Market Watch / Dow Jones Publishing

One in three Americans who get an inheritance blow it

Sept 3, 2015

By Elizabeth O'Brien / Retirement reporter

"Great wealth transfer" has joined "silver tsunami" in the lexicon of aging America. It refers to the wave of wealth, estimated to be in the trillions, which will flow from the oldest generation in the coming decades. Yet evidence suggests that many Americans are ill prepared to handle an inheritance.

Indeed, studies indicate that many recipients quickly dispense with their inheritance. One study found that one third of people who received an inheritance had negative savings within two years of the event. "The vast majority of people blew through it quickly," said Jay Zagorsky, an economist and research scientist at The Ohio State University in Columbus, Ohio and author of the study, which was based on survey data from the Federal Reserve and a National Longitudinal Survey funded by the Bureau of Labor Statistics.

A sudden inheritance might seem like fun money, but recipients should at least consider using part of their windfall to shore up their retirement savings, experts advise. After all, at a time when even $1 million won't guarantee a couple's comfortable retirement, 57% of workers have less than $25,000 in savings and investments, according to the 2015 Retirement Confidence Survey by the Employee Benefit Research Institute.

And while it's understandable to get excited by a gift that feels big—whether that's $50,000 or $500,000—it's a good idea to step back and take stock after receiving an inheritance. "Ask some big questions," Zagorsky said. "Sit down with your spouse and ask, what do we want to have happen with this?"

Here are some considerations to keep in mind:

The big picture

Susan Bradley, a certified financial planner and founder of the Sudden Money Institute in Palm Beach Gardens, Fl., suggests that a "decision-free zone" follow a windfall of any size. During this time, recipients should process their emotions and refrain from making any big moves. The duration of this period can vary based on the person and the circumstances—for some, it could be as long as a year, while for others it could be much shorter.

In addition to working through any emotions that the inheritance stirs up, recipients can also use the decision-free period to take stock of household finances. Zagorsky's research has shown that many Americans don't have a clear picture of their financial health. For example, folks in debt may think they're in the black—and vice versa. No one can make an educated decision about an inheritance without analyzing the family balance sheet first.

Another important step is examining priorities. Some people might want to pay for each child's education through graduate school, even if that means a reduced lifestyle in retirement. Others may want to take annual trips with the extended family, or buy a beach house for the whole family to use.

During this time of evaluation, inheritance recipients should be wary of making promises, said Rand Spero, president of Street Smart Financial in Lexington, Mass., a fee-only planning firm. It's easy to get caught up in the excitement and make promises that won't get kept in the long run, which can lead to hurt feelings.

Pay off debt

Inheritance cash can be put to very productive use paying off high-interest debt. Paying off credit card debt with a 20% interest rate results in a risk-free 20% return—not something you'll ever find in the financial markets.

Paying off oppressive debt should generally top the to-do list for inheritance recipients, with one exception, said Tom Anderson, author of The Value of Debt in Retirement: those without any emergency savings should set aside one month's living expenses before paying down debt. Then, after the debt is paid off, smart savers should consider building that emergency cushion to up to six months' worth of expenses.

Whether or not to pay off the mortgage is a more nuanced decision, Anderson said. While people might love the idea of living debt-free, consider the case of one of Anderson's friends: he used an inheritance to pay off his mortgage only to lose his job and see his home value plummet during the Great Recession. Without a job, he couldn't refinance, and without adequate equity, his home equity line of credit was shut down, leading to a serious cash crunch.

As that example shows, paying off the mortgage can compromise a household's liquidity. Without enough cash on hand to weather a stretch of unemployment, a medical emergency, or a big-ticket home repair, families can wind up seriously in debt.

Paying off the mortgage might make sense if these conditions are met, Anderson said: the recipient has no high-interest debt, has at least six months' of living expenses in an emergency bucket, and is on track with retirement savings.

This last criteria is a big "if": most Americans don't have enough saved for retirement, so the 401(k) or IRA might be a better use of inheritance cash. There are many online retirement calculators, such as this one from MarketWatch, which can give savers a sense of whether they're on track for retirement, while financial planners can do more customized and detailed projections.

Mind the details

Inheritances may involve excitement, or apprehension, but they also involve mundane tasks that are easy to overlook. It might make sense to create a separate checking or savings account for the new money in the decision-free zone. “If it’s in the same account where you pay for your Domino’s pizza, then it starts to blend in too fast,” Anderson said. If the inherited amount is bigger than $250,000, the cap for FDIC deposit insurance per depositor, per bank, then spread the money around, Spero said.

Those who inherit real estate shouldn’t delay retitling the property into their name, said Troy Lewis, chair of the tax executive committee of the American Institute of Certified Public Accountants and the owner of Lewis & Associates in Draper, Utah. Lewis has seen improperly titled real estate delay the closing of those properties when it came time to sell.

Most inherited property—including cash, real estate, securities and collectibles—isn’t counted as gross income for tax purposes, Lewis said. Yet those who inherit a 401(k) or IRA do have tax consequences and deadlines to meet. The Internal Revenue Service has guidelines on its web site, but some may be more comfortable hiring a CPA to walk them through it.

It’s also a good idea to reevaluate the beneficiaries on accounts that have gotten a cash infusion, Spero said. Maybe an inheritor didn’t mind that his spendthrift brother was listed as the beneficiary of an account that didn’t hold much money, but that could change once the balance has ballooned.

In short, an inheritance is a responsibility that shouldn’t be rushed. “There’s not a right answer,” Spero said. “There’s a right process.”