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WHITE PAPER

Suddenly Inheriting Wealth

In Early Adulthood or Midlife

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This guide aims to help you navigate the complexities of sudden wealth inheritance by addressing common concerns and providing a decision-making framework. Learn how to embrace this life transition and seize the potentially life-changing opportunities — in honor of your loved ones.

Navigating significant life changes

Receiving an inheritance often follows a significant event in your life and the lives of your loved ones. It’s natural to feel a sense of loss, confusion, or burden. You may be experiencing a mix of endings, beginnings, sadness, and possibilities.

Understanding the emotions and challenges

There are three primary factors contributing to the feeling of being unsettled. Firstly, the trauma and grief of losing a loved one can be overwhelming. Secondly, you may be encountering sudden changes in your identity, relationships, or life circumstances. Thirdly, numerous tasks likely require your attention, such as planning a funeral, acting as a personal representative of the estate, or managing the personal affairs of your loved one.

Recognize this as a transition period and be patient with the process.

Prioritizing tasks

Amid transition, you might feel overwhelmed by a lengthy to-do list. Here are some strategies to help you prioritize:

1. Immediate Actions: What needs to happen today? This may include funeral planning, hiring an estate planning attorney, securing a residence, or simply grieving and spending time with family.

2. Upcoming Actions: What actions need to be taken soon but not today? These could involve opening probate with a local court, cleaning out a home, or setting up an inherited IRA account. These tasks will require attention in the coming weeks or months, but do not need immediate action.

3. Major Decisions: What should wait until you're more clearheaded? Major decisions, such as paying down debt, setting goals, funding those goals, or determining investment strategies should be approached when you are more composed.

4. Outsourcing Tasks: What items can be delegated to professionals? Consider outsourcing tasks like cleaning out a home. This could involve hosting a home walkthrough with family to determine which sentimental or valuable items heirs would like to keep, then hiring an estate clean-out service to handle the heavy lifting.

By categorizing tasks in this manner, you can manage your responsibilities more effectively and reduce feelings of being overwhelmed.

Priority List
Immediate Actions
Upcoming Actions
Major Decisions
Outsource These Tasks

Once you've created your lists, take a moment to think about the following question: *How does this wealth impact my life goals?*

To help you process the answer, and focus your mindset, consider categorizing in the following ways:

- **Goal-helping:** Does this money support the goals you already had? For example, will it help with a down payment on a house or reduce student loans, but not much beyond that?
- **Goal-changing:** Does this money allow you to accomplish your top priority, providing an opportunity to set new goals?
- **Life-changing:** Is this money giving you a chance to re-evaluate your lifestyle, goals, or priorities?

Winston Churchill once said, "Never let a good crisis go to waste."

Life transitions create a "before and after." Is now the time to boldly recraft a vision of what your life can become?

Assessing the financial impact

Now that you've taken a moment to contemplate the meaning of this inheritance, let's discuss the financial implications. How does this inheritance impact your day-to-day life and retirement?

Here are three perspectives on managing a $1 million inheritance:

- **Life+:** The approach known as Life+ offers a sense of security by converting a lump sum into a cash flow stream to supplement your income for the rest of your life. This technique, widely used in retirement planning, is based on the "4% rule." According to this principle, withdrawing $3,333 per month or $40,000 per year (4% of the principal balance) from a diversified investment portfolio for 30+ years has a low risk of depleting the funds. Common uses for Life+ planning include:
  - Down payment on a vacation home and covering the mortgage and maintenance expenses.
  - Charitable donations or other gifts.
  - An annual travel budget, buying a more expensive home, or paying down debt to free up cash flow for future savings or other items.
- **You Only Live Once (YOLO):** The YOLO approach is about embracing the present and spending the money on what brings you joy. This could mean spending all or a portion of the funds within a few years. The math is straightforward, with the entire balance being spent, donated, or invested immediately or over a brief period, such as $100,000 per year over 10 years. Typical uses include:
  - Charitable giving to support a cause important to you (or the deceased).
  - Enjoying life through a dream vacation, world travel, or an extended family sabbatical.
  - Investing in yourself by starting a business, returning to school, or exploring a passion.
- **Financially Independent Retire Early (FIRE):** The FIRE movement emphasizes minimizing expenses to save a sizable portion of your income, allowing you to retire early. The aggressive savings and more modest lifestyle allow you to accelerate reaching a significant goal, such as retirement. If this is your goal, consider saving your inheritance for when you stop working.

When considering these scenarios, take note that if you are 35-years old and have inherited $1 million, the Life+ scenario assumes your investments could hypothetically provide an annual income of $40,000, assuming a market return of 7.2% per year. With that rate, the investment could grow to $2 million in 10 years and $4 million in 20 years, resulting in $160,000 in annual income beginning at age 55 based on the 4% rule.

Which path will you choose? Blending these strategies together and finding a happy medium is where the "art" meets the science of investing.

Receiving the inheritance

Before investing or spending your inheritance, it's important to understand how the assets will be transferred. The process and timeline can vary significantly depending on the form of inheritance:

Inheritance Scenario	Description	Typical Length of Proceedings
Named Beneficiary	If the heir is named as a beneficiary of an account with pay-on-death (POD) or transfer-on-death (TOD) provisions, the assets go directly to the beneficiary upon the owner's death. The beneficiary designation supersedes what is outlined in a will. Common examples include bank accounts, investment accounts, life insurance, and retirement accounts.	Assets are transferred quickly.
With a Will	The estate must go through probate, a court-guided process that determines how an estate's assets are distributed. This process is handled in the residential state of the decedent (person who died) and involves gathering documents, inventory, and appraising the decedent's assets, presenting the information in probate court, paying any outstanding bills and estate taxes before distributed assets to heirs.	Several weeks to years, depending on complexity and if the will is challenged.
Without a Will	A probate court determines the wishes of the deceased and appoints an administrator to act as executor and distribute the assets.	Long and complicated, possibly taking months or years.
With a Trust	The trustee manages the process of distributing the assets according to the trust's provisions, avoiding probate.	Assets are likely transferred more quickly.

Understanding tax implications

Another common question is about receiving an inheritance relates to taxes, fees, and other expenses. Here are tax treatments for the most common forms of property transfer:

- **Inherited property:** The cost basis for bequeathed stocks, property, or other investments is typically the fair market value of the asset on the date of the decedent's death, significantly limiting the capital gains tax you may owe when selling the asset. For example, the decedent purchased Apple stock for $20 per share in 2013, which was worth $200 per share upon their death. While they were alive, the cost basis of the stock was $20. That means if they sold the shares at $200 per share, they would have paid capital gains taxes on the profit of $180 per share. However, at the date of death, this asset is "stepped up" in cost basis to $200. If it's sold by the heir at $201 per share, capital gains tax applies to the new basis — just $1 per share.
- **Life insurance:** Payouts are generally not taxed, although interest earned on the payout is.
- **Individual retirement accounts (IRAs):** Funds in an IRA or 401(k) are tax-deferred, with taxes owed on distribution treated as ordinary income. Inherited IRAs, especially from non-spouses, have required minimum distribution (RMD) rules that can lead to significant tax liabilities.
- **Estate taxes:** If the deceased's assets exceed certain thresholds, the entire estate is subject to tax. Current federal estate tax rates range from 18% to 40%, with an exemption amount of $13.61 million per individual (as of 2023). The current exemption amount is scheduled to "sunset" at the end of 2025 and revert to an estimated $7 million per individual (adjusted for inflation). The maximum federal estate tax rate will remain 40%. Several states have additional estate taxes as well. Estate taxes are paid at the estate-level, not by the beneficiary.

Making the most of your inheritance

With clarity on your financial situation, it's time to consider practical uses for your newfound wealth. Here is a framework to help you make informed decisions.

1. **Make a list of your goals:** Include both significant aspirations and small joys.
2. **Estimate the costs:** For help figuring out the present value of items, use online calculators or consult with a financial advisor. Here is a simple tool to get you started: Present Value Calculator. For items you are funding in the future, you'll need an estimated growth rate. As a starting point, consider the following:
   - Short term (1-3 years) – 3% annual growth
   - Medium term (3-5 years) – 5% annual growth
   - Long term (6+ years) – 7% annual growth
3. **Allocate funds:** Ensure each dollar has a specific purpose. If your list exceeds your available funds, prioritize your goals. If you have excess funds, consider adding them to a retirement income bucket.

Handling new opportunities

Even with a clear plan, sudden money can lead to impulsive decisions. Align new opportunities with your priorities by quantifying them and comparing them against your existing plan. Avoiding impulsive decisions can help ensure you make the most of your inheritance.

And when friends, family, and others in the community hear about your newfound wealth, you may find yourself the target of new sales pitches and charitable causes needing funding or feeling that you're expected to meet a new (and more expensive) lifestyle.

When new prospects arise, it's crucial to align them with your personal priorities. You can do this by quantifying the new opportunity and comparing it against your priority matrix. How does it fit into your existing plan? What existing priority do you have to delay, reduce, or eliminate to make space for this new initiative?

Remember, there is no "right answer" for how you use the funds and what you prioritize. However, making informed wealth decisions requires the discipline of defining, quantifying, and re-evaluating your decisions in a broader context, empowering you to understand the tradeoffs inherent in any decision.

Communicating about your wealth

Inheritance can be a turning point in your life, presenting new opportunities and challenges. Consider the following questions as you navigate this transition:

- How do I feel about this wealth?
- Do I feel a sense of obligation with this wealth?
- How will I communicate with my children about this newfound wealth?
- What impact does this wealth have on my family, especially those who may not have inherited it or who inherited it unequally?

Each of us has a unique mission to fulfill in this world. It is our responsibility and our privilege to identify and articulate this mission, and to boldly pursue it. Wealth is not a mere accessory to this journey; it is a powerful tool that can allow us to manifest our values and aspirations in the world.

If you are standing at the crossroads of life or experiencing a major change and are uncertain of the path ahead, Mercer Advisors can help. Let's talk.