

asap
PAYROLL SERVICE



MANAGING PAYROLL FOR A SMALL BUSINESS

The Ultimate Guide



GETTING STARTED

Payroll is an essential component of every business, large and small.

Once you've made the decision to hire your first employee, it's inevitable that you know how to prepare payroll properly. Payroll processing isn't as straightforward as you may think. It comes with multiple components, such as tax calculations and deductions. Proper payroll processing requires a sound understanding of all applicable federal and state tax laws. These can make your head spin, as you shift your focus from what really matters—growing your business.

To take the burden off your shoulders, the following guide is designed to help you understand how to prepare payroll and identify an intuitive payroll system for your small business. This guide comes with payroll's best practices that will help any small- or medium-sized business make important decisions in critical areas like choosing the right payroll processing method, a timekeeping system, payment method, and understanding and filing payroll tax forms, among other features.

IMPORTANT COMPONENTS OF THE PAYROLL SYSTEM

Ideally, a complete payroll system comes with three key components: Paying the workforce, preparing and paying payroll-related taxes, and filing tax reforms.

Paying the Workforce

Paying your employees the right amount, on schedule, and in the right way, is key to employee satisfaction and productivity. Whether you pay them weekly, bi-weekly, or monthly, this aspect includes tracking work hours, processing withholding taxes, and issuing paychecks or making direct payments to your employees' bank accounts.

Processing and Paying Payroll-Related Taxes

Once withholding taxes are deducted from staff salaries, it's important that you submit those taxes to the relevant authorities: the federal and state government. Depending on the state where you established your business, the following withholding taxes may apply:

- Federal Tax
- State and Local Tax
- Social Security and Medicare Taxes
- Additional Medicare Tax
- Federal Unemployment (FUTA) Tax
- State Unemployment (SUTA) Tax
- Self-Employment Tax
- Worker Compensation Insurance



Generally, the three important tax deductions are federal income tax, Social Security, and Medicare

Filing Tax Forms

Filing tax forms is a time-consuming task every business owner must handle. However, as an employer, you're required by law to file the tax forms on time. Subject to the size of your business and its flexibility, you may file taxes on a monthly, quarterly, or annual basis, and you're required to file:

- **Form 944**, Employer's Annual Federal Tax Return
- **Form 941**, Employer's Quarterly Federal Tax Return
- **Form 940**, Employer's Annual Federal Unemployment Tax Return
- **Form W-2s** for Employees and **Form 1099s** for Contractors
- Annual Return of Withheld Federal Income Tax (**Form 945**)

Understanding Payroll Methods

Accurate and timely processing of payroll is one of the most important prerequisites for running a successful business. Since the IRS has many guidelines and regulations related to withholding and filing taxes, it's important that you invest in the best available payroll method that suits your business' needs, while meeting IRS guidelines. Additionally, it's important to keep employee satisfaction in mind, because employee performance and productivity are a direct function of prompt and accurate payment.



Manual (DIY Method)

Most small business owners, especially those with only a handful of employees, prefer to handle payroll manually. You'll need to build a spreadsheet to track each employee's hours worked, calculate taxes, and process paychecks, then manually calculate and file payroll taxes.

Manual payroll processing is best suited for businesses with one or two employees. If you're a finance-savvy employer with up-to-date information on tax deductions and reforms, you can opt for manual payroll processing.

✓ Pros

The manual payroll method is cost-effective. If you want complete control of your employees' earnings and tax filings, then manual payroll processing is a good fit for your business.

✗ Cons

Clearly, the manual payroll method is very detailed and time-consuming, with the potential for errors and mistakes that can cost your business in the form of IRS penalties.



Accountant

An accountant can be of great help to your business if you're interested in in-house payroll processing. You can engage a part-time or full-time accountant, depending on the size of your business and the number of staff. You also have the option of hiring an accountant on a contractual basis. This is ideal for small businesses with a large number of employees.

✓ Pros

Saves time and energy, while allowing you to focus on growing your business. Accountants have adequate knowledge of processing and filing taxes on your behalf, hence, there's a limited chance for costly errors.

✗ Cons

Accountants can be expensive, especially for a small business that's wanting to minimize expenditures. Additionally, this option gives you minimal control over your financials.



Payroll Software

Payroll software simplifies and automates the process of paying your workforce. It involves computing and deducting employee benefits, preparing pay slips, computing and filing employee taxes, and complying with regulatory requirements, among other functions. The right payroll software can help you set up your business and employee information on the fly. This way, you can enter your employees' information, such as pay period, pay frequency, number of hours worked, and pay date. The system will perform all the tax calculations. Depending on your budget and business needs, investing in the right desktop payroll processing application can save you time, money, and effort.

Payroll processing software is ideal for small businesses wanting to speed up their payroll process and seek absolute control over business financials.

✓ Pros

The right software takes away headaches that come with payroll processing. You can process payroll at the click of a button. It provides accurate wage and tax calculations, because the software is regularly updated with the latest tax tables.

Generally, most payroll software comes at a one-time low price and features enhanced data security. It gives you complete control over your payroll process, saves time, and lets you focus your energy on growing your business.

✗ Cons

As with any application, there's a learning curve. It's important that you train your employees on how to use the software correctly.



Payroll Services (Outsourcing)

Outsourcing your payroll services frees up valuable internal resources to focus on your business, while your payroll is processed efficiently offsite through real-time and remote processing. It's more like having a virtual accountant whose specific responsibility is to take care of your payroll. More importantly, your payroll will be in safe hands. All you have to do is submit a timesheet of your workforce to the payroll service provider, and they'll calculate and pay your staff. They'll also prepare, fill, and file your staff's tax forms to relevant tax authorities. This provides much-needed relief and time to focus on growing your business. Outsourced payroll services are ideal for small businesses with large workforces.

✓ Pros

Outsourcing your payroll lets you focus on important aspects of your business. Knowledge of tax regulations also means that your payroll processor will be efficient and accurate, eliminating the possibility of errors and delayed payments, which may attract penalties from the IRS.

✗ Cons

Communication between the employer and the payroll service provider is critical to avoid errors and wrongful payments. Plus, it's important for the payroll service provider to be up-to-date with federal and state tax laws.

Types of Payment Methods

Payment methods vary, depending on the business type, industry, accounting method, technological enhancement, and number of employees. Some of the common payment methods are:

Cash

A business may opt to pay a contractor or temporary worker handling odd jobs via cash.

Check

Checks are popular with small businesses, because they're cost-effective and traceable. Most payrolls print MICR-encoded checks on blank check paper.

Direct Deposit

Small businesses, especially in technological or professional industries, prefer the direct payment method, because this lets them directly pay their employees on a scheduled date. It's a very efficient way of paying your employees.

Pay Cards

Pay cards are another great option when paying your staff. It works like a debit card and can be used at ATMs.

TRACKING EMPLOYEE'S HOURS

Every business needs to keep track of employee hours. It's a crucial part of your payroll process and, if overlooked, may result in loss of business productivity. Regardless of the nature or size of your business, it's important that you have an effective time-tracking system. This way, you can keep a record of the hours worked and compensate your employees appropriately. A good time tracking system helps to eliminate pay-related conflicts, especially if the staff is paid on a per-hour basis. Some approaches used to track work hours in your organization are:

- Manually using a standard time sheet or spreadsheet
- Time-tracking software
- Biometric system
- Employee badge swipe

Following Department of Labor Laws

According to the Fair Labor Standards Act (FLSA) of 1938, "In some industries, particularly where time

clocks are used, there has been the practice for many years of recording the employee's starting and stopping time to the nearest five minutes, or to the nearest one-tenth or quarter of an hour. Presumably, these arrangements average out so that all of the time actually worked by the employee is properly counted and the employee is fully compensated for all the time actually worked.

This means that every employer is required by the FLSA to track overtime pay, minimum wage, record-keeping, and youth employment standards that affect their workforce. Below are some common wage and hour mistakes:

- Failure to pay employees on the day of termination
- Inadequate (or non-existent) I-9 documentation
- Lack of familiarity with rules related to on-call pay
- Failure to pay for certain travel time
- Improper use of "comp time"
- Unlawful deductions from employee pay checks
- Docking the pay of salaried employees
- Improper designation of "exempt" employees
- Incorrect calculation of overtime pay

Inadequate Recordkeeping of Overtime Pay

The law requires employees who work overtime (more than 40 hours per week) to be compensated for the extra hours. States like California have daily overtime pay that requires employers to compensate their employees on a daily basis when those employees work more than eight hours. Then, too, there are employees who are exempt from overtime pay. Consult your regional Department of Labor (DOL) office for more information.

The FLSA requires employees on hourly contracts who work more than 40 hours per work week to be remunerated at a minimum of 1.5 times the employee's regular pay rate for every extra hour worked. Here's how the overtime pay calculation works:



If an employee works 50 hours in a week at a normal pay rate of \$20 per hour, they're to be paid \$800 for 40 hours, plus an additional \$300 for 10 overtime hours.

This brings their income for that given week to \$1100.

UNDERSTANDING PAYROLL TAX WITHHOLDING LAWS

Abiding by the IRS is an important responsibility of every employer. IRS Circular E explains federal payroll tax withholding and how to comply with the laws.

Mandatory Deductions

Mandatory deductions are a key component of any payroll tax. If you're using in-house payroll software, then it should automate calculating the deductions and withholdings from wages.



Federal Income Tax

Every employer must withhold federal income tax from employees' wages. The amount depends on the employee's gross income, such as exemptions, marital status, and the amount of semi-monthly gross income. In some instances, deductions, including Public Employees Retirement Systems (PERS) or TIAA/CREF retirement contributions, are also determined when setting the employee's federal income tax.

Social Security

Both the employer and employees are required to pay Social Security taxes to fund various Social Security initiatives. This is a vital component of the Federal Insurance Contributions Act (FICA) tax. As of 2020, the Social Security tax rate for employees is 6.2% of their first \$137,700 of wages. The employer then outlays the same amount, for a total of 12.4% per employee.

The wage limit as of 2020 is \$137,700. If the income is beyond the prescribed wage limit, then the employer is exempted from Social Security taxes and vice-versa.

Medicare

Medicare is part of the Federal Insurance Contributions Act (FICA) tax. Every employee is required to contribute 1.45% of their income to this fund. The employer also contributes an equivalent amount (1.45%) of the employee's income. The Medicare tax rate is 1.45% on the first \$200,000 and 2.35% above \$200,000.

Federal Unemployment Tax (FUTA)

The law states that every employer is required to report and pay unemployment taxes quarterly for their employees. This payment should be made using Form 941 Employer's Quarterly Federal Tax Return. This money goes toward financing state unemployment programs. Every employer who has paid at least \$1500 in wages during a calendar quarter

is subject to FUTA. In turn, employees are exempt from FUTA taxes.

As of 2020, the FUTA TAX rate is 6% of employees' salaries. It's important to note, however, that the FUTA tax applies to the first \$7,000 you pay to each workforce during a calendar year. The federal wage base is \$7,000 and if your staffs' wages exceed \$7,000 then you will cease paying FUTA.

State Unemployment Tax (SUTA)

SUTA varies from state to state. Check your state's SUTA tax rate and wage base, because some states don't require employers to pay SUTA and only require FUTA.

State Income Tax

Besides federal income tax, most states collect state income tax.

Workers' Compensation Insurance

Small businesses, especially those in sole proprietorships, partnerships, and limited liability corporations, can make deductions for workers' compensation insurance from their state and federal taxes. The rules with respect to deductible amount vary from state to state, with some states having exemptions for their farm and domestic workforce. For example, if you own a business in California and have only one employee, then you're required to have workers' compensation insurance. Contrast this to states, such as Florida and Alabama, which have their minimum employees for WCI at four and five, respectively. Additional mandatory deductions include court-ordered garnishments for:

- Delinquent child support payments
- Delinquent federal or state taxes
- Delinquent student loans
- Payments to creditors who've won court judgments against you

Voluntary Deductions

Voluntary deductions may vary from business to business and are usually deducted before mandatory taxes. One of the benefits of outsourcing your organization's payroll to a full-service payroll company is that they'll handle all the voluntary deductions by categorizing them in the right classifications. Some voluntary deductions an employer may consider include:

Contributions to an IRA, 401k, or Another Retirement Plan

The Individual Retirement Account (IRA) helps employees save for their retirement in a tax-advanced system that utilizes a tax-deferred arrangement. There are three main types of IRA: Roth, Traditional, and Rollover. The 401(k), on the other hand, is an employer-

sponsored arrangement that lets employees save money from their pay checks before tax deductions. A 401(k) advantage for employees is that they don't have to pay tax until the money is withdrawn from their account.

Health Insurance Premiums

An employer may deduct health insurance premiums from an eligible employee's wages before applying taxes.

Job-related Expenses

Generally termed unreimbursed employee expenses, job-related expenses cover employee tools and equipment, travel expenses, passport for a business trip, uniforms, meals, union dues, and work-related training costs.

Life Insurance Premiums

An employer can also offer group term life-insurance coverage to employees and deduct this cost before payroll tax deductions.

Employer Paid Benefits

Employer-paid benefits relate to non-monetary compensation from the employer to the employees. These benefits are in addition to employees' regular salaries and wages:

- Holidays
- Vacations
- Sick Days
- Insurance (health, dental, vision, life, and disability)
- Retirement plans
- Profit-sharing plans

ADDING A NEW EMPLOYEE TO PAYROLL

Hiring a new employee provides a clear indication that your organization is growing. This step-by-step guide to adding a new employee to your payroll system should help:

Get Your Employer Identification Number (EIN)

Before hiring a new employee, you need to obtain an EIN (also known as Employee Tax ID or SS-4) from the IRS. You'll use this number to report the employee's taxes and employment information to state and federal agencies. Check the [irs.gov](https://www.irs.gov) website for more information.

Obtain State/Local IDs

The employee should provide their state/local ID. This will be used to prepare and file W-2 and 1099 forms.

Hiring Employees or Independent Contractors?

Depending on the nature of your business and your labor needs, you'll need both for your organization at different points in time. However, it's important that you have a clear understanding of the difference between an employee and an independent contractor. In terms of tax reporting, you should file a W-2 for employees and a 1099 for independent contractors. Related to tax deductions, you're required by law to withhold mandatory taxes from employees' earnings. In contrast, independent contractors are responsible for paying their own taxes.

Have Your Employees Complete W-4 Forms

It is the employer's legal duty to ensure that every new employee fills out and returns the Federal Income Tax Withholding Form W-4 before formally starting work. This helps the employer when withholding federal tax income from employees' wages or salaries. In the case of freelancers, they need to complete the W-9.



Set a Payroll Schedule

Most states have their own pay periods. For more information about State Payday Requirements, see <https://www.dol.gov/agencies/whd/state/payday>. Workers in states that do not have mandatory pay period regulations may earn their dues on a weekly, bi-weekly, semi-monthly or monthly basis.

Document Employee Compensation Terms

As the employer, you need to define Employee Compensation Terms, such as tracking time, paid leave, overtime, health care premiums, taxes, and retirement contributions, among other deductions. It's important to clearly articulate all the applicable terms to your employees so they have a clear understanding of tax deductions and their take-home salary.

Running Payroll

Now that you have settled on a preferred payroll and pay method, you need to run the system and pay your workforce.

Keeping Records

You need to keep clear records of your employees' names, addresses, Social Security numbers, tax

deductions, and paid amounts of W-2 and W-4 Forms. It's a federal and state requirement that you keep this information for up to three years after an employee's termination.

Reporting Your Payroll Taxes

As an employer, you're required by law to report all payroll taxes to the IRS and other relevant authorities. This can be a time-consuming task. However, by outsourcing your payroll processing to a professional organization, such as ASAP Payroll Service, you have the peace-of-mind that a knowledgeable professional is handling it for you within the stipulated timeline.

PAYROLL REPORTING REQUIREMENTS AND PAYMENTS

You've withheld taxes from your workers' earnings. Now, you need to report and submit taxes to relevant authorities, as required by law. You're required to submit all withheld taxes on a schedule, as determined by your local, state, or federal tax agency. You can report payroll tax submissions weekly, monthly, or quarterly, as applicable, depending on the amount of tax liability.

Small businesses must file the following tax forms:

Employer's Quarterly Federal Tax Return – Form 941: Filed quarterly, this form is used for reporting the following:

- Wages and taxes for federal income tax
- Employee Social Security and Medicare tax
- Employer Social Security and Medicare tax

Employer's Annual Federal Unemployment Tax Return – Form 940:

This form reports wages and taxes to FUTA. Funds should be deposited quarterly. However, if the amount exceeds \$500, then you should file annually.

- **Wage and Tax Statement – Form W-2:** This form reports individual employee wages and taxes. It should be filed annually. One copy is given to employees and another filed with the Social Security Administration (SSA).
- **Transmittal of Wage and Tax Statements – Form W-3:** This form summarizes all information reported on Form W-2. It should be reported annually to the SSA, along with the W-2 Form.
- **State Payroll Tax Filings and Payments:** Every state has specific rules with respect to state payroll tax filings and payment. Most states require employers report state income tax and state unemployment tax at the same time. Consult your state's department of revenue for information and state unemployment tax agency regarding remittance withheld income tax and unemployment taxes, respectively.

- **Form 1099-MISC, Miscellaneous Income:** This form is used to report the amount paid to independent contractors, if the amount exceeds \$600 in a year for services they provide to your business. You're not required to pay their taxes, as independent contractors are required to pay their own. You simply report these amounts on the 1099 MISC Form.

COMMON PAYROLL PROBLEMS

Payroll processing must be error-free, because errors can result in heavy penalties and fines from relevant government authorities. You'll need to avoid common payroll problems, such as:

- Incorrectly setting up your payroll
- Working with inexperienced payroll processors
- Misclassifying workers
- Preparing payroll manually
- Keeping ineffective time records
- Missing payroll processing deadlines
- Miscalculating overtime
- Failing to issue 1099 forms
- Missing deadlines to deposit withheld taxes
- Forgetting to keep records
- Not keeping compliant with multi-state complications
- Not recording paper checks
- Failing to update your state unemployment insurance (SUI) rate

Pitfalls to Avoid When Preparing Payroll

The following are bad payroll practices that can ruin your business:

- X** Manually processing payroll and other administrative work. Manual payroll processing significantly increases the chance of errors and inefficiencies. This is a red flag for heavy penalties and fines from government agencies.
- X** Overdependence on one person to process payroll. If that staffer goes on leave or resigns from the organization, your payroll system could break down. You'll either have to hire an experienced accountant or outsource your payroll. Either choice takes time and could delay payment to your employees and taxes to the authorities.
- X** Creating an additional expenditure by buying expensive software with monthly recurring fees. This can strain your business financials. Buying one-time, low fee payroll software may be your best choice.
- X** Learning and understanding the payroll system and tax regulations can take an inordinate amount of time and take you away from operating your business. It's better to delegate these tasks to professionals whose full-time responsibility is to handle payroll effectively and accurately. Often, small business owners involve themselves in every aspect of the business. Try to avoid this. Your primary focus should be building and growing your business, not handling administrative tasks.

- X If your employees aren't paid in a timely manner, this affects their satisfaction with their jobs. Untimely payment of wages will lead to increased attrition and decreased morale, productivity, and happiness.
- X Employee payroll data contains personal and financial details. There's no room to compromise on keeping this data secure. There should be adequate security to protect confidential data from landing in hackers' hands.

Payroll Best Practices

Payroll, a primary component of any small business, can help cut costs and enhance efficiency if certain best practices are followed. These best practices can yield significant dividends for your business, including:

- ✓ Integrating payroll with accounting, time-keeping, and HR systems.
- ✓ Customizing pay methods according to the workers' types and work.
- ✓ Letting employees choose their preferred payment method: cash, check, pay card, or direct deposit.
- ✓ For businesses with multiple locations, processing payroll from the main office in order to maintain complete control over business financials.
- ✓ Outsourcing payroll processing to a service provider when handling payroll in-house becomes a burden to staff.
- ✓ Tracking important tax deadlines, because late deposits can attract IRS penalties and interest charges.
- ✓ Making sure employees and independent contractors are properly classified.
- ✓ Handing out W-2 forms to employees and 1099s to independent contractors and having them complete both accurately.
- ✓ Securing confidential payroll data by recording and maintaining proper records in a locked repository. Regularly backing up data in case of data loss.
- ✓ Training more than one staff member to use payroll software, if your business has a limited number of employees.
- ✓ Double checking entries made in the software and when filling out tax forms.
- ✓ Conducting regular audits to ensure all processes work smoothly. Sometimes, you'll perform the same mistake repeatedly, which can lead to unknowingly losing money. For example, if you don't report employees who've recently resigned to your payroll service provider, they'll still receive a salary, making it your error.
- ✓ Gaining a general understanding of how payroll, tax deductions, and tax filing work.

ULTIMATELY...

...payroll is a vital component of any business. It's crucial that it's set up properly for your peace of mind. A good payroll system saves you time, money, and effort, but also helps your business grow exponentially.

[Request a Payroll Quote](#)

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