



Calculating Employee Compensation

Best Practices to Assure Regulatory Compliance

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Introduction

How savvy is your organization about calculating employee compensation? Let's face it: the Fair Labor Standards Act (FLSA) is complex, with plenty of gray areas for misinterpretation and confusion. The Department of Labor (DOL) website (www.DOL.gov) is an excellent online support tool for HR professionals, but the sheer enormity of relevant information can be daunting.

Even employers with the best of intentions can find it difficult to ensure FLSA compliance, and today there is no room for error. A single compensation mistake can trigger an employee dispute, a claim of unfair labor practices, DOL investigation, litigation and/or penalties. The potential damage to employee morale and productivity, as well as your organization's reputation and finances, is enormous.

In 2011, the DOL Wage and Hour Division stepped up audit and enforcement initiatives to assess employer compliance with labor laws, using litigation and financial penalties to ensure accountability and deter future violations. The number of FLSA-related cases filed in federal court has increased significantly year over year.

This much is clear: attention to compensation and payroll practices is vital to your organization's well-being. This HR Access white paper¹ — from a series focusing on FLSA compliance — clarifies several of the most troublesome compensation gray areas, and offers HR professionals some insight and advice about preparing for an audit.

Calculating Regular Rate of Pay the DOL Way

Every employer's first obligation to a new employee is to calculate the individual's regular rate of pay. Easy, right? Simply start with the hourly wage you promised the employee for the position, or take the employee's annual wages and divide by 2080 hours.

Er, not so fast. While it is true an employee can have identical regular and hourly pay, the regular rate of pay is used to calculate overtime. If this seems unclear, fear not. The DOL has published a definition, which says: The regular rate is determined by adding together the employee's pay for the workweek and all other earnings and dividing the total by the number of hours the employee worked in that week.²

Formula for Calculating Regular Rate of Pay	
Employee's Pay + Earnings = Total Regular Pay	Regular
----- >	Rate of
Total Number of Hours Employee Worked	Pay

Source: U.S. Department of Labor

This fundamental distinction is very important. Many organizations have production bonuses or other types of incentive earnings that must be added to the total hours worked. The total regular pay — including wages and other earnings — divided by the total number of hours worked derives a new rate, the regular rate of pay.

The FLSA requires all employee remuneration — earnings above and beyond the paid-for hours of work — to be used in calculating the regular rate of pay unless covered by a statutory exemption. Examples of these other forms of compensation include certain gifts, vacations or employee benefit plan contributions, shift differentials, production bonuses or prizes, commissions, reimbursement for education, and tip credits.

There also are formulas in the FLSA for determining overtime for workers who are paid by the delivery, on a commission basis, on a day rate, or any other form of not-strictly-hourly compensation. It is the employer's responsibility to figure out the regular rate for the worker and then calculate the overtime.

Calculating Bonuses and Other Compensation

Many organizations may have some type of employee bonus, perhaps attendance or production bonuses. Organizations need to know which types of bonuses must be used in calculating overtime pay for non-exempt workers.

The DOL has two criteria for bonus payments. They are considered either **discretionary** or **nondiscretionary**. The difference is unambiguous. Discretionary bonus payments are not planned; nondiscretionary bonuses are planned.

Employers must use the formulas in the FLSA for determining overtime for workers who are paid by the delivery, on a commission basis, or at a day rate.

FLSA Rules Are Concrete

A DOL Wage and Hour Division investigation of the largest cement and ready-mix concrete company in the U.S. disclosed systemic overtime violations. These resulted from the employer's failure to pay employees overtime wages for hours worked beyond 40 in a workweek. Investigators found the same violation occurred in eight states.

The cement company paid its drivers by the number of deliveries they made. The company believed the employees would receive a higher compensation under the system compared to an hourly wage. The company also said the pay-per-load system was common practice in the industry.

A settlement reached in December 2010 required the company to pay \$1.5 million in overtime back wages to 1,705 current and former ready-mix drivers. The company also was ordered to comply with the FLSA in the future or risk being found in contempt.³

Your organization, for example, may have a successful year financially and decides to share some of the prosperity with employees by way of a special cash payment — not planned, not expected, and at the employer’s sole discretion. Such a bonus is discretionary and exempt from overtime calculation.

With nondiscretionary bonuses, however, there is some type of employer commitment. The bonus could be part of a contractual agreement. Or there may be a past practice for a bonus, so employees have expectations for another one in the future.

Perhaps the organization offers a bonus when employees attain a baseline goal for quality, or a production threshold. Employees are aware of criteria for earning the bonus well in advance. These types of bonuses are considered nondiscretionary. They must be included in the regular rate of pay calculation because they are eligible for the overtime premium.

Applying a Bonus Retroactively

Employers can choose to allocate a bonus over a period of time. Perhaps the employee earned a bonus for attaining quality goals for a set number of hours during a week, month or quarter.

The bonus payment can be allocated to the hours it represents. Using the regular rate of pay to calculate what the premium amount would be, the employer can apply it to any overtime hours worked in that pay period.

Bonus Allocation Methodology (using sample wages)

Production bonus = \$200 for month
Working 45 hours each week (4 weeks)

- $\$200 / 4 \text{ weeks}, \$50 / 45 \text{ hours}$
- $\$1.11 / \text{hour}$
- **OT Premium Rate = .56**
- $[\.56 \times 5 \text{ (OT Hours)} = \$2.80]$
- $\$2.80 \times 4 \text{ weeks} = \$11.20 \text{ additional overtime for the month}$

Employers usually pay bonuses at the end of a month or quarter for a previous period of time worked. Understanding how to apply a bonus retroactively can be tricky. Consider the example in the preceding chart.

An employer intends to pay a production bonus of \$200 for work done over a four-week period. The employee worked 45 hours each week. To determine the overtime, the employer divides the \$200 by the four weeks, or \$50 a week, then divides the \$50 by the 45 hours worked during the week, to arrive at a new premium rate for overtime of \$1.11 an hour.

Because overtime is just half of that premium rate, the rate is 56 cents. The employer multiplies the 56 cents by five overtime hours, then by four weeks to arrive at \$11.20 owed the employee in overtime compensation for the month.

The employer must pay overtime as soon as possible — ideally, the next pay period — when a worker is due a nondiscretionary bonus.

Employees are becoming more aware of compliance and what they should be paid. Disputes over minimal amounts of money can end up costing employers large sums in legal fees.

Workers know their rights and entitlements, and may be quick to complain about late pay. Under the FLSA, “late pay” is the same as “no pay.”

When to Include Non-Productive Time

A commonly misunderstood part of calculating regular rate of pay is when to include non-productive time in the equation. Non-productive is defined as paid time not worked. Examples include vacation, holidays, sick time and idle work time. A full list of these statutory exemptions is available at <http://www.dol.gov/elaws/esa/flsa/otcalc/docstatexc.asp>.

Under the FLSA, it is not mandatory to include non-productive time in regular rate of pay calculations. Rather, it is the employer's option to include this time in the total time worked for overtime calculations.

The key is to be consistent. Treat the entire workforce equally and have guidelines or policies in writing so employees understand them. They need to know if they work more than 40 hours in a week and some of that is vacation time, they may not receive any overtime because the organization does not include non-productive time toward overtime calculations.

Also, organizations need to be aware of state and local regulations that may require the inclusion of certain nonproductive time — a holiday, perhaps — in overtime calculations.

Compensatory Time versus Overtime

There is another gray area — where employers give compensatory time in lieu of cash for overtime hours accrued, believing it is okay to allow an employee who has worked overtime to take the time off in a future week or pay period. This practice is a violation of the FLSA.

The DOL has very clear and rigid rules on how compensatory time for non-exempt employees can be applied. It differs by public and private sectors.

“Compensatory time off (comp time) is paid time off the job that is earned and accrued by an employee instead of immediate cash payment for working overtime hours. The use of comp time instead of overtime is limited by Section 7(o) of the FLSA to a public agency that is a state, a political subdivision of a state, or an interstate governmental agency.”⁴

Compensatory time off in lieu of cash for overtime work is not permitted in private sector employment.

Some organizations may provide both compensatory time and overtime, but compensatory does not take the place of cash payment for overtime.

Employers need to check rules for compensatory time in the states in which they operate. Although in most situations federal law controls, the FLSA says, “If there is a discrepancy between the two, do what is better for the employee.”

Overtime Was Underpaid

A Texas company ran into legal trouble when it played games with an employee's pay rate in order to limit its overtime liability.

The case involved a skilled aircraft painter who was hired at \$5.50 per hour for “straight time” and a per diem of \$12.50 per hour, up to a maximum of 40 hours a week. When he worked more than 40 hours, the employer paid him an overtime rate of \$20.

Eventually the worker sued his employer, claiming he was actually owed \$27 an hour for overtime, not \$20. The Fifth Circuit Court of Appeals upheld a lower court ruling stating the company should have included the per diem payments when calculating the worker's regular rate of pay.

The court awarded the worker more than \$4,000 in overtime pay, doubled because of the employer's willful violation of the law, plus \$56,000 in attorney fees.

Alternative Overtime Arrangements

As with most rules, there are exceptions. The FLSA overtime exceptions include:

The Belo Plan – This plan permits a fixed payment when the employee’s duties necessitate irregular work hours and the total wages would vary widely from week to week if computed on an hourly rate basis. An organization’s application of the Belo Plan must be pre-approved by the DOL Wage and Hour Division.

Time Off Plans – The FLSA does not require payment for time not worked, such as vacations, sick leave or holidays. Paid time off plans are a matter of agreement between employer and employee.

Pre-Payment Plans – The basic principle of the pre-payment plan calls for the employer to pay an employee in advance of the anticipated overtime compensation. This arrangement requires written approval from the DOL Wage and Hour Division.

Government Worker Exception – Unless otherwise stipulated, government workers can receive compensation time in any week during the year.

Calculating Imputed Income

Imputed income is a term the Internal Revenue Service (IRS) uses to assign value to employee benefits that should be taxed as income. The IRS is looking for revenue wherever it can find it; imputed income is an area that always seems to generate controversy.

Every cash-related item is taxable, regardless of its value. When an employer hands out \$5 gift cards for the local coffee shop, workers may not see these as overly generous gifts, especially when they learn they are taxable and must be reported on the workers’ income tax forms.

The organization might give an employee a nice prize, a smartphone, say, for attendance or reaching a sales target. The gift is taxable and its value needs to be added to the individual’s income and reported on a W-2. Speaking of phones, the IRS may add personal use of business-issued cell phones to the fringe benefits list.

Imputed Income Examples

- Gifts, Prizes and Awards
- Group-Term Life (>\$50,000)
- Moving Expenses
- Fringe Benefits
- Company Car or Aircraft (personal use)

Among high-value imputed income items are: group-term life insurance over \$50,000, moving expenses, personal use of a company car or aircraft, and club memberships. Perhaps the employer provides tax preparation services for executives. All of these and many more fringe benefits are taxable and must be reported to the IRS.

The FLSA provides minimum standards that may be exceeded, but cannot be waived or reduced by state laws.

There are different ways an employer can withhold the taxes on imputed income. They can be generous and make the payments on behalf of the employees, or they can ask the employees to take on that responsibility.

For tax-withholding purposes, the employer may gross it up, which is the practice of reimbursing a worker for the taxes paid on the imputed income. Or, the organization could ask the employee to contribute on his/her own behalf, with the value added to the employee's income during a normal pay period. This method, commonly used for cash gifts and non-cash benefits, will increase the employee's taxable earnings and tax withholdings for that pay check.

Imputed income is another one of those difficult-to-understand areas of compensation. There is help, however, in IRS Publication 15-B, "The Employer's Guide to Fringe Benefits" (www.irs.gov/pub/irs-pdf/p15b.pdf). This is an excellent tool for helping organizations manage taxable compensation to employees.⁵



The guide includes a General Valuation Rule employers can use to determine the fair market value of most fringe benefits. This tool is invaluable to HR professionals who invariably are asked which fringe benefits are taxable and how are their values determined. A wise employer will keep it handy.

Best Practices for Identifying Taxable Benefits

HR professionals in organizations of every size and type know how hard it is to keep up-to-date with IRS rules. However, even smaller organizations with limited time and resources can follow these baseline best practices for identifying taxable benefits.

1. Develop guidelines of compensation and taxable fringe benefits for your organization.
2. Communicate guidelines to managers and supervisors who many times are the ones purchasing gift cards and approving expenses.
3. Include guidelines in training sessions. Inform management and new hires about the need to report gifts to their HR payroll department for inclusion in their W-2s.
4. Review accounts payable activity, especially at year end. Many of these taxable items show up on an expense report or an invoice. Make sure individuals who received the awards understand their tax obligations.
5. Build a solid year-end project plan with tasks and activities that address and review a full menu of compensation and benefits, including taxable fringe benefits.

IRS Publication 15-B lists fringe benefit exclusion rules. These rules exclude all or part of the value of certain benefits, such as contributions to an accident or health plan, from the employee's pay. The excluded benefits are not subject to federal income tax withholding.

DOL Has an App for That

The DOL has launched its first smartphone application, a timesheet to help employees independently track the hours they work and determine the wages due them.

Available in English and Spanish, users can track regular work hours, break time and any overtime hours for one or more employers. Glossary, contact information and materials about wage laws are accessible easily through links to the Web pages of the department's Wage and Hour Division.

In announcing the application, the DOL said "this new technology is significant because, instead of relying on their employers' records, workers now can keep their own records. This information could prove invaluable during a Wage and Hour Division investigation when an employer has failed to maintain accurate employment records."⁶

Watch For a DOL Audit Coming Your Way

The DOL Wage and Hour Division's mission is to "promote and achieve compliance with labor standards to protect and enhance the welfare of the Nation's workforce." By all accounts, the agency is doing a very good job.

The Wage and Hour Division recovered more than \$185 million in back wages for over 228,000 employees in fiscal year 2008 to put the eight-year cumulative total of back wages collected by the agency at over \$1.4 billion. These cumulative statistics, the latest published on the Division's website, illustrate its past enforcement success.⁷

Now the agency is looking to improve its record. In 2011, the WHD hired approximately 100 additional auditing personnel. These increases will result in an estimated 4,700 more inspections. The division has proposed adding more investigators in 2012

Included in these types of inspections are reviews of payroll records and interviews with employees to assess employer compliance with the FLSA. Among its other strategies are penalty assessments to increase the cost of non-compliance, and coordination with local agencies and criminal enforcement authorities to combat willful violations.

This is not a cautionary tale. It is today's reality. The number of FLSA-related class actions has skyrocketed as private organizations and law firms specializing in labor law seek certain types of workers from different employers, and bring them together in federal court as a collective plaintiff.

HR Access has assembled a list of the Top 10 Watch Areas where the Wage and Hour Division is focusing the most attention when performing an audit, and where litigation has been rising over the past two years.

The daily challenge for every organization is to ensure workplace policies and record keeping are in good shape and prepared for an audit. Compliance, after all, is a fashion always in style.

Useful Links for Calculating Employee Compensation

Department of Labor:

<http://www.dol.gov/elaws/esa/flsa/screen75.asp>

<http://www.flsa.com/overtime.html>

Internal Revenue Service:

www.irs.gov/pub/irs-pdf/p15b.pdf

American Payroll Association

<http://www.americanpayroll.org/>

Top 10 Audit Watch Areas

10. Control Framework

9. W-4

8. Tax Withholdings

7. Taxable Earnings

6. Off-the-Clock Work Time

5. Rest and Meal Breaks

4. Time Worked

3. Overtime Calculations

2. Exempt vs. Non-Exempt Classification

1. Independent Contractor vs. Employee

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1 McAndrews, C. & Obertin, L. (2011). Calculating Employee Compensation - The Correct Way [PowerPoint slides in pdf]. Retrieved from <http://www.hraccessnorthamerica.com/resources/webinars/>

2 U.S. Courts (2010, May 27). U.S. Court of Appeals for the Fifth Circuit, Document: 00511124146 [electronic document in pdf]. Retrieved from <http://www.ca5.uscourts.gov/opinions/pub/09/09-20098-CV0.wpd.pdf>

3 U.S. Department of Labor Wage and Hour Division (2010, December 30). US Labor Department resolves back wage case against Houston-based CEMEX. Retrieved from <http://www.dol.gov/whd/media/press/Southwest/>

4 U.S. Department of Labor Office of Compliance Assistance Policy (2011). Compensatory Time Off. Retrieved from <http://www.dol.gov/elaws/esa/flsa/otcalc/glossary.asp?p=compensatory%20time%20off>

5 U.S. Department of Treasury Internal Revenue Service (2011). Publication 15-B Employer's Tax Guide to Fringe Benefits. Retrieved from <http://www.irs.gov/pub/irs-pdf/p15b.pdf>

6 Ibid. 2 (2011, May 9). Keeping track of wages: The US Labor Department has an app for that! Retrieved from <http://www.dol.gov/whd/media/press/national.htm>

7 Ibid. 2 (2008, December) Wage and Hour Collects Over \$1.4 billion in Back Wages for Over 2 Million Employees Since Fiscal Year 2001. Retrieved from <http://www.dol.gov/whd/statistics/2008FiscalYear.pdf>

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