What To Do With an Expected Inheritance

The comments section of this blog, the forum, and my email box are a constant source of good material to write about. This one came via an email back in April.

Q.

Obviously one does not want to count on an inheritance, but like Social Security, believing it won't be there may lead to working longer/harder than needed. How do you think someone expecting an inheritance should factor that in to their financial planning?

A.

I've written before about what to do with a windfall. However, this question is more about a possible future windfall, which is a very different thing.

There are three factors to consider when factoring in an inheritance to your financial plan. The first is the size of the inheritance and the second is when you are likely to receive it. For example, if you plan to retire with $5 Million and the inheritance will be $100,000 and come about the time you retire, you should just ignore it. It isn't going to materially affect your financial planning. But if the inheritance is $2 Million and will come before, at, or shortly after retirement, then that's too large to ignore. Likewise an inheritance of $200,000 that you'll receive before age 50.

The third factor, and the real sand in the gears in this calculation, is how likely you are to receive the inheritance. Lots of things can happen to an inheritance. You can have a fall-out with the person you thought was going to leave you money. That person could also live longer than expected, or burn through a bunch of cash treating his terminal illness. The person could also be a poor investor or be taken advantage of by an unscrupulous professional, making that inheritance much smaller than you were expecting. Some parents leave different amounts to children depending on the children's various financial situations. If your parents are like that, expect as the high income professional in the family to get a smaller chunk.

The Easiest Thing

The easiest thing to do with any possible inheritance is to just count it as gravy. That means if it comes, great. If it doesn't, that's fine too. That means that the money you inherit should be earmarked for charitable contributions, leaving as your own inheritance, or at least only counting on it for extras rather than mandatory living expenses. You still need to work, save, and invest until you have enough to retire comfortably without the inheritance.

The "Sure Thing"

On the other hand, some people are going to inherit a rather substantial sum relatively early in their investing careers, and the chance of something going awry seems very small. If that is the case with you, you may want to add the value of the inheritance in to your plan. At that point, it's just a math problem. Let's look at an example.

Let's say you're 40 years old, have a retirement nest egg of $500K, plan to retire when you hit $5 Million, and expect an inheritance of $1 Million to show up at some point in your mid 50s, give or take 5 years. Let's say you are saving $50K a year toward retirement. If your investments earn 5% real over the years, you should be able to retire at 68 as seen in this spreadsheet function:

=FV(5%,28,–50000,–500000,1) = $5.03M

So, what happens if you add in a $1 Million inheritance at 55? Well, let's first run that equation for just 15 years:

=FV(5%,15,–50000,–500000,1) = $2.17M

Now add $1 Million to that pot and you can run this equation:

=FV(5%,13,–50000,–2170000,1) = $5.02M

Essentially you've cut 5 years off your career with this inheritance. But what if you still wanted to work until 68, how much less could you save each year? Well, it turns out you can save much less, about $20K a year. See, your first 15 years looks like this:

=FV(5%,15,–20000,–500000,1) = $1.49M and then you add your million dollar inheritance and your next 13 years looks like this:

=FV(5%,13,–20000,–(1000000+1490000),1) = $5.07M

Talking to the Folks

This one better not be counting on an inheritance when I keel over

Perhaps the best thing to do is to actually talk to your parent or whoever you expect the inheritance from and tactfully (very tactfully) ask if an inheritance is something you should incorporate into your financial plan. Perhaps you'll be able to then have a general idea as to the amount and liquidity of the asset. You can then run the person's stats through an online life expectancy calculator to get an idea about when you'll receive the inheritance.

Have I done this? Heck no. I help my parents manage their portfolio. I know how much is there, and divided by their 6 kids it isn't going to dramatically affect my financial situation, although it could be a significant boost for some of my siblings with smaller retirement nest eggs. But I anticipate being well into retirement before the last of my parents departs this Earth. I'll need to have "enough" before they'll have had enough. Besides, my mom reads my blog so if she wants to tell me how much I should expect in the will, I'm sure she will. I've already told my siblings I'm taking the rocking chair Grandpa made no matter who my parents leave it to!

The Bottom Line

If you're sure you're going to get an inheritance, sure about how much it will be, and sure about when you're going to get it, then factor it in to your retirement plans (always adjusting as you go of course.) I suspect that's a very small percentage of inheritors, however. Most of us don't know how much money we're going to inherit, when we'll get it, and cannot even be 90% sure, much less 100% sure, that we're actually going to get it at all. If that's the case, I'd ignore it for your planning purposes and use that money for your charitable giving, your own inheritance, or your "gravy money."

What do you think? Do you expect an inheritance? How much and when? How has the knowledge of knowing that is coming affected your retirement planning? Comment below!