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Options Integrity

Evaluating the Tax Character of Options-Based Income

This paper is intended to provide a general framework for evaluating options-based income strategies. It is educational in nature and is not intended to suggest that any particular options strategy, fund structure, or implementation method is appropriate or superior in all circumstances. The suitability of any investment strategy depends on an investor's objectives, risk tolerance, tax circumstances, and other individual considerations. Readers less familiar with options strategies or tax terminology should refer to the glossary of key terms provided at the end of this paper.



Executive Summary

- A higher fund distribution rate does not necessarily result in a higher after-tax outcome for investors.
- Options-based income strategies can generate distributions from multiple sources, including ordinary income, capital gains, option premiums, dividends, and return of capital, each of which may have different tax implications.
- Similar distribution rates can be achieved through different strategy designs, potentially leading to different outcomes for after-tax returns, market participation, and distribution sustainability.
- Return of capital may defer taxation by reducing an investor's cost basis, but it is not necessarily tax-free income and may affect future taxable gains or losses.
- The structure used to implement an options-income strategy—including index-based, security-level, and note-based approaches—can influence flexibility, tax character, and participation in market gains.
- When evaluating options-based income strategies, investors should consider total return, tax character, market participation, and implementation structure, not solely the headline distribution rate.

Assessing options-based income funds solely on distribution rate can be misleading.

While a higher distribution may be appealing on the surface, it does not necessarily indicate what an investor may keep after taxes, how much market participation or risk exposure they may give up, or how much flexibility a fund has to manage taxable outcomes over time.

It's an important distinction for taxable accounts. Options-based income strategies can generate cash flow from several sources, including ordinary income, dividends, option premiums, realized gains, and return of capital. Two strategies may achieve similar distribution rates, but the tax character of those distributions—and the total return trade-offs required to produce them—can be very different.

The point is not that one tax characterization is always better than another, or that tax considerations should override investment merit. Rather, evaluating options-based income strategies for taxable portfolios may require looking beyond the headline payout and asking a more complete question: What is the impact on total return, and how much of that return is ultimately kept after tax?

Distribution rate is not the same as after-tax income

A distribution rate is a cash-flow measure. It generally tells investors how much a fund has distributed relative to its price or net asset value over a stated period. It does not explain whether the distribution came from interest, dividends, option activity, realized gains, return of capital, or a combination of these sources. It also does not indicate whether producing that distribution required the strategy to limit upside participation, increase turnover, take additional risk, or realize gains in a tax-inefficient way.

Ordinary income and short-term capital gains are generally taxed less favorably than long-term capital gains or qualified dividend income for many US taxpayers. Return of capital may defer current taxation, but it generally reduces the investor's cost basis and can increase taxable gain, or reduce a taxable loss, when the position is sold in the future. Investors should therefore evaluate both the amount of cash distributed and the tax character of that cash flow.

This trade-off is important for strategies using derivatives, because income they generate is not without cost. In plain terms, writing a call option can generate current premium income, but it may also limit the strategy's ability to participate in gains above the option's strike price during the option period. The more income a strategy seeks to generate through option writing, the more important it becomes to understand how much upside participation may be retained, how the strategy behaves in rising or falling markets, and whether the distribution is supported by total return over time.

Tax component	What it generally represents	Why it matters for taxable accounts
Ordinary income	Interest income, certain option-related income, or other income items depending on structure.	Generally taxed at the investor's marginal ordinary income tax rate.
Short-term capital gains	Realized gains on positions generally held for one year or less.	Generally taxed at ordinary income tax rates.
Long-term capital gains	Realized gains on positions generally held for more than one year.	May receive preferential federal tax treatment.
Qualified dividend income	Dividends that meet applicable issuer and holding-period requirements.	May receive preferential federal tax treatment.
Return of capital	A non-dividend distribution that generally represents a return of part of the investor's invested capital.	May defer current taxation by reducing cost basis, but is not tax-free in an absolute sense; a lower basis may increase taxable gain when shares are sold.

Return of capital: tax deferral, not tax elimination

Return of capital is often misunderstood. In general, return of capital is reported as a non-dividend distribution rather than current taxable income. Instead of being taxed when received, it reduces the investor's cost basis in the fund. If the investor later sells the position, the lower basis may result in a larger capital gain or a smaller capital loss.

That can be valuable in the right context because it may shift the timing of taxation from the year a distribution is received to the year the investor sells the investment. Depending on the investor's holding period and circumstances, that future taxable event may also be treated differently than current ordinary income.

The trade-off is that return of capital should not be viewed as "free" income. When a distribution represents a return of invested capital rather than income generated by the portfolio, it may reduce the amount of capital remaining invested and, as a result, may reduce the portfolio's ability to generate the same level of future income or growth. It can also make the headline distribution appear more attractive than the portfolio's underlying earnings power would suggest. For that reason, return of capital is best understood as a potential tax-deferral mechanism that should be evaluated alongside total return, basis tracking, distribution sustainability, and the investor's broader tax situation.

Design matters

The way an options-based income strategy is designed can influence the amount of cash flow it generates, the tax character of distributions, the degree of market participation retained and the manager's flexibility in implementing the strategy. Different implementation methods involve different advantages and trade-offs depending on the investment objective, portfolio construction, tax considerations, and market environment.

A useful first step is to separate the strategy's underlying exposure from its income overlay. The underlying exposure is the portfolio or instrument that provides market participation, typically equities, bonds, or index funds. The overlay is the mechanism used to generate additional cash flow, such as trading options directly, using an index option program, or gaining options-linked exposure through a structured note or equity-linked note.

Each approach can target similar headline yields, but involve different trade-offs across cash flow, market exposure, tax character, and the manager's ability to coordinate the overlay with the underlying portfolio.



Index-Level Option Strategies

In an index-level strategy, the income overlay is applied with index options tied to a broad market reference point. These approaches can be efficient to implement, scalable across portfolios, and relatively straightforward to explain. Depending on the manager's objectives, they may provide an effective means of generating options income while maintaining broad market exposure. If the overlay is actively managed, the manager may be able to adjust the overall amount of market participation by changing how much option exposure is used and the strike price and term of the options written. However, because the overlay is managed at the index level, it may be less directly connected to the individual holdings in the portfolio. That can make it harder to align option decisions with stock-specific views, and it may create basis risk if the index exposure does not closely match the underlying portfolio. The value of the index option is driven by the movement of the index rather than each of its individual constituents. As a result, its risk and return characteristics reflect a more diversified exposure than an option on a single security.



Security-Level Option Strategies

In a security-level strategy, the income overlay is written on selected individual holdings rather than on a broad index. This approach may give the manager greater flexibility over where option exposure is used and how much upside participation is retained in individual securities. Depending on the investment process, it may also allow the options overlay to be coordinated more closely with security-specific investment views, portfolio objectives, and tax management considerations. For example, the manager may write less aggressively on a high-conviction holding, leave a position uncovered, or roll an option to preserve participation when the investment thesis remains strong. Conversely, the manager may be more willing to overwrite, trim, or allow call-away where conviction has moderated or where tax and portfolio objectives support that decision. This flexibility may be advantageous in certain circumstances; however, outcomes can depend heavily on portfolio construction, execution, market conditions, and the manager's investment process. It does not guarantee better tax results, higher after-tax returns, improved performance, or greater market participation.



Note-Based or Derivative-Linked Structures

In a note-based strategy, the options-income exposure may be delivered through a structured note or other derivative-linked instrument rather than through options written directly on the portfolio. This can simplify implementation and provide a defined exposure, but it can also make the strategy more dependent on the terms of the instrument. The note's terms may influence the amount of income generated, how much market participation is retained, when gains or losses are recognized, and how payments are characterized for tax purposes. Compared with certain directly managed option overlays, the manager's ability to adjust participation, coordinate strategy with underlying holdings, or manage taxable outcomes may depend more heavily on the terms of the instrument once it is in place.



Fund Structure

ETF structures may, in certain circumstances, offer tax-management advantages over traditional mutual funds, particularly through in-kind creation and redemption mechanisms that may help reduce realized capital gains at the fund level. The extent of these potential advantages depends on portfolio activity, market conditions, applicable tax rules, and other factors.

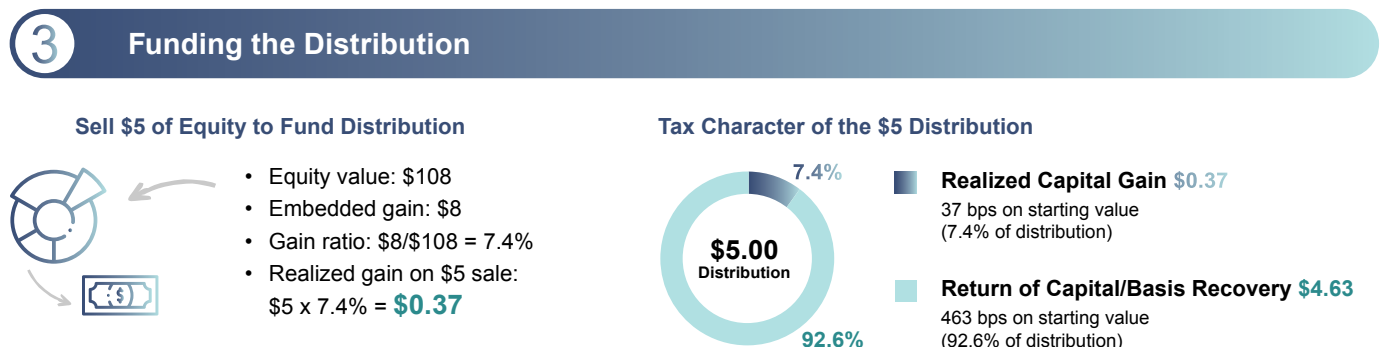
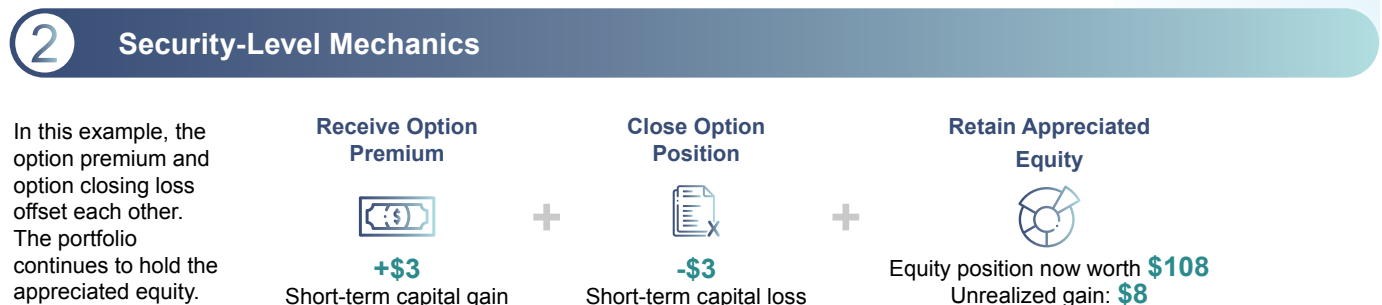
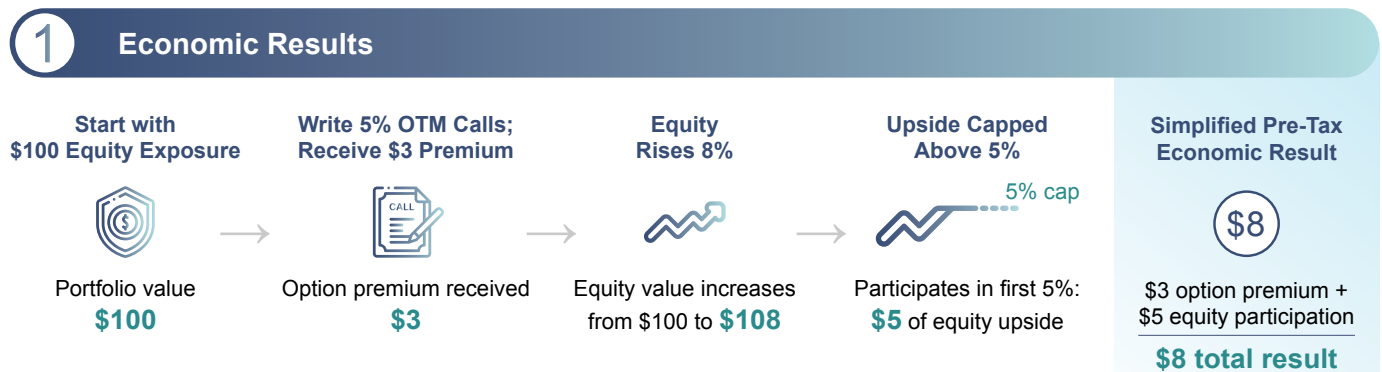
A Simple Illustration

Consider a simplified covered call fund example. Let's assume:

- This fund begins with \$100 of equity exposure, writes 5% out-of-the-money call options at the security level intended to generate \$3 of option premium, and pays a fixed \$5 distribution, equivalent to a 5% distribution yield on the starting value.
- The underlying equity value rises by 8%, or \$8, before considering the option overlay.
- The options overlay caps participation above the 5% strike (\$5 of appreciation of the underlying equity portfolio).

In practice, when using a security-level option strategy, that capped result may be achieved either by closing or settling the option position and retaining the underlying equity exposure or by allowing the underlying shares to be called away. This leads to the same economic result but can have different impacts on tax characterization.

In this example, the simplified pre-tax economic result is \$8: \$3 of option premium, plus \$5 of equity participation before it is capped by the call option exposure.



FOR ILLUSTRATIVE PURPOSES ONLY. This example is simplified and is intended solely to illustrate certain concepts associated with options-based income strategies. It does not reflect the results of any actual portfolio or investment strategy. Actual results and tax character will depend on fund structure, trading activity, holding periods, market conditions, and applicable tax rules.

The key point is that the same 5% headline distribution yield can be achieved through different structures, and those structures may create different trade-offs.

Because the strategy distributes \$5 while generating only \$3 of option premium in the period, the additional \$2 must be supported by other taxable income, realized gains, or return of capital. In this example, it was funded by selling a portion of the equity holdings. The relevant question is not simply whether the strategy reached the stated distribution target, but what trade-offs were required to do so across cash flow, market exposure, tax character, and active coordination between the overlay and underlying portfolio positioning.

This example is not intended to show that one structure will always produce a better after-tax result. Rather, it illustrates why similar pre-tax economics may lead to different reported tax character, different timing of taxable events, and different participation outcomes depending on structure, trading activity, holding periods, market conditions, and investor circumstances.

No single implementation method is inherently superior in every situation. Each approach involves different trade-offs, and the relative benefits depend on the manager's investment process, implementation, market conditions, tax considerations, and investor objectives.

Structure	How overlay is managed	Key trade-offs
Index-level or aggregate overlay	Uses broad option exposure to generate cash flow against a portfolio or market allocation.	Efficient and scalable, but less directly tied to individual holdings and the portfolio manager's stock-level views. Index options may qualify for a blend of short- and long-term capital gains treatment.
Security-level overlay	Writes options on selected individual holdings to generate cash flow while managing participation holding by holding.	May offer more flexibility to align overlay decisions with fundamental views, tax lots, and market participation, but depends heavily on execution.
Note-based or derivative-linked structure	Uses instrument terms to deliver an options-linked cash-flow and participation profile.	May simplify implementation, but tax character, participation, and flexibility may be more constrained by contract terms.

Bringing the framework together

Options-based income strategies may play a useful role for investors seeking additional sources of cash flow, market exposure, and a potentially different volatility profile than a traditional allocation. For taxable accounts, the quality of income should be evaluated alongside the quantity of income, including how distributions are generated, how they are characterized for tax purposes, what market participation trade-offs are required to produce them, and how much flexibility the structure gives the manager to adapt over time.

At Sterling Capital, our options-based income capabilities are built around the belief that the quality of income matters as much as the quantity of income. We believe that understanding how distributions are generated, the associated market participation trade-offs, and the flexibility afforded by different implementation methods can help inform investment decisions.

Financial professionals interested in applying the concepts discussed in this paper may also want to learn more about Sterling Capital's options-based ETF strategies including hedged equity income and multi-strategy credit income solutions. As with any investment strategy, suitability should be evaluated based on each investor's individual objectives and circumstances.

Definitions

After-tax return

An investment's return after accounting for applicable taxes. The result depends on an investor's circumstances and the timing and character of income, gains, losses, and distributions.

Basis risk

The risk that the performance of an option strategy, hedge, or reference index differs from the performance of the underlying portfolio it is intended to represent or complement.

Call option

A contract that gives its buyer the right, but not the obligation, to buy an underlying asset at a specified strike price before or at expiration, depending on the contract's terms.

Capital gain

Gain generally recognized on the sale of an investment. In the United States, a gain on an investment held for one year or less is generally considered short-term and taxed at ordinary income tax rates. A gain on an investment held for more than one year is generally considered long-term and may qualify for preferential tax rates.

Cost basis

Generally, the amount used to determine gain or loss for tax purposes when an investment is sold, subject to applicable tax adjustments.

Covered call

An options strategy in which a call option is written on a security that is already owned. The option premium may generate income but gains above the strike price may be limited during the option term.

Distribution rate (or distribution yield)

A measure of distributions over a stated period relative to a fund's price or net asset value. It is not the same as total return and does not identify the tax character of those distributions.

Market participation

The extent to which a portfolio captures gains or losses in the underlying securities or market. Options strategies may increase or reduce a portfolio's participation in market movements depending on how they are implemented.

Option overlay

An options strategy applied to an underlying portfolio to alter its income, risk, or market-participation characteristics. These strategies may involve covered calls, protective puts, or combinations of multiple options strategies.

Ordinary income

Income generally taxed at an investor's applicable ordinary federal income tax rates rather than at preferential long-term capital gain rates.

Out of the money

For a call option, a strike price that is higher than the current market price of the underlying security.

Qualified dividend income

Certain dividends that satisfy applicable requirements and may qualify for preferential tax treatment relative to ordinary income.

Return of capital (ROC)

A non-dividend distribution that generally reduces an investor's cost basis. Return of capital is not necessarily tax-free income and may increase future taxable gain, or reduce a taxable loss, when the investment is sold.

Roll an option

To close an existing option position before its expiration date and establish a new option position, often with a different strike price or expiration date.

Strike price

The price specified in an option contract at which the underlying asset may be bought or sold.

Structured note

A debt instrument whose return is linked to the performance of an underlying asset, index, rate, or investment strategy, subject to the note's terms and the issuer's ability to meet its obligations.

Tax character

The category assigned to an item for tax purposes, such as ordinary income, qualified dividend income, capital gain, or return of capital.

Tax deferral

The postponement of a tax liability to a future date. Tax deferral does not eliminate the liability.

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For more information on Sterling Capital's Options-Based Income capabilities, and to learn how we can help you achieve your investment goals.



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