Morgan Stanley

Making the Most of Your Sudden Wealth

Most financial gains are inheritances, but they can also be:

- Legal settlements
- Proceeds from the sale of a business, real estate or other asset
- Executive bonuses
- Equity compensation
- Lottery winnings

All of them share at least two characteristics. They can propel you to financial security or serve as a source of future regret, if not managed wisely. This fact sheet will help you identify the issues involved in managing, preserving and maximizing your new wealth.

Talk to your parents or other potential benefactors and ensure they've consulted with an attorney who specializes in trusts and estate planning. There are numerous techniques involving trusts and gifting strategies that can reduce the size of an estate for tax purposes and still leave a benefactor's legacy intact. The key is to consider and implement those that are appropriate as early as possible.

Taking Steps to Preserve Your Sudden Wealth

Receiving a financial gain certainly doesn't seem to be a problem at first glance, but consider these statistics about inheritances:

- 33% of US households expect to receive an inheritance[1]
- 1 in 3 people who receive an inheritance lose all of their savings within two years[1]

AVOIDING ESTATE TAX EROSION OF AN INHERITANCE

Inheritances may be subject to estate tax at both the federal and state levels:

- If your benefactor's estate, including any taxable gifts made during life, is under $12,060,000 for 2022, no federal estate tax is owed.
- For any excess over that amount, federal estate tax can be as high as 40%.
- Estate tax at the state level varies from state to state.
- Inheritance tax may also be due for residents of Iowa, Kentucky, Maryland, Nerbraska, New Jersey Pennsylvania, or Tennessee.

[1] Wescott. Five Common Pitfalls of Sudden Wealth, March 2022. Available at https://wescott.com/insights/five-common-pitfalls-of-sudden-wealth/.

AVOIDING INCOME TAX EROSION OF AN INHERITANCE

Inheritances are not considered income and are generally not taxable. However, there are a few exceptions:

- If you're inheriting a traditional IRA, any withdrawal you take is generally taxable as ordinary income. If you inherit a Roth IRA, withdrawals are generally not taxable.
- If you're inheriting stocks, bonds, real estate or other assets, you pay income tax on any dividends or interest you receive. You also pay capital gains tax if you sell the assets at a profit. Long-term gains are taxed at 0%, 15% or 20%, depending on your tax bracket. The good news is that cost basis on appreciated assets you inherit is stepped up to the price of the assets on the day of the benefactor's passing or an alternate valuation date.

WHAT ABOUT NON-INHERITANCE SUDDEN WEALTH?

Tax treatment varies:

- In the case of the sale of real estate or other assets, you pay capital gains tax on your gain, provided you've held the asset for a year or more.
- With a life insurance payout, you generally pay no income tax, but depending on the size of the insured's estate and who owns the policy, estate tax might be due.
- With a lawsuit settlement, you may or may not incur tax liability. Damages for physical injury are typically tax-free. Damages for lost profits or discrimination are often taxable. Again, it's advisable to consult a knowledgeable attorney as early as possible in the process.

Beyond Taxes: Do's and Don'ts of Managing Your Sudden Wealth

DO DECIDE IF YOU REALLY NEED IT

If you don't really need the money, here are a few ideas to think about:

- Consider talking to your benefactor about generation-skipping trusts or other strategies that would enable him or her to pass on the inheritance to your children.
- If you are the beneficiary of a life insurance policy, consider disclaiming the death benefit, which would then go to a contingent beneficiary. The contingent beneficiary could be your children, other family members or perhaps a trust.

Again, it's critical to consult with an attorney and accountant to determine which, if any, of these strategies make sense for you. Disclaiming is also a formal procedure with complicated rules, documentation and timing requirements.

DO TAKE A COOLING-OFF PERIOD AND DEVELOP A COMPREHENSIVE FINANCIAL PLAN

Take some time to cool off when receiving a financial gain and think about what you really want to do with it. During this time, you might want to keep your assets in a money market fund or other liquid investment. You should also think about creating a comprehensive financial plan that:

- Reflects your new circumstances.
- Provides you with a road map for preserving your assets and accomplishing the goals that are most important to you.
- Helps you integrate your new wealth into your overall finances and manage it in accordance with your goals and risk tolerance.

DO CONSIDER FUNDING YOUR RETIREMENT

- Think about increasing your contribution to your 401(k) plan at work—perhaps to the maximum allowed.
- Consider opening a traditional or Roth IRA (if you qualify) and contribute the maximum each year. That's $6,000 for 2022 or $7,000 if you're 50 years of age or older during the calendar year.
- Invest your inheritance and use any income it provides to help replace the dollars you contribute to your 401(k) or IRA. Any growth achieved by your investments can go toward your retirement.

DO CREATE A LIST OF GOALS

Think about what you really want to achieve. A college education for your children or grandchildren? A vacation home you've been dreaming about? An early retirement? A sound financial plan can help you project the cost of your objectives and determine how close you are to reaching them and what you need to do to fill any gaps.

DO CONSIDER FUNDING YOUR CHILD'S OR GRANDCHILD'S COLLEGE EDUCATION

Consider contributing to a 529 Plan that offers:

- Tax-deferred growth
- Tax-free withdrawals when used for qualified expenses
- The ability to remove assets from your estate

DO CREATE AN EMERGENCY CASH RESERVE

Your reserve should cover three to six months of living expenses just in case someone loses their job or unforeseen expenses arise. You can keep these funds in a money market fund or any investment that you can convert to cash easily if you need it.

DO PAY OFF HIGH-INTEREST DEBT

Consider paying off any debt with high interest rates like credit card balances, personal loans or even your children's student loans. However, paying off a mortgage may or may not be a good idea since mortgage interest is tax-deductible. With today's low investment yields, you might be better off keeping your mortgage and investing the proceeds in low-yield fixed income investments.

DON'T CHANGE YOUR LIFESTYLE, TAKE EXCESSIVE RISKS OR TELL EVERYONE YOU KNOW ABOUT YOUR GOOD FORTUNE

- Don't quit your job, buy a Ferrari or give money away to friends and family members.
- Don't take excessive risks. People who become suddenly wealthy are often targets for people seeking funding for a startup business or other investment.

Inheriting a 401(k) or Other Tax-Qualified, Employer-Sponsored Retirement Plan

There's one kind of financial gain that's different from all the others. It's the one that comes from inheriting a 401(k) plan account, IRA, or other tax-qualified retirement account.

- Some plans require participants to leave all plan assets to their spouse unless the spouse consents to a different beneficiary (different rules apply to defined benefit pension plans). Some plans have rules on the form of payment in which spouses or non-spouse beneficiaries can receive plan assets. Talk to your parent or other benefactor to determine the rules that apply to his or her 401(k) or other tax-qualified retirement account. The more you know and the earlier you know it, the better you'll be able to make smart decisions.
- You may be able to roll over your benefactor's 401(k) account or other retirement plan inheritance to an inherited IRA. By doing so, you arrange for the plan trustee to transfer assets directly to the inherited IRA. Beneficiaries generally must then begin taking withdrawals after the year of the account owner's passing and withdraw a minimum amount each year based on IRS single life expectancy tables. Surviving spouses may delay starting distributions until they reach age 72, or if later, when the account holder would have reached age 72 (70½ in some circumstances).

How Morgan Stanley Can Help

Morgan Stanley does not give tax advice. However, we can help you understand the tax consequences you might face and how to manage them. We can also help you avoid the common mistakes that can jeopardize your inheritance or sudden wealth. Most importantly, we can help you create a comprehensive financial plan that integrates your new wealth into your overall finances, and provide you with tangible strategies for pursuing your most important goals.

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