

## The Final FLSA Overtime Rule

On May 18, 2016 the Department of Labor released the final rule regarding the overtime regulations of the Fair Labor Standards Act (FLSA). While the rule maintains the spirit of the changes originally proposed in June 2015, there are a number of modifications of note. Overall, the final rule will provide not only a challenge for organizations, but also an opportunity for a broader, proactive process to ensure compliance as of the Dec. 1, 2016 effective date.

### Highlights of the Final Rule

The final rule is meant both to modernize the regulations to reflect today's environment, and to ensure that the regulations continue to remain current by adjusting salary levels every three years. For context, the current standard salary level of \$23,360 was implemented in 2004. Following are the details of the final rule:

- Changes are effective as of Dec. 1, 2016.
- The standard salary level will be set at \$913 per week, \$47,476 annually (the 40<sup>th</sup> percentile of full-time salaried workers in the South census region, currently the lowest wage region).
  - Up to 10% of the standard salary level can be satisfied through nondiscretionary bonuses, incentives, or commissions paid at least quarterly.
- The highly compensated employees (HCE) level will increase to \$134,004 in total annual compensation (the 90<sup>th</sup> percentile of all full-time salaried workers).
- Both the standard salary level and the HCE level will automatically update every three years to the percentiles listed above.
  - The first automatic adjustment will be Jan. 1, 2020.
- There are no changes to the current duties.

As a reminder, the FLSA allows exemption from overtime eligibility for the following categories, assuming that employees meet the standard salary level. The language shown below is found on Fact Sheet #17A as published by the Department of Labor. The HCE provision allows for a relaxed duties test, where the employee must customarily and regularly perform at least one of the duties listed for the executive, administrative or professional exemptions below. If an employee does not qualify as an HCE, then the employee's duties must meet each of the tests for a given category.

- Executive
  - The employee's primary duty must be managing the enterprise, or managing a customarily recognized department or subdivision of the enterprise;
  - 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 employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.
- Administrative
  - 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; and
  - The employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.
- Professional
  - To qualify for the learned professional employee exemption, all of the following tests must be met:
    1. 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;
    2. The advanced knowledge must be in a field of science or learning; and
    3. The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.
  - To qualify for the creative professional employee exemption, the following test must be met:
    1. The employee's primary duty must be the performance of work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.
- Computer Employee
  - The employee must be employed as a computer systems analyst, computer programmer, software engineer or other similarly skilled worker in the computer field performing the duties described below. The employee's primary duty must consist of:
    1. The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications;
    2. 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;
    3. The design, documentation, testing, creation or modification of computer programs related to machine operating systems; or
    4. A combination of the aforementioned duties, the performance of which requires the same level of skills.
- Outside Sales
  - The employee's primary duty must be making sales (as defined in the FLSA), or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and
  - The employee must be customarily and regularly engaged away from the employer's place or places of business.

## Strategies for Compliance, Other Considerations, and Impact Modeling

There are obvious strategies for ensuring compliance with the changing regulations. An organization can identify affected employees and either increase their pay to meet the \$47,476 in annual salary, or decide to pay any overtime that would now be incurred. The former option assumes that the employee meets the duties tests for one of the exemption categories.

Beginning with the end in mind, determine the desired end state. Does the organization want to be compliant as of Dec. 1, 2016 with an acceptable increase in expenses, do they want to remain cost neutral, or do they want spend the time and resources to pursue a more efficient and effective workforce?

### Strategies for Compliance

Below are a list of potential strategies to consider for compliance with the final rule. This is not meant to be exhaustive, and a number of these strategies may be employed at the same time.

Strategy	Potential Implications
Increase the base salary for employees who truly perform exempt duties and are currently paid below the standard salary level.	The financial impact of this option could vary greatly, and this could cause internal equity concerns as employee pay moves closer to their supervisor's pay. In addition, salaries and grades will need to be reviewed at least every three years as the standard salary level increases.
Reclassify identified employees as nonexempt and pay overtime as necessary.	Similar to the strategy above, the financial impact of this option can vary quite a bit. However, this option requires assumptions regarding overtime worked, therefore making the financial modeling less accurate. It's also likely that many jobs will include both nonexempt and exempt employees in this option. This may cause fairness concerns. Finally, employees may feel a loss of status as they move from exempt to nonexempt.
Reclassify employees as nonexempt and reduce hourly rate to maintain total annual compensation.	Theoretically, this option is cost neutral, but damage to employee engagement is a concern. In addition to the loss of status mentioned above, employees could also realize lower total compensation if they do not work the overtime necessary to match their previous salary.
Review all reward programs and determine if any financial increases can be offset by decreases elsewhere in the reward programs.	At a high level, it's possible that an organization can reduce expenses in other reward categories to help offset increases in salary and/or overtime. At a more granular level, there may be special pay programs (e.g., shift differential pay) that are overused by the organization and could be reduced with minimum employee engagement impact.
Review the structure of the workforce and work processes.	This is a broad strategy that could include a number of paths such as innovating/automating work or demanding increased

Strategy	Potential Implications
	productivity to reduce hours. An organization can also review scheduling practices and even consider hiring additional employees to help reduce necessary overtime. If done well, these types of strategies can result in improved employee engagement and more efficient work processes.

The best approach for an organization is likely to be a tailored combination of the strategies above. As discussed earlier, it depends on the goals and approach of the unique organization.

By virtue of the increased standard salary level and duties tests, organizations should have far fewer questionable exemption classifications. It will be helpful to review job descriptions and actual employee duties against the duties tests for the various exemption categories. This is especially true for employees near the standard salary level or the HCE salary level, or for any other employees classified as exempt whose duties may not meet the duties tests.

Finally, even with the final rule’s automatic increase frequency changing from annual to every three years, the organization will likely benefit from annual compensation and FLSA reviews.

Other Considerations

A number of reward or other organizational programs may impact employees moving from exempt to nonexempt status. They may now be eligible for shift differentials and other premium pay items. Their paid time accruals, benefit eligibility or bonus targets may change as well.

A simple example is an exempt employee currently paid at \$45,000 annually with a 10% year-end bonus opportunity. The organization has decided to provide a salary increase to ensure the employee remains exempt. The real financial impact is not just the approximately \$2,500 salary increase, but also the incremental increase in the value of the 10% bonus opportunity.

As with any change management effort, effective and timely communication will be vital. Managers and employees alike must be informed about the changes, the reasoning behind them and how they’ll be impacted individually. This communications effort should begin months in advance instead of waiting until November. It’s also important to remember that even if exempt employees who are reclassified as nonexempt will earn more with overtime, they may feel a loss of status when they move to nonexempt and must now track time.

Management and employee training will be necessary as a number of employees may be moving from exempt to nonexempt, and managers may be managing nonexempt employees for the first time. Employees and managers both will need to learn timekeeping and what constitutes hours worked under FLSA. The implications for telecommuting and answering emails or calls at night are significant. Managers may also need to deal with unauthorized overtime worked by employees.

### Impact Modeling

In order to make informed decisions in response to the final FLSA rule, a comprehensive modeling file must be created and utilized. If this file is built to take advantage of variables and includes inputs beyond employee job title and salary, it can be a powerful tool as the organization compares various courses of action.

### **Pulling It All Together**

Based on the content presented up to this point, we recommend a strategic and methodical approach similar to the following:

<b>Step</b>	<b>Description and Comments</b>
Plan an overall project approach.	Identify the project steps and begin by considering the organization's strategy, culture, and objectives for this project.
Develop an inventory of jobs and employees impacted.	Starting with an employee census, begin a modeling file of all employees, and identify the employees and roles that will be directly impacted by the final rule.
Discuss options for treatment of these employees.	Discuss the options and potential implications for various approaches to compliance. Build out the modeling file to allow for real-time financial impact based on the selected scenarios.
Determine impact on any other pay or benefit programs.	Consider all reward and organizational programs that may be impacted by FLSA exemption. These may include paid time off, variable pay programs and developmental opportunities.
Estimate the financial implications.	Incorporate any of the other impacted reward programs.
Decide on a final approach.	Based on discussion around the results of the previous steps, determine a course of action.
Build the internal systems.	Determine, with payroll and/or information systems what changes have to be made in job codes, time off accruals, benefit tracking, or any other HR system that links to exemption status.
Communicate to and train managers and affected employees.	Communicate the changes taking place in December, and begin training managers and employees on timekeeping and policy/scheduling considerations.

Step	Description and Comments
Continue to assess the situation.	The situation will need to be monitored as new employees are hired and current employees receive pay raises or transfer jobs. Organizations will also want to review their compensation programs at least every three years to coincide with the automatic salary increases.

This process and its intricate details will change depending on each organization’s unique situation, strategy, and culture. If the process is tailored to the organization, through a review of the workforce, scheduling, and reward programs, it is possible that the process will actually provide a return to the organization through actual dollars saved, improved employee engagement, and/or higher quality work outcomes.

## Conclusion

The Dec. 1, 2016 effective date provides organizations with the time to be proactive in their approach to this final rule. Forward-thinking organizations will use this change as an impetus to take a systematic approach and broadly review their workforce, its structure, and how they reward their employees. Doing so can help create a return, whereas a reactive approach will likely be cost neutral at best while also potentially harming employee engagement.

## About the Authors

*Mr. Chris Ratajczyk, ACCP, SPHR, is a Managing Director of the Human Resources & Compensation Consulting Practice within the Benefits and Human Resources Consulting division of Arthur J. Gallagher & Co. In this role, Chris leads a broad-based consulting team, while working directly with clients in multiple industries on sustainable solutions that support organizational strategies and goals. His areas of expertise include the evaluation and design of base compensation, variable pay and total rewards programs. Chris can be reached at [Chris\\_Ratajczyk@ajg.com](mailto:Chris_Ratajczyk@ajg.com).*

*Ms. Mary Novak-Jandrey is a National Managing Director of the Human Resources & Compensation Consulting Practice within the Benefits and Human Resources Consulting division of Arthur J. Gallagher & Co. In her role, Mary works with clients in all aspects of human resources, and has deep expertise in the areas of organizational design, total remuneration, workforce planning and performance management. Mary can be reached at [Mary\\_Novak-Jandrey@ajg.com](mailto:Mary_Novak-Jandrey@ajg.com).*

The Benefits and Human Resources Consulting team of Arthur J. Gallagher & Co., through its compliance experts and consultants, will continue to monitor developments on healthcare reform legislation and regulation and provide you with relevant updated information as it becomes available. In the interim, please contact your Gallagher representative with any questions that you may have.

---

*The intent of this Technical Bulletin is to provide general information on employee benefit issues. It should not be construed as legal advice and, as with any interpretation of law, plans sponsors should seek proper legal advice for the application of these rules to their plans.*

© Arthur J. Gallagher & Co. 2016