



Reclassifying Employees to Non-Exempt Status? Consider a “Percentage Bonus” to Avoid Costly Overtime Pay Mistakes

Insights

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Many employers are planning to reclassify employees to non-exempt status now that the Labor Department is significantly raising the salary threshold for employees to be exempt from overtime pay. You likely know that non-exempt employees must be paid 1.5 times their regular rate of pay for hours worked beyond 40 in a workweek. But did you know that most bonuses have to be included in the regular rate? While these calculations can be confusing and administratively burdensome – especially when a bonus is paid for a month, quarter, or year – there’s a little-known solution that can make things easier. Here’s what you need to know about the “percentage bonus” alternative, which allows you to pay a bonus without having to worry about additional overtime pay.

Big Changes Will Impact Employee Classification

If you pay non-exempt employees bonuses, now is a good time to review your compliance obligations for paying overtime premiums, particularly as the DOL’s new rules for exempt employees take effect and you may have more non-exempt staff. Consider the following:

- **New Salary Threshold:** Millions of additional workers are now – or will soon be – eligible for overtime pay thanks to the U.S. Department of Labor’s (DOL’s) new salary threshold for the Fair Labor Standards Act’s (FLSA’s) so-called “white-collar” exemptions. The salary threshold rose from \$35K to about \$44K on July 1 and will jump to nearly \$59k at the start of 2025 – which means your workers will need to earn at least this new threshold to even be considered exempt from OT pay under the white-collar exemptions.
- **Budget Considerations:** If you’re finding the new salary threshold to be cost prohibitive, you’re probably deciding whether it makes sense to reclassify employees to non-exempt rather than raise their salary to meet the new threshold. [You can read more about the new rule and tips to work through your decision tree here.](#)
- **Regular Rate of Pay:** If you ultimately decide to convert employees to non-exempt, you’ll need to pay them overtime premiums based on their “regular rate of pay.” What exactly does that mean? 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. You can read more about the regular rate [here](#).

- **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. Indeed, 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.
- **Complicated Calculations:** If the employer fails to take bonus payments into account for FLSA overtime purposes, then the worker has probably received less than the FLSA-required wages. But it's not always easy to calculate the regular rate of pay, particularly when bonuses cover large periods of time. That's where the "percentage bonus" alternative comes into play. Keep reading for more about this option.

Certain Bonuses Can Include Overtime Pay

You can avoid complicated calculations by designing a bonus payment that is computed as a predetermined percentage of an employee's total straight-time and overtime pay for the period over which the bonus was earned. Notably, however, if the overtime pay is not included, this option will not work.

- **The Details:** A plan could provide, for example, that employees who hit a certain production goal in a four-week period will receive 2% of their total straight time and overtime wages for that period. Critically, percentages must be predetermined and cannot subsequently vary downward or upward in response to increases or decreases in hours worked. The plan also may not produce a fixed or set bonus sum that doesn't vary as the employee's overtime hours and pay fluctuate. So, for example, it would not be acceptable for an employer to decide at the end of a bonus period to back into a percentage that equals the sum the employer wanted to pay. This would not be a predetermined percentage and would run afoul of the law.
- **Here's an Example:** Assume that an employee earns a 5% bonus for above-standards performance during a measuring period of four complete workweeks. Assume also that their total straight-time and overtime wages for that period come to (\$2,400 ST + \$900 OT) = \$3,300. Their resulting bonus of \$165 (5% × \$3,300) includes the requisite FLSA overtime premium, so it's not necessary to pay more.

The DOL recognizes that a properly structured percentage bonus of this kind is already weighted in correct proportion to the employee's straight-time and overtime hours worked and corresponding wages paid.

Percentage-Based Pool Shares

A variation can be used to distribute shares of a fixed bonus pool to each participating non-exempt employee. This involves dividing the total straight-time and overtime wages of all of the participating non-exempt employees into the total bonus pool to be distributed to them. Each participating

employee is then paid a sum equal to the resulting percentage multiplied by their total straight-time and overtime wages for the bonus period.

Assume, for instance, that a \$500,000 annual-bonus pool is established for non-exempt participants whose straight-time and overtime compensation paid for the year equals exactly \$10,000,000.

Assume also that a particular employee's straight-time and overtime wages for the bonus year total exactly \$45,000. This participant's payment would be:

- $(\$500,000 \text{ Pool}) \div (\$10,000,000 \text{ Total Wages}) = 5\% \text{ Proportion}$
- $(5\% \times \$45,000 \text{ Participant's Total Wages}) = \$2,250 \text{ Bonus}$

An alternative would be to divide the total straight-time and overtime wages of each non-exempt participant by the total straight-time and overtime wages of all non-exempt participants. A participant then receives a payment equal to his or her percentage so computed multiplied times the bonus pool. The calculation for the hypothetical employee above would be:

- $(\$45,000 \text{ Total Wages}) \div (\$10,000,000 \text{ Total Wages}) = .45\% \text{ Allocation}$
- $(.45\% \times \$500,000 \text{ Pool}) = \$2,250 \text{ Pool Share}$

The Bottom Line

If you decide that one of these percentage-based approaches is a good way for your organization to address the FLSA overtime ramifications of bonuses, you should also ensure your plan is properly conceived, designed, and maintained. For one thing, the DOL says that the method may be used only for true bonuses:

The term “bonus” is properly applied to a sum which is paid as an addition to total wages, usually because of extra effort of one kind or another, or as a reward for loyal service or as a gift. The term is improperly applied if it is used to designate a portion of regular wages which the employee is entitled to receive under his regular wage contract.

In addition, you should evaluate where this type of plan complies with applicable state and local requirements and ensure these bonuses are accurately and clearly explained to employees.

Conclusion

Fisher Phillips will continue to monitor this area and provide updates as needed. Make sure to subscribed to [Fisher Phillips' Insight System](#) to gather the most up-to-date information. If you have questions, please contact your Fisher Phillips attorney, the author of this Insight, or any attorney in our [Wage and Hour Practice Group](#).

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