Knowing the Three Types of Depreciation

As it pertains to business aircraft, the term “depreciation” can cause a lot of confusion. It’s important to understand the three types of depreciation and how your company approaches each.

Tax Depreciation – This is the amount of depreciation recorded on the company’s tax returns. As an asset is depreciated, it offset income tax payments. The IRS sets the depreciation schedule for various assets. For a non-commercial, Part 91 business aircraft the schedule is over 5 years using a modified accelerated cost recovery system (MACRS). IRS rules can be modified through legislation to provide “bonus” or “accelerated” depreciation to incentivize companies to acquire assets. Companies with high profits find bonus depreciation attractive.

Question: Does your company make asset decisions based on accelerated depreciation incentives?

Book Depreciation – Book depreciation is an expense recorded on the company’s financial statements. The premise is that an aircraft is an asset on the company’s balance sheet. As the aircraft ages, its value is reduced. The reduction in value is an expense which needs to be “written down” via standard accounting principles. The amount depreciated and over what period will vary from company to company. The type and age of aircraft will also be factored in. For example, ACME Co. acquires a Falcon 2000LX for $20MM. The company considers the “useful life” as 10 years with a “salvage value” of 50% at the end of its useful life. Using a straight line depreciation method, ACME would book depreciate 50% of the value ($10MM) over 10 years; or $1MM each year. In determining your book depreciation strategy, conduct market research on your specific make and model of aircraft and determine how conservative or aggressive your company wishes to be.

Question: What is your company’s book depreciation philosophy?

Market Depreciation – Market depreciation is closely tied to book depreciation and should be understood. Market depreciation is how your aircraft’s fair market value has declined over a given period, regardless of book depreciation. There are many industry and economic factors that come into play. For example, the recession of 2007/2008 had a large impact on aircraft values. If you purchased an aircraft in 2007, your market depreciation was significant for the next 3 years; over 50% loss in value in many cases. Over the past three years, in a more stable economy, market depreciation has been more commonly 10-15% depending on the model of aircraft. How does this tie with book depreciation? When ACME acquired their $20MM Falcon, they projected a $10MM value in ten years. What if Falcon discontinues the 2000 series during those 10 years and values plummet as a result? After 10 years, the aircraft is worth $5MM. If ACME did not adjust their book values, the aircraft would be on the books for $10MM after 10 years. If they sell the airplane for $5MM, ACME would have to take a $5MM loss (expense) on the sale. This can have a marked impact on ACME’s profitability. How do you avoid this? It is a best practice to review your aircraft’s fair market value to the company’s book value annually, and adjust book depreciation accordingly.

Question: How are you tracking your aircraft value and how often?