ESTATE PLANNING

Smart Ways to Handle an Inheritance

Here's how to handle an inheritance like a pro. A bequest could change your life, but don’t quit your day job.

(Image credit: Getty Images)

We’ve all heard stories about individuals who passed away quietly after a life of frugality, leaving a fortune to their unsuspecting heirs or, occasionally, a beloved pet.

The reality is a lot less riveting. According to the *Washington Post*, the average American has inherited only about $58,000 as of 2022, taking into account that most of us won't receive any form of inheritance. The Federal Reserve also reports that from 1989 to 2007, on average, only 21% of American households at a given point in time received a wealth transfer.

Complicating matters is the fact that many estate plans contain a smorgasbord of items, including real estate, investments, cash, retirement savings accounts and life insurance plans. It could take months to track down these assets and divide them among the estate’s heirs, and you could incur significant legal fees — particularly if the estate was large or your relative died without a will. There are also different rules for different heirs: Spouses, for example, enjoy some tax breaks and exemptions that aren’t available for adult children or other heirs.

For example, Brian Lee of Tacoma, Wash., got a crash course in estate law after his late father’s brother and sister died almost within a year of each other, in late 2015 and 2017. Neither of his father’s siblings had children when they died, so their estates were divided among their nieces, nephews and other surviving relatives.

Lee ended up with a six-figure inheritance, but because his uncle died without a will, settling the estate took months and cost thousands of dollars in legal fees. Lee's aunt had a will, with Lee as the executor, which made "all the difference in the world in terms of the process," Lee says.

Here's what you need to know in order to handle an inheritance like a pro.

What you'll owe in taxes

Stocks: Unless your parents were fabulously wealthy, you won't have to worry about federal estate taxes, but that doesn't mean Uncle Sam has no interest in your inheritance. If you inherited stocks, mutual funds or other investments in a taxable account, you'll be able to take advantage of a generous tax break known as a step-up in basis. The cost basis for taxable assets, such as stocks and mutual funds, is "stepped up" to the investment's value on the day of the original owner's death.

For example, if your father paid $50 for a share of stock and it was worth $250 on the day he died, your basis would be $250. If you sell the stock immediately, you won't owe any taxes; if you hold on to it, you'll only owe taxes (or be eligible to claim a loss) on the difference between $250 and the sale price.

It's a good idea to notify the investment account custodian of the date of death to ensure that you get the step-up, said Annette Clearwaters, a certified financial planner in Mount Kisco, N.Y.

Because of this favorable tax treatment, a taxable-account inheritance could be a good source of cash for a short-term goal, such as paying off high-interest debt or making a down payment on a house, said Jayson Owens, a CFP in Anchorage, Alaska. If you'd rather keep the money invested, review your inherited investments to see whether they are appropriate for your portfolio. For example, you could sell individual stocks and invest the money in a diversified mutual fund without triggering a big tax bill.

Retirement accounts: If you inherited a tax-deferred retirement plan, such as a traditional IRA, you'll have to pay taxes on the money. Spouses can roll the money into their own IRAs and postpone distributions — and taxes — until they're 73.

However, the Setting Every Community Up for Retirement Enhancement (SECURE) Act, which took effect on Jan. 1, 2020, changed the inherited IRA rules for non-spouse heirs. Instead of taking required minimum distributions, based on their age and life expectancy, heirs must withdraw all assets from the inherited IRA, 403(b) or 401(k) within 10 years of the death of the owner.

If you were fortunate enough to inherit a Roth IRA, you'll still be required to deplete the account in 10 years, but the withdrawals will be tax-free. If you inherit a traditional IRA, 403(b) or 401(k), you may want to consult with a financial planner or tax professional to determine the best time within the 10-year window to take taxable withdrawals. For example, if you're close to retirement, it may make sense to postpone withdrawals until after you stop working, since your overall taxable income will probably decline.

Real estate: When you inherit a relative's home (or other real estate), the value of the property will also be stepped up to its value on the date of the owner's death. That can result in a large lump sum if the home is in a part of the country that has seen real estate prices skyrocket.

Selling a home, however, is considerably more complex than unloading stocks. You'll need to maintain the home, along with paying the mortgage, taxes, insurance and utilities, until it's sold.

Life insurance: Proceeds from a life insurance policy aren't taxable as income. However, the money may be included in your estate for purposes of determining whether you must pay federal or state estate taxes.

Spending your windfall

Even a small inheritance can represent more money than you've ever received at one time. Go ahead and treat yourself to a modest splurge — a special vacation, for example — but avoid making costly changes in your lifestyle.

Brian Lee used his inheritance to pay off his wife's student loans and a small credit card debt; the rest went into retirement savings. Lee says he wanted to honor the legacy of his uncle, a dedicated investor who worked for IBM in the custodial department for 30 years. Lee's uncle spent most of his life in the same small house in Austin, Texas, and drove a 1967 Ford truck, but he was a wealthy man, with an estate valued at more than $3 million when he died. "There's no way I would blow money someone spent a lifetime saving," Lee says.

However, many people overestimate how long their newfound wealth will last. For this reason, consider stashing your inheritance in a money market account or CD account for six months to a year. You'll earn interest on your cash, and your money will be safe while you assemble a team of professionals, which typically should include a fee-only planner, a tax professional and an attorney.

Your team can help you look for ways to fortify your finances. Paying off credit cards and student loans will relieve you of high-interest debt and free up cash for other purposes. If you haven't saved enough to cover several months' worth of expenses, use your windfall to beef up your emergency fund. Once you've got that covered, consider using your inheritance to increase retirement savings.

Finally, if you don't have an estate plan of your own, use some of the money to create one, including powers of attorney, health care directives, a will and, if necessary, a living trust. Your own heirs will thank you.

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