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WEALTH ADVISER

Voices: Steven Abernathy, on Stock Options in Roth IRAs

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Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Steven Abernathy is the chairman of the Abernathy Group II Family Office in New York.

Roth IRAs haven't been around for very long, and have really only taken off in the last few years. There are some techniques with Roth IRAs that advisers may not even be aware of. One such technique is that an individual at a private firm can have stock options issued directly to their Roth.

Steven Abernathy

Traditional IRAs and Roth IRAs are very different vehicles. If you're intelligent about the way you use them, clients can reap the benefits. To begin with, a traditional IRA is a tax-deferred investment that lowers your taxable income, but when you withdraw the money it increases you adjustable gross income and is taxed.

However, in a Roth IRA, assets are put in after-tax: there is no tax advantage on the way in, but on the way out, all withdrawals from that Roth are taken tax-free and do not affect your adjusted gross income.

The IRS doesn't recognize options gifted from a private company as income until they're exercised. Once the options are exercised it becomes a capital gain. If they're never exercised, you've basically never been given anything. That's how options enter the Roth without being taxed, because to begin with, the option is worth nothing.

For example, let's say a company gives you 10,000 options exercisable at $10 a share, and that the options expire in five years. Though the company takes a write off for the price of those options, the employee has no taxable event. This is because if the stock is publicly traded and worth less than $10 at the end of those five years, the option is worthless. If on the other hand, the stock is worth $100 you would have made $900,000.

However, if those options were issued to a Roth, that's where the magic happens. If after five years the stock is worth more than $10, and in our case we said it's worth $100, you now have $900,000 in your Roth. That money is tax-free because the appreciation happened inside the Roth. So when you withdraw it there is no tax on that money and it does not impact your adjusted gross income.

There are a few challenges. Whether or not you're allowed to do this depends on the company issuing the options. Most private companies have the latitude to issue their stock in any manner they wish, though many companies do not know about this technique. Also, because it's a Roth IRA, it's important to realize the assets need to be there for five years and you can't remove them without penalty until you're 59½.

Techniques like these require that advisers be creative and energetic for their clients. But advisers who do the work, who go above and beyond for their clients and really understand how to maximize a Roth can find a lot of benefit for their clients.