VOLUNTARY EMPLOYEES' BENEFICIARY ASSOCIATIONS (VEBAS)

Part 1: An Overview

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By **Richard T. Chari**, Principal, Senior Consultant and Linda Lam, Consultant

In this first installment of a three-part series on vebas, we discuss their benefits for plan sponsors and employees.

Financial complexities, rising costs and challenges around implementation are making it imperative for plan sponsors to understand the available tools and strategies for managing employee benefits.

One such important benefit is a Voluntary Employees' Beneficiary Association (VEBA), a trust with tax advantages that covers medical expenses and healthcare benefits for employees, their dependents and beneficiaries. These trusts typically cover costs related to health insurance for retirees, healthcare costs and medical expenses such as deductibles, co-pays, dental and vision payments. For plan sponsors, VEBAs offer tax benefits, help manage liabilities and attract and retain talent. For employees, they are a valuable perk and help defray healthcare expenses.

At NEPC, we believe understanding VEBAs and potential investment strategies is essential for plan sponsors to effectively manage employee benefits. VEBA structures differ between organizations, and by assessing key factors such as tax implications, liquidity needs, and risk tolerance, organizations can develop thoughtful investment strategies to support the long-term health of their VEBA assets.

We are committed to providing education and actionable insights to help organizations make informed decisions about their VEBAs and investment approaches. As NEPC is an investment firm, our advice on VEBAs is limited to investment considerations; NEPC does not provide legal or tax advice. Wwe recommend plan sponsors seek counsel from their respective legal and tax advice from their respective advisorsprofessionals on these matters.

WHAT IS A VEBA?

A VEBA is an organization1 that provides benefits, such as welfare benefits, to its members or their designated beneficiaries. VEBA trusts are defined under Section 501(c)(9) of the Internal Revenue Code as funding vehicles established by employers or employee associations to fund benefit obligations for welfare benefits, which include health and life insurance, as well as other post-employment benefits. The trusts offer flexibility in benefit design and funding, allowing organizations to tailor their approach to meet the unique needs of their workforce and their long-term obligations.

Below, we explore the key characteristics specific to VEBAs and examine how they function as vehicles for providing a wide array of post-employment benefits.

[1]Membership of a section 501(c)(9) organization must consist of individuals who are employees who have an employment-related common bond. This common bond may be a common employer (or affiliated employers), coverage under one or more collective bargaining agreements, membership in a labor union, or membership in one or more locals of a national or international labor union.

WHAT ARE THE MAIN CHARACTERISTICS OF VEBAS?

VEBAs have traits that distinguish them from other types of employee benefit trusts. These characteristics can influence investment decisions and overall plan management:

Benefits offered include retiree medical benefits and other postemployment benefits

Benefits can be forfeited or changed at the plan sponsor's discretion

Benefits are not accrued and not guaranteed as they are for defined benefit plans.

Benefits may be paid by redeeming assets held within the VEBA trust or by external operating accounts in which the funds are not invested but flow through the trust

Assets are irrevocable and cannot be reverted to the employer

Any reversion of assets back to the plan sponsor is subject to 100% excise tax. This ensures that the funds are used solely for their original intended benefit.

Contributions are discretionary and not required

There are no minimum funding requirements, and sponsors may fund the trusts to meet benefit obligations at their discretion. As a result, the funding levels of plans connected with VEBAs can vary, with some plans potentially being persistently underfunded but still having a mechanism to meet ongoing benefit obligations outside the VEBA.

VEBA trusts can be either tax-exempt or taxable

Contributions into the trust may be deductible, and investment gains and income within the trust can be taxable or tax-exempt depending on the trust's compliance with ERISA and IRC requirements. In some instances, when there is an excess accumulation of assets above the allowed maximum as stipulated in the IRC, unrelated business taxable income (UBTI) may be triggered, resulting in a non-taxable VEBA being subject to tax on investment income.

Plans funded through VEBAs must adhere to requirements and failure to comply can result in the trust being subject to taxation

Common employer or union: The trust must consist of employees from the same employer or union.

Qualifying benefits: Trust assets must exclusively provide qualifying benefits, such as health, disability, or life insurance benefits.

Non-discrimination: Benefits provided by the trust cannot disproportionately favor highly compensated employees or company shareholders.

VEBA liability valuations are typically conducted annually by actuaries

These valuations incorporate a wide array of assumptions depending on the type of plan. In the case of healthcare VEBAs, a key assumption is medical inflation, which is connected to increasing healthcare costs, but some plans can be subject to caps. The inflation assumptions specific to these plans may not always align with actual experience, and VEBA liabilities may fluctuate considerably due to uncertainties in future healthcare expenses.

HOW DO VEBAS OPERATE?

While plans funded through VEBAs and defined benefit plans offer employee benefits, there are distinct differences in each plan's structure, including variations in plan and tax status, benefit guarantees, and minimum funding.

Defined benefit plan participants accrue benefits during their employment, with those benefits protected by ERISA and guaranteed by plan sponsors who must adhere to minimum funding standards to ensure future obligations are met. While plan sponsors may elect to freeze future accruals or restrict participation, they cannot retroactively revoke already earned benefits. Pension assets held in trusts serve to pay out benefits, have tax-exempt status, and grow tax-free; contributions to the plan are also tax-deductible.

In contrast, participants in plans funded through VEBAs do not accrue guaranteed benefits. Instead, they work toward eligibility for benefits that are paid upon retirement. Should a participant leave employment before meeting eligibility criteria, they will forfeit those benefits. The plan sponsor retains discretion to modify or terminate benefits at any time and is not bound by minimum funding requirements.

VEBA assets held as investments in the trust can be used to pay benefits, but sponsors may also opt to utilize external operating accounts by passing contributions through the trust, thereby making benefit payments without long-term investment of the "pass-through" funds. Additionally, VEBA assets may become taxable if the plan does not comply with ERISA regulations or is established as a taxable entity.

By investing assets according to a disciplined strategy and taking into consideration the taxability of a VEBA trust, plan sponsors can provide financial security for employees, retirees, and their beneficiaries. The governance of the trust is typically vested in a board of trustees or a committee charged with oversight and fiduciary responsibility. Core principles such as transparency, regulatory compliance, and prudent management form the underpinnings of the VEBA framework, ensuring that the trust functions with integrity and maintains alignment with its stated objectives.

If your company is evaluating a VEBA, or if you want to better understand its potential impact on your firm, we are available to discuss the process and implications. Stay tuned for the second and third installments of this series, where we explore investment strategies for VEBAs and offer insights into adopting a liability-driven investing approach, respectively. Meanwhile, our consultants are here to answer any questions you may have.

SOURCES

- Internal Revenue Code, Section 501(c)(9)
- Internal Revenue Code, Section 419
- Internal Revenue Code, Section 505 (b)
- IRS Publication 1984 EO CPE Text – F. Selected Problems of Voluntary Employees' Beneficiary Associations (VEBAs)
- IRS Publication 1992 EO CPE Text – J. The Depths of IRC 419 and 419A
- IRS Training Publication 4213-018 (Rev.5/98) – VEBA Awareness

IMPORTANT DISCLOSURES

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