

Depreciation rules for automobiles

The following describes depreciation deductions for an automobile you use in your trade or business are determined.

In fact, 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 (48.5 cents for each business mile driven in 2007), 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, the cost of an automobile is 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 is deemed to start in the middle of Year 1 and end 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 2007, the ceiling is \$3,060 for that year. The annual ceiling amounts for later years are \$4,900 for the second year, \$2,850 for the third year and \$1,775 for all later years. Higher ceiling amounts apply for certain trucks and vans (passenger autos built on a truck chassis, including SUVs and minivans). For electric vehicles placed in service before 2007, still higher ceilings apply. But those higher limits are not available for electric vehicles placed in service after Dec. 31, 2006; instead, the applicable amounts for autos or trucks and vans are used.

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 \$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.)