Are You Paying Your Employees By Commission?

Watch Out for Hidden Traps

By John D. Shyer and Nicole R. Vanderlaan Smith

Many retail and service employers try to simplify their payroll obligations by labeling certain employees as “commission” or “commission only.” While federal law permits this practice in some circumstances, the rules are complicated and present many traps for the unwary. We discuss some of these potential pitfalls below, but the bottom line is simple: Employers should approach this practice with caution and must be prepared to substantiate the applicability of the exemption to each employee.

The federal Fair Labor Standards Act (FLSA) requires covered employers to pay employees overtime if they work more than 40 hours in a week, unless the employee falls into a specified exemption. One such exemption is for the commissioned salesperson (not to be confused with the outside salesperson). Where it applies, employers need not pay overtime compensation. The exemption applies to: 1) commissioned employees of retail or service establishments, 2) whose regular rate of pay is over 1.5 times the minimum wage for every hour worked in a workweek in which overtime hours are worked, 3) where over half the employee’s compensation for a representative period represents commissions on goods or services. 29 U.S.C. § 207(i) (Section 7(i)). Unless all three requirements are met or another exemption applies, overtime pay must be paid for all hours worked over 40 in a workweek at time and a half the regular rate of pay. Because the regular rate of pay for these employees includes commissions, overtime may be costly.

Employers should be comfortable that they will be considered a “retail or service establishment” before applying the exemption to any of their employees.

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Rationale Behind The Exemption

As one court explained, the purpose of this exemption is to address inequities that can arise in paying overtime to commissioned employees. “Service specialists, who are paid on a commission basis and are able to set their own schedules, can work fewer hours in one week and more in the next. If they received overtime, employees could compress their hours into one week (e.g., work 60 hours) to obtain overtime pay, and then coast during the next week (e.g., work 10 hours). By doing so, employees would end up working fewer hours than a regular employee working two forty hour work weeks, but yet earn more.” English v. Ecolab, Inc., 2008 U.S. Dist LEXIS 25862, at *52-53 (S.D.N.Y. Mar. 28, 2008).

The Exemption Only Applies to Employees of Retail or Service Establishments

Employers should be comfortable that they will be considered a “retail or service establishment” before applying the exemption to any of their employees. The Regulations define “retail or service establishments” as those “75 [percent] of whose annual dollar volume of sales of goods or services (or both) is not for resale and is recognized as retail sales or services in the particular industry.” 29 C.F.R. § 779.411. Thus, employers must assess: 1) whether the employee at issue works in an establishment; and 2) whether the establishment is retail.
or service in nature, including that 75% of its annual dollar volume of sales of goods or services are not for resale.

**Establishment**

The Regulations define an “establishment” as “a ‘distinct, physical place of business’ rather than ‘entire business or enterprise’ which may include several separate places of business.” 29 C.F.R. § 779.23. A U.S. Department of Labor (DOL) fact sheet explains that an employee employed by the central office of a retail chain enterprise as a sales instructor working in various sales establishments does not qualify for the exemption because the “employee is employed by the central office and not by the retail ‘establishment.’” See DOL Wage and Hour Division Fact Sheet #20, available at http://1.usa.gov/1Cxshku (last visited April 15, 2015) (DOL Fact Sheet).

**Retail or Service**

The Regulations explain: “Typically a retail or service establishment is one which sells goods or services to the general public. It serves the everyday needs of the community in which it is located. The retail or service establishment performs a function … which is at the very end of the stream of distribution, disposing in small quantities of the products and skills of such organization and does not take part in the manufacturing process.” 29 C.F.R. § 779.318(a). Covered employees are “generally employed in so-called ‘big ticket’ departments,” examples of which include furniture, bedding, home furnishings, floor covering, major appliances, television, and home custom orders. 29 C.F.R. § 779.318(b). Covered employees are employed by the central office and not by the retail ‘establishment.’” See DOL Wage and Hour Division Fact Sheet #20, available at http://1.usa.gov/1Cxshku (last visited April 15, 2015) (DOL Fact Sheet).

On the other end, the Regulations specifically list as falling outside the scope of the exemption insurance companies, electric power companies, accounting firms, advertising agencies, credit bureaus, airports, banks, painting and plumbing contractors, loan officers, and other specified industries, even when the employees in those companies deal with the public. 29 C.F.R. § 779.317. Thus, while there are guidelines to help determine whether an establishment qualifies as a “retail or service establishment,” each case must be considered on its own facts. 29 C.F.R. § 779.318(b).

**Commissions Must Represent More Than 50% of the Employee’s Compensation for a Representative Period**

In certain cases, making this determination will be easy. “If the employee is paid entirely by commissions, or draws and commissions, or if commissions are always greater than salary or hourly amounts paid, the greater than 50% commissions condition will have been met.” DOL Fact Sheet. However, if only a portion of the employee’s pay comes from commissions, it is the employer’s duty to add up all of the employee’s compensation during the representative period to determine if the commissions exceed the sum of all other compensation paid. *Id.* In this analysis, all compensation “in whatever form or by whatever method paid should be included, whether calculated on a time, piece, incentive or other basis …” 29 C.F.R. § 779.415(a).

In assessing the amount that “represents commissions” for the period, “all earnings resulting from the application of a bona fide commission rate are deemed commissions on goods or services without regard to whether the computed commissions exceed the draw or guarantee.” 29 U.S.C. § 207(i)(2). The Regulations warn, though, that “[a] commission rate is not bona fide if the formula for computing the commissions is such that the employee, in fact, always or almost always earns the same fixed amount of compensation for each workweek (as would be the case where the computed commissions seldom or never equal or exceed the amount of the draw or guarantee).” 29 C.F.R. § 779.416(c). Additionally, “[t]ips paid to service employees by customers are never considered commissions for purposes of this exemption.” DOL Fact Sheet.

**Representative Period**

The representative period cannot be less than one month. The FLSA does not further define a representative period, but the Regulations put the outer limit at one year. 29 C.F.R. § 779.417(c). The guidance on how to choose the proper period between these two extremes is not terribly helpful: It “should be long enough to stabilize the measure of the balance between the portions of the employee’s compensation which respectively represent commissions and other earnings, against purely seasonal or plainly temporary changes.” *Id.*

The representativeness of a period is determined not only by length, but also by recency. The Regulations explain that if the representative period is a month, generally “the most recent month for which necessary computations can be made prior to the payday for the first workweek in the current month should be chosen.” 29 C.F.R. § 779.417(b). If a calendar or fiscal quarter year is representative, “the quarterly period used should ordinarily be the one ending immediately prior to the quarter in which the current workweek falls.” *Id.* If a period longer than a quarter year is representative, “the end of such period should likewise be at least as recent as the end of the quarter year immediately preceding the quarter in which the current workweek falls.” *Id.* Under limited circumstances, such as when the employer cannot compute the
employee’s commission earnings in time, an employer may utilize a one-month “grace period.” 29 C.F.R. § 779.418. However, once the employer has elected this approach, it must apply the same method in future periods. Id.

Due to the complexity of the regulations, which are only summarized here, many employers will need to make ongoing reassessments and recalculation to assure they remain in compliance with the law.

**The Employee’s Regular Rate of Pay for the Workweek Must Be More Than 1.5 Times The Minimum Wage**

Generally, the “regular rate” is “the hourly rate actually paid the employee for the normal, nonovertime workweek for which he is employed” and “must reflect all payments which the parties have agreed shall be received regularly during the workweek, exclusive of overtime payments.” 29 C.F.R. § 779.419(b) (internal citation omitted). If the hourly rate so determined (including commissions) is more than 1.5 times the minimum hourly rate applicable to the employee, this condition has been met. 29 C.F.R. § 779.419(a). Here too, periodic, timely recalculations may be required because the employee’s “regular rate” of pay may vary as a function of the hours worked and the compensation—including commissions—paid. 29 C.F.R. § 779.419(b).

**Employers Must Keep Detailed and Accurate Records**

If the employer does not have accurate records of the hours worked each day and of wages paid, it will not be able to show that all conditions of the exemption have been satisfied. Further, failure to maintain appropriate records may subject the employer to penalties.

The regulations impose special additional record-keeping obligations on employers who have elected to pay employees by commission, including:

- A symbol, letter or other notation placed on the payroll records identifying each employee who is paid pursuant to section 7(i).
- A copy of the agreement or understanding under which section 7(i) is utilized or, if such agreement or understanding is not in writing, a memorandum summarizing its terms including the basis of compensation, the applicable representative period, the date the agreement was entered into and how long it remains in effect. The employer may prepare such agreements or memoranda for an individual employee or a group.
- A record of total compensation paid to each employee each pay period (showing separately the amount of commissions and the amount of noncommission straight-time earnings). 29 C.F.R. § 516.16; see also 29 C.F.R. § 779.420.

**Employers should consider conducting regular wage and hour audits to determine if circumstances for any individual commissioned sales employee or group of such employees have changed.**

**Other Important Considerations**

Employers should evaluate the pay of each commissioned sales employee to determine whether the exemption applies, and should reassess the appropriateness of this determination for each representative period as described above. Employers should be mindful that the exemption may not necessarily apply to all persons within a class. For example, a successful salesperson may generate large commissions and qualify for the exemption, whereas a less successful salesperson may not, because the commissions do not represent over half of his or her pay and/or because his or her regular rate of pay is not 1.5 times the minimum wage for every hour worked. If the employee does not qualify for the exemption, employers should ensure the employee is paid the appropriate overtime rate for all hours over 40 worked in the applicable workweek(s).

Employers should consider conducting regular wage and hour audits to determine if circumstances for any individual commissioned sales employee or group of such employees have changed.

Even if an employer is confident certain of its employees fall within this exemption, it is important to ensure these employees record all of their hours worked so that the employer can substantiate the exemption. Employers also need to ensure that these and all employees’ paystubs reflect the information required by law. Employers will find it difficult to defend claims for unpaid overtime compensation if they do not maintain accurate records.

Not every state has a commissioned salesperson exemption, or one that is identical to the exemption under the FLSA. Thus, employers should consider the laws of the state(s) in which they operate to determine if the state(s) imposes different or additional requirements.

**Conclusion**

The commissioned salesperson exemption to the FLSA’s overtime pay requirements only applies in specific circumstances which must be substantiated by detailed employer records. While treating employees as exempt under Section 7(i) may be economically beneficial for the employer in many instances, application of the exemption to any given employee often requires timely, periodic reevaluation and imposes detailed record-keeping requirements on the employer. As a result, employers should not apply the exemption loosely and must confirm that they have complied with all of the rules and maintained all necessary records. Failure to do so may result in costly and time-consuming litigation.

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