Common mistakes in classifying employees under the FLSA

By: Kimberly A. Ross

Perhaps one of the most common mistakes I come across when talking to clients or reviewing personnel files is the way in which they classify their employees under the Fair Labor Standards Act (FLSA). The FLSA is the federal law that mandates that employees be paid overtime (time and a half) for any hours over 40 during a workweek. There are certain exceptions to this rule, and employees who fall within one of these exceptions are considered to be "exempt" from overtime rules and, therefore, do not have to be paid overtime if they work more than 40 hours per week. (There is no prohibition against paying an exempt employee by the hour and paying overtime; rather, employers are prohibited from not paying overtime to non-exempt employees.)

The FLSA also mandates that employees be paid minimum wage, and this requirement also has exceptions. The FLSA covers employers who have at least $500,000 per year in gross sales *and/or* whose employees are regularly involved in interstate commerce. This article is intended to focus on exemptions from overtime laws, though by definition, some of the areas explored also apply to exemptions from minimum wage laws. This is by no means intended to cover every exemption from overtime (or minimum wage) laws, or fully analyze every exemption. Instead, it is intended to alert employers to the more frequently applied exemptions and, therefore, the more common mistakes. Although there are dozens of specific exemptions from FLSA regulations (for overtime, minimum wage, or both), the Department of Labor (DOL) estimates that 86% of the workforce falls into the non-exempt classification.

A frequent mistake arises from the incorrect belief held by many employers that if they pay their employee's a "salary" instead of an hourly wage earner, the employees are exempt from overtime laws. Salary versus hourly is not akin to exempt versus non-exempt. In other words, salary and hourly are merely *methods* of paying employees, but the method has nothing to do with determining whether their specific job functions make them exempt from overtime (or minimum wage) requirements.

For instance, an employer can tell a job applicant that he will be paid a "salary" of $40,000 per year to work as a receptionist. Calling the pay "salary," however, does not exempt that employee from overtime laws. The $40,000 salary can be determined by roughly calculating an hourly rate of $19.25 and multiplying it by 40 hours a week and 52 weeks a year. If the receptionist (assuming he is only performing tasks such as greeting customers and answering phones) works more than 40 hours in a week, he must be paid overtime, regardless of the fact that the employer quoted him a "salary" of $40,000 per year.

Even if the classification as exempt technically results in a benefit to the employee, the FLSA is still being violated. For instance, I had a client that did not provide benefits such as health insurance (this was before the Affordable Care Act), paid holidays, paid vacations, or disability insurance, to non-exempt employees who were paid by the hour. They only provided benefits to exempt employees to whom they paid a salary. Believing they were helping several of their otherwise non-exempt employees, they set a salary level that took into consideration the amount of expected overtime the employees would work, and then

gave them the benefits. Years later, one of these employees became disgruntled, which snowballed into all of the misclassified employees complaining and filing an FLSA lawsuit in federal court. Even though the employees likely received more benefit from the technically illegal arrangement, they would have still prevailed in the litigation.

Another common mistake is the belief that if the employer gives an employee a fancy enough title, he becomes exempt. Calling the above receptionist who is merely greeting customers and answering phones an "Executive Assistant," or even "CEO" or "Controller," will not exempt the employee from overtime laws. Likewise, an employee performing the duties of a CEO with the title of "receptionist" would still be exempt.

The most common exemptions from overtime laws are Executive, Professional and Administrative. There are also exemptions for commission salespersons, certain computer professionals, outside salespersons, salespersons, parts men and mechanics at automobile dealerships, artists, and certain farmworkers, among many others. Some of these exemptions are discussed below as a general guide, but it must be understood that within each definition provided by the regulations interpreting the FLSA, many more terms must be defined and understood to perform a thorough analysis. For this, companies are strongly urged to contact legal counsel.

An **Executive** is an employee whose primary duty is managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise. The employee must be compensated on a salary basis at a rate of not less than $455 per week. (As of the time of publication, this rate is accurate; however, see below for an explanation on how it is soon likely to increase). The employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent and must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement or promotion or any other change of status of other employees must be given particular weight. Many employers believe that if they call someone a "manager" that the person falls within the exemption, which is not the case. The regulations provide a detailed list of what constitutes "management" under the exemption.

Professionals are employees who are compensated on a salary or fee basis at a rate not less than $455 per week (again, likely to soon change). Their 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. The advanced knowledge must be in a field of science or learning and must be customarily acquired by a prolonged course of specialized intellectual instruction (i.e. typically an education that results in an advanced degree). Common examples of "professionals" under the FLSA include physicians, attorneys, accountants, architects, pharmacists, and certain scientists and engineers, although there are certainly others who may fall into the exemption. Keep in mind that the professional must be working in her professional capacity. A lawyer working as a barista will be considered non-exempt in that position.

The **Administrative** exemption is perhaps one of the most commonly misapplied exemptions. In addition to the compensation being on a salary or fee basis at a rate not less than $455 per week (for now), an administrative employee's primary duty 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. The employee's primary duty must also include the exercise of discretion and independent judgment with respect to matters of significance. It is this last element that perhaps causes the most room for error, as employers must analyze the concepts of "discretion" and "independent judgment" and "matters of significance." The regulations provide many examples of these concepts.

Currently, there is a requirement under these three exemptions that the employee receive at least $455 per week (or $23,660 per year). However, the Department of Labor has just increased that number to **$913 per week or $47,476 per year** (down slightly from the DOL's initial request of $970 per week and $50,440 per year). **This new regulation goes into effect on December 1, 2016** and means that employees who currently fall within an exemption category through the specific work they perform will no longer be exempt unless they are also making $913 per week.

The **Commission** exemption applies to sales employees of retail or service establishments if more than half of the employee's earnings come from commissions and the employee averages at least one and a half times minimum wage for each hour worked. Certain salesmen, parts men, and mechanics in automobile dealerships are also exempt from overtime pay provisions of the FLSA. However, they are not exempt from minimum wage requirements and, therefore, these employees must be required to keep track of their hours no differently than non-exempt employees so that the employer at all times is paying minimum wage, especially if little or no commissions are paid in a particular week. There is also an exception for highly compensated employees if they are paid at least $100,000 per year and perform office or non-manual work, as well as customarily and regularly perform at least one of the duties of an exempt executive, administrative, or professional employee. (Note that the $100,000 threshold is expected to increase as well with the new regulations.)

Because of the FLSA exemptions, and because each exemption has different requirements to apply, it is recommended that employers have all their job positions audited by an attorney on a regular basis to make sure that each employee has been properly classified. The penalties that can result from misclassified employees can be devastating to an employer, even where the mistake was unintentional or even when it did not result in a significant loss to the employee. If an employee was treated as exempt but was actually non-exempt, he would be entitled to back pay of all overtime hours worked (plus various other penalties and attorneys' fees). Further, it is the employer's duty to keep accurate records of the time worked, and in the case of litigation it will be the employer's burden to prove that the employee did not work overtime or worked less overtime than the employee is claiming. Because many employers also mistakenly do not require their "salaried" employees to keep accurate time records of their hours, they face an uphill battle in trying to meet their burden. (This is just one reason why it is important for employers to require *all* employees, regardless of their FLSA status and regardless of their method of payment, to keep exact records of their time worked. Some states, including Illinois, actually mandate keeping time records for all employees, not just exempt employees.)

Reclassifying employees to their proper status can be difficult – even painful -- to the company's bottom line, but done with proper guidance, it can frequently be performed with minimal damage. Failing to reclassify employees to their proper status will most often result in a much more costly situation, especially when more than one employee is involved,

which is frequently the case. In addition to the potential for FLSA violations putting companies out of business, individual employees and officers can face personal liability for the violations, including monetary penalties and even imprisonment. Therefore, employers of any size can greatly benefit from having an attorney or HR professional perform regular audits of their job classifications to make sure all employees are properly classified.