10 Steps to Setting Up a Payroll System

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.

Here are 10 steps to help you set up a payroll system for your small business.

1. **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.

2. **Check Whether You Need State/Local IDs.** Some state/local governments require businesses to obtain ID numbers in order to process taxes.

3. **Independent Contractor or Employee — Know the Difference.** Be clear on the distinction between an independent contractor and an employee. 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.

4. **Take Care of 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.

5. **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.

6. **Carefully Document Your Employee Compensation Terms.** 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.

7. **Choosing a Payroll System.** Payroll administration requires an acute attention to detail and accuracy, so it’s worth doing some research to understand your options. Start by asking fellow business owners which method they use and if they have any tips for setting up and administering payroll. Typically, your options for managing payroll include in-house or outsourced options. However, regardless of the option you choose, you -- as the employer -- are responsible for reporting and paying of all payroll taxes.

8. **Running Payroll.** 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.

9. **Get Record Keeping Savvy.** Federal and some 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.

10. **Report Payroll Taxes.** 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.
The link to the IRS site with some general information about obtaining an EIN is:  
http://www.irs.gov/businesses/small/article/0,,id=102767,00.html

If you'd like to apply on-line, you can start the process from this link:  

If you'd rather fill out the paper form, you can find Form SS-4 at  
You should be able to complete the form, print it and mail it in. However, I'd be inclined to do the on-line registration. You'll receive your EIN in a more timely manner.

In addition to the federal EIN, Texas requires you to register with the TWC. You can apply on-line at  
http://www.twc.state.tx.us/customers/bemp/businesses-employers.html  
Click on Register a New Tax Account, then under Log In options choose Sign up for a TWC Internet User ID.

The following is a list of important dates. Also see Publication 509, Tax Calendars.

DUE DATES for Payroll Forms

If any date shown below for filing a return, furnishing a form, or depositing taxes falls on a Saturday, Sunday, or federal holiday, use the next business day. A statewide legal holiday delays a filing due date only if the IRS office where you are required to file is located in that state. However, a statewide legal holiday does not delay the due date of federal tax deposits. For any due date, you will meet the “file” or “furnish” requirement if the envelope containing the return or form is properly addressed, contains sufficient postage, and is postmarked by the U.S. Postal Service on or before the due date, or sent by an IRS-designated private delivery service on or before the due date. See Private Delivery Services on page 6 for more information.

By January 31

Furnish Forms 1099 and W-2. Furnish each employee a completed Form W-2, Wage and Tax Statement. Furnish each other payee a completed Form 1099 (for example, Form 1099-MISC, Miscellaneous Income).

File Form 941 or Form 944. File Form 941, Employer’s QUARTERLY Federal Tax Return, for the fourth quarter of the previous calendar year and deposit any undeposited income, social security, and Medicare taxes. You may pay these taxes with Form 941 if your total tax liability for the quarter is less than $2,500. File Form 944, Employer’s ANNUAL Federal Tax Return, for the previous calendar year instead of Form 941 if the IRS has notified you in writing to file Form 944 and pay any undeposited income, social security, and Medicare taxes. You may pay these taxes with Form 944 if your total tax liability for the year is less than $2,500. For additional rules on when you can pay your taxes with your return, see Payment with return on page 20. If you timely deposited all taxes when due, you have 10 additional calendar days from January 31 to file the appropriate return.

File Form 940. File Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return. However, if you deposited all of the FUTA tax when due, you have 10 additional calendar days to file.

File Form 945. File Form 945, Annual Return of Withheld Federal Income Tax, to report any nonpayroll income tax withheld in 2010. If you deposited all taxes when due, you have 10 additional calendar days to file. See Nonpayroll Income Tax Withholding on page 5 for more information.

By February 15

Request a new Form W-4 from exempt employees. Ask for a new Form W-4, Employee’s Withholding Allowance Certificate, from each employee who claimed exemption from income tax withholding last year.

On February 16

Forms W-4 claiming exemption from withholding expire. Any Form W-4 claiming exemption from withholding for the previous year has now expired. Begin withholding for any employee who previously claimed exemption from withholding but has not given you a new Form W-4 for the current year. If the employee does not give you a new Form W-4, withhold
tax based on the last valid Form W-4 you have for the employee that does not claim exemption from withholding or, if one does not exist, as if he or she is single with zero withholding allowances. See section 9 for more information. If the employee furnishes a new Form W-4 claiming exemption from withholding after February 15, you may apply the exemption to future wages, but do not refund taxes withheld while the exempt status was not in place.

By February 28
File paper Forms 1099 and 1096. File Copy A of all paper Forms 1099 with Form 1096, Annual Summary and Transmittal of U.S. Information Returns, with the IRS. For electronically filed returns, see March 31 below.

File paper Forms W-2 and W-3. File Copy A of all paper Forms W-2 with Form W-3, Transmittal of Wage and Tax Statements, with the Social Security Administration (SSA). For electronically filed returns, see By March 31 below.

File paper Form 8027. File paper Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, with the IRS. See section 6. For electronically filed returns, see By March 31 next.

By March 31
File electronic Forms 1099, 8027, and W-2. File electronic Forms 1099 and 8027 with the IRS. File electronic Forms W-2 with the SSA. For information on reporting Form W-2 information to the SSA electronically, visit the Social Security Administration’s Employer W-2 Filing Instructions & Information webpage at www.socialsecurity.gov/employer. For information on filing information returns electronically with the IRS, see Publication 1220, Specifications for Filing Forms 1097-BTC, 1098, 1099, 3921, 3922, 5498, 8935, and W-2G Electronically, and Publication 1239, Specifications for Filing Form 8027, Employer’s Annual Information Return of Tip Income and Allocated Tips Electronically.

By April 30, July 31, October 31, and January 31
Deposit FUTA taxes. Deposit federal unemployment (FUTA) tax due if it is more than $500.

File Form 941. File Form 941 and deposit any undeposited income, social security, and Medicare taxes. You may pay these taxes with Form 941 if your total tax liability for the quarter is less than $2,500. If you timely deposited all taxes when due, you have 10 additional calendar days from the due dates above to file the return.

Before December 1
New Forms W-4. Remind employees to submit a new Form W-4 if their marital status or withholding allowances have changed or will change for the next year.

Electronic Filing and Payment

Now, more than ever before, businesses can enjoy the benefits of filing and paying their federal taxes electronically. Whether you rely on a tax professional or handle your own taxes, the IRS offers you convenient programs to make filing and payment easier.

Spend less time and worry on taxes and more time running your business. Use e-file and the Electronic Federal Tax Payment System (EFTPS) to your benefit.

- For e-file, visit www.irs.gov/efile for additional information.
- For EFTPS, visit www.eftps.gov or call EFTPS Customer Service at 1-800-555-4477.
- For electronic filing of Forms W-2, visit www.socialsecurity.gov/employer.

Electronic funds withdrawal (EFW). If you file Form 940, Form 941, or Form 944 electronically, you can e-file and e-pay (electronic funds withdrawal) the balance due in a single step using tax preparation software or through a tax professional. However, do not use EFW to make federal tax deposits. For more information on paying your taxes using EFW, visit the IRS website at www.irs.gov/e-pay