

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, Committee on Small Business
From: Committee Staff
Date: June 20, 2016
Re: Hearing: “Damaging Repercussions: DOL’s Overtime Rule, Small Employers, and their Employees”

On Thursday, June 23, 2016 at 10:00 a.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of examining the final rule issued by the Wage and Hour Division of the Department of Labor (DOL or Department) to revise and update the existing Fair Labor Standards Act (FLSA or Act) regulations that implement the exemption from minimum wage and overtime pay for executive, administrative, professional, outside sales and computer employees (the overtime rule).¹ Most private and public sector employees are covered by the FLSA, and employers must comply with the final rule by December 1, 2016.² The Committee will examine the effects of the overtime rule on small employers and their employees.

I. Overview of the FLSA

Signed into law by President Franklin Delano Roosevelt in 1938, the FLSA establishes minimum wage and overtime standards for most employees. It applies to employees of enterprises that have \$500,000 or more in “annual gross volume of sales or business done” and to employees individually because they are engaged in the production of goods for commerce or in interstate commerce.³ In addition, regardless of the amount of gross volume of sales or business done, it applies to: hospitals; businesses providing nursing or medical care for residents; schools (including private, public, for profit, or not-for-profit); and public agencies.⁴ Among other provisions, the FLSA requires that employees falling within its ambit must be compensated at one-and-a-half times (“time and a half”) their regular rate of pay for each hour worked over 40 hours in a workweek unless the employee is exempt from the Act’s coverage.⁵

The FLSA provides an exemption from its overtime provisions for bona fide executive, administrative, and professional (EAP) employees which is referred to as the “EAP” or “white collar” exemption. Rather than define the terms executive, administrative, or professional employee, the FLSA

¹ Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 81 Fed. Reg. 32,391 (May 23, 2016) (hereinafter “Final Rule”).

² *Id.*

³ 29 U.S.C. § 203(s)(1)(A). *See also* DOL, WAGE AND HOUR DIVISION, SMALL ENTITY COMPLIANCE GUIDE TO THE FAIR LABOR STANDARDS ACT’S “WHITE COLLAR” EXEMPTIONS 1 (2016), <https://www.dol.gov/whd/overtime/final2016/SmallBusinessGuide.pdf>.

⁴ 29 U.S.C. §§ 203(s)(1)(B)-(C).

⁵ *Id.* § 207(a)(1). If a state or city establishes higher standards than those in the FLSA, the higher standard applies in that city or state. *Id.* § 218.

authorizes the Secretary of Labor to “define[] and delimit[]” these terms “from time to time by regulations” pursuant to the requirements of the Administrative Procedure Act.⁶

Two primary reasons existed for an EAP exemption in FLSA. First, the nature of the work performed by EAP employees was not as clearly associated with hours of work per day as it was for typical nonexempt work.⁷ Second, bona fide EAP employees were considered to have other forms of compensation (e.g., above-average benefits, stock options, and greater opportunities for advancement) unavailable to nonexempt workers.⁸

Job titles alone do not establish that an employee has exempt status.⁹ Generally, the DOL has required that three criteria have to be met for an employee to qualify for the exemption from the FLSA’s minimum wage and overtime protections: 1) the “salary basis” test (the employee must be paid a fixed and predetermined salary that cannot be reduced because the quality or quantity of work varies); 2) the “duties” test (the employee’s work must primarily involve executive, administrative or professional duties as defined by the regulations); and 3) the “salary level” test (the employee must be paid a specified amount or more).¹⁰ The Department has increased the salary level requirements seven times since 1938, most recently in 2004.¹¹

In 2004, the DOL created a “highly compensated employee” (HCE) exemption through the rulemaking process. Under that exemption, employees earning at least \$100,000 annually are exempt from overtime requirements if they perform at least one of the responsibilities in the duties test for an EAP employee.¹² This provision was not linked to a specific percentage of salaried employees like the salary basis test; rather, the DOL established a salary of \$100,000.¹³

II. The Final Rule

On May 23, 2016, the DOL issued the final rule which was promulgated in response to a directive issued by President Obama in 2014 to update and modernize the overtime regulations.¹⁴ The final rule makes several significant changes to the existing FLSA regulations. The DOL estimates that

⁶ *Id.* § 213 (a)(1). The FLSA regulations are found at 29 C.F.R. Part 541.

⁷ IV CONRAD F. FRITSCH & KATHY VANDELL, EXEMPTIONS FROM THE FAIR LABOR STANDARDS ACT: OUTSIDE SALESWORKERS AND EXECUTIVE, ADMINISTRATIVE, AND PROFESSIONAL EMPLOYEES, 240 (1981).

⁸ *Id.*

⁹ 29 C.F.R. § 541.2.

¹⁰ Final Rule, 81 Fed. Reg. at 32,395. In order to meet the duties test, the employee’s primary duty must be that of an exempt executive, administrative, or professional employee. The primary duty of executive employees is management of the enterprise or of a customarily recognized department or subdivision of the enterprise. An executive employee must regularly and customarily direct the work of two or more employees and have the authority to hire or fire other employees or have a significant say in hiring, firing, promotion, advancement, or any other status change of other employees. 29 C.F.R. § 541.100(a). The primary duty of administrative employees is office or non-manually work directly related to the management or general business operations of the employer or the employer’s customers. Administrative employees must exercise discretion and independent judgment with significant matters. 29 C.F.R. § 541.200(a). The primary duty of a professional employee is performance of work that requires knowledge of an advanced type in science or a specialized area that is acquired through coursework or requires talent, originality, invention or imagination in a recognized creative or artistic field.

29 C.F.R. § 541.300(a).

¹¹ Final Rule, 81 Fed. Reg. at 32,400.

¹² 29 C.F.R. § 541.601(a).

¹³ Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 69 Fed. Reg. 22,122 (Apr. 23, 2004).

¹⁴ Memorandum of March 13, 2014 – Updating and Modernizing Overtime Regulations, 79 Fed. Reg. 15,211 (Mar. 18, 2014). The memorandum instructed the DOL to look for ways to modernize and simplify the regulations while ensuring that the FLSA’s intended overtime protections are fully implemented. *Id.*

the final rule will cost employers \$295.1 million per year in regulatory compliance costs and an additional \$1.2 billion in higher wages.¹⁵

Under the final rule, the salary that must be paid to satisfy the "salary level" test will increase from the current level of \$23,660 to \$47,476 annually (or a weekly change from \$455 to \$913), a more than 100 percent increase. The DOL set the salary level equal to the 40th percentile of all full-time salaried workers in the lowest wage Census Region, which is currently the South.¹⁶ The salary level in the final rule is slightly lower than \$50,440, the amount that DOL initially proposed.¹⁷ The DOL also increased the HCE exemption from \$100,000 to \$134,004 annually in the final rule.¹⁸ The HCE total annual compensation level was set at a level equal to the 90th percentile of earnings of full-time salaried workers nationally as DOL had initially proposed.¹⁹

The final rule will allow employers to count nondiscretionary bonuses and incentive payments (including commissions) toward 10 percent of the required salary level for the standard exemption for the first time. Employers must pay bonuses and incentive payments on a quarterly (or more frequent) basis for these amounts to be counted.²⁰ Furthermore, the final rule also establishes a new process by which the salary level will be automatically updated every three years beginning on January 1, 2020, instead of every year as DOL had proposed.

The salary and compensation threshold levels will be updated by maintaining the fixed percentiles – the 40th percentile for the EAP exemption and the 90th percentile for the HCE exemption. The DOL will publish the new salary levels 150 days before the January 1st effective date.²¹ It is unclear whether an indexing scheme satisfies the requirement that exemptions be developed through rulemaking procedures set out in the Administrative Procedure Act as required by the FLSA.²²

III. DOL's Analysis of Small Employer Impacts

Under the Regulatory Flexibility Act, 5 U.S.C. §§ 601-12 (RFA), agencies must assess the effects of rules on small businesses, small not-for-profits, and small governmental jurisdictions (collectively referred to as "small entities" under the RFA).²³ If the agency determines that the proposed rule will have a "significant economic impact on a substantial number of small entities," it must prepare

¹⁵ Final Rule, 81 Fed. Reg. at 32,393.

¹⁶ *Id.* The South Census Region includes: Alabama; Arkansas; Delaware; the District of Columbia; Florida; Georgia; Kentucky; Louisiana; Maryland; Mississippi; North Carolina; Oklahoma; South Carolina; Tennessee; Texas; Virginia; and West Virginia. Final Rule, 81 Fed. Reg. at 32,408 n.32.

¹⁷ Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees, 80 Fed. Reg. 38,516, 38,517 n.1 (July 6, 2015) [hereinafter "Proposed Rule"].

¹⁸ *Id.*

¹⁹ Final Rule, 81 Fed. Reg. at 32,393.

²⁰ *Id.* This provision does not apply to highly compensated employees. *Id.* at 32,550. The provision regarding bonuses was not part of the DOL's proposed rule.

²¹ *Id.*

²² Compare 29 U.S.C. § 213(a)(1). A full explanation of this legal matter is beyond the scope of this memorandum.

²³ This memo will use the terms "small entities" and "small employers" interchangeably to refer to small businesses, small non-profits, and small governmental jurisdictions. The RFA defines "small businesses" as having the same meaning as "small businesses" under the Small Business Act. 5 U.S.C. § 601(3). The Small Business Administration is authorized to establish size standards for small businesses (other than agricultural enterprises) and does so through notice and comment rulemaking. 15 U.S.C. § 632(a)(2). "Small non-profits" are defined as those that are independently owned and operated and not dominant in their field, and "small governmental jurisdictions" are cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than 50,000. 5 U.S.C. §§ 601(4)-(5).

an “initial regulatory flexibility analysis” (IRFA).²⁴ An agency is required to prepare a final regulatory flexibility analysis (FRFA) if it determines that a final rule will have a “significant economic impact on a substantial number of small entities.”²⁵

Although DOL correctly determined that the proposed rule would have a significant economic effect on a substantial number of small entities and published an IRFA, the adequacy and accuracy of the analysis was questioned by various commenters, including the Chief Counsel for Advocacy of the Small Business Administration.²⁶ While the DOL did address some of the issues raised by the Chief Counsel for Advocacy in the FRFA it published with the final rule, DOL’s analyses in the final rule are so imprecise that it is difficult to ascertain the expected effects on small employers in various industries and different areas of the United States.

The DOL’s final analyses provides a range of estimated impacts for the number of affected small employers and the costs they will incur. It estimated that between 210,800 and 1.6 million small establishments will be affected depending upon the number of currently exempt workers they employ.²⁷ In addition, the DOL estimates that between 4.5 million to 5.9 million small establishments that do not have affected workers will still need to familiarize themselves with the new requirements.²⁸

Small employers will incur regulatory familiarization costs, adjustments costs, managerial costs, and payroll increases to comply with the rule. In the first year, DOL estimates that small employers will incur between \$688.3 million to \$899.9 million in direct costs and payroll increases.²⁹ Based on the estimate of \$688.3 million in first year costs, DOL estimates that a small establishment will incur \$3,265.³⁰ In addition, DOL provides an estimate of costs in years two through 10. It projects that small

²⁴ *Id.* at § 603. An IRFA must describe the small businesses that will be affected, the impact of the proposed rule on small businesses, the compliance burdens imposed and any significant alternatives that could minimize any significant economic impacts. *Id.* at § 603(a)-(c).

²⁵ The FRFA must describe the small entities that will be affected, the impact of the proposed rule on small entities, the compliance burdens imposed, the significant issues raised in public comments in response to the IRFA, any comments by the Chief Counsel for Advocacy on the proposed rule, and any changes the agency made to the rule in response to the Chief Counsel’s comments. *Id.* at § 604(a)(1)-(5). It also must describe the steps an agency has taken to minimize the significant economic impact on small entities and why each alternative that would lessen the economic impact was rejected. *Id.* at § 604(a)(6).

²⁶ The Chief Counsel for Advocacy is responsible for monitoring agency compliance with the RFA. 5 U.S.C. § 612. While the IRFA did provide an assessment of the effects of the proposed rule for small businesses, the Chief Counsel for Advocacy raised concerns that the DOL’s analysis relied on numerous unsupported assumptions, lacked detailed industry information although it was available, did not analyze the number of affected small non-profits and small governmental jurisdictions, appeared to underestimate the costs of compliance for small employers, and did not analyze any regulatory alternatives that would minimize the significant economic impact on small entities. Letter from Claudia Rodgers, Acting Chief Counsel for Advocacy, SBA, and Janis Reyes, Assistant Chief Counsel, Office of Advocacy, SBA, to the Hon. Thomas E. Perez, Secretary, DOL, and the Hon. David Weil, Administrator, Wage and Hour Division, DOL 3-7 (Sept. 4, 2015), <https://www.sba.gov/advocacy/942015-defining-and-delimiting-exemptions-executive-administrative-professional-outside>.

²⁷ If all employees at the establishment are affected, the DOL estimated that 210,800 small establishments (165,700 small businesses, 26,400 small non-profits, and 1,300 small governmental jurisdictions) will be affected. If the rule change only affects one employee at an establishment, 1.6 million small establishments (1.3 million small businesses, 216,200 small non-profits, and 44,500 small governmental jurisdictions) will be affected. Final Rule, 81 Fed. Reg. at 32,534.

²⁸ *Id.*

²⁹ *Id.* at 32,539 (Table 42) and 32,541 (Table 43). DOL’s analysis notes that Tables 42 and 43 are not directly comparable because Table 42 compares costs and payroll increases to payroll and revenue per establishment, whereas Table 43 considers costs and payroll increases relative to profits. *Id.* at 32,540. The DOL does not provide an estimate of total compliance costs including wages for establishments where only one employee is affected.

³⁰ *Id.* at 32,539.

affected establishments will incur \$629.3 million in year four, \$749.3 million in year seven, and \$901.8 million in year 10.³¹ While there are no new recordkeeping requirements, small employers will need to keep records for newly nonexempt workers as well as all other exempt employees.³²

The FRFA also discusses alternatives that were adopted to minimize the significant economic impact on small entities including: setting the salary level at a lower level than initially proposed; establishing a mechanism to update the salary levels every three years instead of every year as initially proposed; allowing employers for the first time to count non-discretionary bonuses, incentives and commissions toward up to 10 percent of the required salary level; and providing more time, 180 days, for employers to comply with the rule than initially proposed.³³ Although DOL did make some modifications to the final rule, the alternatives it selected may not provide a meaningful burden reduction for small employers nor ameliorate the negative effects on employees.

IV. The Effects of the Final Rule on Small Employers and their Employees

A small employer's compliance costs will vary, but could be substantial, depending upon the number of exempt workers it currently employs, the salaries it currently pays, and whether it uses commissions, equity holdings, bonuses, or profit sharing to compensate employees. The effects on small non-profits and small governmental jurisdictions could be particularly acute because of budget limitations. Concerns have been raised that there may be service cuts, staff reductions, and even nonprofit closings.³⁴ Non-profits rely on grants that often have project specific requirements that there will be adequate staff to carry out the tasks but cannot be used to pay salaries.³⁵ The National Association of Counties (NACO) has raised concerns that there will be a significant impact on counties, particularly rural counties. Most counties must operate on a balanced budget and 43 states limit the ability of counties to increase property taxes.³⁶ All types of small employers may find that the non-financial effects of the final rule – such as shifting salaried workers to hourly status, reducing flexibility and benefits, and requiring employees to clock in and out – will have far greater negative repercussions than the compliance costs.

Although the final salary level is lower than the level initially proposed (\$47,476 instead of \$50,440), it is still a significant increase from the prior salary level of \$23,660.³⁷ The over 100 percent increase in the salary level may pose a significant challenge for small rural employers because gross revenues and salaries in rural areas are far less than those in urban areas.³⁸

³¹ *Id.* at 32,542.

³² *Id.* at 32,544.

³³ *Id.* at 32,544-45. In addition, DOL notes that it did not make any changes to the duties test due to comments submitted by small employers. *Id.* at 32,545.

³⁴ Martin Levine and Ruth McCambridge, *Nonprofit Reaction to New Overtime Rules Run the Gamut*, NONPROFIT QUARTERLY, May 24, 2016, <https://nonprofitquarterly.org/2016/05/24/unhappy-paradox-nonprofit-reactions-new-overtime-rules/>.

³⁵ *Id.*

³⁶ Letter from Matthew D. Chase, Executive Director, National Association of Counties, to Mary Zeigler, Wage and Hour Division, DOL, 2 (Aug. 31, 2015), <https://www.regulations.gov/document?D=WHD-2015-0001-2898>.

³⁷ The reduction in salary level from the proposed to the final rule may not be significant due to the fact that the South Census Region includes a large number of states, several of which are Mid-Atlantic states that may have higher average salaries due to the heavy presence of the federal government.

³⁸ Letter from Amanda Austin, Vice President, Public Policy, National Federation of Independent Business, to Wage and Hour Division, DOL, 4-5 (Sept. 3, 2015), <http://www.regulations.gov/#!documentDetail;D=WHD-2015-0001-4142>. A salaried employee in Washington, D.C. currently making \$55,000 annually has the same purchasing power as a similarly employed individual in Enid, Oklahoma earning \$37,121. *Id.* at 5.

Under the final rule, small employers will face uncertainty and have no opportunity to provide public input since DOL will automatically update the salary level every three years. This is likely to result in instability in labor and administrative costs for small businesses in perpetuity.³⁹ Small firms will need to regularly review the effect the automatic increases have on salary compression, merit increases, and budgets.⁴⁰ Furthermore, the automatic increases may subject employers to civil suits under FLSA for inadvertent violations.⁴¹

In addition, concerns have been raised that the final rule will have other repercussions that will negatively affect employers and employees. In the public comments that DOL received, concerns were expressed that there could be: reduced scheduling flexibility; reclassification of employees from salaried to hourly status; loss of earnings predictability; reduced training and advancement opportunities; reduced productivity; negative impacts on the ability of local governments to provide public services; increased prices that will be passed onto consumers; and substitution of part-time jobs in place of full-time jobs.⁴²

If small employers cannot afford to increase previously exempt employees' salaries to the new salary level, they may have no choice but reclassify employees. Because having a salaried position often comes with additional flexibility, increased benefits such as paid vacation and health care, and other perks, being reclassified is likely to be considered a demotion which will negatively affect employee morale. Small employers that compensate their employees through a combination of base salaries as well as commissions, equity in the firm, or a share of the profits – mainly technology start-ups – may be particularly negatively impact.

Because technology start-ups often do not have enough funds early in their operations, they may pay a lower base salary but also provide employees with equity in the firm. This compensation model also provides employees with an incentive to increase productivity because they stand to directly benefit if the company is successful.⁴³ There could be significant negative consequences for technology start-ups due to the overtime rule. If they do not have the funding to increase base salaries, they will have to shift to an hourly compensation model. One study has found that the overtime rule will cost the technology start-up industry between \$317 million to \$4.5 billion in compliance costs to adjust to the new overtime rule, drastically alter start-ups, and have a negative impact on the technology sector.⁴⁴

V. Conclusion

The DOL's overtime rule is a major change from existing regulations. The over 100 percent salary threshold increase is a significant hike, one that is likely to pose a considerable challenge for small businesses with thin margins, as well as small non-profits and small governmental jurisdictions with budgetary restrictions. However, the most damaging repercussions are likely to result from the loss of employee morale as employees are shifted from salaried positions to hourly status, benefits are reduced, flexible work options are limited, and opportunities for career advancement are decreased by this costly new mandate.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ This may be one reason Congress required DOL to promulgate FLSA changes to EAP status through the rulemaking procedures of the Administrative Procedure Act.

⁴² Final Rule, 81 Fed. Reg. at 32,481.

⁴³ Donald L. Boudreaux and Liya Palagrashvili, MERCATUS CENTER, GEORGE MASON UNIVERSITY, AN ECONOMIC ANALYSIS OF OVERTIME PAY REGULATIONS 40-41 (2016), <http://mercatus.org/sites/default/files/Boudreaux-Overtime-Pay-Regs-v2.pdf>.

⁴⁴ *Id.* at 43-44.