

## WAGE AND HOUR UPDATE:

### *California Supreme Court Permits Payment of Expenses By Enhanced Compensation*

By Christopher W. Olmsted



“May an employer satisfy this statutory obligation by paying employees increased wages or commissions instead of separately reimbursing them for their actual expenses?”

Labor Code section 2802, subdivision (a), requires an employer to indemnify its employees for expenses they necessarily incur in the discharge of their duties. May an employer satisfy this statutory obligation by paying employees increased wages or commissions instead of separately reimbursing them for their actual expenses?

The California Supreme Court recently considered this question in a case titled *Gattuso v. Harte-Hanks Shopper, Inc.* The answer is yes—with some important caveats. “We conclude that an employer may satisfy its statutory reimbursement obligation by paying employees enhanced compensation in the form of increases in base salary or increases in commission rates, or both, provided there is a means or method to apportion the enhanced compensation to determine what amount is being paid for labor performed and what amount is reimbursement for business expenses.”

Practical application may prove more challenging—and risky—than the rule seems at first glance.

The facts of the case provide an illustration

that most employers can relate to. Harte-Hanks Shopper, Inc. (Harte-Hanks) is a California corporation that prepares and distributes advertising booklets and leaflets in California, including the PennySaver and the California Shopper.

To sell advertising space in its publications, Harte-Hanks employs both outside and inside sales representatives. Outside sales representatives must drive their own automobiles to contact customers, while inside sales representatives work in their employer’s offices using employer-owned telephone equipment. Harte-Hanks compensates both outside and inside sales representatives by commissions on advertising sales or by a combination of base salary and commissions. With few exceptions, Harte-Hanks does not separately reimburse outside sales representatives for their automobile expenses.

Frank Gattuso is an outside sales representative for Harte-Hanks. He and another employee filed a class action lawsuit against the employer, seeking reimbursement for automobile mileage, maintenance, and other expenses incurred while driving on the job.

In response to the complaint, Harte-Hanks took the position that it satisfies its obligation under Labor Code section 2802 to compensate outside sales representatives for automobile expenses by paying them higher base salaries and higher commission rates than it pays to inside sales representatives.

The parties agreed that section 2802, which requires an employer to indemnify its employees for expenses they necessarily incur in the discharge of their duties, requires Harte-Hanks to fully reimburse its outside sales representatives for the automobile expenses they actually and necessarily incur in performing their employment tasks. The employer and employee disagreed only on whether section 2802 permits an employer to do so through an increase in overall compensation rather than through a separately identified reimbursement payment.

The court acknowledged three different but potentially valid approaches to expense reimbursement: actual expenses, mileage reimbursement, and lump sum payments.

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Christopher W. Olmsted  
Barker Olmsted &  
Barnier  
2341 Jefferson Street,  
Suite 200 • San Diego,  
California 92110  
(619) 682-4040  
cwo@barkerolmsted.com  
www.barkerolmsted.com



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### **Actual expenses**

The Court observed: “The actual expense method is the most accurate, but it is also the most burdensome for both the employer and the employee.” Actual expenses include: fuel, maintenance, repairs, insurance, registration, and depreciation. The problem is that accurate recordkeeping and apportionment of expenses between personal and business use can be cumbersome.

Employers need to make judgment calls that are subject to second guessing. In calculating the reimbursement amount due under section 2802, the employer may consider not only the actual expenses that the employee incurred, but also whether each of those expenses was “necessary,” which in turn depends on the reasonableness of the employee’s choices.

“For example,” observed the Court, “an employee’s choice of automobile will significantly affect the costs incurred. An employee who chooses an expensive model and replaces it frequently will incur substantially greater depreciation costs than an employee who chooses a lower priced model and replaces it less frequently. Similarly, some vehicles use substantially more fuel or require more frequent or more costly maintenance and repairs than others. The choice of vehicle will also affect insurance costs. Other employee choices,

such as the brand and grade of gasoline or tires and the shop performing maintenance and repairs, will also affect the actual costs.”

Thus, calculation of automobile expense reimbursement using the actual expenses method requires not only detailed record keeping by the employee and complex allocation calculations, but also the exercise of judgment (by the employer, the employee, and officials charged with enforcement of section 2802) to determine whether the expenses incurred were reasonable and therefore necessary.

### **Mileage Reimbursement**

Most employers use the IRS mileage rate as an approximation of the actual expense of operating an automobile. Currently the rate is 48.5 cents per mile.

The rule is simple enough. Unfortunately the Court added a little twist that may prove troublesome to employers. The Court observed that reimbursement at the IRS rate does not prevent an employee from challenging the sufficiency of the payment. “If the employee can show that the reimbursement amount that the employer has paid is less than the actual expenses that the employee has necessarily incurred for work-required automobile use (as calculated using the actual expense method), the employer must make up the difference.”

Will the Court’s observation invite plain-

tiffs’ attorneys to bring claims against employers who have paid the IRS mileage rate? It seems that such cases would be difficult to prove—but the door has been opened.

### **Lump Sum**

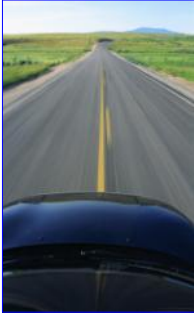
The court also recognized that some employers simply pay a lump sum, often in the form of a per diem, intended to cover vehicle expenses. Harte-Hank used a variation of this method. It paid an increased salary to outside salespersons which was intended to compensate the employees for vehicle expenses.

The court concluded that the lump sum method was legal. There are two caveats, however.

First, the method is legal as long as it is at least enough to cover actual expenses incurred. “Of course, an employee must be permitted to challenge the amount of a lump-sum payment as being insufficient under section 2802. An employee may do so by comparing the payment with the amount that would be payable under either the actual expense method or the mileage reimbursement method. If the comparison reveals that the lump sum is inadequate, the employer must make up the difference.”

The second caveat is that the employer must provide some method or formula to identify the amount of the combined employee compensation payment that is intended to

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provide expense reimbursement. Using that method or formula, the employee (and also officials charged with enforcement of state and federal wage laws) then can readily determine whether the employer has discharged all of its legal obligations as to both wages and business expense reimbursement. The Court concluded that although section 2802 does not expressly require the employer to provide an apportionment method, it is essential that employees and officials charged with enforcing the labor laws be able to differentiate between wages and expense reimbursements. “Because providing an apportionment method is a practical necessity for effective enforcement of section 2802’s reimbursement

provisions, it is implicit in the statutory scheme.”

### **Practical Effects and Implications**

The “Lump Sum” Method is Problematic

Enough to cover actual expenses? Paying employees a lump sum for expenses is legal as long as it is sufficient to cover actual and necessary expenses. How will an employer know this unless it tracks the expenses? Under the lump sum approach, it may become difficult to ensure that the employee is reimbursed for actual expenses unless the employee consistently incurs a predictable amount of expenses (e.g. drives a designated route every day).

The employer could, of course, require employees to submit ex-

pense reports each month. But presumably the whole purpose of taking the lump sum approach was to avoid the burdens of record keeping and reimbursement calculations.

### **Tax Implications**

Of course, the employer could err on the side of caution and pay the employee more than necessary to cover expenses. Aside from the added expense to the employer, this may also raise tax issues for the employer as well as employee.

For this and other reasons, the lump sum method may be cumbersome and legally risky to implement for classes of workers who do not incur consistent and predictable expenses.

## **LUMP SUM EXPENSE PAYMENT COMPLIANCE TIPS**

**Define the increase.** A specific formula, apportionment, or fixed amount should be devised defining what portion of pay constitutes expense reimbursement.

**Transition carefully.** Implementing the lump sum approach without actually increasing compensation may be viewed unfavorably by the DLSE.

**Review procedure.** Employees should be encouraged to request a review of actual expenses in the event that they believe the lump sum does not cover actual expenses.

**Watch variable commissions.** Commissioned employees may earn lower than expected commissions from time to time. If the lump sum method is tied to commission compensation, then employees may not receive sufficient expense reimbursement during slow months unless the employer is prepared to adjust payments during such times.

**Payroll records.** Keep in mind that California Labor Code section 226(a) requires employers to provide an accurate itemized statement in writing with each paycheck, including gross wages, total hours worked, all deductions, and net wages earned. The Supreme Court has expressly noted that pay records should separately identify the amounts that represent payment for labor performed and the amounts that represent reimbursement for business expenses.

**Au revoir, regulations?** As reported in a prior Legal Update, in early 2007, the California Labor Commissioner proposed regulations governing employee expenses. The regulations, which have yet to be implemented, would bar paying higher wages to cover expense reimbursement. The Supreme Court’s decision in *Gattuso 2802* will likely cause the agency to withdraw or completely revise the proposed regulations.