

Legislative and Regulatory Update

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Q&A Guide to the Final FLSA Overtime Pay Exemption Regulations

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Summary

The U.S. Department of Labor (DOL) recently issued final regulations updating the overtime pay rules that govern the so-called “white collar” exemptions for executive, administrative, and professional (EAP) employees and for certain highly compensated employees (HCEs). These new rules update and implement the overtime pay requirements of the federal Fair Labor Standards Act (FLSA). The major changes adopted in the final rules relate to increasing the salary thresholds for exempt status, thereby making many more employees eligible for overtime pay. The final regulations also change the rules for counting certain bonuses and incentive pay toward satisfaction of the salary thresholds.

Key Action Items

1. Employers should review the questions and answers to familiarize themselves with the FLSA’s overtime rules as well as the changes brought about by these final regulations.
2. Review the employer implications section below to become familiar with potential issues and consider rewards and workforce strategy options.
3. Employers should consider the potential implications for benefits plans.

Timing

The changes are generally effective December 1, 2016.

BACKGROUND

What is the Fair Labor Standards Act (FLSA)?

The FLSA is a federal law that establishes minimum wage, overtime pay, recordkeeping, and child labor standards affecting full-time and part-time workers in the private sector and in federal, state, and local governments. Generally, it is administered and enforced by the Wage and Hour Division (WHD) of the Department of Labor (DOL). The recently issued final regulations (as discussed below) impact the FLSA’s requirements related to minimum wage and overtime pay, with particular relevance for employers in determining whether certain employees are exempt from these requirements.

What is the FLSA's overtime rule?

The FLSA generally requires that employees who are **not exempt** from overtime pay be paid at least one and one-half times their regular rate of pay for any hours worked beyond 40 in a workweek.

Which employees are exempt from the FLSA's overtime rules?

Among the categories of employees that are exempt from the FLSA's overtime pay requirements are those "white collar" employees who meet the following three requirements:

1. **Employee is salaried** - i.e. paid a predetermined amount, not subject to reductions based on work performance ("salary basis test");
2. The employee primarily performs **executive, administrative or professional (EAP) duties**, as defined by the regulations ("duties test"); and
3. **Salary** exceeds the levels specified in regulations ("salary level test").

How do the FLSA regulations define "executive, administrative or professional" duties?

To be exempt, an employee must be performing executive, administrative or professional duties, based on a determination of his or her job functions. The "duties test" is prescribed in the FLSA and is different for each category. Whether an employee is exempt requires an analysis of each position individually, based on duties and responsibilities, so an employer cannot declare that a position is exempt based on a class, type of role, title or category of position without doing the functional analysis. Whether an employee meets the duties under one of the categories (i.e., executive, administrative or professional) is generally determined by assessing the employee's "primary" duties. A duty is "primary" if it is the person's principal, main, major or most important duty (if the individual performs the duty 50% of the time it is generally deemed to indicate that it is "primary" for purposes of the rule, although under the FLSA a job duty can also be considered "primary" even if it is performed less than 50% of the time).

- **Executive.** The employee's primary duty must be managing a department or subdivision, the employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent, and the employee must have the authority to hire or fire other employees (or the person's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees are given particular weight).
- **Administrative.** The employee's primary duties must be 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, and must include the exercise of discretion and independent judgment with respect to matters of significance.
- **Professional.** The employee's primary duty must be the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and which includes work requiring the consistent exercise of discretion and judgment in a field of science or learning. Additionally, the advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.

Are there minimum salary or compensation thresholds that must be met to be considered exempt?

Yes, under the new final rules, to qualify for the overtime pay exemption for each category, in addition to the duties and salary basis tests, an individual must be paid at least a prescribed **weekly** minimum salary of \$913 per week, effective December 1, 2016 (a substantial increase from \$455 per week under the current rules). The total **annual** compensation requirement for purposes of the special exemption for "highly compensated employees" is \$134,004 per year under the final rules (up from \$100,000 per year).

Are there any exceptions to meeting all three requirements to be exempt from the FLSA's overtime rules?

Yes, certain employees (for example, teachers, doctors and lawyers) are not subject to the salary level or salary basis requirements. In other words, subject to certain professional standards for each category, as long as a teacher, doctor or lawyer satisfies the applicable primary duties test, the employee is exempt from overtime protection under the FLSA.

2016 FINAL REGULATIONS

What do the new final regulations cover?

The final regulations are primarily focused on updating the standard salary and HCE compensation thresholds needed to qualify as white collar exempt employees.

What is the standard salary level for EAP?

Effective December 1, 2016, the standard salary level for an employee to be exempt will be set at the 40th percentile of earnings of full-time salaried workers in the lowest-wage census region (currently the South), which is \$913 per week (\$47,476 annually).

Are employers allowed to count compensation other than regular pay in determining whether an employee meets the standard salary threshold?

Yes. The final rules allow up to 10% of the salary level test for non-HCE employees to be met by nondiscretionary bonuses, incentive pay, and commissions. However, the final rules require that such amounts must be paid at least quarterly to qualify for inclusion in the salary level test. These amounts cannot be used to meet the standard salary level test that is part of the HCE exemption – see below.

What is the HCE compensation level?

Effective December 1, 2016, the total annual compensation requirement for purposes of the HCE exemption has been increased to the equivalent of the 90th percentile of full-time salaried workers nationally, or from the current \$100,000 level to \$134,004 a year. To qualify for this overtime pay exemption, such employees must also be paid a standard weekly salary of at least \$913/week.

Are employers allowed to count compensation other than regular pay in determining whether an employee meets the HCE threshold?

Yes. As was the case in the past, employers can continue to include nondiscretionary bonus payments, incentive pay and commissions when calculating the total annual compensation limit under the HCE exemption. However, employers must be certain that the standard salary level test that is part of the HCE exemption is first met. In other words, HCEs must be paid at least \$913 per week to satisfy the standard salary level threshold and bonus payments, incentive pay or commissions **can't** be included when calculating this weekly limit.

Also note that if an employee does not earn enough in nondiscretionary bonuses and incentive payments in a particular quarter to retain his or her exempt status, the final rules permit a "catch-up" payment at the end of the quarter. Under the rules, the employer has one pay period to make up for the shortfall (up to 10% of the standard salary level for the preceding 13 week period). Importantly, any such catch-up payment will count only toward the prior quarter's salary amount and not toward the salary amount in the quarter in which it is paid. Note that if the employer chooses not to make the catch-up payment, the employee would be entitled to overtime pay for any overtime hours worked during the quarter.

When were the salary thresholds last updated?

Before changes were adopted in the new final rules, the standard salary level was \$455 per week and the HCE level was \$100,000 annually, which are standards that were established in 2004. The 2004 standards remain in effect until December 1, 2016.

Going forward, will the standard salary and HCE compensation thresholds increase on a regular basis?

The final rule provides a mechanism for automatically updating the standard salary and HCE total compensation limits every three years, beginning on January 1, 2020. As indicated above, the standard

salary level increases will be determined based on the 40th percentile of earnings of full-time salaried workers in the lowest-wage census region at the time of the update and HCE compensation will be determined based on the 90th percentile of full-time salaried workers nationally at the time of the update. The DOL will post the new levels at least 150 days in advance of any change so employers have adequate time to make the necessary adjustments.

Is there a greater emphasis on employers to track hours?

It depends. If the employer determines that reclassifying employees as non-exempt is the best course of action, then there is certainly an increased burden to count hours worked.

Do the special rules for computer and outside sales employees continue to apply?

Yes, the final regulations made no changes to either of these exceptions except that the minimum standard salary to qualify for the computer employee exemption, for an employee who is paid on a salaried basis, is increased to be consistent with the new standard salary threshold for other employees. However, for employees who are compensated on an hourly basis, the minimum pay rate to qualify for the computer employee exemption remains unchanged at \$27.63 per hour.

Are non-profit organizations exempted from these rules?

No, the FLSA does not provide any special exemptions for non-profit organizations, and the final regulations made no changes in this regard. However, whether an entity is subject to the FLSA is generally dependent on the enterprise having annual gross volume of sales or business done of at least \$500,000. Employees of hospitals, residential medical or nursing care providers, schools and public agencies are covered by the FLSA regardless of the amount of sales, if any.

Are all salaried employees exempt from the FLSA overtime requirements?

The words “salaried” and “exempt” are often used interchangeably. While it is true that exempt employees generally need to be paid on a salaried basis, it is not true that all employees that are paid on a salaried basis are exempt from overtime pay under the FLSA.

Employees in jobs that do not meet BOTH the minimum salary and the job duties tests, are non-exempt and must be paid at least the equivalent of the federal minimum wage for every hour worked and receive overtime pay at one and one-half times their regular rate of pay for every hour worked over forty during the workweek (or more than 8 hours in a day in some states).

The FLSA does not require that non-exempt employees be paid hourly. Non-exempt employees may be paid by salary. Salaried non-exempt employees receive a salary rate for a fixed number of hours. However, when they work more than 40 hours in a week, they are entitled to receive overtime pay. As a result, if the salaried employee is non-exempt under the FLSA, an employer still must track their work hours to determine when overtime pay is due and to convert the employee’s salary into the correct hourly rate of pay for this purpose.

Do employers still need to be concerned with state overtime laws?

Yes, the recent changes brought about by the new final regulations only apply for purposes of federal law, and if a state establishes a higher standard than the provisions of the FLSA to qualify for an overtime pay exemption, the higher standard applies in that state. As a result, employers should also be mindful of how these new rules interact with any state wage and hour laws, especially those that have traditionally been stricter than the federal requirements with respect to overtime eligibility. Also, certain states (e.g. California) have different job duties tests that are more favorable to employees, which would continue to apply. In addition, some states require a notification period be met prior to any pay change, which may mean determining and communicating pay changes based on the new FLSA regulations prior to the December 1, 2016 effective date.

IMPLICATIONS FOR EMPLOYERS

How should employers prepare for these changes?

As employers prepare to comply with the new regulations, we recommend a three step process:

- 1) **Identify** those currently exempt jobs where all employees are not paid at least the new minimum salary threshold and also identify programs specific to non-exempt employees.
- 2) **Analyze and select** the best approach for each job to comply with the law, but also taking into consideration important business needs.
- 3) **Implement** changes to pay, job responsibilities, related compensation programs and operations.

And, with any type of change, we recommend employers make changes guided by compliance with the law and in support of the organization's human resources and rewards strategies.

In the first step, it is possible that the employer will have jobs within which some employees' salaries are now above and some are below the new salary threshold. **Identifying** these jobs serves as the foundation for decision-making.

Employers should remember to identify those jobs that are closely related or natural progressions to test for compression in the next step. Employers may also determine a need to adjust pay for jobs at the higher levels in these job progressions.

Many **analyses** will be necessary to select the best approach to ensure both compliance and a suitable business solution. The analysis of increased cost is one particularly pertinent activity. Increased costs could result from raising employees to the new salary threshold to enable those employees to remain exempt from overtime pay, or from reclassifying certain employees to non-exempt status and paying overtime when necessary. Cost increases may also be driven by the indirect impact of these new FLSA rules on employee benefits (e.g., health coverage eligibility), 401(k) contributions, employer taxes and premium pay offered to non-exempt employees. The form of this analysis will depend on whether it is the employer's goal to make this transition cost neutral or fall within certain cost parameters.

Job re-design may be a viable alternative in some situations. By involving operations management, tasks can be identified and re-assigned to change the primary job duties and align exemption status and pay accordingly. A compression analysis should be conducted and include a strategy for maintaining internal equity as pay rates and salary ranges may change. In addition, work arrangements for some jobs may be adjusted to ensure proper oversight and tracking of hours for jobs that may change from exempt to non-exempt status (e.g., virtual work arrangements may not be provided for non-exempt jobs).

Finally, **implementation** will involve updates to HRIS and payroll systems. It may involve training for both managers and employees on the requirements of non-exempt employees, including any state laws related to overtime pay and meal breaks. And no matter the changes, employee communication strategies should recognize and address any disruption these changes may cause.

What impact will the new overtime rules have on retirement plans?

As mentioned above, the new overtime rules increase the compensation threshold required to be considered a "highly compensated employee" from \$100,000 to \$134,004. This threshold has no application, however, to the determination of "highly compensated employees" for nondiscrimination testing in the retirement plan context (or for applicable nondiscrimination testing of health and other group benefit plans).

The new rules may, however, affect retirement plans in other ways. For example, a plan may use a definition of compensation that includes overtime wages. Increasing the amount paid for overtime work or raising employees' wages so as to keep them from qualifying for overtime pay based on being classified as non-exempt (as some employers may decide to do) will likely increase the employer's costs to fund such plan. This is true whether the plan is a defined benefit or defined contribution plan since the costs of

these plans are generally directly tied to the amount of compensation paid to a participant. In addition, in cases where overtime pay is excluded from the plan's definition of compensation, such exclusion may cause the plan's definition to become discriminatory in favor of highly compensated employees, although this would require testing to be sure.

Finally, eligibility provisions in retirement plans may need to be modified going forward depending on what changes (if any) the employer decides are necessary in light of the new rules. For example, if no changes are made with respect to employees' compensation and if eligibility for a particular plan is based on an individual being paid on an hourly basis, then more employees may become eligible if an employer decides to switch some former salaried employees to hourly status to comply more easily with the overtime requirements.

What impact will these new overtime rules have on health and other group benefit plans?

Some employers base eligibility for health benefits, or other group benefit programs, on an employee's exempt or non-exempt job classification (or, in some cases, on salaried versus hourly status). If the employer, for example, sponsors one health plan for non-exempt employees and another for exempt employees, reclassification would result in certain employees no longer being eligible for their current plan, and newly eligible for another. Employers may decide to transfer the employees into the plan corresponding with their status after reclassification or instead amend the eligibility provisions of the affected plans. Such changes must be carefully considered to ensure they do not result in violations of other legal requirements applicable to the plans (e.g. IRS nondiscrimination rules), or cause an employer to breach requirements imposed by collective bargaining agreements or individual employment contracts. Additionally, if employer contributions to a health savings account (HSA), or other account-based programs, are determined based on job classification or earnings-levels (e.g., employer contributions are greater for hourly employees or those with lower earnings), adjustments in pay level or job status may also result in the need to make adjustments to such contributions.

Similarly, in the event that eligibility for short- and long-term disability plans is determined based on job classification, affected employers will need to consider the impact of the new FLSA rules, and plan accordingly.

Furthermore, any plans with compensation-based employee premiums/contributions, and/or compensation-based benefits (e.g., disability plans that pay a specified percentage of an employee's covered compensation, or group-term life plans which provide a death benefit equal to specified multiples of an employee's covered compensation) will also be indirectly impacted by the new FLSA rules. In this regard, employers are well-advised to consider the financial and workforce implications that will result from changes in salary level and/or overtime pay eligibility.

What impact will these new overtime rules have on other rewards?

Any reward plan that is tied to exemption status and/or pay type (hourly, salaried) should be reviewed in light of changes to overtime exemption status, salary or compensation level, and other pay-based changes made in response to the new FLSA rules. Examples of such rewards may include incentive plans, paid-time-off, etc. Employers should analyze, understand and implement adjustments as needed in these affected programs.

Finally, there are a variety of ways in which complying with the changes brought about by this new final rule will impact pay, cost of employment, job design and employee expectations. While we have attempted to capture the most likely implications and ways to address these implications, this is not intended to be an exhaustive plan for all employers.

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