# Change Your Life With Alpacas!

## *Play by the "Rules of the Rich" for Financial Independence*

By Daryl W. Goodrich, JD

Frequently, farm visitors ask why I started with alpacas. My answer? I am fascinated by the opportunities of alpaca ranching.

Alpacas are an opportunity for one to be creative, help build a new industry, generate income, and enhance his quality of life. They are also exciting to be around due to their intelligence, curb appeal, and individual appearance and personality.

Most importantly, alpacas are an opportunity to play by what I call the "Rules of the Rich" to gain financial independence. Financial independence is not a hope! You must plan and work for it.

After law school, I worked as in-house legal counsel for two Fortune 500 companies. I was in a unique position to see and deal with many financially independent people. My specialty was buying and selling businesses for my employer. It is an involved and exciting legal process. I saw over and over small business owners receive hundreds of thousands and millions of dollars selling their businesses to my employer.

I wondered how these owners operated and sold their businesses to become financially independent. When meeting with them for sales details, I asked about their business experiences, goals, and strategies. I also asked my employer's in-house tax accountants about the business and tax strategies allowing businesses to be a pathway to wealth and financial independence.

The unique magnetic alpaca appeal and fiber product draw alpacas into people's lives.

I learned that these selling business owners followed a different set of rules than I was accustomed to. They played by the rules of the rich!

Most started out as I started - being paid for work performed. But, along the way, they learned this different paradigm and applied it in a business format to become financially independent.

My life changed! I began incorporating the rules of the rich into my life. My wife and I purchased some nearby multifamily houses that needed modernization. I kept my legal position and hired two employees to perform the renovation work. We then rented the houses and bought more. Soon I resigned my legal position. My wife and I then managed our multifamily housing investments full time and applied the rules of the rich.

One year we paid no Federal income tax because of a large tax credit earned renovating a commercial property. A Federal tax code provision encouraged commercial building renovation by offering tax credits for the work performed. I had the time of my life! Most of the building purchase price and renovation costs were paid by a loan secured with a mortgage on the building. And, a lot of our cash investment was offset by the taxes saved with the renovation tax credit. When the building was finished and rented, we paid taxes on the rent. But, the resulting cash flow yielded a handsome return on our then small cash investment. Over time, more and more burden-

Photo: Jennifer Clark; inset: David Perez some New Jersey laws regulating multi-family housing were enacted. The business climate became unfavorable for us and finally we sold our real estate.

Nine years ago, we were introduced to alpacas. I realized they were much like real estate. Both require large cash investments that are an opportunity to apply the rules of the rich.

It is an order of magnitude opportunity. If you buy a $100 asset that appreciates 10%, you have a $10 profit. If you buy a $20,000 asset that appreciates 10%, you have a $2,000 profit. I am more financially independent with $2,000 than with $10. I used to hesitate spending $20,000 but not $100, until real estate taught me a new comfort zone. A $20,000 business asset is preferred under the rules of the rich. For the time spent, it can put more tax savings and return on investment money in your pocket.

Alpacas are different things to different people. While I enjoy applying the rules of the rich to alpacas, that is my preference. If it is not your game, there are many other enjoyable alpaca roles. In fact, combining alpaca roles is most exciting! My wife actively spins, knits, and weaves alpaca yarn. Together, we breed and show alpacas, in addition to pursuing the strategies discussed in this article. We also sell alpaca products and volunteer to help alpaca organizations.

Playing by the rules of the rich are strategies that do not require being rich to start. They can be used to get started with little out-of-pocket cash as well as enhance cash flow once started. The below "playing by the rules of the rich" strategies are complex. The impact of these strategies on your particular family finances/business, state taxes, and some federal tax details cannot be covered in this article. *This is not tax or legal advice but merely a presentation of material to consider under the supervision of the tax accountant and attorney who guide your alpaca venture.*

## Strategy #1 – Seek a favorable business climate.

Success is easier in a favorable business climate. Business is never a sure bet, but the rich are not foolhardy or driven by emotion. They understand the risks involved and strive to increase the odds in their favor.

Many factors make up a favorable business climate. For me, little government regulation and enduring strong customer demand are the two leading factors. I feel the alpaca business climate is favorable. Not only are there few government regulations but also there is enduring strong customer demand. States usually have animal care and interstate transportation standards as well as farm environmental impact and land use constraints. These are reasonable and workable.

***My feeling of enduring strong demand stems from four facts.*** First, alpacas are being used in many different ways. Different uses create a diverse customer base that is more stable than a single use base. Changes in one of many uses have less effect on total demand.

Second, alpacas can involve your whole family. Since families value activities they can participate in together, there is a natural demand for alpacas.

Third, the unique magnetic alpaca curb appeal and fiber product desirability draw alpacas into people's lives. This draw is durable and easy since it flows from emotion and need.

Fourth, the alpaca's slow reproductive rate and relatively small number of current alpaca owners lend natural support for the strong demand arising from current supply-demand balance to continue as the alpaca industry matures.

The many uses supporting alpaca enduring strong demand fall into two areas – alpaca uses and fiber uses. Alpaca uses play quality of life and income generation roles.

Darby Vannier

**Playing by the rules of the rich are strategies that do not require being rich to start. It is an order of magnitude opportunity.**

Helen and Pat Dishaw

**Alpaca quality of life roles.** Alpacas are trained for agility and showmanship in 4H. Children and adults enjoy competitively showing alpacas and their agility in regional and national alpaca shows. I have also heard of alpaca pet therapy for people and alpaca focus for Girl Scout activities. Also, many people just find alpacas fun to have around as pets. These many quality of life activities are like those enjoyed by dog, cat, horse, etc. lovers.

The farm lifestyle that so many find stress relieving and an opportunity to teach children responsibility for animals can be achieved with alpaca ranching. The average 150-170 pound alpaca is manageable by most children. And, who can resist the fluffy, teddy bear look of alpacas?

**Alpaca income generating roles.** There are many alpaca income generation ways on a business and hobby level. They can be bred for sale as well as bought and resold. A selection of herd sires can provide stud services. Income flows from boarding alpacas for owners without farm facilities, showing alpacas for owners unable to attend shows, alpaca farm sitting for owners going on vacation, shearing alpacas, and transporting alpacas.

**Fiber uses.** Fiber use is an additional arena of income generation and quality of life roles. Craft spinning, weaving, and knitting are very popular. In addition, one can buy and sell alpaca apparel, accessories, and homewares on craft, custom, and large volume levels. The Alpaca Fiber Cooperative of North America, Inc. (AFCNA) is one such source of alpaca products.

Custom processing of alpaca fiber at home and mini-mills has been growing for a number of years. While the large volume processing of alpaca fiber for commercial and consumer use exists in Peru, it is only now being developed in North America. In the last few years, AFCNA has successfully created a

Alpacas are an opportunity for one to be creative, help build a new industry, generate income, and enhance his quality of life. They are also exciting to be around due to their intelligence, curb appeal, and individual appearance and personality.

large-volume alpaca fiber processing pipeline. It extends from fiber hand sorting through scouring, spinning, and product weaving and knitting. As AFCNA's members submit more fiber and more alpaca farms become members, this pipeline will grow into its large-volume potential.

AFCNA is a farmers' cooperative that serves the alpaca farmer "at-cost," with net income distributed to members based on their level of participation. Go to AFCNA's website at www.afcna.com for more details about membership and how the cooperative business model empowers alpaca farmers to capture the greater value of their fiber in manufactured consumer products. Alpaca farmers will soon make a lot more money from all grades and colors of fiber as well as pet alpacas due to the demand for their fiber.


## Strategy #2 – Seek investment income.

Investment income and earned income are very different. Investment income is money working for you. Earned income is you working for money.

Investment income keeps growing as more investments are made. Earned income is limited by employment opportunities, health, and hours in a day you can physically work. This distinction is fundamental to financial independence – having disposable income not tied to physical limitations or dependant on other people.

Alpacas are investments. They work for you. Each time a cria is born and later sold, each time a herd sire settles another's female, and each time your alpaca fleece is sold, income is generated. The more females and herd sires you have, the more income is generated. Alpacas work for you just as apartments work for landlords and manufacturing plants work for investors.


## Strategy #3 – Limit liability from claims by others.

Property damage and personal injury claims can be large and your liability for them must be avoided or limited. They stem from negligent and intentional acts and omissions you personally commit and employees of your alpaca business commit. They also stem from products your business sells/manufactures that are defective or have inadequate safe use warnings. This is product liability.

Punching a customer in the face would be an intentional act. Accidentally hitting another's face with a shovel while moving it in a manner lacking the care of a prudent person is negligence. Product liability arises, for example, from selling/manufacturing hay feeders that cut alpaca lips when they feed or if cut lips are a known hazard, failing to warn farmers.

You are personally liable for damage and injury claims arising from your acts and omissions whether or not related to your business. If your acts and omissions arise while conducting business activities, your business will also be liable. Your business will be liable as well for business agent and employee acts and omissions other than yours.

Short of avoiding damage and injury, the best exposure limitation is liability and finished product insurance. You should have personal liability insurance for non-business activities and business liability insurance for business activities.

Business liability insurance needs to cover both owners personally and their business. Insurance, though, covers only negligence and not intentional acts. Its coverage will also have a dollar limit based on the premium paid. Select insurance coverage large enough to cover potential claims. Property damage and personal injury exceeding insurance coverage will be borne by you if the injured party holds you

Alpacas are investments. They work for you. Each time a cria is born and later sold, each time a herd sire settles another's female, and each time your alpaca fleece is sold, income is generated.

Natalie Mormile

personally liable and by your alpaca business if it is held liable.

Alpaca business obligations, liabilities and uninsured liability claims can also be an exposure for you personally as the business owner. This exposure is avoided in most instances by selecting a business entity that insulates owners from personal liability beyond their business investment.

I say "most instances" because business owners can be personally liable for business activities in spite of this insulation if they: (i) as stated above, personally commit the damaging/injuring act or omission, (ii) commit fraud or other illegal act (theft, for example), (iii) do not deposit with the IRS employee wage Federal tax withholdings, (iv) personally guarantee a business obligation, or (v) fail to keep alpaca business activities separate from personal affairs.

**THERE ARE BASICALLY** four business entities from which to choose, only two of which insulate owners from business obligations, liabilities, and uninsured liability claims:

A **sole proprietorship** is the simplest in form. It is a single person carrying on a business activity with its income/loss being reported on the owner's personal tax return. For Federal tax purposes, a husband and wife engaged in a business activity can elect to be taxed as a sole proprietorship or a partnership.

The proprietor (owner) is personally liable for all business debts. Business income other than capital gains is treated as earned income subject to the 15.3% Federal self employment tax. No business formation documents are needed other than the filing of a trade name with the appropriate state government office if a name other than the owner's is used.

A **partnership** is a more structured business entity and can have two or more partners (owners). Each partner is personally liable for all partnership business debts. Business income/loss is reported proportionally on each partner's personal tax return with income other than capital gains treated as earned income subject to the Federal 15.3% self employment tax.

A husband and wife business is Federally taxed as a partnership, but they can elect to be taxed as a sole proprietorship. Partnerships can elect to be Federally taxed as a C-Corporation or an S-Corporation.

Partnerships are formed by the partners signing a partnership agreement setting forth their respective rights and obligations and how the business is to be operated. The partnership name needs to be filed with the appropriate state government office.

**Limited liability companies** operate and are Federally taxed much like partnerships. They can have one or more members (owners). Unlike partnerships but like corporations, they insulate their members from personal liability for business debts beyond their business investment. Check your state laws for any variance in this insulation. LLCs are formed by filing a certificate of formation with your state government and the members signing an operating agreement setting forth their respective rights and obligations and how the business is to be operated.

**Corporations** are the most structured business entity and can have one or more shareholders (owners). They are insulated from personal liability for business debts beyond their business investment. Corporations are Federally taxed as C-Corporations. If they meet certain prescribed standards, they may elect to be taxed as S-Corporations. Generally, alpaca farms can meet these standards.

C-Corporations are taxed and then their shareholders are taxed. This is known as double taxation. S-Corporations experience only one level of Federal taxation with tax treatment much like partnerships and LLCs. S-Corporation income and C-Corporation dividends are reported on shareholder personal tax returns as investment income and are not subject to the 15.3% Federal self employment tax.

Corporations are formed by filing articles of incorporation with the appropriate state government office and electing a board of directors who in turn adopt bylaws and elect officers.


## Strategy #4 – Leverage your money.

This strategy increases the return on your business asset investment. It requires you to pay cash for part of the asset purchase price and use borrowed money for the balance. Borrowed money leverages your cash payment to purchase a higher priced and higher valued asset. The increased return benefit stems from Federal tax savings, value appreciation, and income being determined by the purchase price and not your cash payment. Higher-priced, longer-lived, and in-demand assets are more effective for this strategy because they are more easily financed. It is a customary real estate practice. Alpacas are also well suited for money leveraging.

For example, if you buy a juvenile alpaca for $10,000, pay $2,000 cash, finance $8,000 and later sell her pregnant for $15,000, there is a $5,000 profit. This gain is a 250% return on your $2,000 invested cash. It is only a 50% return if you paid the $10,000 price in cash. Your invested cash, though, will increase the longer you hold the alpaca and make principle and interest loan installment payments. This will lower your return on investment.

Even though you paid $2,000 cash in this alpaca example, the whole purchase price may be deducted from income. If you are in a 30% Federal tax bracket, for example, you would save $3,000 in taxes. This tax savings can offset invested cash. When this alpaca is sold, however, this tax savings will be recovered by the IRS, but you will have sales proceeds at that time from which to repay it.

## Strategy #5 – Make Federal taxes work for you.

The IRS Farmer's Tax Guide publication #225 (see "Forms & Publications" at www.irs.gov) explains the IRS view of how Federal tax laws apply to farming. It is a good resource with which you and your tax accountant need to be familiar. This strategy is about enabling you to keep more of your money by maneuvering among these many tax provisions to reduce your taxes. It focuses on tax provisions that give strong benefits to small business owners, including farmers. Tax laws are subject to change by Congress and are often complicated and illogical. A farm-familiar tax accountant is a must.

**Seek capital gains.** This tax saving technique is about positioning yourself to sell capital assets. When capital assets held for more than a year are sold, the gain above their purchase price is taxed at a 15% Federal rate. The gain on the sale of inventory is taxed as ordinary income at a much higher rate.

An alpaca held primarily for breeding and/or fiber production is a capital asset while an alpaca held primarily for sale is inventory. Non-breeding alpacas not used to produce fiber for sale are inventory as well. Only buying and selling breeding-quality and fiber-producing alpacas create inventory alpacas. You must actually breed alpacas to claim you are holding them primarily for breeding. And you must actually produce and sell fiber to claim you are holding alpacas primarily for fiber production.

**Many factors make up a favorable business climate. For me, little government regulation and enduring strong customer demand are the two leading factors. I feel the alpaca business climate is favorable.**

**Put business income & loss on personal tax return.** If your alpaca farm is set up as a corporation, elect S-Corporation tax treatment to implement this technique. If you have a non-corporate business entity, this technique is implemented automatically unless you elect C-Corporation tax treatment. There are three tax saving benefits to this technique.

First, this technique avoids the double taxation of C-Corporation tax treatment.

Second, if your alpaca farm elects to be taxed as an S-Corporation, business ordinary income comes through to your personal Federal tax return as investment income not subject to the Federal 15.3% self employment tax. Sole proprietorship, partnership, and LLC ordinary income comes through as personal earned income subject to the self employment tax. The IRS is likely to complain about avoiding all self employment tax. Accordingly, a reasonable salary should be paid to a "manager" of your farm so some Federal employment tax is paid.

Third, most start-up alpaca farms and other businesses have no income in their early years. As a result, farm expenses create a loss that is not deducted from business income unless carried forward to offset future business income. When business loss comes through to your personal tax return though, it may be deducted from personal earned income to create tax savings. This is known as a "tax shelter" because business loss shelters personal earned income from taxation.

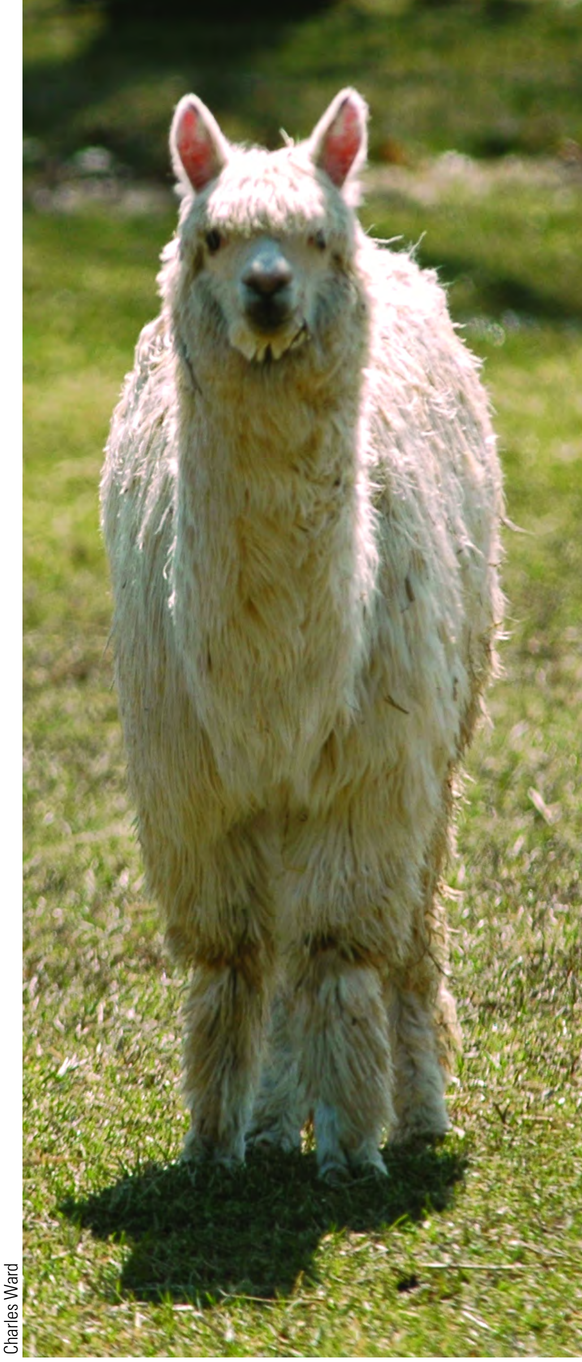
**Seek tax shelter.** As mentioned, tax shelters retain more of your money through tax savings. Tax shelters can be used only if three requirements are met, however.

First, you must materially participate in your alpaca business. Unless you participate at least 500 hours a year in your business, you are not a "material" participant.

Second, you must engage in your alpaca business with the expectation of making a profit. It cannot be a hobby. This is a facts and circumstances analysis that is not black and white. Your alpaca business activities in total must demonstrate a profit-making expectation. Some ways to demonstrate a profit-making expectation come to mind. Maintain a distinct business entity. Commingling business cash and other assets with personal assets blurs a distinct business identity. Partnerships, LLCs, and corporations are more distinct than sole proprietorships, but are not required. Using and registering a trade name supports a sole proprietorship distinct identity.

Incorporate business hallmarks into your alpaca farm activities. Use profit making aids such as sales brochures, ads, and other marketing material. A website, business cards, a professional accounting system, adequate capitalization, and a business plan are important as well. Learn about and implement customary business practices of a profitable alpaca farm to demonstrate a profit-making expectation. In addition, engage experts in business aspects you are not skilled at and spend a substantial amount of time and energy on your business.

Third, losses used in a tax shelter cannot exceed the dollar amount you are at risk for in your business. You are at risk for your business investment and business loans you personally guarantee or are liable for as a partnership partner.


Charles Ward

**Expense alpaca purchase price.** Since business capital assets are used for the production of income over a period of time, their cost is not deductible from income as an ordinary and necessary business operating expense. Their cost, however, may be deducted from income under the Federal tax cost recovery system. The saved taxes offset part of your alpaca investment. This system has two parts – Section 179 deduction and depreciation.

While Section 179 deduction applies to all business capital assets other than real estate, it is especially helpful when building the heart of your farm – a herd of alpacas for breeding or fiber production. The alpaca purchase price may be deducted from income in the year alpacas are purchased even though they may be used over a number of years. Total Section 179 deductions in a tax year, however, are limited to $125,000 adjusted for inflation. This limit is reduced as total capital asset purchases in the tax year exceed $500,000 adjusted for inflation. This deduction can be used only in the asset purchase year. You may choose to deduct all, part, or none of the purchase price. The purchase price part not so deducted may be depreciated.

Section 179 deductions reduce taxable business income for a tax savings, but generate a tax loss for start-up farms without income. As discussed above, start-up small business strategy is to deduct this loss from personal earned income for a tax shelter. This loss, however, cannot shelter personal earned income unless your business entity is a sole proprietorship or a single person or husband & wife LLC electing sole proprietorship tax treatment. Business entity selection for start-up farms deserves careful attention.

**Depreciate alpaca purchase price.** The second part of the Federal tax cost recovery system is depreciation. Depreciation applies to capital assets used for the production of income that wear out over time. It allows their purchase price to be deducted from income over their useful life for tax savings. Federal tax law sets the useful life. Breeding alpacas have a 5-year useful life and fiber producing alpacas have a 7-year useful life.

While useful lives determine the purchase price recovery period, a taxpayer can tailor recovery speed to his needs. Straight line and 150% declining balance are acceptable depreciation methods. Straight line spreads the purchase price evenly over the useful life. The latter method is known as accelerated depreciation. It moves more purchase price recovery to the early years of useful life. Depreciation is complicated by a half-year convention. This convention treats all purchases in a tax year as being on the midpoint of


stock.xchng

that year. Thus, only 1/2 year of depreciation is allowed in the first tax year.

Further, there is a mid-quarter convention. If over 40% of the total asset purchases' dollar amount for a given tax year is made in its last three months, each asset is depreciated as if purchased on the mid-point of the quarter in which purchase is made.

For example: under the half-year convention, using 150% declining balance depreciation method, you can depreciate 15% of your alpaca purchase price in the first year and 25.5% in the second year. Under the mid-quarter convention using 150% declining balance depreciation method, you can depreciate 3.75% of the purchase price of your alpaca purchased in the last three months of the tax year, in the first year and 28.88% in the second year.

The tax savings strategy for the tax cost recovery system generally is to deduct the purchase price as fast as you can. Deducting asset purchase price reduces taxable income. Saved taxes reduce your alpaca cash outlay. Use Section 179 deductions to the extent you can because there is no "useful life" or "convention." Then use accelerated depreciation. And if depreciating, avoid placing more than 40% of total asset purchase price amount (including alpacas) for a tax year in its last three months.

**Expense farm operating costs.** It is important to keep track of farm operating costs. Ordinary and necessary business operating costs may be deducted from business income to reduce taxes. When these costs exceed business income in start-up businesses, for example, a loss is created. These losses may be used to save taxes with tax shelter. There is no business entity limitation for tax shelter with operating costs as with Section 179 deductions.

While these five strategies help achieve financial independence, the last two also enable you to build an alpaca herd faster. Leverage extends your available cash to purchase more alpacas. Tax savings offset part or all of your alpaca purchase down payment. These savings free up money, which can be used for purchasing more alpacas. More initial breeding females means you will not only have more crias born, but it is more likely you will have some female crias. The chance of a male or female cria is believed to be 50-50.

---

Daryl W. Goodrich is a New Jersey attorney who served many years as in-house counsel for Fortune 500 companies General Electric Company and Kidde, Inc. He is past President and a past Director of the Alpaca Fiber Cooperative of North America, Inc. Daryl and his family own Angel Wood Alpaca Farm, LLC in Hackettstown, NJ. He can be reached at daryl@AngelWoodAlpacas.com or by phone at (908) 852-7204.