Setting Up your Business Payroll System

Last week I had a question from a new business owner who asked how to set up a payroll system for the business. This is a very good question and identifies a task that must be carefully done. Whether you have one employee or 50, setting up a payroll system not only streamlines your ability to stay on top of your legal and regulatory responsibilities as an employer, but it can also save you time and help protect you from incurring costly Internal Revenue Service (IRS) penalties.

First, you must obtain an Employer Identification Number (EIN). Before hiring employees, you need to get an employment identification number (EIN) from the IRS. The EIN is often referred to as an Employer Tax ID or as Form SS-4. The EIN is necessary for reporting taxes and other documents to the IRS. In addition, the EIN is necessary when reporting information about your employees to state agencies. You can apply for an EIN online or contact the IRS directly. Check the Minnesota State Revenue website for details about the state ID.

The second item is to make sure you know the difference between an “independent contractor” and an “employee”. Be clear on this distinction. In legal terms, the line between the two is not always clear and it affects how you withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment taxes. Check the IRS website for help on this topic.

Next, you need to take care of the employee paperwork. New employees must fill out Federal Income Tax Withholding Form W-4. Your employee must complete the form and return it to you so that you can withhold the correct federal income tax from their pay.

Decide on a pay period. You may already have a manual process for this, but setting up a pay-period (whether monthly or bi-monthly) is sometimes determined by state law with most favoring bi-monthly payments. The IRS also requires that you withhold income tax for that time period even if your employee does not work the full period.

As you set up payroll, you’ll also want to consider how you handle paid time off (not a legal requirement, but offered by most businesses), how you track employee hours, if and how you pay overtime, and other business variables. Don’t forget that other employee compensation and business deductibles such as health plan premiums and retirement contributions will also need to be deducted from employee paychecks and paid to the appropriate organizations.

Consider using a payroll system. Payroll administration requires an acute attention to detail and accuracy, so it’s worth doing some research to understand your options. Typically, your options for managing payroll include in-house or outsourced options. Most small businesses find that an accounting software like Quick Books will do an excellent job on this. However, don’t forget, that regardless of the option you choose, you -- as the employer -- are responsible for reporting and paying of all payroll taxes.

Once you have all your forms and information collated, you can start running payroll. Depending on which payroll system you choose, you’ll either enter it yourself or give the information to your accountant.
Be aware of record keeping requirements. Federal and state laws require that employers keep certain records for specified periods of time. For example, W-4 forms (on which employees indicate their tax withholding status) must be kept on file for all active employees and for three years after an employee is terminated. You also need to keep W-2s, copies of filed tax forms, and dates and amounts of all tax deposits.

Lastly, don’t forget the reporting. There are several payroll tax reports that you are required to submit to the appropriate authorities on either a quarterly or annual basis. If you are in any way confused about your obligations, take a look at the IRS's Employer's Tax Guide, which provides some very clear guidance on all federal tax filing requirements. Visit your state tax agency for specific tax filing requirements for employers.

Having said all this, maybe you need to decide whether or not you want to do it yourself or hire an accounting service to do it for you. I assure you that this is a task that must be done “on time” and accurately.

Managing your business payroll can be complex. If you need help with this aspect of your business, contact America’s free and confidential source of small business mentoring and coaching, SCORE.

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