities and the owner's intent and breeding strategies.

Partial sales of Alpacas

When the breeder (owner) retains an ownership percentage interest in the alpacas with a percentage sale to other breeders the controlling factors for 1231 remain as to the intent of the breeders and whether the sale was for the purpose of incorporating the alpacas into their breeding programs. The fact that it was a partial sale does not appear to negatively impact the characterization of the business property, rather it arguably supports the intent of the original owner as to the business purpose of the asset. This type of sale is similar to the IRS analysis of "stallions syndicated for breeding purposes" where the transfer is a sale characterized as the transfer of an interest percentage and yet remains eligible for Sec. 1231 treatment. Reg. Sec. 1.1231-(2)(c)(1); From a business perspective, the collaboration expands the use of the livestock to the mutual benefit of all the owners and permits increased exposure in the marketplace for the sale of additional breeding services to other farms and increases the "output" of the breeding males consistent with the combined owners business objectives.

Finally, the fact that one or more of the alpacas had not started breeding but were old enough to do so does not impact the 1231 determination. Instead the rationale is that the mature males were at an age where they were ready to breed, but the owner delayed breeding to complete the business activities such as a show season that would continue to support and enhance the value of the alpacas for their intended purposes, *to serve as breeding livestock*.

BREEDING INTENT

The alpaca owner must be always diligent proving the intent of a breeding program. While the above information may help the alpaca breeder prove that they always have “breeding stock,” selling an “unproven male or unproven female” may be more difficult to prove as breeding stock and be successful in classifying the sale as Section 1231 as compared to the sale of “inventory.”

Required Disclosure:

United States Treasury Regulations require us to inform you that any tax advice contained in this communication and any attachment or enclosure is not intended or written by us to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties.