# Depreciation rules for automobiles

Special limitations apply to the depreciation deductions for an automobile used in your trade or business which may result in it taking longer 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 (40.5 cents for each business mile driven during 2005), 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.)

You are permitted to take 50% additional first-year depreciation ("bonus depreciation") for new tangible personal property (including automobiles) that you predominantly use in your business and place into service before 2005. The adjusted basis of qualified property is reduced by the bonus depreciation deduction before computing the amount otherwise allowable as a depreciation deduction for the tax year and any later tax year. Thus, for example, if in 2004 you place in service a qualifying automobile costing $20,000, the first-year depreciation allowance is $12,000 [($20,000 × .50 = $10,000) + (($20,000 − $10,000) × .20 = $2,000)].

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 2004 and that qualify for the 50% bonus depreciation, the ceiling is $10,610 for that year. If an automobile does not qualify for 50% bonus depreciation or you elect not to claim any bonus depreciation, the ceiling is $2,960 of depreciation for 2004. The ceiling amounts for later years (regardless of whether any additional first-year depreciation applies) are $4,800 for the second year, $2,850 for the third year and $1,675 for all later years. Higher ceiling amounts apply for certain trucks and vans (passenger autos built on a truck chassis, including SUVs and minivans) and electric vehicles.

You cannot avoid these limitations via an election to "expense" the car (a Section 179 election). With the limitations applying, it may 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 $7,958 (75% of $10,610) for the first year (assuming the automobile qualifies for the 50% additional first-year depreciation). The "personal" 25% portion ($2,652) 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.)