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Why Listing A Trust As A Beneficiary On Your 401(k) May Not Be A Good Idea

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When designating a beneficiary on your 401(k), you are legally allowed to use a trust, but is it a wise move? Because both 401(k)s and IRAs will automatically bypass the process on probate and even the lawyers involved, a trust could unnecessarily complicate the entire situation. If there is a beneficiary form, there is no need for a trust to be involved.

But what is trust in the first place?

A trust is a relationship in which a trustor gives his trustee the legal rights to hold title to any of his/her assets or properties – usually for the benefit of a third party, which is called the beneficiary. And although these assets can be given directly to the beneficiary, the primary goal is to establish legal protection and make sure that the trustor's wishes are distributed accordingly, especially if the beneficiary is not completely capable of executing the will.

But why is listing a trust as your beneficiary not a good idea? Here are some important points to consider:

- A trust cannot take full advantage of the Stretch IRA concept – if the trustee has young children or grandchildren, who are not capable of managing a huge lump sum efficiently, a trust can be set up to distribute the money over a period of time. However, the primary disadvantage is that the retirement plan will hinge on Required Minimum Distribution (RMD) payouts, which are usually calculated based on the oldest beneficiary's life expectancy. Naming beneficiaries individually will allow each of them to take RMDs based on their life expectancy, which is a strategic way to stretch out the IRA earnings for the long haul. The fact that a trust does not have a life expectancy is the main reason as to why it cannot take advantage of the Stretch IRA; it is basically what allows you to potentially stretch your IRA down to your family's future generations via a wealth transfer method.

- There is no tax benefit – many trusts have relatively higher tax rates compared to individuals who would otherwise inherit the 401(k). If you name your spouse as the primary beneficiary, it will give your surviving spouse more options on how they can handle the money and defer income taxes. Remember that naming a trust as a beneficiary will hinder the owner from obtaining maximum benefits from the income tax deferral.

- Listing a trust as your beneficiary will cause the IRA to be treated as having no designated beneficiary – as a result, the IRA will be distributed within 5 years upon the date of death. Listing your children in the trust would also force them to pay taxes on the amount, instead of stretching out the IRA themselves.

- Do not overlook the power of spousal rollover – as mentioned earlier, the age of the oldest beneficiary will be used in setting the life expectancy on which the RMDs will be based. If a spouse is the first beneficiary listed on the IRA and is originally passed on via a spousal rollover, this will be more advantageous to the younger heirs. When the surviving spouse dies, it will be left to the younger heirs, but in this instance, is will use their date of birth to set a new amount for the distribution – allowing them to stretch the contributions for a long period of time.

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Issues that involve handling and/or distribution of money are always difficult to handle. The law itself can be really tricky – every financial case holds a sense of ambiguity, which is why it really takes a good lawyer to structure the trust-beneficiary appointment properly. In the case of your 401(k) or your IRA, using a trust as a beneficiary can be an unnecessary complication.

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