ADVISOR INSIGHT

Here's how to handle an unexpected windfall of money

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KEY POINTS

- Assets generally pass to beneficiaries without the transfer of ownership becoming a taxable event.
- Options for handling an inherited retirement account generally depend on your relationship to the decedent.
- While you may not owe any taxes on the inheritance itself, any appreciation on assets that are sold — such as stocks or real estate — would potentially come with taxation.

Sometimes, an inheritance lands in your lap when you aren't expecting it.

Whether due to the untimely death of a loved one, or because you were a named heir and didn't know it, the unplanned event may prompt uncertainty about how to handle the assets.

Depending on what you're inheriting and its value, you may need to take steps to avoid making a mistake that could result in unexpected taxes or expenses.

VIDEO 02:08

Handling an inheritance

“If this was unplanned and you’re taken by surprise, don’t rush to do anything that ends up being irrevocable,” said certified financial planner Kashif Ahmed, president of American Private Wealth in Bedford, Massachusetts.

Additionally, you may not want to share the information with a lot of people, especially if the inheritance is sizable.

“People will start showing up wanting loans or gifts,” said Wendy Goffe, a partner with the law firm of Stoel Rives in Seattle who specializes in estate planning. “You need to be thoughtful about who you tell.”

The basics

The good news is that, in most cases, assets pass to beneficiaries without the transfer of ownership becoming a taxable event.

Legislation passed in 2017 roughly doubled the amount that an individual can bequeath to heirs without it being subject to the 40% federal estate and gift tax.

That lifetime exemption is $11.58 million this year (it adjusts yearly, and after 2025 it is scheduled to revert back to the previous amount, which was about $5.5 million). And, if estate taxes are owed, the beneficiaries are not the ones ponying up — it’s the estate itself.

> **It’s rare to see an estate tax situation.**
>
> —Melissa Brennan
>
> FINANCIAL PLANNER WITH ARS PRIVATE WEALTH

“There aren’t very many people who have over that amount,” said CFP Melissa Brennan, a financial planner with ARS Private Wealth in Houston. “It’s rare to see an estate tax situation.”

up in basis") and the price you sell it for.

Also be aware that states can impose their own estate or inheritance taxes, which means it makes sense to consult with a local estate planning attorney. While estate taxes are paid by the estate of the deceased, inheritance taxes are remitted by the heir.

Additionally, if the inheritance involves a trust, experts say you should enlist the help of an attorney to avoid snags.

Inheriting a house

When a home gets passed on to heirs after the death of parents or other relatives, there are three options that beneficiaries typically choose from: live in it, rent it or sell it.

If there's a mortgage on the house, that debt also comes with the home. This means the heir — assuming they weren't already jointly responsible for the mortgage, such as a spouse — is responsible for paying that obligation. For example, they would need to qualify for a loan on their own, or sell the property and use the proceeds to pay it off.

However, if you inherit a house that's underwater — the amount owed on the mortgage is greater than the market value — it's worthwhile discussing a short sale with the lender.

Home prices spike due to surge in demand

Otherwise, when you do sell the inherited house — whether immediately or years in the future — any gains that might be taxable are based on the “stepped-up” cost basis mentioned above — i.e., the fair-market value at the time of the owner’s death — not their original purchase price.

For instance, if your mom paid $100,000 for her house in 1980 and its fair-market value at her death in 2020 is $350,000, only the difference between that updated amount and the sale price would be considered a capital gain, which may be taxable.

Depending on how you use the house and your tax bracket, rates on long-term gains — appreciation from an asset held more than one year — range from 0% for lower-income taxpayers, to 15% or 20% for those with higher incomes.

However, if you choose to live in the house for at least two years in a five-year period, and then sell it, you get to exclude a certain amount of appreciation from capital gains taxation because it qualifies as a primary residence: $250,000 for individual taxpayers and $500,000 for married couples filing jointly.

If you don’t want to sell the home and have no interest in living in it, renting it out can be an option for some sudden homeowners.

And of course, there’s always the chance you don’t even want to deal with the property at all. If that’s the case, you’ll be glad to know that generally speaking, you don’t have to

"I had clients who inherited a home and they viewed it as an albatross around their neck," said Ahmed of Private Wealth Partners. "They disclaimed it, and it was no longer their problem."

Disclaiming an inherited asset essentially involves formally alerting, in writing, the estate's executor, trustee or custodian that you don't want it. You must do this within nine months of the owner's death, and it cannot be reversed. Consult an attorney to find out if there are any local requirements for disclaiming property.

Retirement accounts

If you are not the decedent's spouse and are inheriting retirement assets — i.e., from an individual retirement account, a 401(k) or similar workplace plan — you would set up an inherited IRA and have the money transferred. While you pay no taxes at that time, you may owe ordinary income tax on distributions.

You also have a limited time to empty the account. Under the Secure Act, which was signed into law last year, retirement assets must be distributed within 10 years if an IRA owner died after Dec. 31, 2019.

There are exceptions to this, including for spouses, who can "stretch" out the inherited funds based on their life expectancy instead of depleting the account within a decade. Other exceptions include minor children, disabled individuals or those who are less than 10 years younger than the decedent.

a Roth IRA, be aware that the account must have b
owner's death or you'll face taxes on any earnings
th distributions are tax-free. You still would need to
if you don't meet an exclusion.

, and they can get tricky, depending on the person's
dent's age. For this reason, it may make sense to con
with a financial advisor to ensure you don't inadvertently set yourself up for a mistake.

For instance, while spouses can generally opt to roll the inherited assets into their own IRA, there may be times when it makes more sense to accept the money via an inherited IRA.

"If you are under age 59½ and you inherited the IRA from a spouse, if you put it into an inherited IRA and need to access the money, it won't be subject to the 10% early withdrawal penalty," said CFP Erika Safran, principal of Safran Wealth Advisors in New York.

"That decision would depend on whether the spouse needs the money right away," she said.

Other accounts

If you inherit non-retirement assets that have tax implications, such as stock held in a brokerage account, you get the stepped up value when you take ownership.

Financial advisors say one mistake they see is an heir maintaining the same portfolio because, say, a certain investment was special to the decedent.

“I think it’s always best to remember that your loved one is not you — and you should use the inheritance as it best benefits you,” said Brennan, of ARS Wealth.

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That means using the money to help you meet short- or long-term goals, and investing it in a way that puts you on a path toward meeting them, as well as reflecting your own risk tolerance (a combination of how long until you need the money and how well you stomach volatility in the stock market).

Life insurance policy payouts are not taxable. You may be asked by the insurer if you want to put it into a different option, such as an annuity.

“I’d rather the person take money and then determine what to do with it,” Safran said.

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