

LEGAL UPDATE

Presented by Poms & Associates Brokers LLC

HOW TO COMPLY WITH THE NEW 2024 FLSA OVERTIME RULE

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On April 23, 2024, the U.S. Department of Labor (DOL) announced its final rule change to employee exemptions under the Fair Labor Standards Act (FLSA). The rule, among other changes, increases the minimum salary threshold for certain “white collar” exempt employees and provides overtime eligibility to millions of additional American workers.

The standard salary level will increase in two phases from the current \$684 per week (\$35,568 per year) to:

- July 1, 2024: \$844 per week (\$43,888 annually)
- Jan. 1, 2025: \$1,128 per week (\$58,656 annually)

The highly compensated exemption (HCE) total annual compensation level will increase from its current \$107,432 per year to:

- July 1, 2024: \$132,964 per year
- Jan. 1, 2025: \$151,164 per year

The salary thresholds will be updated every three years to reflect current earnings data, beginning July 1, 2027.

If the rule takes effect, employers will need to raise those employees’ salaries or reclassify them as eligible for overtime. Of note, the rule relies on a methodology similar to one that was found invalid by a federal judge in 2016. Therefore, many people believe that similar litigation is likely, and the rule could still be blocked.

While it is possible that court challenges could block the rule, in the meantime, employers must prepare for the changes. Employers should review their workforce to identify employees who are currently exempt from the FLSA’s minimum wage and overtime requirements and put a plan in place to comply with the increases to the salary thresholds on July 1, 2024, and January 1, 2025.

BACKGROUND AND THE CURRENT RULE REGARDING FLSA EXEMPTIONS:

The FLSA requires that most employees in the U.S. be paid at least the federal minimum wage for all hours worked and overtime pay at not less than one-and-one-half times their regular rate for all hours worked over 40 hours in a workweek. Section 13(a)(1) of the FLSA, however, provides an exemption from the FLSA’s minimum wage and overtime requirements for “any employee employed in a bona fide executive, administrative, or professional capacity ... as such terms are defined and delimited from time to time by regulations of the Secretary [of Labor].” This exemption is commonly referred to as the “white-collar” or executive, administrative, or professional (“EAP”) exemption.

For this exemption to apply, DOL regulations require that all three of the following tests must be met:

1. **The salary-basis test:** 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; and



2. **The salary-level test:** The amount of salary paid must meet a minimum specified amount (currently \$684 per week, or \$36,568 per year); and
3. **The duties-test:** The employee's job duties must primarily involve executive, administrative, or professional duties as defined by the regulations.



Under the current regulations, the minimum salary level is \$684 per week, which annualizes to \$35,568 per year. Employers are permitted to use nondiscretionary bonuses and incentive payments (including commissions) to satisfy up to 10% of the minimum salary level under the EAP exemption. If the sum of the employee's salary, nondiscretionary bonuses, and

incentive payments at the end of the year is less than the minimum salary level, the employer can make a final "catch-up" payment within one pay period after the end of the year to bring the employee's compensation up to the required level. Any catch-up payment will count only toward the employee's prior year salary amount and not toward the salary amount in the year in which it is paid.

The FLSA's regulations also contain a special rule for "highly compensated" employees (not recognized in California) that combines a much higher annual compensation requirement with a minimal duties test. Under the existing regulations, an employee was deemed as exempt under the highly compensated employee ("HCE") exemption under Section 13(a)(1) if:

- the employee earns a total annual compensation of \$107,432 or more, which includes at least \$684 per week paid on a salary or fee basis.
- the employee's primary duty includes performing office or non-manual work; and
- the employee "customarily and regularly" performs at least one of the exempt duties or responsibilities of an exempt executive, administrative, or professional employee.

THE NEW RULE REGARDING FLSA EXEMPTIONS:

According to the DOL, the January 1, 2025, salary level corresponds to the 35th percentile of the weekly earnings of full-time salaried workers in the lowest-wage U.S. Census region, which is currently the southern United States.

The USDOL's new Fair Labor Standards Act (FLSA) overtime rule will:

- Increase the minimum salary (the "salary level test") for most exempt employees paid on a salary basis to \$844 per week (\$43,888 annually) on July 1, 2024, and then to \$1,128 per week (\$58,656 annually) on January 1, 2025.
- Increase the minimum annual salary for highly compensated employees (HCE), although this exemption is not recognized in every state (including CA). That increase will also take effect in two stages. First, on July 1, 2024, the salary threshold will rise from \$107,432 to \$132,964 per year (a 23% increase). Second, on January 1, 2025, it will rise to \$151,164 (a 41% increase from current levels); and
- Adjust these minimum salary levels for inflation every three years, starting on July 1, 2027. The new methodology pegs the salary threshold at the 35th percentile of full-time non-hourly workers in the lowest-earning Census region (currently, the South). The new level for the HCE exemption will be pegged to the 85th percentile of all non-hourly workers nationwide. And like the white-collar thresholds, it will be updated every three years. That methodology will be used to update the salary level going forward.

WHAT SHOULD EMPLOYERS DO TO PREPARE FOR THIS CHANGE?

As mentioned, it is possible a federal court will prevent the DOL from enforcing the Final Rule while the legal challenges are pending. That leaves employers in a difficult position of preparing to comply while the rule's prospects are unclear. Adding to the complexity is a looming presidential election. A turnover in administrations could bring a change of course by the DOL. Nevertheless, employers should put a strategy in place to effectuate changes by the July and January deadlines in the event the rule does go into effect.

For now, employers need to identify currently exempt employees who do not satisfy the new minimum salary

threshold and devise a strategy for compliance. If you decide to reclassify your employees to non-exempt status, there are many considerations you'll have to work through, including the following:

- **How Much to Pay?** Will you divide the employee's weekly salary by 40 hours to determine their hourly rate, or will you factor in the employee's estimated overtime and adjust accordingly?
- **Regular Rate Calculations.** Overtime premiums are based on the employee's "regular rate of pay." Employers are sometimes surprised to learn the regular rate is not simply an employee's hourly rate of pay or their take-home pay. The regular rate is based on "all remuneration" earned from employment with the exception of eight specific exclusions contained in section 7(e) of the FLSA.
- **Incentive and Bonus Pay.** The regular rate includes all types of compensation – including things like non-discretionary bonuses, commissions, payments for undesirable shifts or duties, and some non-cash payments depending on the circumstances. Keep in mind that most bonuses are not discretionary and must be included in the regular rate. It is common for employers to pay out bonuses based on a formula announced ahead of time and designed to incentivize certain behavior. Such bonuses are not discretionary. You can read more about the regular rate here.
- **How to Track Those Employees' Work Time?** Employers are required to make and keep records of non-exempt employees' working time. Before converting employees to non-exempt status, it may require some planning, reconfiguration of workflow, and implementation of new processes or technology to ensure that you are accurately recording their work time. It is best practice to think about these questions in advance and explore multiple potential recordkeeping processes to determine which options meet your needs and are cost-effective.
- **How Benefits Will Be Affected?** Do you have different vacation, sick leave, and other policies for exempt and non-exempt employees? You will have to consider how to transition reclassified employees to new programs and train workers and their supervisors on new procedures.

Whether the Final Rule ultimately takes effect, it presents an opportunity for employers to review the exempt status of their workforce. Consider an audit of wage and hour practices to ensure compliance with the FLSA and the state laws of the jurisdictions where your business has operations.

To prepare for the FLSA overtime rule, an employer should consider taking the following steps:

Step 1: Identify Employees Who May Need to Be Reclassified

Review all employee classifications to determine which of their employees qualify as exempt under the executive, administrative, and professional exemptions. After confirming these employees are properly classified, companies should consider creating a list of any such employee making less than \$43,888 as of July 1, 2024, or less than \$58,656 starting January 1, 2025. These employees will either need to be converted to hourly employees, or have their salaries raised to the new thresholds. Highly compensated employees also should be identified. Remember, the HCE exemption is not recognized in California.

Step 2: Develop a New Compensation Plan

After identifying affected employees, consider the following options:

- Increase their weekly salary to the new minimum or higher to retain their exempt status; or
- Reclassify them as nonexempt and:
 - Pay them overtime for any overtime hours worked.
 - Reduce or eliminate overtime hours; or
 - Reduce the amount of pay allocated to base salary (while making sure it remains above the minimum wage) and add pay to account for overtime for hours worked over 40 in the workweek, to hold total weekly pay constant.

Decide whether to make changes in two stages - first in July and then again in January - or bite the bullet and make changes to comply with the higher January threshold come July. The former approach may help to minimize costs and to satisfy employees' expectations for an annual cost-of-living adjustment for 2025; the latter approach may help to minimize confusion and the administrative burden.

An employer should weigh not just the labor cost of each option, but also the potential administrative burdens, morale problems and litigation risks that could result from reclassifying exempt employees as nonexempt. The following table illustrates some of the pros and cons of each approach.

| OPTION | PROS | CONS |
|---|--|---|
| Increase weekly salary to retain exempt status | <ul style="list-style-type: none"> • May help employee morale / retention. • Eliminates need to track working hours, thereby limiting compliance risk. | <ul style="list-style-type: none"> • Possible pay compression • Likely most expensive option |
| Pay overtime for any overtime hours worked | <ul style="list-style-type: none"> • Has potential to improve morale for employees who work longer hours. | <ul style="list-style-type: none"> • Could cost even more than raising salaries if employer is not willing and/or able to limit overtime hours. • Could trigger additional compliance obligations, especially if the employee is paid commissions, nondiscretionary bonuses or other forms of compensation that must be included in the regular rate of pay when calculating overtime. • May damage employee morale if nonexempt positions are given less flexibility and/or fewer benefits. |
| Reduce or eliminate overtime hours | <ul style="list-style-type: none"> • Could free up money in the staffing budget for temporary workers or new hires to help pick up the slack. • A strictly 40-hour workweek could improve work-life balance. | <ul style="list-style-type: none"> • Likely to lower employee productivity, especially if previously exempt employees worked significantly more than 40 hours per week. • Requires that management ensure employees do not perform off-the-clock work and pay them for it if they do. |
| Hold weekly pay constant by reducing base salary and adding pay to account for overtime | <ul style="list-style-type: none"> • Keeps expenses constant. • A predictable workweek could improve work-life balance. | <ul style="list-style-type: none"> • Requires careful monitoring of employees' working time to ensure they do not go beyond the budgeted amount. • May prove difficult in states and localities with higher minimum wages. |

Beware of the temptation to reclassify affected workers as independent contractors. Without a significant restructuring of work arrangements, this approach is almost certain to leave the business vulnerable to a misclassification lawsuit. Since multiple workers are likely to be affected by a common policy, plan or design, there is a high potential for a collective action.

Step 3: Consider Nondiscretionary Bonuses and Incentive Pay

The 2020 overtime rule amended the FLSA to allow employers to count nondiscretionary bonuses and incentive payments (including commissions) to satisfy up to 10% of the *standard* salary level (but not toward the minimum salary for highly compensated employees), as long as they are paid annually or more frequently.

An employer should factor this option into its decision-making process.

Bear in mind, employers may use any 52-week period - such as a calendar year, a fiscal year or an anniversary of hire year - to fulfill the annual pay frequency requirement. Also, if an employee's pay falls short of the required minimum at the end of the year, there is a provision allowing employers to make one final make-up payment to cover the difference.

Step 4: Account for State Differences

In addition to the federal FLSA, an employer also must follow the laws of the state and/or locality where work is performed if it provides a greater protection or benefit to the employee. An employer should take these differences into account as it formulates its plans.

A few states already require employers to pay overtime-exempt executive, administrative and professional employees a salary higher than the scheduled federal salary of \$1,128 per week (or may do so next year after annual inflation adjustments). For employees in these states, the new FLSA rule may be moot if it does not increase the new salary threshold above those existing state-required minimums.

Another key difference is the minimum wage. For exempt employees who work long hours, it may cost more to reclassify them as nonexempt and pay them overtime than it would to raise their salary and keep the exemption.

Practical Example: An employee works 65 hours per week as an exempt manager of a retail store. Their store is located in one of the many states and localities that has a minimum wage of \$15.00 or more. The employee is owed at least \$1,162.50 for the workweek, which will be more than the minimum salary of \$1,128.00 per week.

- 40 hours × \$15.00 = \$600.00
- 25 overtime hours × \$22.50 (one and one-half of \$15.00) = \$562.50
- \$600.00 + \$562.50 = \$1,162.50

When reclassifying exempt employees as nonexempt, it's also important to consider state-specific requirements regarding overtime, show-up time/reporting time, meal and rest breaks and more.

Step 5: Check Wage Budget for Pay Compression

Increasing the salaries of employees earning less than the new minimum salary to preserve their exemption status can put upward pressure on the salaries of those who already earn a little, but not much more than the new minimum salary.

Practical Example: Consider two exempt employees: Employee One's salary is \$35,568 per year and Employee Two's salary is \$65,000 per year.

Currently, Employee Two's salary is 83% higher than Employee One's. If Employee One's salary is raised to \$58,656 to preserve their exempt status, Employee Two's salary would be only 11% higher than Employee One's. Problems around morale and retention can be expected if Employee Two's salary is not increased as well - especially because the new \$58,656 minimum salary has been publicized widely in popular media and potentially internal communications as well.

An employer should account for this dynamic as it formulates a plan for compliance.

Step 6: Align Timekeeping Systems

An employer should already have timekeeping systems in place for any nonexempt employees. These timekeeping policies and procedures should be updated and aligned with any employees who will join the ranks of the nonexempt as a result of the overtime rule.

Although the FLSA does not require employers to use any specific method to keep track of nonexempt employees' work hours, it does require the records to be accurate.

The availability of company phones, laptops and other devices can facilitate off-the-clock work, so an employer may want to consider revoking access to the devices or deploying technological solutions that limit their usage to core working hours (e.g., 9:00 a.m. to 5:00 p.m., Monday to Friday).

An employer that relies on employees to self-report their working time should exercise caution with newly reclassified nonexempt employees, as they may not take timekeeping seriously. In particular, an employer should look out for "repeating eights": a time sheet on which an exempt employee reports working eight hours a day from 9:00 a.m. to 5:00 p.m., Monday to Friday, will not be given much credibility, and a court can instead rely on the misclassified employee's credible, sworn testimony.



Step 7: Review Wage and Hour Policies and Processes

In preparation for the new overtime rule, an employer should review and update its internal policies on the following:

- Overtime.
- Salary basis.
- Meal breaks.
- Rest breaks.
- Telecommuting.
- Timekeeping; and
- Bonus eligibility.

Step 8: Review Your Policies on Company Equipment and Personal Devices

Do you have different policies for exempt and non-exempt employees when it comes to issuing company equipment and using personal devices? Exempt employees may have more leeway to use company laptops or their own personal devices – such as smartphones – to conduct business while traveling or outside of their regular office hours. Perhaps you limit such use for non-exempt employees, so they aren't tempted to perform off-the-clock work. In that case, you'll need to apply your policies consistently and advise reclassified employees about their new responsibilities.

Regardless of whether you allow non-exempt employees to work remotely or use portable devices, be sure your policies are clear about acceptable work hours, proper timekeeping procedures, and capturing all hours worked.

Step 9: Audit Job Descriptions

Employees' job descriptions should be carefully reviewed in preparation for the overtime rule. In addition to checking job descriptions for fundamental details like job titles and qualifications, it is crucial to ensure that they:

- Are accurate; and
- Support the job's exemption classification.

These reviews should be conducted regularly regardless of external circumstances, but it will be especially important after reclassifying employees as a result of the new overtime rule.

Ideally, job descriptions should be crafted with the involvement of employees' managers, counsel, and HR to maximize accuracy and compliance.

Organizing the list of job duties and responsibilities in an optimal manner (i.e., order of importance, frequency with which tasks are performed or essential versus non-essential duties) can help to bolster the case that an exempt employee's primary duty is exempt work.

Having employees sign and acknowledge the accuracy of their job descriptions can help minimize liability in the event of a lawsuit.

Step 10: Develop a Communication Plan

A communication plan can help avoid the kind of confusion and misunderstandings that may lead to litigation. To allay fears and uncertainty, an employer may want to send employees an initial communication before the rule takes effect.

For those employees who will be reclassified, employers should prepare talking points for managers and employees about the change, the reason for the change, and how the change will impact their compensation, benefits, and opportunities for advancement. This can help employer representatives stay on-message when breaking the news to affected employees.

A "Change in FLSA Status for Exempt Employee Letter" should be used to formally communicate changes to an overtime-exempt employee who must be reclassified as nonexempt. Conversely, this letter may also be used in rarer cases where a nonexempt employee is reclassified as exempt.

Step 11: Train Reclassified Employees and Their Managers

Reclassified employees should be trained in their responsibilities as nonexempt employees. Train these

reclassified employees who become entitled to overtime regarding the company's policies and practices concerning the various issues applicable to hourly workers. The specifics may vary from business to business, but here are a few examples of what you'll want to cover:

- scheduled hours.
- overtime approval policies.
- timekeeping procedures.
- recordkeeping requirements.
- rules about meal and rest breaks.
- policies on using personal devices for work; and
- prohibition on off-the-clock work.

Be sure to train newly-nonexempt employees about "off-the-clock" work restrictions. Guard against "off-the-clock" work for any newly-nonexempt employees. Such measures may include reviewing policies and procedures to ensure that rules specifically written for salaried or hourly employees still control behavior as intended if a salaried employee is converted to a nonexempt, hourly employee who is eligible for overtime. Such policies may include those concerning company-issued mobile devices or access to company resources, such as email and chat groups, outside of "regular" work hours.

Step 12: Throughout Your Analysis Consider the Impact on Employee Morale

For many employers, it may not be possible to simply raise every affected employee's salary up to the new salary level threshold. But reclassifying employees to non-exempt could have a negative impact on morale.

Many employees associate prestige with being classified as an exempt-salaried employee, especially since the white-collar exemptions require a certain level of supervisory responsibility or discretion and independent judgment. Oftentimes, exempt employees like the flexibility that comes with being salaried, and they don't want to track and record their hours worked. Managers who will now have to clock in and out with their direct reports may be particularly sensitive to this change.

Therefore, even if their pay remains the same, employees may view a switch to non-exempt status as a demotion. So, you will need to weigh the impact on morale when making the decision to convert employees. Proactively communicate and be prepared to answer questions about why you decided on this route rather than increasing pay. It may be helpful to review and summarize market studies on salary data, so you have facts to back up your decision.

Remind employees that they are valued and let them know you are required to make changes in light of the federal government's new wage and hour rules. The DOL has made clear that the goal is to make more people eligible for overtime pay — which means more workers will likely need to be converted to non-exempt — and you can explain to employees that your decisions are meant to keep your business compliant with the latest regulations.

KEY TAKEAWAYS

The significant increase in the salary level test for the white-collar exemptions will require employers to quickly identify and evaluate positions compensated below (or near) the new thresholds and decide whether to reclassify employees or raise their salaries. In making this determination, employers should look at the hours worked for those employees under the salary threshold to estimate the potential cost of paying overtime.

For those employees who will be reclassified, employers should prepare talking points for managers and employees about the change, the reason for the change, and how the change will impact their compensation, benefits, and opportunities for advancement. Additionally, employers should develop training and robust time-reporting policies for reclassified workers who will not be accustomed to recording their hours worked.

To the extent that reclassified employees were receiving bonuses, commissions, or other incentive compensation, employers will need to carefully examine those methods of compensation to determine if they should continue to be paid and, if so, whether they must be factored into the regular rate for now-hourly workers. Employers should also be prepared to follow up and audit timekeeping practices for newly reclassified employees to ensure they are following proper processes and procedures.

Remember to review other jurisdictions where you have business operations, including remote workers. Many other states have higher, stricter, or different wage and hour requirements for exemptions from overtime, than those under the FLSA.

The above analyses and decisions will necessarily take time, particularly for large employers with hundreds of exempt employees. As a result, the sooner employers begin to evaluate how they will comply with the new rule, the better. But to be clear, employers should not rush to implement changes too far in advance of the current July 1, 2024, effective date because, if the rule is ultimately invalidated or stayed, it may be difficult for employers to walk back any changes made in the interim, as many employers learned when the Obama-era salary level rule was enjoined.

Needless to say, employers must also continue complying with applicable state wage and hour laws for the newly reclassified employees.

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