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Navigating an Inheritance

Inheriting money, property, or other goods can be a life-changing event. It can potentially have a huge positive impact on your personal and family finances, once all the paperwork is sorted out. But until then it can be difficult for someone who's never been in this situation before to know exactly what to do—and what to avoid doing. Whether or not you were expecting this windfall, it's easy to find yourself on unfamiliar ground, with potential tax obligations to sort out and new family pressures to weather. And it all hits while you're in the midst of grieving the passing of someone you loved. It can be a little overwhelming.

The person who left you the inheritance no doubt intended for it to be a positive force for good in your life, and it will be. But inheritance does come with a few strings attached. At McRae, we've spent decades guiding clients through tricky life transitions like this, and we can help you understand your options and responsibilities. Here's a guide to what you need to know now.

Inheriting: What Next?

Receiving an inheritance can open up new possibilities in your life, but it doesn't come without its complications. You may encounter family conflict (and heightened emotions), particularly if some parties inherit less than others, or less than they feel they deserved. You may find you've also inherited new tax obligations and other responsibilities. And you may suddenly find friends, extended family members, or others aware of your new situation approaching you with charity pleas or shaky "investment opportunities." It can be a challenging, stressful time.

So start by taking a deep breath—don't feel pressured into making any quick decisions. Instead, take the time to understand what exactly you've inherited, what your new responsibilities (including tax liabilities) are, and your options. You don't have to go it alone: An accountant, an attorney, and a financial adviser can form the experienced team you need to construct a plan that ensures your inheritance continues providing benefits for many years. Let's start from the beginning.

Understanding Your Inheritance

Broadly speaking, inheritance falls into three general categories: You can inherit money or other assets directly, you can inherit them in trust, or you can inherit a retirement account (typically called a BDA, or Beneficiary-Designated Retirement Account). Here's a deeper dive into each of these forms.

Inheritance Path #1: Direct Inheritance

When you inherit assets directly—e.g., cash, securities, a car, real estate, life insurance proceeds, even a business—the ownership of those assets transfers into your name. But before that happens, the will typically goes through a "probate" process, where any inheritance directives are validated and estate taxes and other applicable costs are taken out of the estate. After probate, you receive full control of the assets and any income they might generate. This could take several months to a year, depending on your particular situation.

Inheritance Path #2: In Trust

A trust is a legal entity holding title (i.e., ownership) to assets on behalf of third parties called beneficiaries. "Current" or "Income" beneficiaries receive the income or benefits from the asset, often for a specified need while they're alive, and according to timing based on how the particular trust is set up. When the current beneficiaries pass, the trust passes to "remainder" beneficiaries like their children. The original asset owner who establishes the trust creates the trust instrument, which defines terms for managing and distributing the assets and income, and names a trustee to

Were You Invited To Be a Trustee?

(Don't panic…here's help.)

Trusteeship is a big honor…and an even bigger commitment. So before you accept, make sure you understand your duties, your legal liabilities, and the personal cost in time, energy, and emotion. Your main duty will be administrating the trust assets, handling any tax and legal issues, and authorizing distributions from the trust according to the terms of the trust instrument. Sounds simple enough, but this can be a thankless job: The Trustee is required to follow the trust agreement, but trust beneficiaries and related parties don't always appreciate this nuance. Family members can be demanding, quarrelsome, and resentful when you're the one standing between them and their goals saying "No." Finally, a trustee must understand and uphold certain specific fiduciary duties, and may need legal advice and protection from liability in certain situations. Before you accept this great honor, think long and hard about the obligations it entails.

act as steward. The trustee takes over management of the assets, and the disbursement of any funds is subject to the trustee's approval and restricted by the terms of the trust instrument.

Inheritance Path #3: A Retirement Account

If a parent who passed away had a 401(k), a SEP account, an IRA, or similar retirement account, this inherited money is placed in something called a Beneficiary-Designated Retirement Account, or BDA. You're likely going to owe some taxes. Here's why: Retirement plans accumulate wealth on a tax-deferred basis for years or decades and aren't designed to continue conferring these tax advantages to successive generations. Therefore, IRS rules generally require that the beneficiary must deplete the account in 10 years, so the government can receive tax revenue. (Note: The inherited retirement account can't be commingled with other money, and separate statements must be prepared and submitted to the IRS. They take this one pretty seriously.)

If you inherit money, the best way to spend it is paying off any high interest-rate debts like credit cards.

Whether or not your inheritance includes a BDA, your team will need to review the tax implications of your inheritance. In most cases, you won't have to pay federal taxes: The IRS takes their share at the estate or trust level, and the remainder is distributed tax-free to beneficiaries like you. But state taxes can apply—as Estate Taxes, Inheritance Taxes, or both—and there are other exceptions as well, making this an excellent place to work with an experienced tax preparer to make sure you cover any tax obligations.

Setting Goals: What Do You Want To Do?

Once you've paid your taxes, gathered your team, and explored your inheritance a little, it's time to start thinking about your goals. Keeping your head is critical. Financial windfalls have a tendency to erode fiscal discipline—with a sizeable inheritance it's all too easy to convince yourself you can now quit that day job, or start buying things you can suddenly afford but don't really need. That's a recipe for wiping out your inheritance in a pretty short timeframe, which is almost certainly not what your benefactor intended.

Instead, follow a general guiding principle of putting the money to work, so it can continue to generate income for years and decades to come. Consult with your financial adviser to

Eight Things to Consider When Inheriting

When you inherit a significant amount of money, here's how to protect it and put it to work for you.

1. **Don't rush into anything.** This can be an emotional time, and it's important not to make important decisions hastily. Slow down and assemble a trusted team (ideally a financial adviser, a tax accountant, and a lawyer).
2. **Think about your goals.** Determine how you want to use this money, and develop a plan. Do you need money now? Do you want to save it for your kids or someone else? Do you have any charitable giving goals?
3. **Put your windfall to work.** To the extent your inheritance is flexible, seek professional help investing it so it can generate income, and support your goals, not just now but for years to come.
4. **Understand your new tax situation.** Generally, Americans living in the U.S. don't have to pay federal taxes on inheritance (they're typically paid before money is distributed to the inheritors), but state laws vary. Talk to your accountant.
5. **If you inherit a retirement account, know the rules.** If your inheritance includes a tax-deferred retirement plan, you're obligated to start taking withdrawals and paying taxes based on specific IRS tables.
6. **Revise your financial plan.** Any major change in your assets, especially if there's increased complexity, calls for a fresh look at your plan, to minimize taxes, comply with regulations, and develop a long-term plan to preserve wealth.
7. **Update your will (or create one).** Lock in the benefits of your inheritance for beneficiaries long after you're gone. Talk to your financial adviser first, to clarify your wishes, then enlist the lawyers to document them.
8. **Don't blow it.** If you think of your inheritance as a gift for today and use it to cover today's costs, it'll be gone by tomorrow. Keep up your fiscal discipline, though, and it can be a gift that keeps on giving.

generate conservative estimates for the income-generation potential of your new assets, and think about your long-term goals in light of that. Do you want to ramp up funding for retirement? Start that business you've always wanted to? Set aside college funds for your children, or give a portion to charity? Your financial planners and tax advisers can help you decide what's realistic, and manage the details.

Of course, if you absolutely have to dip into the inheritance now for short-term goals like funding living expenses or to pay off high-interest credit card bills, it isn't the end of the world, and that may be money well spent. But try to take as little as you can for as short a time frame as possible, because every dollar taken now compromises your principal and shrinks its lifetime earning potential. Work with a financial adviser to create a financial plan that structures your assets to support your short- and long-term goals.

Receiving an inheritance is a great opportunity to revisit your life goals.

Thinking Long-Term... REALLY Long-Term

A smart investment plan to manage your inheritance can ensure that the benefits last a lifetime...and even longer. Think about what you want to happen to your newly expanded assets should something happen to you, and create a will (or modify an existing will) that puts that in writing. Forestall conflict amongst your inheritors by clearly specifying who gets what, and make sure all the details are locked and loaded in the will. You don't want to leave it up to state courts to manage the distribution of your assets for lack of proper legal instructions.

You'll definitely want to consider getting some extra help here, so you can thoughtfully make decisions about the ownership structure of any assets and protect the interests of all parties involved.

Conclusion

Losing a loved one is never easy. But whoever named you beneficiary clearly has your best interests at heart, and no doubt intended for this gift to benefit you for a long time to come. So work through the complexities and tax implications. Preserve the principal by not spending what you don't have to, and set some realistic long-term goals, and organize and invest your inheritance in ways that fulfill those goals. And organize YOUR beneficiaries for success after you're gone. If you can do that, your windfall can be a gift that lasts for many, many years.

To manage all this you need a smart team in your corner, and we'd love to be a part of it. At McRae Capital, we've helped many clients find their way through to the far side of the inheritance process—we can help you maximize value, minimize tax burden and other costs, handle the paperwork, and help make sure everything's done correctly according to your wishes. It's thoughtful upfront planning that paves the way for a brighter future, and as always, we're here to help.

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