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U.S. Department of Labor More Than Doubles Minimum Salary Levels for FLSA Overtime Exemptions

Employers have six months to come into compliance—changes projected to impact 4.2 million exempt employees.

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On May 18, 2016, the U.S. Department of Labor (DOL) issued its much-anticipated Final Rule amending the Fair Labor Standards Act (FLSA) regulations implementing the exemption from minimum wage and overtime pay for executive, administrative, and professional employees (the EAP exemption) and for highly compensated employees (the HCE exemption).

The Final Rule substantially raises the minimum salary level requirement for the EAP exemption to \$913 a week (or \$47,476 annually) and the total annual minimum compensation requirement for the HCE exemption to \$134,004. The Final Rule becomes effective on December 1, 2016, at which time the initial increases to the EAP salary level and HCE total annual compensation requirement will take effect. Future automatic updates to those thresholds will occur every three years, beginning on January 1, 2020. The EAP salary level will continue to be tied to the 40th percentile of wages for full-time salaried employees in the lowest wage Census Region, and the HCE compensation level will continue to be tied to the 90th percentile of wages for full-time salaried employees nationally. The DOL estimates that the Final Rule will impact 4.2 million exempt EAP employees—with 4.1 million becoming eligible for overtime and the remaining receiving raises to retain their exempt status. The DOL further estimates that more than half of those employees—56 percent—are women.

Key Provisions of the Final Rule

- Effective December 1st, the minimum salary required for the EAP exemption increases from \$455 a week or \$23,660 annually to **\$913 a week or \$47,476 annually**, calculated based on the 40th percentile of wages for full-time salaried employees in the lowest-wage Census Region.

- Effective December 1st, the minimum total annual compensation for the HCE exemption increases from \$100,000 annually to **\$134,004 annually**, calculated based on the 90th percentile of wages for full-time salaried employees nationally.
- These minimum salary and compensation thresholds will automatically update every three years beginning January 1, 2020, with the new level announced 150 days prior to the effective date.
- Employers may use nondiscretionary bonuses and incentive payments (including commissions) paid at least quarterly to satisfy up to 10 percent of the salary level for the EAP exemption. The HCE exemption already allowed total annual compensation to be calculated by including commissions, nondiscretionary bonuses, and other nondiscretionary compensation earned during the year, without a 10 percent cap and without a quarterly payment requirement.
- The Final Rule does not alter the exemption for computer professional employees who are paid on an hourly basis at a rate of at least \$27.63, but it clarifies that computer professionals paid on a salary basis must be paid at or above the minimum salary level for exempt EAP employees.
- The Final Rule makes no changes to the duties tests for the exemptions.
- The Final Rule adds provisions clarifying that, as long as an exempt employee's pay includes a guarantee of at least the minimum weekly required amount, that employee's compensation may be computed on an hourly, daily, shift or fee basis.
- The Final Rule includes a lower minimum salary level for employees in American Samoa (\$767 per week, as of December 1, 2016), and it adds a provision exempting motion picture producing employees from the salary basis test if they are paid a base rate of at least \$1,397 per week as of December 1, 2016 (with later adjustments every three years).
- The Final Rule includes no other new provisions with regional variations or industry exceptions, and it does not otherwise modify the FLSA regulations.

Background

The FLSA mandates that employers pay employees a minimum wage and pay premium overtime at 1.5 times their regular rate for all hours worked over 40 in a workweek, unless the employees are classified as exempt from these requirements. The EAP regulations, which were last updated in 2004, set forth tests for exemption from these requirements. For an employee to qualify for the EAP exemption, three tests must be met: (1) the employee must be paid a predetermined and fixed salary that is not subject to reduction because of variations in the quality or quantity of work performed (the "salary basis test"); (2) the amount of salary paid must meet a minimum specified amount, currently set at \$455 per week (or \$23,660 annually) (the "salary level test"); and (3) the employee's job duties must primarily involve executive, administrative or professional duties as defined by the regulations (the "duties test"). For an employee to qualify for the HCE exemption, the employee (1) must earn a total annual compensation of \$100,000 or more, which includes at least \$455 per week paid on a salary basis; (2) must have primary duty that includes performing office or non-manual work; and (3) must customarily and regularly perform at least one of the exempt duties of an EAP exempt employee.

On March 13, 2014, President Obama directed the DOL "to modernize and streamline the existing overtime regulations." On July 6, 2015, the DOL published a notice of proposed rulemaking (NPRM)

setting forth its proposed revisions to the overtime regulations. (See [July 7, 2015 Client Alert](#).) In response, the DOL received more than 270,000 public comments. Many of the comments asserted that the proposed salary level of \$50,440 was too high, that it failed to take into account regional wage differences, and that it failed to recognize the adverse impact these increased personnel costs would have especially on small businesses and nonprofit employers. Many commenters also stated that the proposed rule gave employers too little time to come into compliance or to structure their budgets to take into account the periodic adjustments to the minimum salary level. The Final Rule incorporated changes responsive to only some of the public comments.

The following discussion summarizes the key provisions of the Final Rule, and the differences between the Final Rule and the NPRM.

New EAP Exemption Minimum Salary

In the NPRM, the DOL's proposed minimum salary level for the EAP exemption of \$50,440 annually was calculated based on the 40th percentile of weekly earnings of full-time salaried employees *nationally*. In response to the public comments to the NPRM, the Final Rule sets the minimum salary level at the 40th percentile of weekly earnings for full-time salaried employees *in the lowest-wage Census region* (which is currently the South) to better account for the lower wage rates and lower cost of living in certain regions. This results in a salary level of \$913 per week (or \$47,476 annually). In addition, the Final Rule allows nondiscretionary compensation paid at least quarterly to be calculated as part as the minimum salary level, which is a change from the current regulations. According to the DOL, 35 percent of full-time salaried employees will be automatically entitled to overtime based on their salary alone.

New HCE Compensation

In the NPRM, the DOL's proposed minimum total annual compensation for the HCE exemption was calculated based on the 90th percentile of full-time salaried employees nationally, which was \$122,148 in 2013. The Final Rule adopts this same guideline, but sets the initial increase to \$134,004, based on compensation data from the fourth quarter of 2015. To qualify for the HCE exemption, employees must not only receive at least \$134,004 annually, but also receive at least the new salary amount of \$913 per week on a salary (or fee) basis and pass the pre-existing duties test discussed above.

According to the DOL, this new level is more in line with the level set in 2004, and will avoid the unintended exemption of large numbers of employees in high-wage areas who are clearly not performing EAP duties.

Automatic Updates

In the NPRM, the DOL proposed updating the salary and compensation thresholds annually, with only 60 days' notice of each adjustment. Under the Final Rule, however, the thresholds will be updated every three years, beginning January 1, 2020, and the new levels will be published in the Federal Register 150 days in advance of their effective date, beginning August 1, 2019. Each update will adjust the salary threshold to the 40th percentile of full-time salaried employees in the lowest-wage Census region. Based on historical wage growth in the South, at the time of the first update on January 1, 2020, the minimum salary level for the EAP exemptions is likely to be approximately \$984 per week (\$51,168 annually). The HCE total annual compensation threshold will increase to the 90th percentile of full-time salaried employees nationally, which is currently estimated to be approximately \$147,524 in 2020.

Duties

Although the NPRM requested public comment on potential changes to the current duties test, the Final Rule did not make any changes.

Congressional Review

As noted above, the Final Rule becomes effective on December 1, 2016. Under the Congressional Review Act, however, Congress has 60 days in which to take action to block these new regulations from taking effect. President Obama is likely to veto any such attempt, so any Congressional action would likely need widespread, bipartisan support to be effective.

Next Steps for Employers

The Final Rule imposes significant changes on how employers classify and pay their employees, and any employer that does not comply faces substantial penalties. The DOL uses a variety of remedies to enforce compliance with the FLSA. Employers who willfully or repeatedly violate the overtime pay requirements are subject to civil monetary penalties of up to \$1,100 per violation. The DOL or aggrieved employees may also bring suit for back pay and an equal amount in liquidated damages. Successful employees are also entitled to recover their attorneys' fees, making these cases particularly attractive for plaintiffs' attorneys.

Accordingly, we recommend that employers immediately consider the following strategies for handling these new requirements:

1. **Measure and diagnose the anticipated impact on affected employees.** Identify now those exempt employees who will be converted to overtime-eligible under the Final Rule, and start tracking their hours. For each such employee, identify the number and frequency of overtime hours worked, and the reasons for that overtime. Obtaining this information will enable employers to make informed decisions about whether and how to absorb the new overtime costs. Employers should also review any existing benefit plans that offer different benefits to exempt and non-exempt employees, and consider whether it is necessary or desirable to make any changes to those plans' eligibility rules or benefit levels.
2. **Adjust salaries to maintain exemptions or account for overtime.** For employees whose salaries are close to the new threshold and who meet the duties test, employers may choose to raise their salaries to meet the new applicable threshold and maintain their exempt status. Employers may also choose to adjust the amount of an employee's earnings to reallocate them between the regular rate of pay and overtime compensation. The revised pay may be on a salaried or hourly basis (there is no requirement to convert employees to hourly pay status), but it must include payment of overtime when the employee works more than 40 hours in a week. Consideration should also be given to any administrative complications, particularly under any applicable state laws such as California, associated with creating a class of salaried, non-exempt employees.
3. **Identify delegable work tasks and offload the burden to part-time employees or, if legally feasible, contractors.** Although there will be added costs in bringing on additional workers to take on tasks that a single hard-working employee now handles, it costs less to pay for those additional hours at a straight-time rate than at an overtime rate.

4. **Expect exempt employees to shoulder more of the burden.** If it costs employers more money to have a junior or mid-level employee stay late at the office or come in on the weekend, higher-level exempt employees may need to take responsibility for those work commitments. (Be careful, however, not to load too many non-exempt tasks onto exempt employees to avoid diluting the exempt nature of their primary duties.) To help avoid overburdening those exempt employees, managers should monitor the productivity of their non-exempt staff to identify whether any employees have comparatively light workloads, below the 40 hours per workweek limit. To the extent tasks can be delegated to slightly less productive non-exempt staff so they are more fully utilized (without triggering overtime), that may offset somewhat the extra hours exempt employees are absorbing in order to reduce the overtime hours of their non-exempt colleagues.
5. **Trim activities that count as working hours but don't add sufficient value.** Although it may alter the culture of the workplace to curtail or eliminate them, employers may not be able to maintain some activities that count as compensable working hours for non-exempt employees. Some employers, for example, voluntarily provide paid lunch breaks. Switching a 30 minute lunch break from paid to unpaid – and ensuring that managers in fact allow their staff to spend the lunch break as they wish – could convert a 40-hour workweek to a 37.5-hour workweek, creating a buffer in which a non-exempt employee can work slightly longer workdays without triggering overtime payments. (Employers should be sure to comply with any state or local meal or rest break laws.) Reconsider frequent staff meetings that consume work time. Evaluate whether travel to an in-person meeting is necessary, or whether a video conference call or shared screen technology would be sufficient. Scrutinize whether, and how many, non-exempt employees need to participate in calls or meetings, or whether subsequent debriefings would free them up to perform work that might otherwise require overtime.
6. **Consider shifting the standard workweek if weekend events produce substantial overtime.** Because overtime pay is calculated on a workweek basis, weekend events can produce significant overtime hours. If employers adopt a Wednesday – Tuesday workweek, however, employers can give employees time off on Monday or Tuesday to offset those extra weekend work hours during the same workweek, reducing or eliminating overtime payments. Note that any change to the standard workweek should be permanent, as employers are not permitted to regularly shift their workweeks so as to avoid overtime obligations.
7. **Consider using the fluctuating workweek method of calculating overtime for employees who do not work regular schedules.** The fluctuating workweek method permits employers to pay non-exempt employees a fixed salary, even if the employees' hours fluctuate from week-to-week, and permits employers to meet their overtime obligations by paying an additional one-half the regular rate of pay (instead of an additional 1.5 times the regular rate of pay). Under this method, the fixed salary is deemed to compensate employees for all straight time hours, whether under or over 40 hours in a work week. To use this method, there must be a mutual understanding between the employer and employee that the fixed salary is compensation (apart from overtime premiums) for the hours worked each workweek, whatever their number, rather than for working 40 hours or some other fixed weekly work period; this understanding should be memorialized in writing. In addition, the fixed salary must be sufficient to provide compensation to the employee at a rate not less than the applicable minimum wage rate for every hour worked in those weeks in which the number of hours worked is the greatest, and the employee must receive at least one-half the employee's regular rate of pay for all overtime hours in addition to the fixed salary. Although this method will not eliminate the extra costs of converting an employee from exempt to non-exempt status, it will reduce those costs. In addition, because currently exempt employees

are already paid a guaranteed weekly salary, it will be easy to meet the fixed salary requirement to qualify for the fluctuating workweek method. Bear in mind, however, that the fluctuating workweek method is not permitted under the laws of certain states, such as California.

8. **Build into customer contracts provisions that tie the cost of the contract to changing labor costs.** Particularly for government contractors and other employers with customer contracts in which labor costs are an identified element of the payment price, the increased personnel costs from the overtime rule can be passed on to customers. Because the Final Rule calls for increases every three years, such employers should consider including provisions in new contracts, and seeking amendments to existing contracts, that adjust the total payment to account for the personnel budget increases the employer will incur.
9. **Educate affected employees about the reason for the change.** Even if becoming overtime-eligible may result in larger paychecks, many exempt employees view conversion to non-exempt status negatively, regarding it as a demotion or a sign that their employer does not regard them as holding an important position. Employers should explain to affected employees that the change results from new regulations, that it is based only on their compensation level, and that it affects all similarly compensated employees nationwide in the same manner.

Employers with questions about how the new regulations apply to their workforce or about how to implement these changes should consult with legal counsel. Employers should also keep in mind that these regulations only implement the federal FLSA and that state and local laws may have more stringent requirements.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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