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LEGAL INSIGHT

When Must You Include a Bonus in Calculating Your Employee's Overtime Pay?

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Bonuses come in all sizes and forms. They can be used to motivate future performance, reward past performance or company success, or simply serve as a gift at the holidays or other occasion. Depending on the circumstances, a bonus may have to be included in the employee's overtime rate. If not handled properly, this can expose your company to liability for unpaid overtime under the Fair Labor Standards Act and state wage and hour laws.

In general, the Fair Labor Standards Act ("FLSA") requires that all non-exempt employees (i.e. those who do not fit into one of the FLSA's defined exemptions), be paid overtime at time and a half of their "regular rate" for all hours worked over 40 in a workweek. The regular rate is the rate at which overtime is calculated, and includes more than just your employee's normal salary or hourly rate. Subject to a few exclusions, the "regular rate" encompasses all compensation provided to the employee as part of his employment.

With respect to bonuses, a good rule of thumb is that any bonus given to your employees as a means of inducing superior performance, productivity, attendance, or quality (to name a few), must be included in the regular rate. As with any rule, however, it comes with some exceptions - three of which are worthy of specific mention:

- **Gift / Holiday Bonus** - The FLSA provides that bonuses given as gifts, such as at the holidays, may be excluded from the regular rate as long as the amount of the bonus is not dependent on hours worked, production, or efficiency. In other words, it should not serve as a motivator for increased or more efficient performance. In addition, a gift bonus may not be so significant that your employees consider it part of their wages rather than a gift. Notably, you may give holiday bonuses on a regular basis such that your employees have an expectation of receiving a bonus without losing its excludable status.

- **Discretionary Bonus** - Discretionary bonuses provide a mechanism for rewarding performance, attendance, quality, productivity, etc. without increasing the employee's regular rate. To maintain discretionary status, (i) the fact that the bonus will be awarded, and (ii) the calculation or amount of the award must be determined at the sole discretion of the employer and not announced to employees until at or near the end of the period for which the bonus is given. In other words, it cannot be announced or known in advance such that it serves as a motivator for superior performance. Accordingly, if you give a discretionary bonus on such a regular basis that your employee has an expectation of receiving it, you risk the bonus losing its excludable status. Of course, if your employees have a right to the bonus, whether through promise, contract, or agreement, the bonus is not discretionary, and in such a case must be included in the regular rate. There are no restrictions on how you may calculate a discretionary bonus; thus, you may base it on the achievement of corporate goals, or, at the individual level, an employee's productivity or hours worked.

- **Percentage of Total Earnings Bonus** - In contrast to the gift and discretionary bonuses, which are excludable from the regular rate, a percentage of total earnings bonus incorporates the overtime into the bonus itself. By calculating the bonus on total earnings during the specified timeframe, which includes overtime pay for that time frame, the overtime component is built into the bonus, so no additional overtime is required.

Once you've determined that a bonus qualifies as includable wages, how do you handle the overtime calculations? First you must identify the time frame over which the bonus was earned. This will vary depending on the circumstances and may be a single week, month, quarter, or other timeframe. Once the timeframe is defined, you must apportion the bonus between the workweeks within that timeframe. The two most typical methods are to apportion the bonus based on workweeks (e.g., divide a quarterly bonus equally among the 13 weeks in the quarter), or apportion it based on hours worked during the timeframe (e.g., divide a two-week bonus between the two weeks based on the ratio of hours worked each week). In most cases, the proper method of apportionment will involve an equal distribution of the bonus based on hours, weeks, or some other objective factor. Where that is not possible, you may apportion the bonus in another way so long as the mechanism is reasonable and equitable under the circumstances.

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For each week in which a portion of the bonus is added, the regular rate is increased and additional overtime compensation may be due. If the employee didn't work more than 40 hours in that week, then no overtime is required. If the employee worked more than 40 hours, however, then the employee's regular rate must be recalculated to include the bonus, and you must make up any deficit between the overtime previously paid and what is due based on the higher regular rate.

Understanding ahead of time whether a bonus is excludable is critical to accurately valuing the overall cost of the bonus to your company. To the extent your non-exempt employees are working significant amounts of overtime, the award of a non-excludable bonus will require the additional payment of overtime for the weeks covered by the bonus. If this additional overtime is not calculated and factored into the overall cost of the bonus, you could be faced with potentially significant unexpected overtime liability.

For Further Information

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