



Small business owner's guide to payroll processing

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Table of Contents

Introduction: Why payroll matters more than you think	1
Payroll fundamentals every business owner should know	2
Setting up your payroll foundation	3
10-step payroll process to consider	6
Common pitfalls and how to avoid them	9
Choosing the right payroll solution	11
Expert tips for long-term success	13
OnPay can help	14



Introduction: Why payroll matters more than you think

Whether you're running a bustling retail shop or a low-key consulting firm, there's one thing every business owner learns quickly: payroll is more than just about cutting checks. It's about maintaining trust with your team, staying compliant with complex regulations, and keeping the IRS happy — all while juggling the hundred other tasks on your plate.

While the basics include calculating and distributing wages, more complex issues like withholding taxes, managing deductions, funding benefits, and sticking to deadlines are critical to your business's success.

This guide will cover everything you need to know about payroll processing, from the fundamentals to the fine details that keep successful businesses running smoothly.

The real cost of getting payroll wrong

Before we dive into the how-to, let's talk about why getting payroll right matters. The IRS doesn't give employers much wiggle room when it comes to payroll taxes, and the penalties can add up fast:

- Failure to deposit penalty: 2% to 15% of unpaid taxes, depending on how late you are
- Failure to file penalty: 5% of unpaid tax per month (up to 25%)
- Accuracy penalty: 20% of any unpaid taxes due to errors

Beyond the financial hit, payroll mistakes can damage employee trust, increase hiring and training costs, and create administrative headaches that prevent you from growing your business.

Payroll fundamentals every business owner should know

What happens during payroll processing?

Think of payroll as a periodic reconciliation between what you owe your employees and what various government agencies expect from you. Every pay period, you're essentially responsible for:

1. Calculating what each employee earned
2. Determining what needs to be withheld for taxes
3. Accounting for other deductions (insurance, retirement, etc.)
4. Making sure everyone gets paid correctly and on time
5. Sending the government its share

Pay periods can be monthly, bi-weekly, twice a month, or every week, depending on your business operations and your employees' needs.

How HR comes into play

Human resource teams typically play a big part in making payroll run smoothly. In most cases, they'll make sure new hires complete essential paperwork — W-4s, I-9s, benefit elections — and keep employee data up-to-date. When HR and payroll work together, it helps avoid the scramble of missing information when it's time to run payroll.

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In many cases, HR is responsible for managing employee data, including salary information, tax withholdings, and deductions.

— David Kindness, CPA

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How complex is payroll?

The honest answer? It depends on your business. A single-employee consulting firm has different needs than a restaurant with 20 part-time workers earning tips. But here's the thing: even a simple payroll setup can involve multiple moving pieces that need to work together perfectly — every single time.

The good news is that breaking payroll down into manageable steps makes it much less overwhelming, whether you're doing it manually or using software.

Setting up your payroll foundation

Essential employee information you'll need

Before you can run your first payroll, you need to collect specific information from each employee:

Tax Documents	Financial Information	Benefit Authorizations
<p>Form W-4: Determines federal income tax withholding</p> <p>Form I-9: Verifies employment eligibility (required for all employees)</p> <p>Form W-9: For contractors and freelancers (you'll need this for year-end 1099s)</p>	<p>Bank account details for direct deposit</p> <p>Emergency contact information</p> <p>Salary or hourly rate agreements</p> <p>A physical address to mail checks and tax forms (if applicable)</p>	<p>Written permission for insurance premium deductions</p> <p>Retirement plan contribution elections</p> <p>Any other voluntary deductions</p>

Creating your payroll policy

Similar to having policies for attendance, dress code, or reserving conference rooms, a clear payroll policy keeps everyone on the same page. Here are some items to consider adding to it:

- How timesheets are submitted and approved
- Your payment methods and schedule
- How deductions work
- What to do if there's an error on a paycheck
- Overtime and time-off procedures
- How to access online payroll portals

Choosing your payment method

When it comes to getting employee wages from Point A to Point B, employers have several options.

Direct deposit ★ *Recommended*

- ✓ Fast, secure, and convenient
- ✓ Preferred by most employees
- ✓ Minimal risk of loss or theft

Paper checks

- Traditional and no need for software
- Time-consuming to process and distribute
- Risk of checks being lost or stolen

Cash payments

- Immediate access for employees
- High-risk, time-intensive, and easy to misplace
- Difficult to track and secure

Payroll cards

- Helpful for employees without bank accounts
- Can be easily lost or stolen
- May have fees that affect employees



Establishing a pay schedule

Your pay schedule needs to work for your business and your employees while also complying with state laws. The most common options to choose from are:

Weekly: 52 pay periods per year

Bi-weekly: 26 pay periods per year

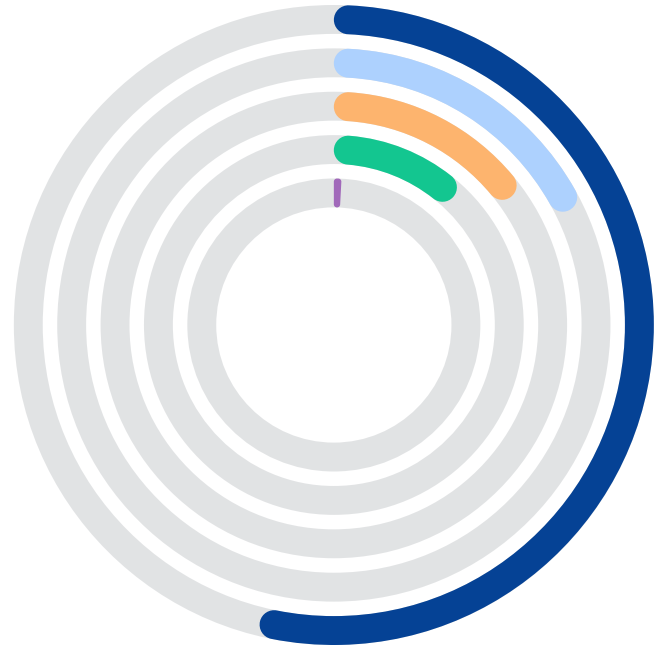
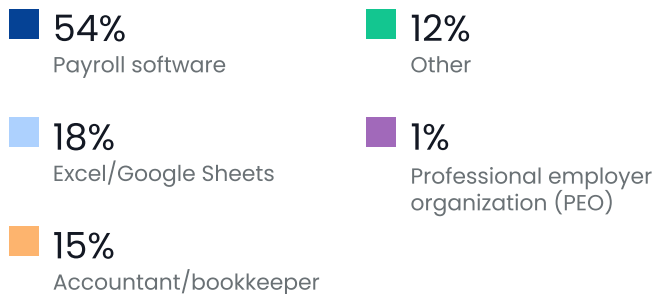
Semi-monthly: 24 pay periods per year (typically 1st and 15th)

Monthly: 12 pay periods per year

Once you choose a schedule, stick with it. Being consistent helps employees manage their finances and simplifies your administrative processes.

Paying employees

How do small businesses manage payroll?



54% of businesses use payroll software to pay employees

Source: *OnPay 2025 Small Business Outlook*

The 10-step payroll process to consider

Here's the step-by-step process that successful businesses use to run payroll accurately and efficiently:

1 Track time and attendance

Accurate time tracking is the foundation of correct payroll. Whether you use time clocks, software, or simple timesheets, make sure you record:

Regular hours worked

Paid time off used

Overtime hours

Any shift differentials or bonuses

2 Review and approve timesheets

Have a supervisor or designated person review all time records for accuracy before processing payroll. This creates an audit trail and catches errors early.

3 Calculate gross pay

For salaried employees, this is straightforward — divide their annual salary by the number of pay periods. For hourly workers, multiply hours worked by their hourly rate, remembering to calculate overtime at time-and-a-half for hours over 40 in a week.

4 Determine pre-tax deductions

Subtract pre-tax deductions such as:

401(k) contributions

Flexible spending account contributions

Health insurance premiums

These reduce the employee's taxable income.

5 Calculate tax withholdings

This is where it gets complex. You'll need to withhold:

Federal income tax (based on W-4 information)

State income tax (if applicable)

FICA taxes (Social Security and Medicare – 7.65% total)

Local taxes (if required)

6 Apply post-tax deductions

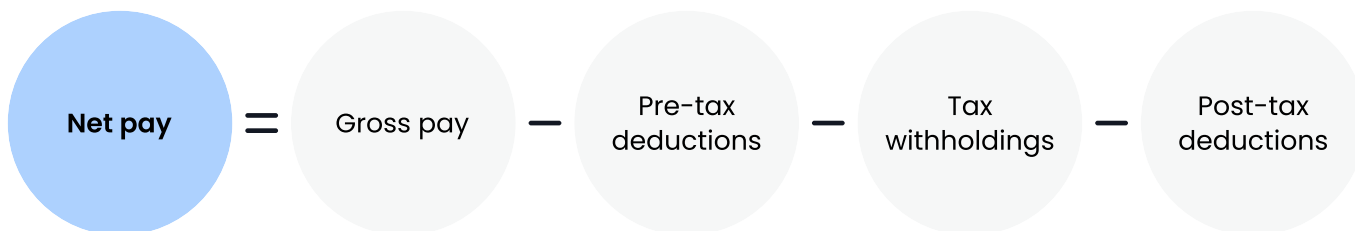
After calculating taxes, subtract any post-tax deductions like:

Union dues

Certain insurance premiums

Wage garnishments

7 Calculate net pay



This is what employees actually receive.

8 Process payments

Whether through direct deposit, checks, or other methods, ensure payments go out on schedule. Most employees count on their paychecks arriving exactly when expected.

9 Handle tax deposits and filings

Don't forget about your responsibilities to various tax agencies:

Deposit federal taxes (usually monthly or bi-weekly)

File required quarterly and annual reports

Don't forget to pay federal unemployment taxes (FUTA)

Pay state unemployment taxes

10 Record and store everything

Document all payroll transactions in your accounting system and securely store payroll records. The Department of Labor requires you to keep these records for at least three years. Maintaining clear records will be helpful in case of an audit.

Real-world example: breaking down a paycheck

Let's walk through an example to see how this works in practice:

EMPLOYEE PROFILE

Annual salary: \$100,000

Contributes 5% to 401(k)

Paid monthly

Pays \$300/month for
health insurance

Lives in Pennsylvania

THE CALCULATION

Monthly gross pay	\$8,333.33 ($\$100,000 \div 12$)
401(k) contribution	\$416.67 (5% of gross pay, pre-tax)
Taxable income	\$7,916.67 ($\$8,333.33 - \416.67)
Tax withholdings	Federal income tax: \$1,329.21 (16.79% rate)
	FICA taxes: \$605.63 (7.65% rate)
	FUTA tax: \$47.50 (0.6% rate)
	Pennsylvania state tax: \$243.04 (3.07% rate)
	Total taxes: \$2,225.38
Health insurance	\$300.00 (post-tax deduction)
Net pay	\$5,391.29

This employee takes home about 65% of their gross pay after all deductions — a typical result that illustrates the importance of accurate calculations.

Common pitfalls and how to avoid them

Even experienced business owners can stumble when it comes to payroll. Here are the mishaps that most often arise:

Employee misclassification

The issue: Treating an employee as an independent contractor (or vice versa) to save on taxes or paperwork. Employees receive overtime, minimum wage, and potential benefits like health insurance, paid time off, and more, while contractors do not.

Why it may attract attention: The IRS and Department of Labor take this seriously. Misclassification can result in back taxes, penalties, and even legal action.

How to avoid it: When in doubt, classify workers as employees. If someone works set hours, uses your equipment, and follows your processes, they're probably an employee regardless of what your contract says.

Falling behind on law changes

The issue: Minimum wage laws, overtime regulations, and tax rates change regularly.

How to stay current:

- Subscribe to updates from your state's labor department
- Follow IRS announcements
- Consider using a payroll service that handles compliance automatically and shares state-by-state information (OnPay does!)

Security oversights

The issue: Payroll data contains everything identity thieves want — names, addresses, Social Security numbers (SSNs), and bank account information.

Keep digital evil-doers at bay

- Use secure, encrypted payroll software
- Limit access to payroll information
- Regularly update passwords and security protocols
- Train employees on data security best practices
- If you mail sensitive documents, replace SSNs with asterisks (*'s)

Manual calculation errors

The issue: Even small math mistakes can create big problems when they affect tax withholdings or net pay.

Solution: Use payroll software or have a second person review all calculations. The time saved and errors prevented make this investment worthwhile.

Missing deadlines

The issue: Payroll tax deposits and filings have strict deadlines. Missing them triggers automatic penalties.

Prevention tips:

- Set up calendar reminders for all payroll deadlines
- Consider software that handles deposits automatically
- Build buffer time into your payroll schedule
- Download OnPay's calendar



Choosing the right payroll solution

You have three main options for handling payroll, and each has considerations to keep in mind.

Option 1: Manual processing

Best for

Very small businesses with simple payroll needs.

What it involves

Using spreadsheets, tax tables, and manual calculations to process everything yourself.

Pro

- ✓ Lowest upfront cost
- ✓ Complete control over the process
- ✓ Good learning experience

Con

- ✗ Time-intensive (can take hours or days per pay period)
- ✗ High risk of errors
- ✗ You're responsible for staying current on all tax law changes
- ✗ No built-in security features

Option 2: Payroll software

Best for

Most small to medium businesses.

What it involves

Using automated software to handle calculations, tax deposits, and filings.

Pro

- ✓ Dramatic time savings (often less than an hour per pay period)
- ✓ Built-in compliance and tax updates
- ✓ Reduced error risk
- ✓ Integrated security features
- ✓ Often includes HR features like time tracking

Con

- ✗ Monthly software costs
- ✗ Learning curve for new systems
- ✗ Still requires your oversight and approval

Option 3: Full-service payroll provider

Best for

Businesses seeking to completely outsource payroll.

What it involves

A professional service handles everything from calculations to tax filings.

Pro

- ✓ Hands-off approach
- ✓ Expert handling of complex situations
- ✓ Often includes additional HR support
- ✓ Liability protection

Con

- ✗ Largest investment
- ✗ Less direct control
- ✗ Dependence on external provider

Making your decision

According to recent survey data from OnPay, over half of small businesses use payroll software, and there's a good reason for this growing adoption. Software provides the best balance of cost, control, and convenience for most businesses.

Consider your specific situation:

- Number of employees: More employees generally justify higher-end solutions
- Complexity: Multiple pay rates, tips, commissions, and benefits increase complexity
- Growth plans: Choose a solution that can scale with your business
- Time availability: How much time do you want to spend on payroll each month?
- Risk tolerance: How comfortable are you with handling compliance yourself?

Tips for long-term success

Bookkeeper's corner

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Payroll used to be difficult, but it's gotten much easier. That said, payroll is still a critically important responsibility for a business, so don't confuse processing ease with a lack of seriousness."

— Billie Anne Grigg, *Profit First Professionals*

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- 1 **Don't go manual, even for small teams:** The cost of payroll software is almost always worth it compared to the time and error risk of manual processing.
- 2 **Follow the rules, always:** If you hire an employee, treat them like an employee. Don't try to "fudge" classifications or cut corners on tax withholdings.
- 3 **Get organized and stay organized:** Use software reminders, calendar alerts, and systematic processes. Most payroll problems stem from disorganization, not complexity.
- 4 **Get professional help with setup:** Even if you plan to run payroll yourself, having an accountant or payroll specialist help you set up the system correctly is money well spent.

OnPay can help

Payroll processing is one of those business functions that's part of the larger organizational puzzle. Getting it right builds employee trust, ensures compliance, and frees up time to focus on growing your business. Whether you choose to handle it yourself with software or outsource it entirely, the key is having a reliable, accurate process that you can count on month after month.

However you decide to handle payroll management, our team is here to answer any questions you may have, get you started off on the right foot, and lend a hand as your business grows. Take advantage of our one-month free trial and see why thousands of small businesses choose OnPay.

This guide provides general information about payroll processing. Tax laws and regulations vary by location and change frequently. Always consult with a qualified tax or payroll professional for advice specific to your situation.

Stop spending hours on payroll —
start your free trial by visiting

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