

Overtime Exemptions: The New Federal Regulations

Introduction

On April 20, 2004, after a delay of more than a year, the U.S. Department of Labor issued new Regulations governing the so-called “white collar” exemptions to the federal Fair Labor Standards Act (“FLSA”). Under those exemptions, executive, administrative, professional, outside sales and computer employees do not need to be paid overtime for hours worked in excess of 40 in a week. The new Regulations substantially change the scope and application of these exemptions. Unless Congressional action blocks, delays or alters the new Regulations, they will take effect on Sunday, August 23, 2004.

The new Regulations and an explanatory Preamble can be accessed at by clicking [here](#).

Highlights

- The salary level required for executive, administrative and professional employees is raised to \$455 per week (\$23,660 per year).
- The “duties” tests for executive, administrative, professional, computer and outside sales employees have been simplified.
- The amount of “non-exempt” work that exempt employees can perform and still retain their exemption has been increased.
- A new special exemption for certain employees with total annual compensation of at least \$100,000 is created.
- Employers can suspend exempt employees without pay in broadened circumstances.
- Employers who make improper deductions from the salaries of exempt employees have new opportunities to preserve those employees’ exempt status.
- Employers have new options to provide extra, non-salaried compensation to exempt employees.

Discussion

1. Executive Employees

Salary Basis

As under the current regulations, executive employees must be paid on a “salary basis” in order to be exempt. However, the types of compensation that qualify as a “salary basis” have been expanded. These changes are discussed in Section 8 of this Client Update.

Salary Level

In order to be exempt, executive employees must be paid a salary at a rate not less than \$455 per week. This is an increase from \$250 per week under the current regulations.¹

Duties

In order to be exempt as an “executive,” an employee’s duties must meet three requirements:

- Management

The employee must have as her primary duty the management of the enterprise, or a customarily recognized department or subdivision of the enterprise. This requirement is unchanged from the current regulations.

However, the definition of “primary duty” is significantly expanded. The new definition of “primary duty” is discussed in Section 7 of this Client Update.

In addition, the definition of “management” has also been greatly expanded. In essence, the former requirement that an executive “consistently exercise discretion and independent judgment” has been replaced with a definition quite similar to the NLRB definition of a “supervisor.” “Management” duties are now defined to include:

- interviewing, selecting and training employees
- setting and adjusting rates of pay and hours of work of employees
- directing the work of employees
- maintaining production or sales records for use in supervision or control
- appraising employees’ productivity and efficiency for the purpose of recommending promotions or other changes in status
- handling employee complaints and grievances
- disciplining employees
- planning the work of, or apportioning work among, employees
- determining techniques, types of materials, supplies, machinery, equipment or tools to be used
- determining merchandise to be bought, stocked and sold
- controlling the flow and distribution of materials or merchandise
- providing for the safety and security of employees or property
- monitoring or implementing legal compliance measures

The “executive” must be involved in “management,” but need not be the overall manager of the department or subdivision and need not have sole charge of the department or subdivision. As a result, there can be more than one employee in a particular subdivision or department who is exempt as an executive.

The definition of a customarily recognized “department or subdivision” has also been expanded to include any separate establishment. It also includes a recognized unit or function even if there is no single or fixed location and

¹ The \$250 per week salary level has been applicable under the so-called “short test” of the current regulations. The even lower “long test” has effectively been obsolete for many years. Under the new Regulations, both the “short test” and the “long test” are eliminated and replaced by a single, simpler “standard” test.

even if the employees who are involved in that unit or function come from an unassigned pool of employees or from other recognized units of the enterprise.

- **Two Employees**

To be an exempt executive, an employee also must customarily and regularly direct the work of two or more full-time employees, or the equivalent of two full-time employees. An executive employee can receive “credit” for supervising an employee for some work hours, even if another manager supervises that same employee at other times. However, only one executive can receive “credit” for supervising an employee at any given time.

- **Supervisory Authority**

In order to be exempt as an “executive,” the employee must also have the authority to hire or fire employees, or the employee’s suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status must be given particular weight.

Business Owner

Alternatively, a bona fide 20% equity owner of a business who is “actively engaged” in the management of the enterprise is exempt as an executive without regard to any other requirement, i.e., without regard to salary level or basis of payment, without regard to the individual’s primary duty, and without regard to the extent of the individual’s involvement in management.

2. Administrative Employees

Salary Basis

As under the current regulations, administrative employees must be paid on a “salary” or a “fee” basis in order to be exempt.

Salary Level

In order to be exempt, administrative employees must be paid a salary or fee at a rate not less than \$455 per week. Once again, this is an increase from \$250 per week under the current regulations.

Duties

In order to be exempt as “administrative” an employee’s duties must meet two requirements:

- **Work related to management or operations.**

The 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, i.e., work directly related to assisting with the running or servicing of the business. This wording is not materially different than the current regulations,² but the examples of “administrative” work that are set forth in the regulations make clear that an expansion of the exemption is intended: work in the areas of tax, finance, accounting, budgeting, auditing, insurance, quality control, purchasing, procurement, advertising, marketing, research, safety and health, personnel management, human resources, employee benefits, labor relations, public relations, government relations, computer network, internet and database administration, and legal and regulatory compliance.

² The current regulations refer to work related to “management policies,” not merely “management,” but as both the current and new regulations refer to work relating to “general business operations,” this difference seems immaterial.

- Discretion and independent judgement.

The employee's primary duty also must include the exercise of discretion and independent judgment with respect to matters of significance.

Once again, this wording suggests that the standards in current regulations are being maintained or even tightened,³ but in fact the opposite is the case. The definition of "discretion and independent judgment"⁴ is much more detailed, and encompasses much more work. "Discretion and independent judgment" is defined to include work involving the comparison and evaluation of possible courses of conduct, and acting or making a decision after the various possibilities have been considered. Factors to consider include: authority with respect to management policies or operating practices; carrying out major operational assignments, affecting business operations (or a segment thereof) to a significant degree; authority to commit to a significant financial impact; authority to waive or deviate from established policies and procedures without prior approval; authority to negotiate for and bind the employer; providing consultation or expert advice to management; involvement in planning long- or short-term business objectives; investigating and resolving significant matters; and handling complaints, resolving disputes or arbitrating grievances.

Under the new Regulations, an employee can be considered to exercise discretion and independent judgment even if the employee merely makes recommendations to others, and even if the recommendations are not accepted. Moreover, the employee's primary duty need only include the exercise of discretion and independent judgment, which need no longer be exercised "consistently" or "customarily and regularly."

The new Regulations eliminate the additional requirement of the current regulations that the employee either directly assist an exempt employee, or perform special projects or work involving specialized knowledge under only general supervision.

Educational Administrators

There is a special exemption for employees whose primary duty is performing administrative functions directly related to academic instruction or training in an educational establishment. Under this exemption, there is no separate requirement that these employees exercise discretion and independent judgment.

3. Professional Employees

Salary Basis

As under the current Regulations, professional employees must be paid on a "salary" or a "fee" basis in order to be exempt.

Salary Level

In order to be exempt, professional employees must be paid a salary or fee at a rate not less than \$455 per week. Once again, this is an increase from \$250 per week under the current regulations.

³ The current regulations simply speak of the consistent exercise of discretion and independent judgment, without any reference to "matters of significance." But this difference is illusory: It is hard to see how an employee could be said to exercise discretion and independent judgment with respect to matters of no significance.

⁴ Which is also applicable to the "professional" employee exemption.

Duties

Learned Professional

In order to be exempt as a “learned professional,” an employee’s primary duty must involve:

- work requiring knowledge of an advanced type - this means work that is predominantly intellectual and requires the consistent exercise of discretion and judgment;
- work in a field of science or learning; and
- work customarily acquired by a prolonged course of specialized intellectual instruction - this means work for which specialized academic training (a specialized academic degree) is customarily required.

The new Regulations make clear that occupations whose educational prerequisites involve 3 years of non-specialized college instruction and a fourth year in an accredited specialized program generally will be exempt.

Creative Professional

In order to be exempt as a creative professional, the employee’s primary duty must involve work:

- requiring invention, imagination, originality or talent
- in a recognized field of artistic or creative endeavor

The classic fields are music, writing, acting or graphic arts.

Teachers, Lawyers and Doctors

Teachers, lawyers and doctors continue to be exempt without regard to salary or any other requirement.

4. Computer Professional Employees

The two separate definitions of computer professional under the current regulations have been combined into one definition.

Compensation

A computer professional can be exempt if paid on salary or fee basis of not less than \$455 per week, OR at an hourly rate of at least \$27.63 per hour.

Duties

Exempt computer professionals are employed as computer systems analysts, computer programmers, software engineers, or other similarly skilled workers in the computer field whose primary duty is one of the following:

- Application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications; OR
- 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; OR
- Design, documentation, testing, creation or modification of computer programs related to machine operating systems; OR
- A combination of the above.

There is no independent requirement that the employee exercise discretion and independent judgment.

5. Outside Sales Employees

Compensation

Outside sales employees are not subject to any salary requirement.

Duties

To be exempt as an outside sales person, the employee must meet two duties requirements:

- The employee must have the primary duty of making sales, or obtaining orders or contracts for services or for the use of facilities
 - Incidental work such as deliveries, collections and writing sales reports, updating sales or display catalogues and planning itineraries are considered part of the primary duty of making sales.
- The employee must customarily and regularly be engaged away from the employer's place(s) of business in performing that primary duty.

6. Highly Compensated Employees

The new Regulations establish a new exemption for employees with a total annual compensation of at least \$100,000. Such employees are exempt if they customarily and regularly perform at least one of the exempt duties of an executive, administrative or professional employee. The exempt duty does not need to be the highly compensated employee's primary duty, and does not need to involve the exercise of discretion and independent judgment.

The required \$100,000 compensation must include at least \$455 per week that is paid on a salary or fee basis. The remainder of the compensation can be in the form of commissions, non-discretionary bonuses and other non-discretionary compensation.

The cost of fringe benefits or insurance may not count toward the \$100,000. To determine whether the employee receives at least \$100,000 in a year, the employer may designate any 52-week period as the year; if no designation is made, the determination is made on the basis of the calendar year. The Regulations allow for "make-up" payments. At the end of the year, if the employee has not earned \$100,000, the employer may make a single, lump-sum payment, as late as one month after the end of the year, to bring the employee's compensation up to the \$100,000 level.

For employees who do not work a full year, the total compensation that is required may be pro-rated.⁵ If an employee terminates employment before the end of the "year," a "make-up" payment to the requisite pro rata total compensation may be made no later than one month after the end of employment.

7. Primary Duty

Because each of the white collar exemptions depends upon the employee's "primary duty," the definition of that term is crucial. The new Regulations define the "primary duty" as the employee's principal, main, major or most important duty. Factors to consider include the relative importance of the work; the amount of time spent; the employee's relative freedom from direct supervision; and the employee's relative compensation.

Under the new Regulations, the amount of time spent on exempt duties is de-emphasized. Duties that involve more than half of an employee's time will still generally be considered the "primary duty," but duties may also be considered "primary" even if they do not involve half of the employee's time.

⁵ But pro-rating for FMLA or other absences is not permitted.

The definition of “primary duty” has also been greatly expanded in another respect. Non-exempt work that otherwise would be considered non-exempt, but that is “directly and closely related” to an employee’s exempt work, will be considered exempt work and therefore counts toward making the employee’s exempt work qualify as the employee’s “primary duty.”

Under the definition in the new Regulations, virtually anything that the employee does may be considered related to exempt duties. Keeping records, distributing materials, spot-checking work, note-taking and typing and other activities can all be considered “directly related” to exempt duties. As a result, an employee who (for example) spends 25% of the time in administrative work, and another 25% of the time doing related typing and word processing, has a “primary duty” of the exempt work.

8. Salary Basis

The new Regulations maintain the current definition of a salary basis of payment, and generally maintain the current rules concerning the deductions from salary that are permitted, and concerning the deductions from salary that destroy a “salary basis” of payment.

New Deductions Allowed

But the Regulations do broaden the scope of permissible deductions in a number of respects:

- Deductions may be made for one or more full days for sickness or disability in accordance with a bona fide sickness or disability plan, policy or practice even if the plan or practice does not provide a full day’s pay for an absence, and even if the employee has not been absent long enough to receive pay for the absent day (e.g., has not satisfied a waiting period).
- Deductions for unpaid disciplinary suspensions for infractions of safety rules of major significance now may be made in any amount, including partial-day suspensions.
- Deductions may be made for unpaid disciplinary suspensions of one or more full days for infractions of workplace conduct rules, pursuant to a written policy applicable to all employees.

The new Regulations also confirm that deductions may be made from accrued leave balances without destroying the salary basis of payment. The new Regulations also confirm that requiring employees to record or track hours, or to work a specific schedule, does not destroy the salary basis of payment.

Effect of Improper Deductions

Under the new Regulations, an employer who makes impermissible deductions will lose the exemption only for the time period in which the improper deductions were made, and for only employees in the same job classification and working for the same manager. This is a dramatic change from the current regulations, under which an employer lost the exemption for any employees whose salary was theoretically subject to impermissible deductions.

Moreover, isolated or inadvertent improper deductions will not result in loss of the exemption if the employer reimburses the employees.

“Safe Harbor”

The new Regulations also establish a safe harbor to protect employers against loss of exemption on account of improper deductions. The “safe harbor” applies if:

- the employer has a clearly communicated policy that prohibits improper pay deductions;
- the policy includes a complaint mechanism for employees;

- the employer reimburses employees for any improper deductions;
- the employer makes a good faith effort to comply in the future.

The Department of Labor intends to issue a “model” policy that will meet these requirements.

Extra Compensation

The new Regulations confirm that an employer can provide extra compensation, in addition to the guaranteed minimum salary, without destroying the exemption.

9. What Employers Should Do Now

In anticipation of the new Regulations, each employer should take the following steps:

- review its classification of all exempt and non-exempt employees;
- revise or adjust formal job descriptions as appropriate;
- adjust compensation of lower-paid employees, if necessary and advisable, to bring them within the scope of the revised exemptions;
- adjust compensation of higher-paid employees, if necessary and advisable, to come within the scope of the new exemption for highly compensated employees;
- consider the adoption of written workplace conduct rules applicable to all employees, in order to be able to suspend exempt employees for workplace misconduct;
- consider adopting a policy, or the DOL “model” policy, concerning improper deductions from the salary of exempt employees.

These new Regulations will have a significant impact on virtually all employers. This memorandum necessarily gives only an overview. Should you have any questions or desire further information, please contact any member of Ropes & Gray Labor & Employment Group.

