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Exempt or Nonexempt?

Missing the Mark on Employee Classification or Compensation Will Cost You.

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Personal bankers for Bank of America's wealthiest clients settled for \$22 million. Farmers Insurance Exchange claims adjusters were awarded more than \$90 million. Starbucks, PacBell and RadioShack "working" managers are poised to receive millions.

To what do employees owe these sizable awards? Their employers failed to properly classify them as exempt or nonexempt from overtime pay. As a result, the employers find themselves saddled with costs that include up to four years of unpaid wages-plus interest, statutory penalties and attorney fees.

Employer misclassifications of employees can quickly erupt into class action lawsuits sparked by just one disgruntled former or current employee. California and federal laws are onerous in this area, and both permit personal liability upon the officers and managers who controlled the decision not to pay overtime.

The lesson learned is that this is a risk employers can't ignore. Dealing with this risk means employers must analyze and satisfy two basic tests to determine whether or not an employee is exempt. The tests, among other wage and hour rules, can be found in the California Industrial Welfare Commission wage orders posted [online](#).

Employers are required to conspicuously post applicable wage orders in the workplace. Wage Order 1, for example, applies to manufacturing companies. Wage Order 7 applies to mercantile businesses. Wage Order 4 applies to professional, technical, mechanical and clerical occupations, including professional service firms. The focus of this article is on the essence of Wage Order 4's overtime and exemption rules.

The Salary Basis Test

As of Jan. 1, 2008, to satisfy the first test, the "salary basis" test, the employee, whether full or part time, must be paid at least a \$2,777.33 per month salary. This is based on the rule's twice minimum wage requirement. The salary amount cannot be deducted from or added to because of actual

hours worked.

The Duties Test: The Root of Many Problems

The duties test requires that employees routinely spend more than 50 percent of their working time performing exempt duties. Most of the overtime litigation is borne from this more difficult test.

Keep in mind that the law and the California Department of Industrial Relations state that job titles, large salaries and highly skilled work are not determinative. Instead, employers must analyze the work performed by each employee under professional, administrative and executive exemptions.

Exempt Duties Under the Professional Exemption

To be considered exempt from overtime pay under the professional exemption, employees must be:

- Licensed in California and spend more than 50 percent of their time engaged in the practice of law, medicine, dentistry, optometry, architecture, engineering, teaching or accounting; or primarily engaged in an occupation commonly recognized as a learned or artistic profession as defined in Wage Order 4; and
- Customarily and regularly exercising discretion and independent judgment when performing that work.

Unlicensed professionals typically must satisfy one of the other exemptions.

Exempt Duties Under the Administrative Exemption

For the administrative exemption, employees must spend more than 50 percent of their time performing the following duties:

- Office or non-manual work directly related to management policies or general business operations of the employer or its customers;
- Regularly exercise discretion and independent judgment; and
- Regularly and directly assists a proprietor, other executive or administrator; or perform, under only general supervision, specialized work requiring specialized training, experience or knowledge; or executes, under only general supervision, special assignments and tasks.

Exempt Duties Under the Executive Exemption

The executive exemption applies to employees who spend more than 50 percent of their time performing the following duties:

- Managing a unit, department or enterprise of the employer;
- Directing or supervising the work of at least two full-time employees;
- Exercising authority to hire, fire, promote or change the status of other employees or their recommendations for such changes are given deference; and
- Customarily and regularly exercising discretion and independent judgment.

Analysis of the Duties Tests

Let's take a typical office-based business. The officers, department heads, certain licensed professionals and even the office manager probably are exempt. The receptionist and file clerks are clearly nonexempt. The secretarial, payroll, payables and receivables employees are typically nonexempt. But what about everyone in the middle, including those who may be called "managers" and have a high job responsibility and skills?

Determining if these employees are exempt is not easy. Job titles alone, the employee's stated desire to be treated as exempt and what others in your profession do have been made nearly irrelevant in overtime exemption litigation.

A helpful starting place in exemption analysis is to list, for all employees, how much of their working time is spent:

- Administering business affairs of the company or producing the goods or services that the company is in business to produce;
- Using their head more than their hands;
- Innovating or directing innovation more than merely applying sophisticated skills to technical work;
- Making the company's rules and policies more than following them;
- Exercising authority to act outside the rules and policies rather than being disciplined for doing so;
- Supervising others and making supervisory decisions more than personally doing the work; and
- Being the trusted adviser to the client rather than just doing the client's work proficiently.

Do the five or six most important "exempt" job functions exceed 50 percent of the employee's time? Test your preliminary conclusions by asking: Do the five or six least important "nonexempt" job functions take more than 50 percent of the employee's time?

Alternatives to Limit Overtime Pay

Since you always have nonexempt employees, you have four primary ways to limit overtime pay exposure:

1. LIMITING OT

Manage your business so that employees do not work more, or much more, than the eight-hour-a-day threshold for daily overtime pay entitlement. For employers with seasonal workloads, this is easier said than done. During busy season, overtime is a given and layoffs during slow times may frustrate the ability to recruit and retain skilled employees.

2. MAKE-UP TIME

Make-up time exists under California law to encourage employers to permit employees to work up to three hours extra in one day to make up for work they missed because of a personal obligation in the same week.

These make-up hours are paid at straight time and not at the time and a half overtime rate if some basic rules are followed:

- The employee must request the time off and the make-up time in writing in advance and the employer may grant the request in its discretion;
- Make-up time must be taken in the same week in which the time off was taken;
- The employer cannot solicit employees to ask for make-up time to avoid overtime pay; and
- The employer pays overtime on hours worked in a week in excess of 40 anyway.

3. ALTERNATIVE WORK SCHEDULES

On a two-thirds secret vote of employees in a work unit, an alternate work schedule (AWS) can be adopted that permits employees to work longer days at straight time pay in exchange for fewer days in a work week. For AWS purposes, "work unit" means employees in a readily identifiable group, such as a division, a department, a job classification, a shift, a separate physical location or

a recognized subdivision of one of those groups. An AWS must have a straight time maximum of 10 hours in one day and 40 in one week.

Among several AWS rules contained in the wage orders, the employer must:

- Report results to the Department of Industrial Relations within 30 days of the vote;
- Provide reasonable accommodation to employees who are unable to work the AWS;
- Conduct a secret repeal vote on petition of one-third of affected employees and then repeal the AWS if two-thirds of the employees vote to repeal;
- Pay daily overtime in any day that the employer requires an employee to work less hours than the AWS, but more than eight hours; and
- Not reduce the regular rate of pay as a result of adoption, repeal or nullification of an AWS.

In addition, employers are permitted to give new employees who are unable to work the AWS an eight-hour schedule. Finally, certain AWS in effect July 1, 1999 are exempt from some of these rules if the work schedule complied with prior wage orders.

4. COMP TIME-OFF

A make-up time program can help employers manage overtime exposure in a given week. An AWS basically recasts work week hours to possibly improve work efficiency and morale, while protecting against overtime exposure. Yet, neither of these methods give employers the flexibility to limit overtime pay, normalize payroll expense over the course of a year, and have employees available or on paid time off depending on seasonal workloads.

In lieu of overtime pay, some employers use statutory compensatory time off (CTO) programs to "bank" extra hours worked during busy times, while paid time off is given during slower times. However, the Legislature intended CTO law to be difficult to comply with because CTO is a form of compensation deferral that is inconsistent with basic labor rules that require employers to pay employees for work in regular payrolls when or shortly after the work is done.

Both California and stricter federal rules apply. Some say that it is nearly impossible to leap through all the required flaming compliance hoops and not get burned.

The Federal Fair Labor Standards Act (FLSA) essentially bans CTO for nonexempt employees who do not work for the government, although in some cases the FLSA permits CTO accrual and use within a two-week period. The FLSA applies to:

- Employees who are engaged in commerce or the production of goods for commerce; and
- Employers with at least \$500,000 annual revenue and have employees engaged in commerce or in the production of goods for commerce, or who handle, sell or work on goods or materials that have been moved in or produced for commerce.

The interstate commerce analysis is easier for vessel and marine equipment builders, electrical power suppliers and companies that ship their products or provide services across state lines. They are typically FLSA governed.

The analysis can be tricky for others since "commerce" includes trade, transportation, transmission and communication directed outside the state. "Goods" includes tangible products, as well as written materials, such as brochures, newsletters and lawyers' briefs that move in interstate or foreign commerce.

For example, a provider of professional services from a single California office who does little or

no work for out-of-state clients and who does little or no out-of-state marketing may not be FLSA governed, while a provider with offices in multiple states probably is FLSA governed.

If the FLSA does not apply, California law permits CTO for nonexempt employees if all of the following conditions are met:

- The employer is not covered by one of five wage orders (i.e. manufacturing; canning, freezing, and preserving; public housekeeping; amusement and recreation; and agricultural, farm product preparation and post-harvest product handling);
- The employer and employee must sign a written agreement, or be subject to a collective bargaining agreement, permitting CTO before the work is performed;
- The employee can accrue a 240-hour maximum of CTO and overtime pay must be paid each payroll period after that;
- The employee requests CTO in writing in lieu of overtime pay; and
- The employee must be regularly scheduled to work no less than a 40-hour week.

Among the numerous rules affecting CTO program operation that employers frequently neglect is that CTO must be granted at the applicable overtime rate (i.e., 1.5 or two times hourly wage) of each overtime hour worked. For example, an employee who works two hours of overtime in a day must be credited three CTO hours.

The employer also must keep records of all CTO accrual and use. Employees must be permitted to use CTO within a reasonable period after making a request to their employers as long as the CTO does not unduly disrupt the employer's operations. If requested by the employee, the employer must pay overtime compensation in lieu of CTO that has accrued in the last two payroll periods. On termination of employment, unused CTO must be paid in full at the higher of the final wage or the employee's average wage rate for the last three years.

CTO seems like an attractive option to manage OT pay and retain great employees. Yet, an employer needs an asbestos coat to avoid getting burned by all the rules that it may be breaking.

Anyone who ignores these rules or thinks they are easily applied is asking to be a defendant. If you are taken to court or the labor board on overtime issues, the employer has, what litigators call, the "burden of proof."

Employers need experienced labor counsel or human resource professionals to effectively deal with these risks.

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