Options for forfeited employee FSA balances

Many businesses offer health care and dependent care flexible spending accounts (FSAs) as part of their employee benefits package. These plans provide valuable tax savings to employees and payroll tax savings to employers.

If your company operates a calendar-year FSA with a 2½-month grace period, employees have until March 15 to incur eligible expenses for their 2025 plan balances. After that, any unused 2025 funds may be forfeited under the “use-it-or-lose-it” rule. Here’s a refresher on how FSAs work and what employers can do with forfeited balances.

The basics

Under an employer-sponsored FSA plan, employees may be able to contribute a portion of their pay to a:

Health care FSA. These accounts may be used for qualifying out-of-pocket medical, dental and vision expenses for the employee and his or her spouse and/or qualified dependents. For 2026, the maximum employee contribution to a health care FSA increases to $3,400 (from $3,300 in 2025). (The limit is annually indexed for inflation.)

Dependent care FSA. These accounts may be used for qualifying child care or adult dependent care expenses. For 2026, under 2025 tax legislation, the dependent care FSA contribution limit increases to $7,500 per household ($3,750 for married couples

filing separately). The limit for 2025 was $5,000 ($2,500 for separate filers). (The limit isn't inflation-indexed, so it won't go up in the future unless another increase is passed by Congress and signed into law.)

Employee contributions are made on a pretax basis, reducing federal income tax, Social Security tax and Medicare tax (and often state income tax). The FSA plan directly pays or reimburses employees for qualified expenses, and the payments or reimbursements are tax-free.

Use-it-or-lose-it rule

If employees don't use their full FSA balances by the end of the plan year, leftover balances generally revert to the employer under the use-it-or-lose-it rule. However, there are two exceptions:

1. An FSA plan can allow a grace period of up to 2½ months. Most FSA plans operate on a calendar-year basis. For a calendar-year FSA plan, the grace period gives employees until March 15 of the following year to incur qualified expenses to drain their unused FSA balances from the previous year.

1. A *health care* FSA plan can allow employees to carry over up to an annually inflation-indexed amount of unused balances from one year to the next. The amount that can be carried over from 2026 to 2027 is $680 (up from the $660 that could be carried over from 2025 to 2026).

It's important to note that a health care FSA plan can offer *either* the carryover *or* the grace period, but not both. Dependent care FSA plans can offer *only* the grace period, *not* the carryover.

Options for forfeited FSA funds

After any applicable grace period ends, or after applying any permitted health care FSA carryover, employers may retain forfeited balances under IRS cafeteria plan rules. Many businesses use the funds to offset plan administrative expenses.

Other permitted uses generally include, on a reasonable and uniform basis: 1) reducing the amount employees need to contribute in a future year to reach a certain FSA balance (for example, employees need to contribute only $950 to have a $1,000 FSA balance, with the extra $50 funded by forfeited balances from a previous year), or 2) returning amounts to participants (typically treated as taxable wages and subject to payroll taxes and income tax withholding).

Forfeitures can’t be returned to plan participants based on individual claims experience. Any allocation of returned funds must be nondiscriminatory and consistent with plan terms.

Natural check-in point

Around the grace-period deadline is a natural time for business owners to review how their FSA plans handle unused balances. It’s also a good opportunity to confirm that your current plan design, including grace period or carryover provisions, aligns with your employees’ needs and your administrative practices. Contact us to help review and modify your FSA plan provisions, handle forfeitures properly and prepare for next year’s enrollment cycle.

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