



Guide to

# Tackling Tax Prep

for Small Business Owners



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# Why

## did we write this guide?

At National Funding, we know small business owners wear a lot of hats. Once you start running the show, the world expects you to be an expert in Marketing, Management, Customer Service...and countless other responsibilities that keep your customers happy and your business running smoothly.

So, that's why we put this guide together. Because, even if you have a tax pro who files your business' annual return, you still need to deliver all the records and documents needed in advance. Instead of spending hours sifting through piles of receipts and hand-scribbled notes trying to log expenses and costs—we'll show you what you need in order to organize your expenses and maximize their benefits.





## is this guide for?

This guide will equip small business owners in any industry with information that helps them prepare their financial docs prior to filing their business' Federal tax return. When it comes to taxes, there's no "one size fits all" solution. We recommend reviewing this guide with your tax professional to discuss a plan tailored for your business' specific structure and circumstances.



# CHAPTER 1

## Tax Fundamentals

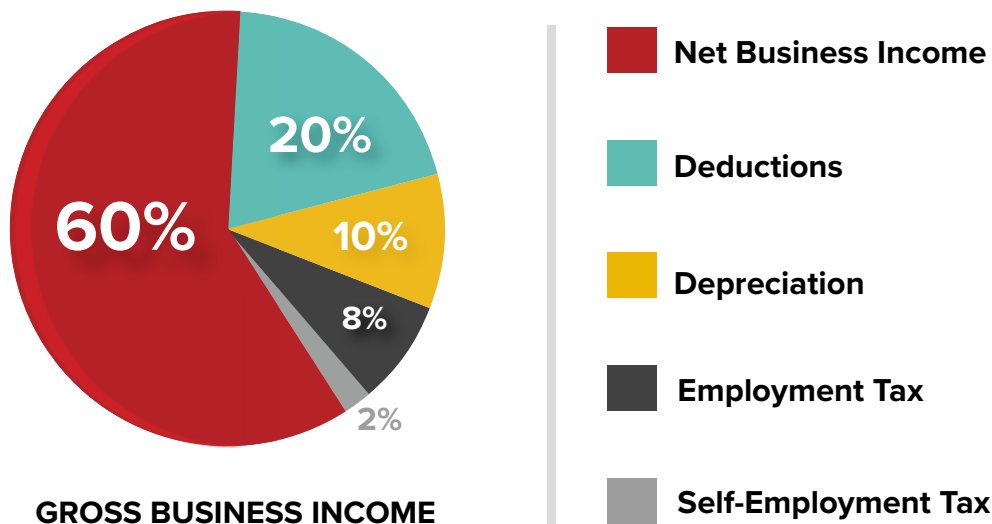
*The hardest thing in the world to understand is the income tax.*

**-Albert Einstein**  
Physicist and Genius

Between running your business and maintaining a personal life, deciphering all 74,608 pages of the Federal Tax Code isn't high on your to-do list. Like visiting the DMV, there's something about taxes that naturally evokes a negative response. Unfortunately, as a small business owner, taxes are something that we just need to grin and bear. While being your own boss has many perks—avoiding the IRS isn't one of them.

# How Taxes Work: A Quick, Painless Overview

People all over the world consider taxes a “necessary evil.” Even though they fund schools, infrastructure and countless other government-sponsored programs and initiatives, handing over a percentage of your hard-earned income isn’t fun.



Businesses—and individuals—are taxed based on a sliding scale of income brackets: The more you make, the more they take.

Fortunately, the government knows it wouldn’t be fair to just look at income alone—you need to spend money to make money.

**Q:** How does the IRS determine how much of your income is taxable?

**A:** Forms.

Each with its own unique number and purpose, forms report deductions, write-offs and help you qualify for tax credits that can land you in a lower tax bracket. In a sense, these forms are the friends who make sure the government only taxes what they’re supposed to—and not a penny more.

## Deadlines and Extensions

**The IRS doesn’t mess around with deadlines.** The deadline for small businesses to file their Federal and State tax return—or [file an extension](#)—is March 15th. If you file for an extension, your new deadline is September 15th; an extra 6 months to get things in order.

–Use [Form 7004](#) to file a business income tax extension

# CHAPTER 2

## Getting Started

*Preparation is the  
key to success*

**-Alexander Graham Bell**  
Inventor and Innovator



A man with a beard and mustache, smiling, wearing a red and blue plaid shirt. He is standing in front of a blurred background of greenery and a building. A red triangle is in the top right corner.

# Meet Jack

Jack is the owner of **Jack-Of-All-Trades**, a handyman service that specializes in light carpentry and minor plumbing fixes. Last year Jack signed a maintenance contract with a property management group with five 50-unit apartment complexes. Suddenly, his one-man operation grew to a crew with 25 full-time employees!

*Jack leased a bigger workshop, purchased new tools, a slew of company phones and even hired an office manager to help coordinate service requests and keep track of scheduling.*

*Business is better than ever—but gearing up for tax season, Jack's wondering how to make sure his return reflects how much his business grew.*

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No matter how your business fared last year, the first step to tax prep is getting all your records, statements and documents in order. Before you start dumping receipts and bank statements on your desk—let's cover the four types of business taxes...

# Types of Business Taxes

Unlike filing an Individual return, businesses are required to submit forms that account for four different types of taxes that relate to specific areas of the company.

1. **Income Tax:** All income earned or received
2. **Employment Tax:** Businesses with employees
3. **Self-Employment Tax:** Applicable to the business owner
4. **Excise Tax:** Limited to certain businesses that manufacture, sell or use specific products, equipment and/or services

All businesses are responsible for paying, but they must file using forms specific to their business structure:

- **Sole Proprietor**
- **Partnership**
- **C Corporation**
- **S Corporation**

Business Structure	Applicable Taxes	Form
Sole Proprietor	Income	<a href="#">1040</a> and <a href="#">Schedule C</a> <sup>1</sup> or <a href="#">C-EZ (Schedule F</a> <sup>1</sup> for farm business)
	Self-Employment	<a href="#">1040</a> and <a href="#">Schedule SE</a>
	Estimated	<a href="#">1040-ES</a>
	Employment: • Social Security • Medicare • Income Tax Withholding • Federal Unemployment Tax	• <a href="#">941</a> or <a href="#">944</a> ( <a href="#">943</a> for farm employees)  • <a href="#">940</a>
	Excise*	Specific to business industry

Business Structure	Applicable Taxes	Form
Partner in Partnership (Individual)	Income	<a href="#">1040</a> and <a href="#">Schedule E</a> <sup>2</sup>
	Self-Employment	<a href="#">1040</a> and <a href="#">Schedule SE</a>
	Estimated	<a href="#">1040-ES</a>

\*Excise Tax forms vary depending on your specific circumstances. Ask your tax professional or visit [IRS.gov](#) for further information

Business Structure	Applicable Taxes	Form
Partnership (business entity)	Annual return of income	<a href="#">1065</a>
	Employment: • Social Security • Medicare • Income Tax Withholding • Federal Unemployment Tax	<a href="#">1040-ES</a>  • <a href="#">941</a> or <a href="#">944</a>  ( <a href="#">943</a> for farm employees)  • <a href="#">940</a>
	Excise*	Specific to business industry

Business Structure	Applicable Taxes	Form
C and S Corporations	Income C Corporation S Corporation	• <a href="#">1120</a> <sup>2</sup> • <a href="#">1120S</a> <sup>2</sup>
	Estimated	<a href="#">1120-W</a>
	Employment: • Social Security • Medicare • Income Tax Withholding • Federal Unemployment Tax	<a href="#">1040-ES</a>  • <a href="#">941</a> or <a href="#">944</a>  ( <a href="#">943</a> for farm employees)  • <a href="#">940</a>

Knowing the scope of your business' tax responsibility is the first step towards understanding what and how to prepare to file.



*Jack takes a look at his office calendar and notices that it's already January 15th—just two short months until the tax deadline. Wanting to get the ball rolling, he calls his accountant, Lori, to schedule their first meeting of the tax season. After proudly bringing her up-to-speed with how much his company grew since last year, he asks to swing by her office to drop off “the usual paperwork” she requests every year to get started.*



“Well, it certainly is great that you’ve expanded your business, Jack. But, now that you’ve hired employees, leased a work space and bought more tools—there’s a lot more to report.”

“...how much more?”



“I’ll send you an email outlining everything you’ll need to bring over.”

*After hanging up, Jack’s headache started to build as he slumped down into his chair. Waiting for Lori’s email, he massaged his temples wondering how much time all this tax preparation was going to take.*



## SUBJECT: Jack-of-all-Trades Tax Prep Checklist

From: Lori Olson, CPA

To: Jack Taylor, Owner

Hi Jack,

Here's the list of documents I ask all my clients to provide before starting on their business' return. Try your best to bring everything on the list—and let me know if you run into any challenges.

### General Documents

- Last year's tax return
- Federal Tax ID Number

### For Business Income Taxes

- Accounting Journals and Ledgers: All reports that record business transactions; money going in and out of your accounts.
- Transactional Supporting Documents: Journals and Ledgers provide a “high-level” summary view of business transactions, but Supporting Documents show them in detail.
- Invoices received and paid
- Bank deposit slips
- Bank account statements
- Business checkbook and canceled checks
- Credit card statements
- Vehicle and Mileage logs

### Business-Related Expenses

Providing a detailed, itemized breakdown of your expenses help reduce your taxable income and can possibly drop you to a lower tax bracket. We'll work on these more later—but the first step is getting everything organized so I know what we're working with here.

Categorize receipts into the groups listed below and include purchase dates:

- Supplies: general office supplies
- Recurring operational costs: rent, utilities and subscription-based services
- Entertainment/Travel
- Marketing/Advertising costs
- Professional fees: Attorneys, Accountants (me!) and Consultants
- Insurance Policy Details: Individual and Group Plan documents, company vehicle policy and any other policies covering business assets
- Equipment and Assets: Include Depreciation Schedules for each

### For Employment Taxes

- Employee forms:
- [W-9](#): Employee Tax Withholding Certificate
- [I-9](#): Verification of employee legal working status
- [W-2](#): Wage and Tax Statements for each employee
- Subcontractors and Professional Services:
- 1099: Non-Employee Tax Form
- [1099-MISC](#): Summary of fees and payments for Non-Employees
- Payroll reports:
- Monthly/Quarterly reports of Hours Worked for each employee and total
- Monthly/Quarterly reports of Wages Paid for each employee and total
- Gross monthly payroll
- Total deductions withheld from employee gross wages

### For Self-Employment Taxes

A calculated percentage of your net income:

- Social Security Tax: 12.9%
- Medicare Tax: 2.9%

All right, that's it for now! Let me know if you run into any challenges and don't hesitate to call with questions.

Hope to hear from you soon,

Lori

# CHAPTER 3

## Deducting Business Expenses

*Next to being shot at and missed, nothing is really quite as satisfying as an income tax refund*

**-F.J. Raymond**  
Author

Being your own boss is expensive. Luckily, most of those costs can work in your favor at tax time. Translating them into deductions, depreciation amounts and credits is up to your CPA to figure out. But, they can't do it alone, which is why Lori asked Jack for all those records.

# To Deduct or Not to Deduct? That's a Very Important Question

Because deductions help lower your taxable income—thus lessening the amount the government receives—how CPAs report expenses to the IRS varies from business to business. Suffice to say, the short answer to this very important question is: it depends.

The IRS sets countless hard-and-fast rules to prevent businesses from shirking their financial responsibilities. Unless you're a hotelier scouting out the location for your next boutique hotel, the \$10,000 spent on your holiday to Bora Bora won't fly as a business expense. When it comes to deducting your expenses, resist the urge to include everything you bought last year and say it was for your business.

Most of the money you spent owning and operating your business can be classified as either [Business Expenses or Capital Expenses](#) (we'll get into these soon).

**Business Expenses** (also called “**expenses**”):  
Expenses within your trade/business that are:

1. **Ordinary:** Common and accepted
2. **Necessary:** Helpful and appropriate

These expenses are deducted from your gross income the same year they're incurred. Employee-related costs and expenses fall into this category.

- Use [Form 2106](#) to claim Business Expenses
- For more information, reference chapters 7-8 of [Publication 535](#)

## Common Business Expenses

Business Expenses			
Vehicles	Inventory	Home Office	Retirement Savings
Employees	Start Up Costs	Professional Service Fees	Business/Office Supplies
Entertainment & Meals	Customer/Client/Employee Gifts	Travel	Moving/Relocation Fees
Health & Business Insurance	Employee Disability & Sick Pay	Accrued Interest	Bad Debts
Charitable Contributions	Taxes	Real Estate	Special Assessments
Marketing & Advertising	Repairs & Improvements	Domestic Manufacturing	Office/Business Furniture



With Lori's email open on his computer, Jack zipped through the first few items. "This isn't so bad," he thought. But, all his momentum came to a screeching halt the moment he read two words: **Depreciation Schedules**.

"Guess I spoke too soon, what in the world are those?" He thought and reached for his phone to call Lori.



"Hi Jack, how's it going?"

"Okay I guess. I've been working on putting together all the docs you asked for—but I just ran into a snag. I'm stuck on Depreciation Schedules."



"Ah, I see. Well, the IRS treats certain big ticket items like tools, machinery or vehicles different than other expenses. Instead of deducting the costs of them the same year they were purchased, you claim a portion of the total cost over a pre-determined number of years"



"...sounds complicated."



"It **sounds** a lot harder than it is. Remember, I'm here to take care of the tough stuff. Tell you what, I'll put together some helpful hints and email them over. In the meantime, why don't you take a break? Sounds like you've earned it!"



"That's the best advice you've given me yet!"





## **SUBJECT: Depreciation Schedules Explanation**

**From: Lori Olson, CPA**

**To: Jack Taylor, Owner**

Hi Jack,

Thanks for giving me a call earlier—I'm happy to answer your questions and am here to help!

When reporting items purchased for your business, the IRS doesn't treat everything equally. After all, is a \$25 ream of paper the same as a \$7,000 Xerox copier? Definitely not. The IRS considers frequently replaced or purchased items, like reams of paper, Business Expenses. And items purchased for long-term use, like Xerox copiers, Capital Expenses; assets in layman's terms.

Let's say you bought 4 professional-grade, industrial carpet steam cleaners at \$4,999.00 each. Sure, writing a check for \$19,996 plus tax put a significant dent in your business checking account, but you're confident that these super-powered cleaning machines will pay off big time.

So, are these steam cleaners considered a business expense or an asset? To find out, ask yourself the following questions:

- Do you own and/or lease the item?
- Will you use it for business at least 50% of the time?
- Will it help generate income?
- Will you start using it to generate income this year?
- Is it known to have a "usable life" longer than one year?

If you answered "yes" to all five, then we should treat them as assets. And the IRS requires you to claim assets differently than business expenses.

There are three different ways to claim assets, and two of them require Depreciation Schedules. Since it sounds like this is the first time you're claiming assets on your business return, we can go over them in detail when we meet. For now, just include the following information for each asset:

- Asset name
- Short description of use
- Purchase price including additional expenses related to purchase (sales tax, etc.)
- Date purchased
- Duration of asset's viable use in years; usable lifecycle
- Estimated re-sale value if sold at the end of asset's usable lifecycle

We can decide which method works best for your business together. The good news is that you don't need to go with one method for all the assets you've purchased. Figuring out which method to go with is the easy part—but the paperwork involved can be tricky. Luckily, you won't need to worry about it, that's my job.

See you soon,

Lori

# CHAPTER 4

## Understanding Capital Expenses and Depreciation



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The goal of this guide is to help you understand how each methods' unique rules and benefits work at a very high level. However, applying them to your own tax return is much more complex. This is why we **strongly recommend** consulting with an accountant or tax professional to devise a strategy tailored for your business' needs.



# The Benefit of Capital Expenses

Lori's email alluded to a very important tax benefit all small business owners must be aware of:

## Capital Expenses.

The IRS states that businesses must “capitalize” assets that yield long-term use and contribute to future income.

But what does that mean to you and your business?

- **Tax Definition of “Capitalize”**: An accounting method used to delay the recognition of expenses by recording them incrementally as long-term assets.
- **Traditional Definition of “Capitalize”**: To take a chance to gain advantage from something.

Let's say a farmer spent roughly \$60,000 on equipment used to clear fields and seed new crops. Because he'll need to wait nine months to reap and sell what was sown, the farm's income this year will be significantly lower than next year. So, does it make sense to deduct the whole \$60,000 now when it'd have more impact on overall income in the future?

**Probably not.**

With Capital Expenses you have the option to **take advantage** of deducting costs to lower future taxable income.

## Capital Expenses (also called “assets”):

Ordinary and necessary expenses within your trade/business for:

1. Assets that will be used in your business beyond one year
2. Assets that benefit your business beyond one year

## Common Capital Expenses

Capital Expenses		
Machinery	Vehicles	Buildings
Copyrights & Patents	Business Property Improvements & Repairs	Inventory
Office Furnishings & Decor	Small Tools	Equipment

Use [Form 4562](#) to elect [Section 179](#) or claim depreciation and amortization deductions.

The **depreciated value** of these assets are deducted from your gross income for a pre-determined number of years.

**Important Note:** Even though items like “vehicles” and “inventory” appear in both tables, that doesn’t mean you report them twice. Instead, you’ll allocate different costs associated with each item as either a business or capital expense.

Expense	Business Expense	Capital Expense
Vehicles	Usage & Maintenance: Gas, mileage-based services, insurance, parking fees, tolls, repairs, licenses, garage rental fees, registration	Purchase and/or lease payments
Inventory	Cost of items depleted by the end of the taxable year	Cost of items not depleted by the end of the taxable year
Property Repairs & Improvements	Improvements & repairs that maintain, restore or protect the property so it’s in an efficient, operating condition. Non-significant incidental repairs	Improvements, modifications & repairs that enhance, upgrade or extend property value, strength, capacity, size, etc. Adapts the property for a different use or extends the “useful life” of the property
Office Furniture	Furniture that will likely be replaced in a year or purchase price doesn’t meet your company’s “Capitalization Limit”	Furniture that will not be replaced in a year or purchase price does meet your company’s “Capitalization Limit”

**Capitalization Limit:** Determined by the business owner and accountant that sets the minimum cost requirement that distinguishes business expenses from capital expenses.

## Determining Depreciation Value

As mentioned before, deductions lessen the amount of money the government is entitled to, so the IRS takes depreciation into account when assessing how much you can claim on your return.

**Note: There is an exception to this rule that we’ll get to soon.**

Like practically everything you buy, purchases tend to go down in value the second they leave the store. Even though the farmer spent \$60,000 on brand new equipment this year, five years from now, it’ll be worth a fraction of that. He knows it, and unfortunately, the IRS knows it, too.

In her email, Lori asked Jack to provide all the information she’ll need to start determining the **depreciated value** of his assets:

- Asset name
- Short description of use
- Purchase price including additional expenses related to purchase (sales tax, etc.)
- Date purchased
- Duration of asset’s viable use in years; usable lifecycle
- Estimated re-sale value if sold at the end of asset’s usable lifecycle; Salvage Value

**Total Purchase Price – Salvage Value = Depreciated Value**

# Choose How You Capitalize Costs Wisely

The IRS provides three different methods small business owners can use to claim capital expenses:

- Section 179
- MACRS: Modified Accelerated Cost Recovery System
- Straight Line Depreciation

## Section 179

The only method allowing small business owners to deduct the total cost of qualifying capital expenses the same year they were purchased; [Section 179](#) is the aforementioned exception to depreciation. And after years of flux and changes, Congress signed the “Protecting Americans from Tax Hikes Act” (PATH Act) on December 18th, 2015.

The PATH Act is a big win for small business owners because it sets the maximum capital expense deduction limit at \$500,000 “until further notice.”

Depreciation Method	Definition	Need Depreciation Schedule?	Implementation	Example
Section 179	Special IRS law allowing businesses to deduct all or part of an asset's purchase price the year it was bought	No	<ol style="list-style-type: none"> <li>1. Deduct the full purchase price of qualifying assets - up to the allowed maximum amount</li> <li>2. For qualifying items above the maximum allowed amount, deduct a percentage of the purchase price <b>Bonus First Year Depreciation</b></li> <li>3. Multiply the Bonus First Year Depreciation amount by the <b>Normal First Year Depreciation Rate</b></li> </ol>	<ol style="list-style-type: none"> <li>1. Total Equipment Cost: \$650,000 - <b>First Year Maximum Write Off</b> \$500,000 = <b>Remaining Cost Above Maximum</b> \$150,000</li> <li>2. \$150,000 x <b>50% Bonus First Year Depreciation</b> = \$75,000</li> <li>3. \$75,000 x <b>20% Normal First Year Depreciation</b> = \$15,000</li> <li>4. \$500,000 + \$75,000 + \$15,000 = <b>Total First Year Deduction</b> \$590,000</li> </ol>

Qualifying Assets: Section 179	
Tangible General Property	Business Vehicles
Office Equipment	Agricultural Structures
Office Furniture	Gasoline Tanks/Pumps
Computers	Livestock
Off-Shelf Computer Programs	Research Facilities
Machinery	Petroleum Storage
Large Business Equipment	Testing Equipment
Manufacturing Tools	Signs
Production-Related Equipment	Refrigerators

## MACRS: Modified Accelerated Cost Recovery System

Only applicable to farms, energy companies and approximately 100+ “non-typical” business types, MACRS is generally used to assess land depreciation costs. Its laundry list of governing rules and regulations is so complex the explanation document on IRS.gov is 119-pages long!

With this method—play it safe and let your tax pro take the lead.

Depreciation Method	Definition	Need Depreciation Schedule?	Example
MACRS: Modified Accelerated Cost Recovery System	A standardized method for calculating <u>property</u> depreciation allowing businesses to claim costs at a faster rate than the Straight Line method.	Yes	<ol style="list-style-type: none"><li><b>Basis:</b> Property purchase price including sales tax, etc. minus the percentage of property used for personal use.</li><li><b>Property Classification:</b> Property classification determines depreciation method and Recovery Period (number of years allowed to claim).</li><li><b>Recovery Period:</b> 3, 5, 7, 10, 15, 20, 25, 27.5 or 39 years</li><li><b>Depreciation Method:</b> Depending on the property classification you can either choose Declining Balance or Straight Line method.</li><li><b>Convention:</b> IRS term for describing what percentage of the property cost is recoverable in the first year.</li></ol>

## Straight Line Depreciation

This is the most commonly used method because it’s relatively easy to understand by allocating deductions evenly over an asset’s usable lifecycle.

Depreciation Method	Definition	Need Depreciation Schedule?	Implementation	Example
Straight Line	Distributes the asset's expense equally for each year of its usable lifetime.	Yes	<ol style="list-style-type: none"><li>Subtract the initial purchase price from the amount you could sell it for at the end of its usable lifetime (<b>Salvage Value</b>). The remaining difference is called the <b>Depreciable Base</b>.</li><li>Divide the depreciable base by the number of years in its usable lifetime to get the <b>Annual Depreciation Expense</b>.</li><li>Adjust the amount claimed in Year 1 to reflect the duration it was used that year.</li></ol>	<ol style="list-style-type: none"><li>Purchase Price: \$10,000 - Salvage Value: \$1,000 = Depreciable Base \$9,000</li><li><math>\\$9,000 \div \text{Usable Lifetime } 9 \text{ years} = \text{Annual Depreciation Expense } \\$1,000</math></li><li><math>\\$1,000 - \text{Year 1 Adjustment } \\$750 = \text{Year 10 Depreciation Expense } \\$250</math></li></ol>

## The Declining Balance Method

The Declining Balance Method isn't used as often as the other methods discussed. It involves applying the depreciation rate against the non-depreciated balance. Instead of spreading the cost of the asset evenly over its life, this system expenses the asset at a constant rate.

Remember the example of the farmer and his \$60,000 equipment? Most company's opt not to use this method because it lowers their income early in the asset's life and less when it's older.



Example Depreciation Schedule					
1	2010	\$10,000	\$750	\$750	\$9,250
2	2011	\$9,250	\$1,000	\$1,750	\$8,250
3	2012	\$8,250	\$1,000	\$2,750	\$7,250
4	2013	\$7,250	\$1,000	\$3,750	\$6,250
5	2014	\$6,250	\$1,000	\$4,750	\$5,250
6	2015	\$5,250	\$1,000	\$5,750	\$4,250
7	2016	\$4,250	\$1,000	\$6,750	\$3,250
8	2017	\$3,250	\$1,000	\$7,750	\$2,250
9	2018	\$2,250	\$1,000	\$8,750	\$1,250
10	2019	\$1,250	\$250	\$9,000	\$1,000

Salvage Value

*Relaxing at home after a long day at the office, Lori heard her phone ring and saw Jack's number display on the caller ID.*



# CHAPTER 5

## Conclusion

“Opportunities are usually disguised as **hard work**, so most people don’t recognize them”

**-Ann Landers**

*Pseudonym for advice columnist, Ruth Crowley*

Getting into the habit of organizing your records and receipts year round makes good business sense. Not only will it save you time, but it shows you the big picture of how spending today impacts future income.

If you’re running a start-up or have been in business for generations, as a small business owner, you work hard to protect what’s yours and see it grow. Knowing how to properly prepare your taxes is just one of the many things you can do to keep your business moving on a path towards long-term success.

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Section179.org: <http://www.section179.org/>

IRS.gov – Topic 554 Self-Employment Tax: <https://www.irs.gov/taxtopics/tc554.html>

Easy to understand definitions of every kind of tax deduction: <http://taxreceipts.com/tax-guide/>

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