The Good Guide to what to do with an inheritance

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Good With Money, the ethical personal finance website, in partnership with EQ Investors, the Good Egg mark and B Corp wealth manager, which was one of the first firms to offer regular investors a "positive impact" portfolio option for their investments.

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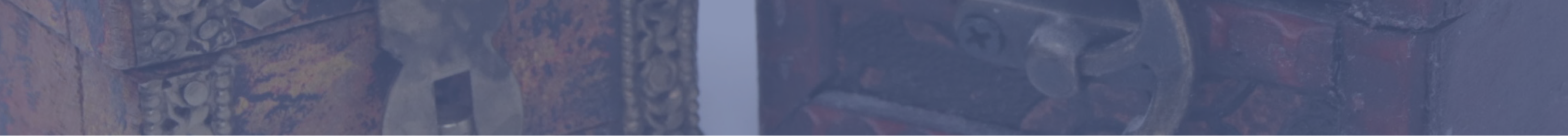


About this guide

This short guide is for people in their twenties, thirties and forties who at some point in their working lives, expect to receive what's not so elegantly called a 'lump sum' of money from older relatives, whether that's parents or grandparents.

It could also be useful if you receive a lump sum from another source, like a workplace bonus.

It's for people who have already made that first step on the property ladder, as for those who haven't, the logical thing to do with a lump sum is to put this towards a home deposit.

But once you've jumped that hurdle, there are numerous options for what to do with subsequent gifts, and it is these options that this guide will attempt to weigh up.

What are the other ways you could end up with a lump sum?

- unexpected work bonus
- selling a business
- premium bond prizes, or other prizes
- share scheme from workplace doing well

This guide could help you with these, too.

Disclaimer

And also, a small disclaimer, that tax rules, as well as personal circumstances, can change in a flash, particularly in these strange and volatile times. So while the information in this guide is accurate at the time of printing, it may become out of date.

We will endeavour to publish updates as and when required.

If you have any questions about the guide, please email goodwithmoneygirl@gmail.com or contact@eqinvestors.com.

Introduction: Not expecting an inheritance? Here's why you might be wrong

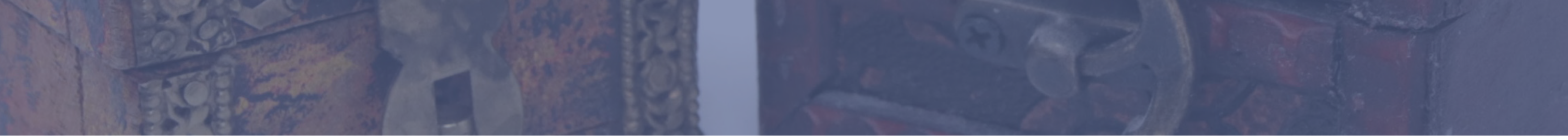
The word 'inheritance' feels like it belongs to the wealthy and privileged, as if it is something that only happens to those who grew up on large family estates, went to the best boarding schools and whose parents also inherited from their parents.

But these days, inheriting money from parents or grandparents has become a fairly normal expectation across a far wider demographic - in fact, for anyone whose parents own their own homes.

That's because inheritance in 2021 and beyond is driven by housing wealth: an accumulation of it from parents and a need for it, earlier and earlier in life, from adult children.

It's a direct consequence of the stratospheric rise in house prices that has taken place in the last 40 years or so, which has made baby boomers asset rich but simultaneously created greater need among the younger generations to raise big deposits to get on the property ladder. The average house price in 1982 was £20,000. By 2019, it was £230,000.

Many people over the age of 60 paid off their home loans long ago. Meanwhile, those in their late 20s and early 30s must save deposits for a first home that are typically bigger than the average salary of someone in their 30s; at £46,187, according to the latest Halifax bank estimate, compared with an average salary for 30 to 39-year olds of £31,896, according to the Office for National Statistics.



The irony of parents having to use their housing wealth to help younger family members move onto and up the housing ladder can't be lost. A few years ago, the narrative was around how lucky the baby boomers were to have benefited from such house price growth. The narrative is now shifting, to focus on how lucky are the children and grandchildren of those boomers, who stand to inherit it.

Those over 60s, cushioned by possibly unrepeatable house price gains, find themselves under increasing pressure to pass on those gains to their own children, one way or the other, if they want them to enjoy the benefits of this new found wealth and to own their own homes. Unless their children turn out to be exceptionally high earners, who don't need help, that is. And there is a genuine generosity behind this - a feeling among baby boomers that they did indeed have it easier, and a sense of wanting to maintain the 'intergenerational contract', which is at the heart of things like the National Insurance system and the state pension.

For the greater good of society, this intergenerational contract is vital and while it is supposed to happen through the tax and national insurance system, it also now increasingly takes place on the level of individual families.

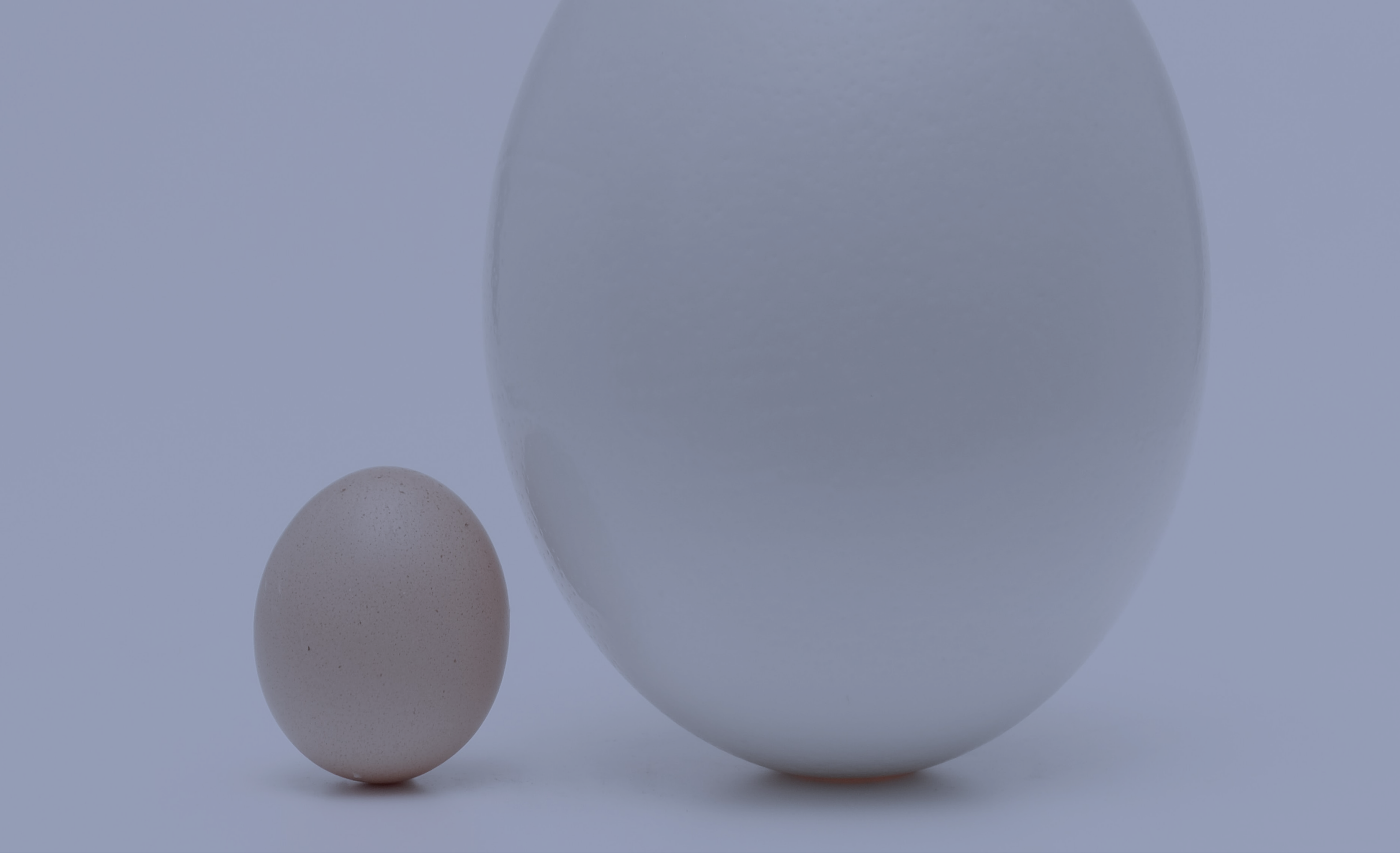
There is another reason we can begin to expect to inherit more from our parents: the switch from defined benefit to defined contribution pension schemes.

With most defined benefit schemes (which were the dominant type of occupational pension scheme but are slowing dying out), when someone dies, there is nothing left at the end to leave to relatives. Whereas with defined contribution schemes, which are replacing the older-style schemes, when someone dies, whatever is left in their pension pot goes to whoever is listed on their beneficiaries form.

It's possible that very little will be left in the pot - only the most fortunate pension savers have enough in their pension and then some for their family when they die.

Whichever way it comes - whether through property or through pension assets - a great wealth transfer is upon us. Over the next few years, many young people will be faced with decisions on what to do with this wall of money headed their way.

It's a precious gift no one would want to waste, if they are lucky enough to receive it. Let us help you work it out.



But first, how much exactly is a lump sum?

Even £5,000, used wisely, can change your life.

So when we talk about receiving a lump sum, we mean from around £5,000 upwards, although in reality, for those receiving cash from home-owning, baby boomer parents, it could be much more.

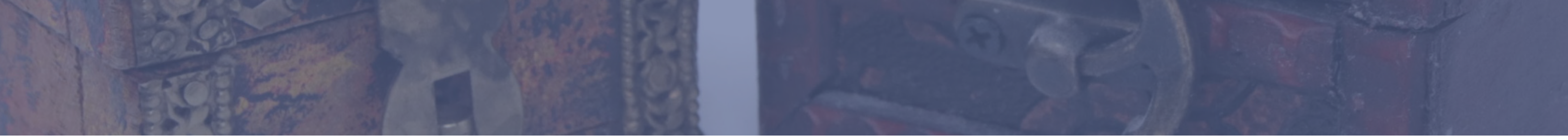
The average amount gifted for a home deposit is £19,000, according to the English Housing Survey.

Anything bestowed after that will depend on your parents or grandparents remaining wealth, either through pensions or property. But it could eventually add up to hundreds of thousands of pounds gifted either when your parents are alive or after they die.

And clearly, the more money you inherit, the more options there are and the more life changing it becomes.

Can your parents afford to gift you a living inheritance?

Accessing lump sums to pass on to children isn't easy if your wealth is tied up in your home. The logical way to access the cash is for parents to downsize. However some parents are using lump sums from their pensions and some are using equity release. Others are using wealth built up in ISAs or other savings.



There are risks associated with gifting from pensions for generous parents. Giving some of their tax-free lump sum money makes perfect sense given the age at which those approaching retirement can access cash (age 55+, relative to the age of their children (25 ish, who will most likely be considering how they will afford their first home around this time.

But parents need to make some careful calculations to ensure they will still have enough to live on in retirement and are not being overly generous. And children who are potentially receiving such gifts also need to be mindful of their parents circumstances, and talk to them about whether they have ensured they will still have enough money for themselves.

The retirement age is currently 66 and life expectancy for millennials is around 85 (slightly longer for women). So your parents or grandparents will need enough funds to give them an income for 20 years - if not more, to be on the safe side.

Depending on the type of pension your older relatives have, they might also leave behind some pension wealth to you when they die. This is the case with defined contribution rather than defined benefit pensions.

You may feel it's intrusive to ask parents about their pension arrangements. But it should be OK to take an interest in ensuring they have enough money to fund their retirements, particularly if they have expressed that they want to help you out financially.

It might be wise for all of you to sit down with a financial adviser or planner together, to work out how much your parents can give, if that's what they want to do, without impoverishing themselves.

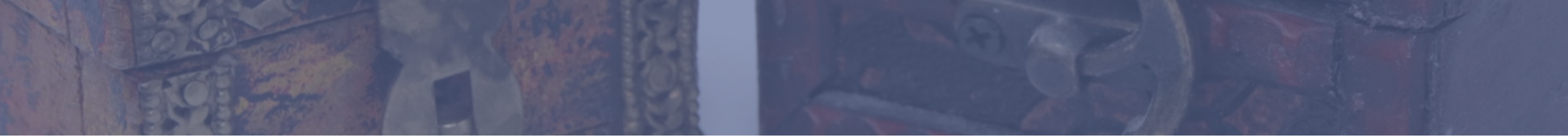
How much could I expect to receive?

"There is no more expensive thing than a free gift"
Michel de Montaigne

What size of lump sums are actually realistic? Some estimates suggest that the millennial generation could be in line for more than £100,000 each, whereas their expectations are somewhat lower than this, at around £70,000.

Any amount you receive will depend on many factors, such as the number of siblings you have and any inheritance tax payable on your gift if your parents die within seven years of gifting you the money.

The amount you receive will also simply depend on your parents or grandparents' means and their wishes for what to do with any money they won't need for their own retirements or care costs.



If you aren’t sure about whether any gifts are on the cards for you but suspect there might be, it’s important to talk about this with your parents.

Expected inheritances that don’t materialise can cause poor decision-making with life-changing consequences.

Equally, receiving unconditional lump sums without having a clear plan in place for them can result in squandering valuable gifts.

Sometimes, parents or grandparents set conditions for gifts, to ensure that their hard-earned savings go to good future use. This can involve agreeing to invest the cash for the long term, using it for further education or training or investing it for the next generation of grandchildren.

If there are terms associated with it, it’s important to understand these, too.

You might wish to know more about the ins and outs of inheritance tax

It is a complicated subject to go into but a couple of things to bear in mind:

- Main residences (ie. your parents home) passed on to children or grandchildren, benefit from something called the residence nil rate band. It means no inheritance tax is paid on the first £500,000 inherited. Above that, and 40% inheritance tax is due on estates.
- Married couples' nil rate bands are added together, so in practice, the amount that can be passed on as a main home to children or grandchildren without attracting an inheritance tax bill is £1mn.

Inheritance tax: what is it? Who pays it?

It’s important to note that you, as the recipient of the gift, would be liable to pay any inheritance tax and this usually is paid from the ‘estate’ you are receiving money from.

On estates worth more than £325,000, the standard inheritance tax rate is 40%. But of course, as with all things tax, it’s rarely that straightforward.

This guide isn’t designed to give comprehensive information on inheritance tax itself - there is a guide for this on the EQ Investors website here.

Drip-fed inheritance gifts

Tax is one reason you might not get an inheritance all in one go.

But there are other reasons, for instance, for the sake of trying to balance immediate and future needs and trying to avoid waste, it can make sense for parents to gift money in smaller chunks rather than in one big lump sum.

It’s not just inheritance that can result in you receiving a lump sum. You might receive a bonus through work, or a premium bond payout.

If you receive financial gifts in lump sums, it can make it harder for you to look after it. It may be more tempting to spend it on smaller things, rather than save it up, for instance.

How to invest an inheritance

Investing for the first time can be daunting for anyone. It's possible to spend hours and hours researching different options yet still not be certain what is right for you.

When you are thinking about investing money passed on by a loved one there is added emotional pressure. Making a mistake with the money you earn is horrible but making mistake with a legacy could make you feel that you've let down your parents or grandparents. This extra sense of responsibility makes decision making harder, sometimes to the point where they don't get made.

Understanding the purpose of your money will help you make the right decision. Spend some time thinking about what is important to you now and what might be important in the years to come.

Our priorities shift over time – the hardest part of financial planning can be picturing what will be important 10, 20 or 30 years from now. Knowing how long your money is likely to be invested gives you a good basis for deciding how to invest.

Over the longer-term inflation can seriously erode the purchasing power of money in savings accounts. Investments in the stock market tend to do better than cash over the long term, even though there is risk involved. Have in place a suitable emergency fund and think about investing for the longer-term future using the two tax efficient vehicles available to everyone.

By Jeannie Boyle, director of EQ Investors and Chartered Financial Planner

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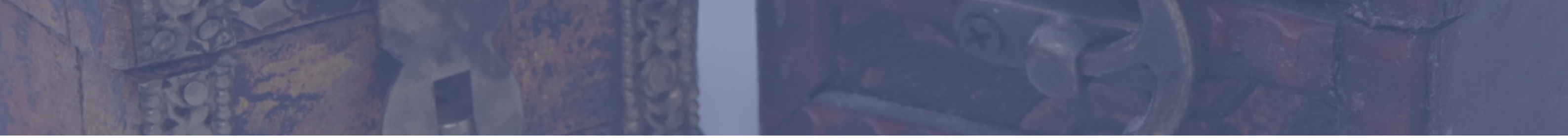


The next decision you need to make is what sort of investment 'wrapper' is right for you. The UK has two tax efficient wrappers you can use – the ISA and the pension. These allow you to invest money without paying any tax whilst the money is invested. You can invest money outside of pensions and ISAs, but you might have to pay some tax on your profits.

If you know you are unlikely to need access to your money until later in life you could top up your pension. Many of us are forced to neglect our retirement saving while we save to buy a home. This could be a good opportunity to top up pensions.

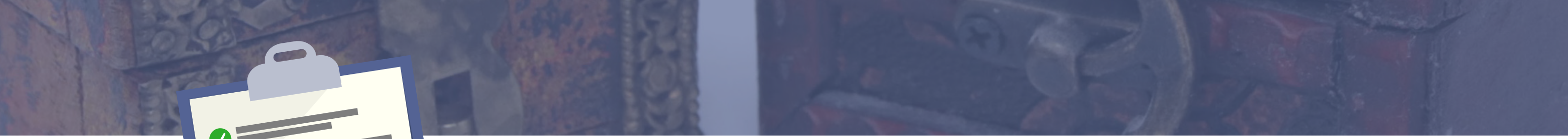
Money in ISAs can be accessed at any time. This flexibility makes them the perfect way to invest money you might need before you retire. There are a few different types of ISA but the simplest one to use for investing is the Stocks & Shares ISA. It allows you to invest up to £20,000 each year.

The next step is deciding what investments to make inside your ISA. Investing means taking some risk.

There are a range of products on the market that you can wrap in an ISA or pension. Don't start by investing money into a single company even if you're convinced it's got great prospects. You can choose ready-made portfolios that invest in shares, bonds and other assets across a range of countries and regions - helping to dilute risk whilst improving the chances of investing in the right places. Reduce risk by spreading out your contributions at regular intervals. A common approach might be to split the investment into four chunks which can be invested at regular intervals over 12-18 months.

Whatever you do invest in, though, make sure you do your research first and don't invest in anything you don't understand.

Using a discretionary investment manager like EQ means that the investment decisions are made on your behalf. Experts carry out the research and monitor the investments, so you don't have to.



Check List

If you have received, or expect to soon receive, a lump sum, there is an important check list to go through.

Pay off any debts first

Debt involves paying interest, so pay off any unsecured debts that charge you interest, like credit cards or personal loans, first. Interest-free debt, such as for home furnishings or cars, or low interest mortgages, do not need to be paid off as a priority with any inheritance money, unless the monthly repayments are bothering you and you would like a clean slate.

Have you got three months of salary in savings?

It's a good idea to have a cash buffer for emergencies, such as time out of work or home repair works not covered by insurance. Three months worth of gross salary is probably the minimum amount you should keep ready to hand in reserve, but six months would be ideal. That can be a lot of money. If your lump sum is in the region of £5,000 to £10,000, you may end up using the whole lot just to fill your emergency savings pot. Emergency savings are best kept in an account you can access easily: an "instant access" account, rather than in an investment account or term/ notice account. Unfortunately, interest rates tend to be the lowest on instant access accounts...Once these are ticked off your to-do list, next comes the fun bit - visualising your life goals, and working back from there to establish what to do with your money.

It's unlikely you'll just have one life goal in mind - more likely four or five. So then it becomes a question of prioritising them, bearing in mind the size of the lump sum and how much it is likely to help you fulfil those goals.

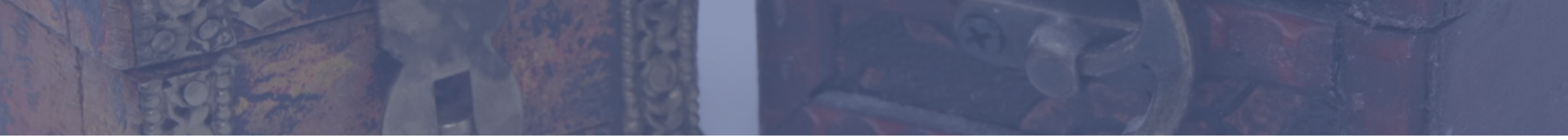
It's also a good idea to divide these life goals up into short (3 to 7 years) and long term (7 years plus).

Short term life goals egs:

- Paying for a course of study
- Getting married
- Going travelling/ volunteering abroad
- Affording to pay for a car in cash
- Investing in a business
- Becoming self-employed

Long term life goals:

- Upsizing to a large family home
- Your kids university maintenance costs covered
- Private school fees
- A decent retirement pot
- Mortgage freedom



How to deploy the money:

If you have any debts, pay these off first. That doesn't include mortgage debt and if you have 0% interest car loans or furniture loan payments, you don't have to (though you may want to) pay these off. But interest-bearing debt - the highest interest first - should definitely go first. This could be credit cards, personal loans or overdrafts.

Once you've paid off any debts, you can get down to the other, more exciting options:

Pay down your mortgage balance

This can help towards reducing your mortgage term so that you are mortgage free early or have much lower repayments, giving you more monthly headroom from your income to do other things with your money beside paying off housing debt (and who wouldn't want that?!)

Overpay £10,000 on a £200,000 mortgage that has a 25-year term and a 2 per cent interest rate, and you can reduce the term by 1 year and seven months and pay £6,212 less in interest over the term.

Overpay £50,000 on the same mortgage and you'd finish paying off your loan a whole 7 years and six months earlier and would save yourself £26,339 in interest.

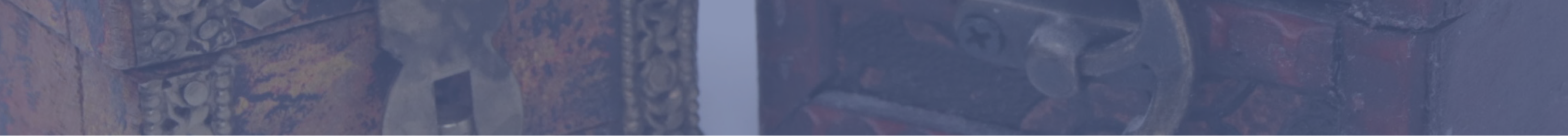
Check the amount that your mortgage allows you to overpay yearly without penalty. On most mortgages, overpayments worth 10 per cent of the balance are allowed every year, without penalty.

Invest the money using ISA allowances

You have a £20,000 ISA allowance, which means every year, you can save of invest into ISAs £20,000 without paying any income tax or capital gains tax on the proceeds. It may not be obvious to you until you have quite a chunk to invest how advantageous this is.

The types of ISA available to you are:

- Stocks and shares
- Cash
- Lifetime (which can be either stocks and shares or cash and has a £4,000 limit of its own within the £20,000 annual limit)
- Innovative Finance (a bit special, you can see our separate guide to these)
- Junior ISAs (for your kids, if you have them, and in their name rather than yours) have a separate annual allowance of £9,000 a year



Choosing the right ISA

It can be hard to know which type of ISA to go for but if you want higher growth prospects, for higher risks, over the longer term (at least three years, plus then stocks and shares ISAs could be a good bet.

With these, you can choose from funds, 'Exchange-traded funds', investment trusts and individual company stocks. It can be daunting to know what to choose when you open a stocks and shares ISA, but with a bit of research, this option stands to make you higher growth over the long term than savings.

Interest rates on savings accounts are typically very low, and as a result, you stand to lose money by choosing cash accounts for the long term because inflation is likely to be higher.

Maximising your pension contributions

If you really want to go for your own long term financial security, it doesn't get better than a pension. You get tax relief from the Government on top of your returns: if you are a basic rate taxpayer, that's an extra 20 per cent, and if you are a higher rate taxpayer, it's an extra 40 per cent in free money from the Government.

You can add up to £40,000 a year tax-free into your pension, or up to your current earnings.

So if you can't think of anything in the near term you would want with the money, then a pension (which, don't forget, you will most likely be able to access some of when you reach 57, which is to become the minimum pension age) is a worthwhile place to put it.

How NOT to blow your inheritance

Around one in 10 Brits born in the 1980s will inherit more than half as much money from their parents as the average person earns in a lifetime, according to a report by the Institute for Fiscal Studies.

The economic think tank found that the median inheritance is £136,000 for those born in the 1980s compared to £66,000 for those born in the 1960s.

But while the size of inheritances has more than doubled in two decades, incomes have barely risen for young adults compared to previous generations.

When handled wisely, an inheritance has the potential to provide financial security for a lifetime, but being handed a big pot of money (or other assets) when you're not used to having much also comes with its temptations - and ultimately, the risk of losing some or all of it.

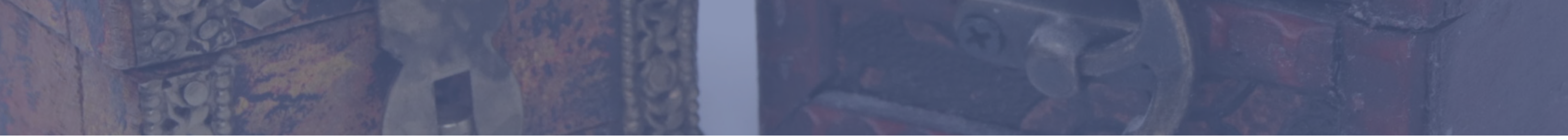
Greg Davies, founder of behavioural finance specialists Oxford Risk, says there are some important steps you can take early on to avoid blowing your inheritance.

An interview with Greg Davies, behavioural finance expert at Oxford Risk

Oxford Risk | Behavioural finance. Applied.

Take a pause

When dealing with the death of a loved one, there are some practical decisions that you can't put off such as making funeral plans.



But what to do with your inheritance is not something you need to decide on quickly, especially as there are potentially huge long-term consequences.

“Giving yourself time is the most important thing you can do when making any big decision,” says Greg. “You need at least six months. Give yourself time to grieve properly, for emotions to settle and to consider all your options.”

When parents pass away, it can be the first time their children see a full picture of their finances. There may be assets you didn’t know existed, or other people included in their will that you hadn’t even known about.

“You should never assume that because you were close, you knew everything about them,” says Greg. “It takes several months to be able to understand the broader context.”

Follow the deceased’s wishes with caution

Many people will want to follow the wishes (whether these are known or perceived) of their loved one when deciding what to do with their inheritance.

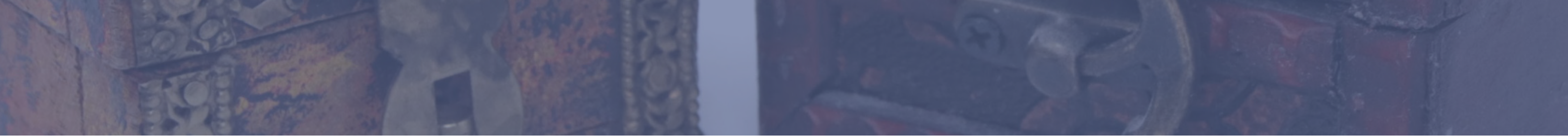
While this is understandable, those wishes can end up being costly financially, warns Greg. He says: “When receiving an inheritance, there are often emotional strings attached and this can be both positive and negative. For example, you may be left an asset such as a house instead of cash.

“The house might be in a country you don’t live in and can’t visit often. If you kept it simply because the person who died loved it, you could end up sinking money into it. Ask yourself ‘what is the importance of that emotional connection in my own life?”

Change your wealth ‘number’

An inheritance is likely to mean you have far more money than you’re used to. Greg says: “Your ‘wealth number’ instantly goes from one to 10. However, your emotional perception of how wealthy you are doesn’t make the same jump. It takes a while for us mentally to assimilate rapid increases in our wealth.”

He says we may feel that it isn’t actually ours so we think ‘I can take lots of risk with this money’, or we start spending massive amounts of it.



We then justify this by thinking ‘even after I’ve spent huge chunks of it, I’ll still be wealthier than I was’.”

Greg likens this to the ‘House Money Effect” in gambling. He says: “When someone goes into a casino, they might win money very quickly but their mental wealth doesn’t have time to catch up. Gamblers can view their new chips as not really their money but belonging to the house. The thing is - and this goes for inheritance too - this IS your money.

“Consciously think to yourself “I’ve got a wealth number of 10”. This will have positive consequences for your decision making.

Get professional advice

Looking at your own financial existence in a holistic way is hard. This is where a good financial adviser comes in.

Greg says: “Too many people do the impulse spending first and then think about their kids’ education and retirement. Flip that around so you put the most important things first. You really need a spreadsheet for this. It can be extremely difficult to do this ourselves and it might be tempting to bury your head in the sand.

“This is where a financial adviser is so important, because they can look at your financial situation in a clear and objective way.

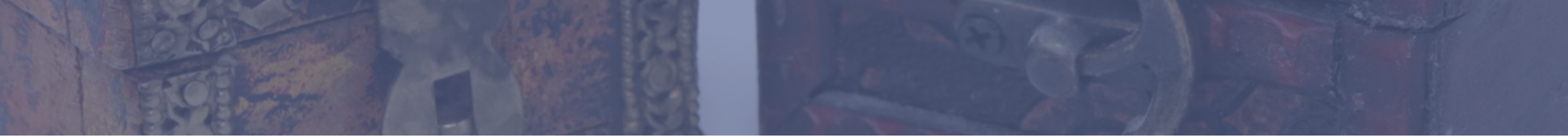
Reframe what the gift is

“We often hear of lottery winners who get a huge windfall, fail to reset and plan properly, and end up spending all of it only to end up back where they were,” says Greg.

“To avoid this, try reframing what the gift you’ve been given is. Look at it as the gift of financial resilience and comfort. This is the primary gift, not the money itself. When you look at it like this, you’re more likely to make better decisions about what to do with it.”

Know your spending personality

A good financial adviser will take your personality into account when setting goals for your money. They might consider how impulsive you are and how financially comfortable or anxious you tend to feel.



Greg says: “Someone who is very impulsive or has a history of spending more than they earn will need more brakes to be put on.”

He says you should also consider your deeper values, such as whether you want to invest sustainably and what causes are most important to you.

Consider an “investment playpot”

If you are really tempted to spend in an emotional way, Greg advises giving yourself an “investment playpot” using five to 10 per cent of your assets.

He says: “If you feel emotionally driven to do something, do it but only in a controlled and contained way. Instead of pretending you’re a completely rational person, take ‘one’ off your ‘10’ and accept that you might end up at ‘nine’.

“Setting aside this chunk of money buys yourself time to make decisions about the rest of it. Tell yourself you won’t touch the rest for another six months.”

If, however, you’re tempted to make a big purchase such as a new sports car or luxury holiday, Greg advises to delay it. After all, he says, if you didn’t have the goal of owning a flash sports car before you came into the money, it’s likely that six months down the line you’ll regret that purchase.

Final word

If you expect to come into an inheritance at some point, or have already done so and don't know what to do with it, we hope you've found this guide thought-provoking and inspiring.

Being left something by older generations is an immense gift - the gift of opportunity and future freedom, for you and your children. There may be no hurry to make decisions. If you can take your time and mull your options, then do. It's a lot to consider. But don't do it alone.

Speak to your partner, your parents - even your children, if they're old enough. But also speak to dispassionate professionals who can see things more clearly than family members might.

Good With Money has a list of ethical advisers who can help you, here.

EQ Investors, the sponsors of this guide, is an investment platform that can help you with portfolio picking for stocks and shares ISAs, financial planning, and lots more.

You can get in touch with them here.

We wish you well with your decision-making!

About Good With Money

Good With Money is a money website with a difference: it is all about how your money can do more good for people and planet, as well as line your pocket.

It created the Good Egg mark, a licence for financial services companies which make a positive impact.

Sign up to the weekly newsletter for the latest reviews and deals here.

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EQ Investors – meet an expert for a virtual coffee

EQ's financial planners help people at all stages of life with their financial goals. Over the years they have found that the best way to start this process is an initial meeting to get to know each other and to understand more about what you need and what they can offer. They offer these meetings free of charge as they are as beneficial for them as they are for you.

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