Inherit the windfall

By Amy Sutherland

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Few people ever win the lottery, but many come into unexpected inheritances. They make a killing selling their house, cash in big-ticket stock options, or sell a business.

However, like Mega Millions jackpots, windfalls have huge implications, given how they can affect financial planning, taxes, and life goals — so much so that many people freeze and just leave the cash in a checking account.

That would be the biggest and most common mistake someone could make, according to Dana Levit, a financial planner and owner of Paragon Financial Advisors in Newton. Levit says most people make their way to her office because they have inherited money, typically more than they expected, and don't know what to do with it.

“What I tell people is this is a phenomenal opportunity to take a good look at your overall finances and life goals and if you are on track for them,'' she says.

She first advises using the money to establish what most people don't have — an emergency fund. You need this to cover a possible job loss, medical emergencies, or even replacing a car. You want roughly three months of living expenses minimum, she says. If you can provide for more than that, Levit suggests stashing that money in a tax-deferred retirement account.

Next she recommends using your bonanza to wipe out high-interest credit card debt. Then see if you are on track for retirement. If, like most people, you are not, you will want to invest some of your new wealth in that.

Only then does Levit suggest considering other goals such as how big of an estate do you want to leave your children. That list may also include something extravagant, like snatching up a Rocky Mountain ski chalet.

However, as the balance in your checking account soars, you should resist the urge to make impulsive, big-ticket purchases, says Steve Weisman, an attorney and lecturer at Bentley College who's authored a number of books on financial planning, including “Boomer or Bust.''

“There's always the temptation,'' Weisman says. “That's putting all your eggs in one Lamborghini.''

That's OK as long as the extravagance fits into your overall financial plan and that beachfront condo in Maui doesn't end up representing too much of your portfolio, Weisman says. If you end up with too much of your assets in real estate, where they are not easily accessible, that could cause problems down the road if you run into an emergency. A second house, or even an expensive car, could also boost your monthly expenses beyond what's affordable.

People can also go on charitable donation benders, writing checks to family and friends right and left, playing Santa Claus to all extended empty hands. And those hands will be extended, Weisman says.

“The more money you have, the bigger target on your back,'' he says.

If you decide that you're going to give some of your largess to your relatives, you may want to think about what you would like those folks to do with those funds, such as helping a sibling start a business or a niece buy a house, says Derek Ferriera, a financial planner with Lincoln Financial Advisors.

“Most people just want to give the money and not think about what they can accomplish with it,'' Ferriera says.

Then you must decide on the most advantageous way to pass the money on. That might mean making it a gift or a loan, or setting up a trust. If you pick a trust, what kind? You may want to protect the money from their creditors or the possibility of a future divorce.

If your jackpot comes with tax implications, such as from the sale of a business or a large severance package, you may need to give some of it to friends or family or to a charitable organization. Otherwise you could be giving a chunk to the IRS, Ferriera says, which is exactly what most people don’t want to do.

With a charitable donation you’ll have to choose a nonprofit institution, which may be a no-brainer for some people, but for others may require substantial research. If you are going to give a sizable gift, you may want to consider how big a role you want in the organization. You might want to make an anonymous donation, but you may also want to get more involved. You can also establish a charitable trust with a lump sum in one year to get the maximum tax advantage and then dole out donations through it to various organizations in the future.

Answering all these questions about how to best use your windfall can take time, but the last thing you want to do is rush through them, Ferriera says. Your answers will have implications for decades, possibly generations, to come.

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