Losing an Inheritance Is Easy, Because Saying No Is Hard

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Most inheritances are about $50,000. Whether you come into a little money or a lot, waiting to make any moves is one of the best things to do first.

Elisabeth Root, an associate professor at Ohio State University, at home in Columbus, Ohio. She recently inherited money from her uncle and sought advice on how best to manage it.

Credit - Andrew Spear for The New York Times

By Susan B. Garland

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When Elisabeth Root learned that her uncle had left her almost $1 million after his death earlier this year, she panicked. The inheritance was more money than she had ever handled.

“I’m an educated person, but I had no idea what I was doing,” she said.

Still, Dr. Root, 42, knew enough not to do what many other heirs do: embark on a spending frenzy. “My thought was, ‘Oh, thank goodness, I don’t have to worry anymore about retirement or putting my kids through college,” said Dr. Root, an associate professor of geography at Ohio State University in Columbus.

For help, she met with a certified financial planner who suggested that she place some cash in an emergency fund and invest most of the money for the long term. She withdrew a small portion for a splurge: When she traveled to New Zealand for a work conference, she took her husband, who is a high school teacher, and their two children and rented a house for a month.

“We may not have been as extravagant if we had not had the money,” she said. For the most part, however, “we have not changed our lifestyle.”

Though Dr. Root’s newfound wealth exceeds the size of most inheritances, her careful approach can be a lesson to others on how to handle a windfall of any amount. One study found that adults who receive an inheritance save just half, while spending, donating or losing the rest; nearly 20 percent of baby boomers who received $100,000 or more spend their entire gift.

Many beneficiaries view their inheritances as free money, experts say, and some run through their sudden wealth on cars, major house renovations and large gifts to children. Other mistakes — not anticipating a tax hit on inherited retirement plans or making unwise investments — can also chip away at the money pot.

Ms. Bradley recommends that new heirs enter “a decision-free zone” for at least several months to a year to think through options. During that time, she suggests creating what she calls a brain trust of professionals, such as a financial adviser, an accountant and a lawyer.

Until a plan is in place, heirs should park any cash and life insurance proceeds in a federally insured bank account, but not in a joint account with a spouse, experts say. Dr. Root considers her marriage strong, but she placed her inherited funds in her own name. “You never know what is going to happen in life — I sort of feel like this is my money,” said Dr. Root, who designated her husband as the primary beneficiary of her accounts.

Financial planners also say inheritors must resist entreaties from friends and relatives seeking loans or gifts. Tyrone Phillippi, a certified financial planner in Dayton, Ohio, said one client, against his advice, gave money to a relative to open a bar. “It did not go well — the money was basically gone,” he said.

Teri Alexander, a certified financial planner in Grandview Heights, Ohio, and Dr. Root’s adviser, suggests that clients write a letter to family members and others explaining that they “need time and space” — perhaps several years — before they spend any of the money. “That may keep them at bay — even spouses,” she said.

To Spend or to Save?

About half of all inheritances are less than $50,000, and an additional 30 percent range from $50,000 to $249,000, according to the Federal Reserve. Even small inheritances offer an opportunity to ease some burdens — and to fulfill some dreams — if deployed sensibly, experts say.

Heirs “get into the bucket list immediately, when they should be thinking about how the money can shape the future, whether it’s going back to school to learn a new career or saving a bit more for retirement,” Mr. Phillippi said.

Take the example of two sisters who each received $200,000 when their father died in 2014. One sister, Joy, a retired teacher in her 60s who asked that only her middle name be used to discuss a family matter, said she was investing the money to pay for future long-term-care costs and to leave to her daughter. Joy, who is divorced, said she was living on her pension and savings.

Joy’s sister, a widow, spent the entire gift on a new car and a condo with a large monthly fee that she can no longer afford. “My sister tells me she is struggling and is scared,” she said.

Though there are no rules of thumb for the best uses of sudden wealth, experts say new heirs should set aside cash — enough to cover six months of expenses — in an emergency fund. Retirees, for example, could use this stash to avoid tapping investments in a market downturn.

Paying off high-interest credit card debt also makes sense, said Laura Webb, a certified financial planner in Asheville, N.C. But rather than racking up new credit card charges, she said, “people should take the money they were paying for interest and add it to long-term savings.”

Deciding on paying off a mortgage could depend on one’s age. Retirees may want to be debt free, but Ms. Webb said younger homeowners with low-interest mortgages may be better off investing the money if they can get a higher after-tax return than they pay on the debt.

Beware the Tax Bomb

A large chunk of an inheritance is likely to be in an Individual Retirement Account, and heirs can lose much of the money if they do not follow the complex rules for handling I.R.A.s.

A traditional I.R.A., which holds tax-deferred contributions, is a great tax shelter for heirs. Non-spouse beneficiaries can allow the assets to grow over their lifetimes, paying income taxes only on the distribution they are required to take each year after the original owner dies. (Congress is mulling a bill that would force non-spouse beneficiaries to empty an I.R.A. within 10 years.)

But beneficiaries could inadvertently end up with a big tax bill. If an heir moves the I.R.A. money into a brokerage account or into his or her own I.R.A., the entire account becomes taxable immediately.

Instead, an inheritor should ask a financial institution to set up a specially titled “inherited I.R.A.” The financial institution must ensure that the funds transfer directly from the firm that holds the benefactor’s I.R.A.

Ed Slott, a certified public accountant and I.R.A. specialist in Rockville Centre, N.Y., recalled a visit from a client’s son. The client had left a $600,000 I.R.A. to his son, who wanted to reinvest the money more aggressively.

Though Mr. Slott warned the son to set up the inherited I.R.A. first and then reinvest, he did not want to wait. “It was what I call a fatal error,” he said. “The minute he took the money, it was taxable, and he lost $200,000.”

Mr. Slott said inheritors of Roth I.R.A.s, which are funded with after-tax contributions, must take annual distributions, even though the withdrawals are tax free. If a beneficiary fails to take the distribution, the Internal Revenue Service will impose a 50 percent penalty on the amount that should have been withdrawn. “Can you imagine paying a penalty on a distribution that should have been tax free?” he said.

Teri Alexander, a financial adviser in Columbus, is navigating her own inheritance issues. Credit Andrew Spear for The New York Times

Keeping Emotions at Bay

It’s likely that an elderly parent’s portfolio will be laden with low-risk investments like cash, Treasury bonds and dividend-paying stocks. A beneficiary who may be years from retirement could probably fare better investing more aggressively, experts say.

But the emotions that often come with an inheritance can immobilize heirs. Many inheritors are reluctant to part with investments that once meant so much to their parents. That can be particularly risky if a portfolio is invested in just one or two stocks.

Ms. Alexander recalled one former client who in 2006 inherited a portfolio that was mostly invested in shares of a single bank. Her client’s father had sat on the bank’s board. Despite the adviser’s warnings that diversifying the portfolio would be safer, the client refused to sell. “She thought it was a great company, and it was doing well,” Ms. Alexander said. Two years later, the banking industry collapsed, and her client’s portfolio lost three-quarters of its value, she said.

Ms. Webb said one client was petrified to risk a penny of her parents’ hard-earned money. She wanted to place the entire inheritance in certificates of deposit. It took a year for Ms. Webb to persuade her to move into low-risk bonds and dividend-paying stocks, which, she said, “gave her a comfortable income stream.”

Rather than holding on to their parents’ investments, heirs can honor their parents by using some of the money to “remember the loved ones they lost,” Mr. Phillippi said.

After her mother, a pharmacist, died two years ago at 85, Ms. Alexander and her sister decided to fund a university scholarship for female pharmacists.

And because Ms. Alexander’s parents loved music — her mother played piano and her father sang tenor — she is paying for piano lessons for her 3-year-old grandson.

“My mother was passionate about music, and this is a way I can pass on this passion to him,” she said. “This is a gift from his great-grandparents.”