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FSA Forfeitures: An Employer's How-To Guide

The grace period deadline is approaching for participants in calendar year health and dependent care Flexible Spending Arrangements (FSAs) to pay or reimburse qualifying expenses for 2022. After the deadline (March 15, for calendar year plans), some employers may find their FSAs generated leftover "forfeitures" due to contributions exceeding reimbursements for the plan year.

In this brief "how-to guide," we provide an overview of how employers can use FSA forfeitures, considering requirements under the Employee Retirement Income Security Act (ERISA) and guidance issued by the Internal Revenue Service (IRS).

If an employer's FSA is subject to ERISA, the use of participant FSA forfeitures must comply with ERISA's fiduciary rules. FSA forfeitures are considered ERISA plan assets and must be used accordingly. For example, ERISA requires that plan assets never inure to the benefit of the employer and must be used for the exclusive purpose of providing benefits to plan participants.

In light of those requirements, employers with ERISA-governed FSAs must ensure that forfeitures are used to benefit current plan participants and not retained as earnings or used for other impermissible purposes.

In addition to the ERISA requirements, employers should also consider guidance issued by the IRS. The IRS released proposed regulations in 2007 that describe several permitted uses for FSA forfeitures (the Proposed Rule). Although the Proposed Rule was never finalized, employers can rely on its guidance pending the release of final regulations. According to the Proposed Rule, employers can use forfeitures in the following ways:

- To be retained by the employer (this option is not available to ERISA-governed plans);
- If not retained by the employer, as follows:
  - To reduce required salary reduction amounts for the immediately following plan year;
  - To be returned to employees;
  - To increase annual coverage amounts; and/or

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- To defray expenses to administer the plan.

Forfeitures returned to employees are considered wages for FICA purposes and are subject to federal income tax withholding. If an employer chooses to reduce employee salary reductions, return forfeitures to employees or increase coverage amounts, it must do so on a reasonable and uniform basis. Due to a lack of guidance in the Proposed Rule, employers will need to decide whether to allocate forfeitures to current or prior-year FSA participants. For all employees (including current or prior year participants), the Proposed Rule specifies that employers must avoid allocating forfeitures based on the amounts each employee forfeited from their FSA account, as doing so would violate the "use-or-lose" rules applicable to FSAs.

If you have any questions about the proper use of FSA forfeitures or other cafeteria plan compliance issues, please contact your Reinhart attorney.

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