Employee Classification

Keeping it all straight

The comptroller of a small company notices that her accounting clerk works a lot of overtime. In an effort to cut costs, the comptroller reasons that if she were to change the accounting clerk position to an exempt position, she would be able to offer the employee a raise and avoid costly overtime pay. In fact, the comptroller’s proposed solution may expose her company to a serious wage and hour violation.

The Fair Labor Standards Act: What is it and who’s covered?

The Fair Labor Standards Act (FLSA) is a federal law that sets minimum wage, overtime pay, recordkeeping, and child labor standards requirements for both employers and employees covered by the Act. As a federal law, it preempts state wage and hour requirements, unless the state guidelines are more beneficial to the employee.

Employees are covered by the FLSA if their work is performed in the United States (or a United States possession/territory), a true employer-employee relationship exists, and the requirements of one of the following tests are met:

1) Enterprise/Employer Coverage Test

   a) Two or more employees are sufficiently engaged in interstate commerce or in the production, handling, or selling of goods or materials moved or produced for interstate commerce;

   and

   b) The employer has gross annual sales of not less than $500,000, unless working in an enterprise not subject to this dollar-value test (i.e., hospitals and nursing homes);

   or

2) Individual Employee Coverage Test

   The employee’s own actions involve the handling or production of goods in interstate commerce. This includes employees who regularly use the mail or telephone for interstate communication, or who work for employers who contract to do clerical, custodial, or other work for businesses engaged in interstate commerce.

The administration of the FLSA falls under the jurisdiction of the Wage and Hour Division of the U.S. Department of Labor (DOL). The DOL is responsible for issuing rules, regulations, and interpretations under the Act and for conducting inspections and investigations for compliance. Under the FLSA, a covered employer may have employees who are exempt from certain provisions of the Act, including minimum wage and overtime pay regulations. These exemptions include, but are not limited to, the “white collar” exemptions: executive, administrative, professional, computer software professionals, and outside sales.
Exempt or Non-Exempt?

The FLSA specifies that non-exempt employees must be paid at least the current federal minimum wage rate for the first 40 hours worked in a workweek (seven consecutive 24-hour periods) and must receive an overtime rate of at least time and one-half their regular rate of pay for all hours worked over 40 in a workweek.

Classifying employees as either exempt or non-exempt is neither exact nor easy. The decision cannot be made arbitrarily, nor should it be made based solely on the job title or the way the employee is paid (i.e., hourly or salaried). Instead, the determination must be made based on the job duties associated with the position. Generally, the employee must be paid on a salaried basis and must meet the salary level as prescribed in the Act. An up-to-date job description is a good starting point.

Generally, non-exempt employees’ work is routine with set standards and rules. Depending on the individual's job duties, examples of non-exempt positions may include: bank teller, bookkeeper, and shipping/receiving clerk.

Section 13(a)(1) of the FLSA provides an exemption from the minimum wage and overtime provisions for bona fide executive, administrative, professional, and outside sales employees. Section 13(a)(17) may also exempt certain employees in computer-related areas. Generally, three tests are used to determine if an employee meets one of these white collar exemptions: salary level, salary basis, and job duties. An additional exemption may apply to highly compensated employees who are paid at least $100,000 a year.

The chart at the end of this publication identifies the requirements for each exemption.

Be aware of current state wage laws that may be more beneficial to the employee. An employee must be exempt under both state and federal law to be exempt from overtime payments.

Hourly or Salaried?

Under the FLSA, a non-exempt employee may be paid on an hourly, salaried, piece rate, or commissioned basis, as long as they receive at least minimum wage for all hours worked and the appropriate overtime pay. Exempt employees who qualify under the executive, administrative, or professional exemptions are often paid on a salaried basis and are not required to receive overtime pay.

Note: The salary level and salary basis tests do not apply to doctors, lawyers, teachers, certain computer-related occupations, or outside sales employees. Additionally, exempt administrative or professional employees may be paid on a fee basis (paid an agreed sum for completing a single job, regardless of the time required to complete the work). A fee payment will meet the minimum salary level required for the exemption if, based on the time required to complete the job, the fee is at a rate that would amount to at least $455 a week if the employee worked 40 hours.

Exempt employees should receive their full salary every pay period. The salary amount should not be reduced because of variations in quality or quantity of work performed or generally for absences of less than a full day. Exempt employees cannot have their salary reduced for absences occasioned by the employer or by the operating requirements of the business. In general, if the employee is ready, willing, and able to work, no deduction may be made from the predetermined salary when work is not available.
Overtime Calculation

When it comes to overtime calculation, each workweek stands alone. The pay frequency (weekly, biweekly, and so forth) does not affect exempt or non-exempt classification or an employer’s obligation to comply with overtime regulations.

Overtime is generally calculated at one and one-half the employee’s regular rate of pay for all hours worked over 40 in a week. (Some states have more stringent overtime laws that offer a greater benefit to covered employees, and thus take precedence.) The regular rate includes all remuneration for hours worked, except for certain payments that may be excluded, such as expense reimbursements, discretionary bonuses, gifts, paid vacation days, holiday pay, and paid sick days, except where company policy dictates otherwise. A couple of examples of appropriate methods for calculating overtime under federal law, depending on the method of payment, are listed below.

1. Hourly employees receive one and one-half times their regular rate for all hours worked over 40 in a week.

2. Salaried, non-exempt employees who have agreed to work a fixed number of hours for a specified salary receive one and one-half times their regular rate of pay for all hours worked over 40 in a week.

3. For employees paid on a piece rate basis, their regular rate is determined by dividing the total weekly earnings by the total number of hours worked that week. The employee is entitled to one-half times this regular rate for all hours worked over 40, plus the full piecework earnings.

4. When an employee works two or more jobs with different hourly rates of pay, an employer may calculate the employee’s regular rate using the weighted average of the rates. The employee’s total earnings are added together and the total is divided by the hours worked in the workweek for all jobs. The employer then uses this rate to calculate overtime.

Employees subject to the FLSA overtime provisions must be paid the appropriate overtime rate, even if they were to agree to receive straight time. Non-exempt employees cannot waive their rights to overtime pay.

Potential Overtime Violations to Avoid

Treating all salaried employees as exempt employees.

Whether you pay your employees on an hourly or salaried basis is not the sole determining factor in the classification of exempt status, but only one consideration in this analysis. What your employees do as determined by their job duties also determines exempt or non-exempt status. In addition, a minimum salary level is required for most white-collar exemptions.

Paying non-exempt employees commission only.

Certain commissioned employees of retail or service establishments may be exempt from overtime pay. Employees who do not meet the outside sales exemption to the overtime requirements must still be paid at least minimum wage for all hours worked, plus the applicable overtime rate for hours worked over 40 in a workweek. If the commission comes in after the pay period ends, the employer must apportion the commission back over the workweeks during which it was earned to calculate the regular rate, the overtime rate, and make the appropriate adjustments to the employee’s pay.

Offering employees a choice between overtime pay and a higher hourly rate.

This option only increases the rate used to calculate overtime. An employee cannot waive the right to overtime pay.
**Potential Overtime Violations to Avoid Continued**

**Excluding certain incentives or bonuses from the overtime calculation.**

In general, if a bonus is measured by production, hours, or efficiency, or it is so substantial that it can be assumed that employees consider it part of their wages and not a gift from the employer, it must be included when calculating the regular rate for overtime purposes. A purely discretionary bonus does not have to be included.

"Banking" extra hours worked one week to be paid the next week at straight time.

The DOL looks at each week in and of itself for the purposes of calculating overtime. Banking time for future use is generally not a permissible method of compensating non-exempt employees for overtime hours worked.

**Paying overtime to a split-rate employee at the lower rate.**

Regardless of the work performed, an employee’s overtime pay generally must be calculated at one and one-half times the weighted average of the two rates for the week. Certain statutory exceptions may permit alternative methods of overtime computation.

**Liabilities**

Misclassification of exempt or non-exempt status may result in a combination of fines, penalties, or the payment of unpaid wages, as imposed by the Department of Labor (DOL). Willful violations may result in criminal prosecution and employers may be fined up to $10,000. Second convictions may result in imprisonment. Employers who willfully or repeatedly violate the minimum wage or overtime pay provisions of the FLSA also are subject to civil money penalties of up to $1,100 for each violation.

Employees may file a complaint with the DOL within two years of the violation (three years in the case of a willful violation). Alternatively, they have the right to file an independent suit in court for unpaid overtime. These suits may also seek legal fees and liquidated damages.

The FSLA prohibits employers from taking adverse action against any employee who files a complaint regarding minimum wage or overtime violations or participates in an investigation initiated by the DOL.

The DOL may audit an employer at any time. Many investigations are initiated by employee complaints. Employers should be aware that an investigation can expand beyond the initial complaint to all wage and hour practices. In addition, the Wage and Hour Division targets certain types of businesses or industries for investigations.
Questions and Answers

If a non-exempt employee works two separate jobs within the same company at two different pay scales, are they eligible for overtime pay, and at what rate?

At minimum, they would be eligible for overtime pay calculated at one and one-half times the weighted average for both pay rates for hours worked over 40 in a workweek. State law may offer a greater benefit to the employee.

During a natural disaster, my employees worked only one day during the week. Am I still required to pay them a full week's wages?

Exempt employees must receive their full weekly salary for any workweek in which any work was performed. Non-exempt employees may generally be paid only for hours worked, unless company policy or state law dictates otherwise.

How do I calculate overtime pay when a holiday falls during the week?

Employers are not required to count holidays as time worked when computing overtime hours. Only hours worked must be counted, unless company policy or state law dictates otherwise.

Must I pay overtime pay to non-exempt employees for unauthorized hours worked?

Yes. Overtime pay must be paid for all hours worked over 40 in a week, regardless of whether the time was authorized in advance. State law may dictate more stringent guidelines.
This chart is a summary of requirements for certain exemptions under the Fair Labor Standards Act. The regulations (29 CFR Part 541) are available on the Department of Labor’s Web site at [www.dol.gov](http://www.dol.gov).

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<th>Compensation</th>
<th>Primary Duty</th>
<th>Misc./Other</th>
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<tbody>
<tr>
<td><strong>Executive</strong></td>
<td>Salary basis of</td>
<td>• Primary duty is management of the enterprise or of a customarily recognized department or subdivision</td>
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<td>at least $455 a week.</td>
<td>• Customarily and regularly directs the work of two or more full-time employees (or the equivalent)</td>
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<td>• Has the authority to hire or fire other employees or whose suggestions and recommendations as to hiring, firing, advancement, promotion, or other change of status of other employees are given particular weight.</td>
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<td>Employees who own at least a 20% interest in the enterprise are exempt if they are actively engaged in its management. In such cases, the salary level and salary basis requirements do not apply.</td>
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<tr>
<td><strong>Administrative</strong></td>
<td>Salary or fee basis of at least $455 a week.</td>
<td>• Primary duty is the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer’s customers</td>
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<td>• Primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.</td>
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<td>Executive assistants or administrative assistants to business owners or senior managers of large businesses who have been delegated authority regarding matters of significance may qualify for this exemption.</td>
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<td><strong>Professional</strong></td>
<td>Salary or fee basis of at least $455 a week (except for doctors, lawyers, teachers).</td>
<td>• Primary duty is the performance of work requiring advance knowledge in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction</td>
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<td>• Primary duty is the performance of work requiring invention, imagination, originality, or talent in a recognized field of artistic or creative endeavor.</td>
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<td>“Customarily” means the exemption may also be available to such professionals who have substantially the same knowledge level and perform same work as the degreed professional but attained the knowledge through a combination of work experience and intellectual instruction.</td>
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<tr>
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| **Computer Software Professionals** | Salary basis of at least $455 a week or hourly if paid at least $27.63 an hour. | - Employed as a computer systems analyst, computer programmer, software engineer, or similarly skilled worker in the computer field.  
- Primary duty must consist of the application of systems analysis techniques and procedures, including consulting with users to determine hardware, software, or system functional specifications; the design, development, documentation, analysis, creation, testing, or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications; the design, development, documentation, analysis, creation, testing, or modification of computer programs related to machine operating systems; or combination of the above system design specifications; the design, development, documentation, analysis, creation, testing, or modification of computer programs related to machine operating systems; or combination of the above. |

**Outside Sales Personnel** | No salary level or salary basis requirement. | - Selling tangible or intangible items; or obtaining orders or contracts for services or use of facilities  
- Regularly and customarily working away from the employer’s place of business. |

**Highly Compensated Employees** | Total annual compensation of $100,000 or more (which must include at least $455 a week paid on a salary or fee basis). | - Performs office or non-manual work  
- Customarily and regularly performs at least one of the duties of an exempt executive, administrative, or professional employee identified in the standard tests for exemption.  
Total annual compensation does not include credit for board, lodging or other facilities; payments for medical or life insurance; or contributions to retirement plans or fringe benefits. |

The information in this publication is based in part on the final regulations under the Fair Labor Standards Act, 29 CFR Part 541, Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees; Final Rule [04/23/2004], released April 23, 2004 and effective on August 23, 2004. Additional questions regarding the Fair Labor Standards Act and exempt and non-exempt classifications may be referred to the U.S. Department of Labor. Questions regarding state wage and hour laws should be directed to your State Department of Labor.

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