Depreciation rules for automobiles

Special limitations apply which may result in it taking longer for you to depreciate a car than it would other business property.

First of all, note that a separate depreciation allowance for a car only comes into play if you choose to determine the cost of its business use by the "actual expense" method. If, instead, you use the standard mileage rate (36.5 cents for each business mile driven during the year 2002), a depreciation allowance is built in as part of the rate.

If you are using the actual expense method in calculating the depreciation allowance, an automobile is treated as an asset with a 5-year recovery period. Under the regular depreciation tables, automobiles are actually depreciated over a 6-year span according to the following percentages: Year 1, 20%; Year 2, 32%, Year 3, 19.2%, Years 4 and 5, 11.52%, and Year 6, 5.76%. Six years are involved because depreciation starts in the middle of Year 1 and ends in the middle of Year 6. (These percentages are not available for cars used 50% or less for business purposes. For these, straight-line depreciation is required.)

However, under additional limitations applicable to cars, you are limited to specified depreciation ceilings, under "luxury automobile" rules. These ceilings, which are indexed for inflation, operate to extend depreciation beyond the sixth year for cars costing more than what the total depreciation allowance would be over the six years. For cars first put in service in 2002, the ceilings are $3,060 of depreciation for the year the car is first placed in service, $4,900 for the second year, $2,950 for the third year, and $1,775 for all later years. (These same limitations apply to vehicles first put in service in 2000 and 2001.)

You cannot avoid these limitations via an election to "expense" the car (a Section 179 election). With the limitations applying, it will take longer than the regular 6 years to depreciate the entire cost of the car, if it is not disposed of sooner.

If the car is used partly for business purposes and partly for personal purposes, the limits are reduced to the business percentage. For example, the maximum depreciation deduction for a car used 75% for business is $2,295 (75% of $3,060) for the first year. The "personal" 25% portion ($765) is disallowed.

What is the impact of these limitations from the standpoint of the business decisions you must make? They raise the "after-tax" cost of automobiles used in your business. That is, the true cost of regular equipment used in the business will be its actual cost reduced by the tax benefits enjoyed via depreciation deductions. To the extent these deductions are reduced (deferred to future years actually), the tax benefits are less and the true cost is higher. It may be advisable to consider this factor in deciding how much to spend on automobiles used in your business.

Please note that these limitations cannot be avoided by leasing a "luxury" car instead of buying it. Although the mechanics of the tax rules are different with leases, essentially your taxable income is increased to mirror the tax savings you would have lost had you bought the car. (These rules do not apply to car rentals for less than 30 days.)