



# TAX PRIMER FOR GLOBAL X'S COVERED CALL ETFs

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The Global X Covered Call suite of ETFs generally invest in the underlying securities of an index and sell call options on that index. These strategies are designed to provide investors with an alternative source of income, while diversifying one's sources of risk and returns.

ETFs are generally considered to be a tax-efficient structure: they rarely distribute capital gains, and dividends and income are passed-through to investors. Due to the use of options in covered call strategies, however, the tax implications for investors in these ETFs may be different from more traditional equity or fixed income-only ETFs. In this piece, we seek to highlight how the distributions from these ETFs are determined and potential implications for shareholders.

## COVERED CALL ETFs & THE MIXED STRADDLE ELECTION

Due to their investments in both equities and option contracts, Global X's covered call ETFs elect to use a 'mixed straddle' approach for taxation purposes. With a mixed straddle approach, options contracts are treated as a §1256 contract and stocks are treated as a non-§1256 security. This is an important distinction in calculating the required distributions from the fund at year-end, and how those distributions are characterized (e.g. long term or short term capital gains). For more detailed information on the mixed straddle election, please see [Form 6781](#) from the Internal Revenue Service (IRS).

Please note that while the Funds elect to use the mixed straddle approach to calculate distributions and determine how they are characterized, the end investor ultimately receives a Form 1099 designating the character of the Fund's distributions.

## DAILY NETTING OF POSITIONS

One can think of a covered call fund as consisting of two distinct buckets: an equity bucket (non-§1256 securities) and an options bucket (§1256 contracts). On a daily basis, the total realized and unrealized gains and losses within each bucket are netted, summing to a total gain or loss for each bucket. In other words, the price movements for all the non-§1256 securities are summed to establish a daily gain (or loss) for the equity bucket. And the price movements for §1256 options contracts are netted to establish a daily gain (or loss) for the options bucket. Total daily gains (losses) for the non-§1256 securities are treated as short term capital gains (losses). The options bucket's total gains (losses) are treated as a blended 60% long term and 40% short term capital gains (losses).

The reason non-§1256 securities are treated as short term is that a mixed straddle approach takes into account the fact that selling/writing an option and buying the underlying security creates offsetting positions. For example, if the stocks in the Nasdaq 100 collectively rise on a given day, a call option written on the Nasdaq 100 will lose value. With the mixed straddle approach, the holding period of a security is suspended as soon as it enters into an offsetting position. Therefore, all non-§1256 securities are considered short term positions generating short term capital gains or losses.

## DIVIDENDS:

Dividends are considered a part of the fund's overall income, but they do not factor into the mixed straddle calculation, which looks only at capital movement (ex: realized and unrealized capital gains). It's important to note that dividends received by the fund are not treated as qualified dividend income (QDI) due to a suspension of the holding period.

## COMBINING THE TWO BUCKETS: EXPLORING 6 SCENARIOS

The next step is the combination of the two buckets to determine the overall short term and/or long term capital gains accrued daily by the Fund as part of a running total throughout the year. Unfortunately, this is not as simple as just adding each bucket together. How those short term and long term gains or losses are summed or offset depends on the scenario. Below, we highlight six hypothetical examples below to illustrate this as well as potential market conditions that could cause each scenario to occur.

*Please note that in the following examples, a §1256 gain (loss) will refer to the options positions. A non-§1256 gain (loss) will refer to non-derivatives positions, such as equities*

### IN SCENARIOS 1 & 2, ONE BUCKET HAS GAINS, AND THE OTHER HAS LOSSES, BUT THE NON-1256 BUCKET IS LARGER THAN THE 1256 BUCKET IN ABSOLUTE VALUE.

#### SCENARIO #1:

If the daily sum of §1256 and non-§1256 buckets is an overall loss, and the loss is due to the non-§1256 amount being larger, then the net amount is classified as a short term loss. This could occur during a market selloff where stocks lose value and the written call options modestly gain.

§1256 GAIN	NON-§1256 LOSS	NET LOSS	SHORT TERM	LONG TERM
100,000	(300,000)	(200,000)	(200,000)	-

#### SCENARIO #2:

If the daily sum of the §1256 and non-§1256 buckets is an overall gain, and the gain is due to the non-§1256 amount being larger, then the net amount is classified as a short term gain. This could occur in a market rally where stocks appreciate in value and the written call options modestly lose value.

§1256 LOSS	NON-§1256 GAIN	NET GAIN	SHORT TERM	LONG TERM
1,000,000	1,500,000	500,000	500,000	-

### IN SCENARIOS 3 & 4, ONE BUCKET HAS GAINS, AND THE OTHER HAS LOSSES, BUT THE 1256 BUCKET IS LARGER THAN THE NON-1256 BUCKET IN ABSOLUTE VALUE.

#### SCENARIO #3:

If the daily sum of the §1256 and non-§1256 buckets is an overall gain, and the gain is due to the §1256 amount being larger, then the net gain is allocated as 60% long term and 40% short term. This could occur in a gently downward market, where stocks settle lower and the written call options gain value.

§1256 GAIN	NON-§1256 LOSS	NET GAIN	SHORT TERM	LONG TERM
2,000,000	(400,000)	1,600,000	640,000	960,000

#### SCENARIO #4:

If the daily sum of the §1256 and non-§1256 buckets is an overall loss, and the loss is due to the §1256 amount being larger, then the net loss is allocated as 60% long term and 40% short term. This could occur in a slightly upward market, where stocks settle slightly higher and the written call options lose value, potentially with volatility increasing.

§1256 LOSS	NON-§1256 GAIN	NET LOSS	SHORT TERM	LONG TERM
(1,000,000)	500,000	(500,000)	(200,000)	(300,000)



## IN SCENARIOS 5 & 6, BOTH BUCKETS HAVE EITHER GAINS OR LOSSES.

### SCENARIO #5:

If the daily sum of the §1256 and non-§1256 buckets is a gain in both, then the §1256 gain is allocated 60% long term and 40% short term gains; the non-§1256 is all short term gains. This could occur in a modest market rally where volatility falls, causing both stocks and written call options to modestly gain value.

§1256 GAIN	NON-§1256 GAIN	NET GAIN	SHORT TERM	LONG TERM
100,000	2,000,000	2,100,000	2,040,000	60,000

### SCENARIO #6:

If the daily sum of the §1256 and non-§1256 buckets is a loss in both, then the §1256 loss is allocated 60% long term and 40% short term losses; the non-§1256 is all short term losses. This could occur in a modest market selloff where stocks lose value, and volatility increases, causing written call options to also lose value.

§1256 LOSS	NON-§1256 LOSS	NET LOSS	SHORT TERM	LONG TERM
(500,000)	(200,000)	(700,000)	(400,000)	(300,000)

## WHAT THIS MEANS FOR INVESTORS IN COVERED CALL ETFs

At the end of the year, accountants for the covered call funds add up the daily running total of short term and long term capital gains to determine the net capital gain, impacting the character of distributions made to shareholders. If there is a net gain, the gain could be short term gains, long term gains, or both.

In 2022, for example, the Global X Nasdaq 100 Covered Call ETF (QYLD) made total distributions of \$2.188099 per share. Of these distributions, \$0.404399, or 19%, was treated as ordinary dividends/short term capital gains. \$1.7837 (81%) was treated as return of capital.

As indicated by the scenarios discussed above, market environment plays a major role in determining the amount of distributions required and whether they are treated as short term or long term gains. While every day was unique in 2022, overall, the Nasdaq 100 experienced a total return loss of 32.4% over the course of the year. This means that Scenario 1 was likely a common occurrence: a day where the stocks in the Nasdaq 100 decreased in value, and the written call options on the Nasdaq 100 experienced modest gains. In scenario 1, the result is net losses are treated as short term losses, which aligns with 2022's distributions predominantly being classified as return of capital.

## RETURN OF CAPITAL

For the Global X covered call ETFs, return of capital is the amount distributed by the funds in excess of what is required by the mixed straddle approach. For example, in 2022, the QYLD could have only distributed \$0.404399 per share rather than the \$2.188099 that was paid out. The \$1.783700 difference is treated as return of capital. Return of capital is not ordinary income and reduces one's basis in their investment. It is generally not taxed as income when received either.

Return of capital arises because a fund's distribution policy differs from the mixed straddle approach. For example, for QYLD, the fund expects to distribute on a monthly basis one-half of the premiums received by writing calls on the Nasdaq 100, capped at 1% of the Fund's net asset value (NAV). This distribution policy is designed to provide recurring income to investors based on the income generated by writing call options. This policy, however, is clearly quite different from the mixed straddle calculations discussed previously, and therefore could result in excess distributions when the annual accounting is finalized. Alternatively, in some years, the mixed straddle accounting may find that a fund distributed less than necessary throughout the year and may need to make up the difference with a larger distribution at the end of the year.

## CONCLUSION

Covered call ETFs can play an important role in generating income for investors, particularly those who want professional portfolio managers to execute trading across dozens of stocks and options contracts. Due to their investments in both equities and options contracts that can create offsetting positions, Global X's covered call funds utilize a mixed-straddle approach to determine the required short term and long term distributions by year-end. Given that the mixed straddle approach is heavily influenced by market environment, it is difficult to anticipate the distribution amounts, or their characterization, prior to year-end when all the calculations are finalized. Particularly tax-sensitive investors may want to consider holding covered call ETFs in a tax-advantaged account or consult with a tax accountant prior to investing. ✗

Investing involves risk, including the possible loss of principal. Concentration in a particular industry or sector will subject QYLD to loss due to adverse occurrences that may affect that industry or sector. Investors in QYLD should be willing to accept a high degree of volatility in the price of the fund's shares and the possibility of significant losses.

The Global X Covered Call Suite of funds engage in options trading. An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset and writing a call option on that same asset with the goal of realizing additional income from the option premium. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying asset above the exercise price, but continues to bear the risk of a decline in the index. A liquid market may not exist for options held by the fund. While the fund receives premiums for writing the call options, the price it realizes from the exercise of an option could be substantially below the asset's current market price. QYLD is non-diversified.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. Indices are unmanaged and do not include the effect of fees, expenses or sales charges. One cannot invest directly in an index.

**Carefully consider the fund's investment objectives, risks, and charges and expenses. This and other information can be found in the fund's full or summary prospectus, which may be obtained by visiting [globalxetfs.com](http://globalxetfs.com). Please read the prospectus carefully before investing.**

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