NEOS RIA CHANNEL®

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The Importance of Tax Efficiency Within Your Income Portfolio

How You Can Think About Incorporating Income-Focused Options-Based ETFs

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Recent Growth of Options-Based Strategies and ETFs

In recent years there has been tremendous growth in the number of options-based ETFs as well as their assets under management. At the end of 2017, there were 105 options-based funds focused on broad-based US equity markets with a total of $38.1 billion AUM.[1] This included just 11 ETFs and ETNs. In February of 2025, this had risen to 582 ETFs alone, with assets of $184.39 billion, three-year inflows of over $137 billion, and over $8 billion of inflows in just the past month.[2]

It's likely that investors have become increasingly attracted to options-based ETFs for several reasons:

- High income potential through option writing (selling) strategies
- Downside protection through buffered strategies that purchase protective put options
- Enhanced tax efficiency via index option contracts and opportunistic tax loss harvesting
- Lower correlation to traditional equity or fixed income allocations, which may be especially compelling during times of declining interest rates.

When implemented in a systematic way, options-based ETFs may offer investors an accessible way to pursue higher portfolio income than equity or bond market investments, increased tax efficiency, as well as defined outcomes over a period of time.

Not All Options Are Created Equally

As the number of options-based ETF offerings increases, it's important to know that not all of these "options" are created equal. Equity options strategies can source income from various investment vehicles, including swap agreements, equity-

[1] https://cdn.cboe.com/resources/education/research_publications/performance-options-based-funds.pdf

[2] Data as of 2/11/2025 - https://www.etfcentral.com/segments/options-strategies

linked notes, index options, single stock options, and ETF options. So, while these funds may be able to offer a unique set of benefits, it's imperative to understand what's "under the hood" of the products you invest in.

For example, swap agreements and equity-linked notes have counterparty risk or credit risk to the product's issuer and are taxed as ordinary income when positions are held for less than one year. These strategies also require larger minimum investments than desirable for many investors. Single stock options and ETF options are also taxed at ordinary income tax rates and come with the risk of being called away prior to expiration.

On the other hand, Index options offer unique characteristics that may make them well-suited for systematic option strategies within an ETF wrapper. Those characteristics include:

- Enhanced tax efficiency through IRS Code 1256, allowing gains to be taxed at 60% long-term and 40% short-termrates regardless of their holding period.
- Index options are cash settled
- Index options can't be called away prior to their expiration

	Overview	Taxation	Risks
Index Options	Gives the holder the right (but not the obligation) to buy / sell the value of an underlying index, such as the S&P 500 index, at a stated price.	Favorable tax treatment • (60% long-term / 40% short-term capital gains regardless of holding period)	Purchased options: • premiums paid Sold Options: • potential upside cap beyond strike price in exchange for premiums received
Swap Agreements	Agreement in which two parties exchange or "swap" payments based on the change in value of an underlying asset or benchmark	Taxed as ordinary income • (100% short-term capital gains when held less than one year)	Additional risks can include: • counterparty risk • interest rate risk • price risk
Equity Linked Notes	Has features of fixed income securities and equities. Seeks income via coupon payments linked to the performance of an asset, like a stock or index.	Taxed as ordinary income • (100% short-term capital gains when held less than one year)	Additional risks can include: • issuer credit risk • price risk
Single Stock Options	Gives the holder the right (but not the obligation) to buy or sell shares of a stock at an agreed upon date and price.	Taxed as ordinary income • (100% short-term capital gains when held less than one year)	Purchased options: • premiums paid Sold Options: • potential upside cap beyond strike price in exchange for premiums received
ETF Options	Gives the holder the right (but not the obligation) to buy or sell shares of an ETF at an agreed upon date and price.	Taxed as ordinary income • (100% short-term capital gains when held less than one year)	Purchased options: • premiums paid Sold Options: • potential upside cap beyond strike price in exchange for premiums received

Source: NEOS Investments

The Importance of Tax-Efficient Income

The US income tax code is complex, with marginal tax rates varying by individual and family income and the holding period and type of investment. In addition, state and local rates differ across the country.

Ordinary Income Tax Rates	Lower Income Tax Rates
22% to 37% Rates for Joint Incomes Over $94,300	15% to 20% Rates for Joint Incomes Over $94,050
Bond Interest	Qualified Equity Dividends
Salaries and Bonuses	Long-term Capital Gains
Short-term Capital Gains	
Equity Options, such as NVDA or AAPL (100% short-term capital gains when held less than one year)	
ETF Options, such as SPY or QQQ (100% short-term capital gains when held less than one year)	
Non-qualified Dividends, such as REITs	
Equity Linked Notes (100% short-term capital gains when held less than one year)	
Swap agreements (100% short-term capital gains when held less than one year)	

For example, gains from SPY via ETF options or NVDA from an equity option are taxed as short-term capital gains, when held less than one year. The same goes for swap agreements and equity-linked notes offering derivative exposure to specific securities or indexes. However, as mentioned above, an index option (such as S&P 500 or Nasdaq-100) receives favorable taxation on any gains regardless of the holding period because of their unique classification from the IRS.

The official language from IRS form 6781 states, “If your section 1256 contracts produce capital gain or loss, gains or losses on section 1256 contracts open at the end of the year, or terminated during the year, are treated as 60% long term and 40% short term, regardless of how long the contracts were held.” This can have a significant impact on the amount of money that investors get to keep.

EXAMPLE

A married couple with over $731,200 in annual taxable income would face:

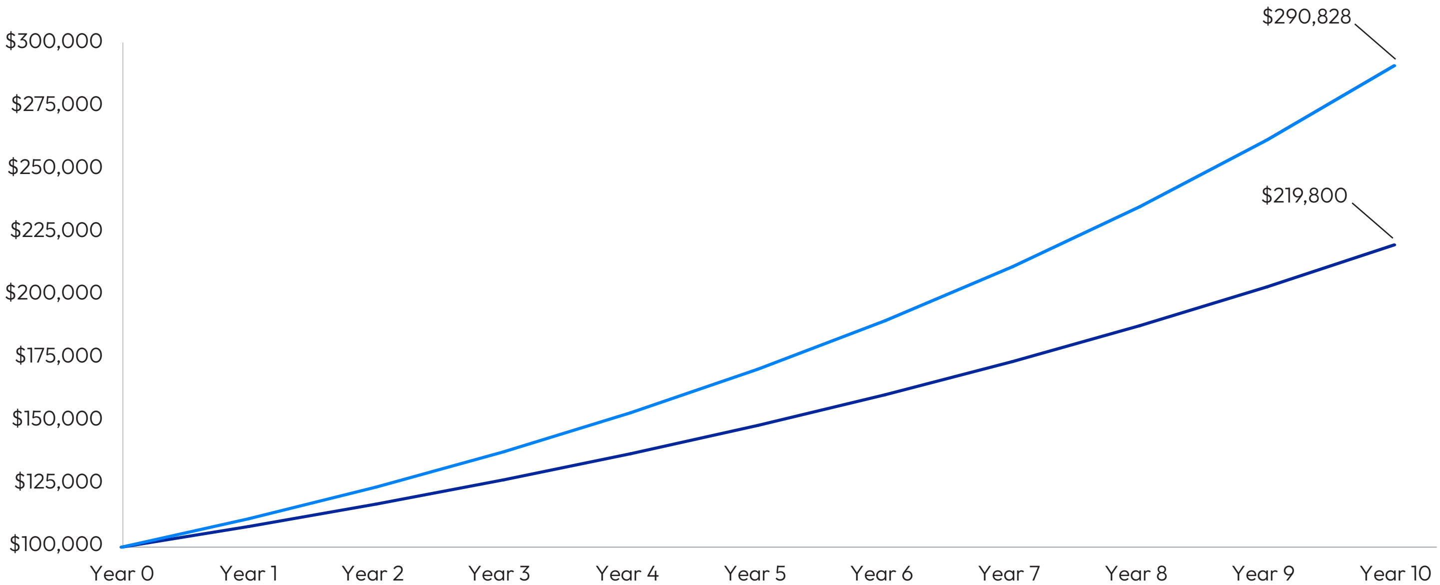
- A 37% marginal tax rate on ordinary income and short-term capital gains and a 20% tax rate on qualified dividends and long-term capital gains
- The blended rate for gains from Section 1256 contracts, such as options on broad-based stock indices, would be 26.8%
- Paying a 26.8% tax rate rather than the 37% marginal tax rate on ordinary income would save taxpayers $10,200 per year for each $100,000 in options-based income. Compounding this difference in tax rates can add substantially to portfolio value over ten years.

The hypothetical illustration below shows the compounding effect this can have over time.[3]

Annual Distribution Rate Assumption 12.00%			
ROC Rate (Deferred)	Index Option 60/40 Rate	QDI/LT Rate	Ordinary Income Rate
0%	26.8%	20%	37%

Hypothetical Compounding Monthly Distribution Value

10 Year Growth



Tax Scenario 1		
60% ROC	30% Index Options	10% QDI
7.20%	2.64%	0.96%
After-tax yearly distribution rate = 10.8%		

Tax Scenario 2	
20% QDI	80% Ordinary Income
1.92%	6.05%
After-tax yearly distribution rate = 7.97%	

IMPORTANT CALLOUTS

- Portions of the distributions classified as return of capital (ROC) are not taxable in the year they're received
- A gross yield of 16.26%, rather than 12.00% would be needed in scenario 2 to achieve the after-tax yield from scenario 1
- Income generated from sold index options are taxed as 60% long-term / 40% short-term capital gains, regardless of their holding period
- The blended tax rate in scenario 1 is 10.04% compared to 33.60% in tax scenario 2

[3] In this hypothetical scenario, 60% of the distribution was offset via portfolio losses which allowed this portion of the distribution to be classified as a "Return of Capital" (ROC). ROC is non-taxable in the year it's received because it's not considered as realized income nor profits. Over time ROC may reduce an investors cost basis in a fund and upon the sale of shares they may be taxed at long term rate (20%). This scenario assumes only the compounding affect of distribution amounts without any capital appreciation/ depreciation. This is for illustrative purposes only. This hypothetical scenario does not reflect the experience of any investor and should not be relied on for investment decisions. NEOS ETFs may incorporate tax loss harvesting within their portfolios to maximize realization of losses to offset gains when applicable. Market conditions may limit the ability to generate tax losses.

Return of Capital Designation...Is it Good, Bad, or Tax Efficient?

In addition to the advantageous tax classification offered to index option contracts shown in the illustration above, another potential tax advantage of option writing ETFs is a "return of capital" classification on all or a part of fund distributions. It's important to note that "return of capital" is a tax concept and may come from opportunistically harvesting portfolio losses to offset gains. It can be a scary-sounding concept, often confused with the economic concept of "return of principal," which can have negative consequences.

Return of principal happens when investment funds offer regularly scheduled distribution payments but don't generate the necessary return streams to support those distribution payments, leading to principal erosion - also known as the economic concept of "return of principal."

Some potential tax advantages of distributions classified as a "return of capital" are:

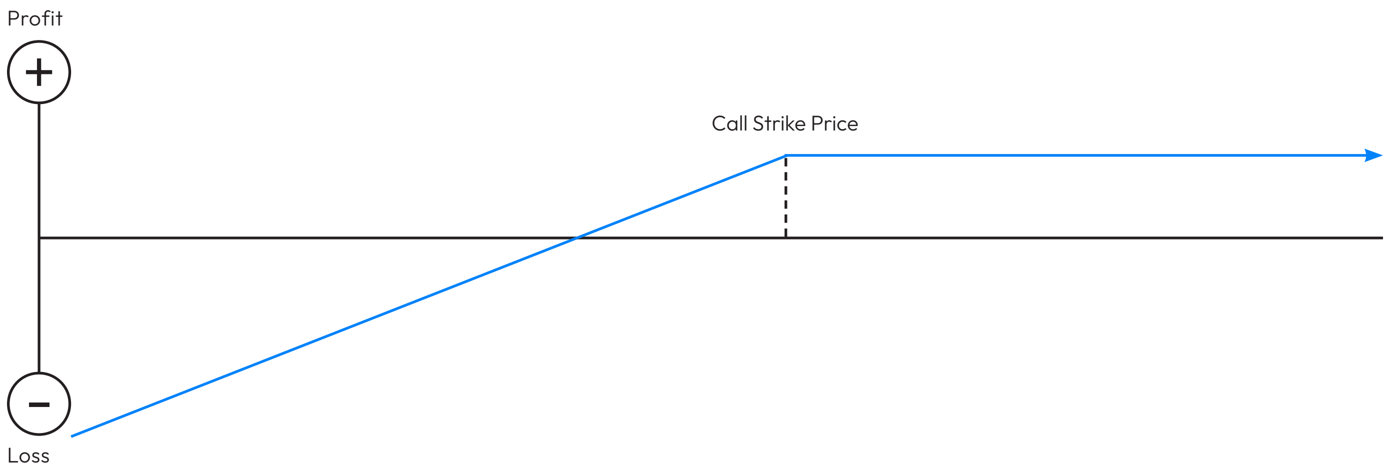
- Unlike dividends or interest income, return of capital is not considered income and is not immediately taxable in the year it's received.
- Instead, it reduces an investor's cost basis in an ETF, allowing them to convert current fund distributions to long-term capital gains if/when shares are sold.
- The ETF structure allows portfolio losses to be carried forward indefinitely. This flexibility allows losses to be realized in years when needed to offset capital gains while deferring the realization of losses in years when they can't be immediately used.

Potential Benefits Through Active Management of Options-Based ETFs from NEOS Investments

A standard buy-write strategy, such as the strategy tracked by the Cboe S&P 500 BuyWrite Index, owns an underlying portfolio of stocks and sells one-month call options slightly out-of-the-money on the full portfolio value. This strategy works well in months when the stock market is range-bound, either slightly rising or falling.

In months when the stock market rises sharply, the gains on the portfolio will be limited by the call options that have been sold. A mechanical strategy typically holds positions until maturity and does not intentionally generate tax losses.

Payoff Diagram of a Buy-Write Strategy



An actively managed buy-write strategy like those run by NEOS Investments has the freedom to sell options on less than the total value of the underlying portfolio, ladder multiple options contracts with different levels of moneyness, and opportunistically generate tax losses to offset gains.

A Look at the Equity High-Income Lineup from NEOS Investments

- The NEOS S&P 500 High Income ETF (SPYI) sells covered call options on the S&P 500 Index (SPX), seeking to earn an annual distributable yield of 10% to 12%.
- The NEOS Nasdaq-100 High Income ETF (QQQI) sells covered call options on the Nasdaq 100 Index, seeking 12% to 15% of distributable income annually.
- The NEOS Russell 2000 High Income ETF (IWMI) sells covered call options on the Russell 2000 Index, seeking 11-14% of distributable income annually.

Using the NEOS S&P 500 High Income ETF (SPYI) as an example, these potential benefits are apparent when comparing the ETF to the Cboe S&P 500 BuyWrite Monthly Index mentioned above which takes a passive, mechanical approach:

Hypothetical Growth of $10,000

SPYI vs Cboe S&P 500 BuyWrite Monthly Index[4]

[4] Performance data quoted represents past performance and is no guarantee of future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. For the most recent month-end performance, please call (866) 498-5677 or visit the Fund's website at https://neosfunds.com/. Index returns are for informational purposes only and it is not possible to invest directly in an index. Source: US Bank, Morningstar 2024. The hypothetical growth of $10,000 chart reflects a hypothetical investment and assumes reinvestment of dividends and capital gains. Fund expenses, including management fees and other expenses were deducted.

In times of lower market volatility, SPYI's fund managers have the flexibility to sell multiple call options with varying levels of moneyness and portfolio coverage to generate the desired income target while still leaving prospects for capital appreciation in a rising market environment.

In times of higher market volatility, options prices tend to be higher, and fund managers can either sell fewer options or write them further out of the money to achieve the desired income targets.

The active and systematic nature of SPYI has offered reliable tax-efficient monthly income and strong total return since its inception on 8/29/2022 through 1/31/2025.

- Tax efficiency comes from S&P 500 Index option contracts and opportunistically harvesting portfolio losses
- Prospects for long-term capital appreciation are maintained through a data-driven laddered call writing strategy
- Outperformance during recent market rallies compared to the Cboe S&P 500 BuyWrite Monthly Index is shown above
- Traditional buy-write strategies may fall short in those areas compared to SPYI.

Options Background of the NEOS Team

Troy Cates and Garrett Paolella are co-founders of NEOS Investments and pioneers in the options-based ETF space. Over a decade ago, they created and managed some of the earliest products of their kind that were introduced to the ETF market. NEOS stands for "Next Evolution Options Strategies," and their current fund lineup combines their unique knowledge of options-based ETFs with the advancements of the ETF structure and industry as a whole. Their goal is to offer multidimensional benefits such as high monthly income generation, tax efficiency, and upside potential – or in some cases - downside protection, in a single exchange-traded product.

Risk and Return of Options-Based Strategies

Beyond the income generation and tax efficiency aspects, covered call strategies are less volatile than long-only stock market investments. While they may sacrifice some upside potential due to their short call positions, the downside return potential slightly improves through the income generated by the sale of the call options. That is, covered call strategies will likely have higher returns in range-bound markets and lower returns in rapidly appreciating markets compared to long-only equity positions, reducing the range of potential returns and volatility.

Continuing to use SPYI as an example, the table below shows the concepts outlined in the previous paragraph.

September 2022 - January 2025		
	SPY	SPYI
Maximum Drawdown	-9.21%	-7.78%
Beta	1.00	0.72
Standard Deviation	15.15%	11.19%
Up Capture Ratio	100.00%	75.09%

How to Think About Incorporating Options-based ETFs into Portfolios

Options-based income ETFs can complement or act as an alternative to traditional core equity or income-focused portfolio allocations. These ETFs may be well-suited for investors looking to increase their income potential, improve tax efficiency, and their lower correlation with traditional asset classes.

Complementing Core Equity Allocations: By utilizing options-based income ETFs as a complement to existing equity allocations, investors can pursue long-term capital growth while enhancing their income potential through the strategies embedded in these funds. This approach may allow investors to maintain their core equity exposures and strike a balance between growth and income that aligns with their long-term investment goals.

An Alternative to Income-Focused Investments: Unlike traditional income investments such as bonds or dividend-paying stocks, options-based income ETFs typically provide higher income potential and exhibit lower correlation to interest rate movements. This makes them an appealing alternative for investors looking to diversify their income sources, especially in environments where interest rates are either declining or remain low.

Conclusion

As the options-based ETF space grows, it's crucial to recognize that not all "options" are created equal. With a wide range of strategies and products available, investors must identify those that align with their goals and risk tolerance. Experienced managers like the ones at NEOS Investments may be able to add value by crafting strategies that focus on multidimensional benefits including high income potential, tax efficiency, and risk management, while also pursuing long-term capital appreciation.

Important Disclosures:

Investors should carefully consider the investment objectives, risks, charges and expenses of Exchange Traded Funds (ETFs) before investing. To obtain an ETF's prospectus containing this and other important information, please call (866) 498-5677 or view/download a prospectus here: SPYI Prospectus, QQQI Prospectus, IWMI Prospectus. Please read the prospectus carefully before you invest.

An investment in NEOS ETFs involve risk, including possible loss of principal. The equity securities purchased by the Funds may involve large price swings and potential for loss. There is no guarantee the NEOS ETFs will make monthly distributions and the amounts may fluctuate from month to month. Distributions made by NEOS ETFs have been classified as a return of capital and may be comprised of option premiums, dividends, capital gains, and interest payments. To view both current and historical monthly estimates of ETF distribution composition, investors may view the 19a-1 notices available on each corresponding Fund's webpage.

The use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other traditional investments. These risks include (i) the risk that the counterparty to a derivative transaction may not fulfill its contractual obligations; (ii) risk of mispricing or improper valuation; and (iii) the risk that changes in the value of the derivative may not correlate perfectly with the underlying asset, rate or index. Derivative prices are highly volatile and may fluctuate substantially during a short period of time. The use of leverage by the Fund, such as borrowing money to purchase securities or the use of options, will cause the Fund to incur additional expenses and magnify the Fund's gains or losses. The earnings and prospects of small and medium sized companies are more volatile than larger companies and may experience higher failure rates than larger companies. Small and medium sized companies normally have a lower trading volume than larger companies, which may tend to make their market price fall more disproportionately than larger companies in response to selling pressures and may have limited markets, product lines, or financial resources and lack management experience. The funds are new with a limited operating history.

Investments in smaller companies typically exhibit higher volatility. Investors in NEOS ETFs should be willing to accept a high degree of volatility in the price of the fund's shares and the possibility of significant losses.

All funds shown are managed differently and do not react the same to economic or market events. The investment objectives, strategies, policies or restrictions of other funds may differ, and more information can be found in their respective prospectuses. Therefore, we generally do not believe it is possible to make direct fund comparisons in an effort to highlight the benefits of a fund versus another.

SPDR® S&P 500 ETF Trust (SPY) Investment Objective: The Trust seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500® Index (the "Index"). Click here for standardized performance, ETF fees, and prospectus.

S&P 500® Index: An Index composed of selected stocks from five hundred (500) issuers, all of which are listed on national stock exchanges and spans over approximately 24 separate industry groups.

The Cboe S&P 500 Monthly BuyWrite IndexSM (BXM) is a benchmark index designed to track the performance of a hypothetical buy-write strategy on the S&P 500® Index.

Option: Options are financial derivatives that give buyers the right, but not the obligation, to buy or sell an underlying asset at an agreed-upon price and date.

Tax Loss Harvesting: The timely selling of securities at a loss in order to offset the

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