

Tax Deferral Is Good — Letting Covered-Call Premiums Pay Your Tax Is Better.

Option overlay strategies for concentrated positions: a practical guide to a tax-smart liquidation strategy for owners of highly appreciated stock.

Yayati Asset Management · White Paper · For RIAs & institutional investors

Executive Summary

IN BRIEF

For many successful investors, entrepreneurs, and corporate executives, a single highly appreciated stock position represents both their greatest financial achievement and their most vexing planning challenge. They know, intellectually, that concentration is risk — yet the moment they contemplate selling, arithmetic intervenes: a California investor sitting on \$10 million in long-term capital gains faces a tax bill approaching \$3.7 million. In New York, approximately \$3.4 million.

This paper explores an alternative path that does not require choosing between paying the tax today and doing nothing indefinitely. Through an actively managed option overlay strategy, investors can generate income from their concentrated position, establish predefined exit parameters, harvest tax losses, and preserve optionality — all without surrendering the position prematurely or accepting the paralysis of inaction.

The strategy is not a tax avoidance scheme. It is a disciplined, customizable framework for making the inevitable exit from a concentrated position as tax-efficient and personally aligned as possible — on the investor's own terms.

The Concentrated Stock Problem: A \$3.5 Million Decision

The application of capital gains taxes is well understood. However, in practice, their psychological and financial impact often surprises even sophisticated investors. The table below illustrates the marginal tax burden on a hypothetical investor with a \$10 million unrealized long-term capital gain and a near-zero cost basis on a highly appreciated stock position.

MARGINAL TAX BURDEN — \$10M LONG-TERM GAIN, NEAR-ZERO BASIS

COMPONENT	FEDERAL-ONLY	FED'L + NEW YORK	FED'L + CALIFORNIA
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COMPONENT	FEDERAL-ONLY	FED'L + NEW YORK	FED'L + CALIFORNIA
LONG-TERM CAP GAINS	20.0%	20.0%	20.0%
NET INVESTMENT INCOME TAX	3.8%	3.8%	3.8%
STATE / LOCAL	—	10.0%	13.3%
EFFECTIVE MARGINAL RATE	23.8%	33.8%	37.1%
TAX ON \$10M GAIN	\$2,380,000	\$3,380,000	\$3,710,000
AFTER-TAX PROCEEDS	\$7,620,000	\$6,620,000	\$6,290,000

One of the interesting cognitive biases of individual investors is that a tax liability — or any other loss, for that matter — is most visceral when registered as a dollar figure rather than a percentage, even though the impact is exactly the same. The prospect of writing a check for \$3.4 or \$3.7 million is not an abstraction; it is a concrete, irreversible loss of wealth that feels qualitatively different from market volatility, which at least carries the hope of recovery. This dynamic can produce a form of investor paralysis: investors understand the risks of concentration intellectually but find themselves unable to act because the cost feels more certain than the benefit.

A second, more emotional dimension compounds the problem. For many investors, the stock that built their wealth is not simply a financial instrument — it may be the company they founded, the employer who granted them options over a career, or the first investment that truly changed their financial trajectory. Selling means closing a chapter, and it carries the real risk of seller's remorse if the stock continues to appreciate afterward. An option overlay strategy offers a disciplined answer to both concerns.

How an Option Overlay Strategy Works

The Core Mechanism: Covered Call Writing

A covered call is among the lowest-risk options strategies available: the investor sells a call option against shares they already hold, receiving an immediate cash premium in exchange for granting the buyer the right to purchase those shares at a pre-agreed strike price within a defined time frame. The elegant insight behind using covered calls as part of a tax strategy is that regardless of outcome, the investor is better positioned in terms of after-tax proceeds than if they had simply held the underlying stock without the overlay.

If the stock price does not rise above the call option's strike price, the investor keeps the premium, which may be treated as ordinary income. If the stock price rises above the option's strike price, closing out the position will generate a short-term capital loss that can offset other realized gains — including gains realized by liquidating shares of the concentrated stock position. If the call is exercised, the investor has effectively executed a sale at the strike price they selected in advance as an acceptable minimum exit level, with premium proceeds further supplementing the sale. In either direction, the strategy creates a tax-smart outcome and allows the investor to self-fund a portion of the eventual capital gains tax liability through accumulated premium income.

Whether the market price of an underlying stock crosses the strike price of an option on that stock is largely a function of that stock's volatility. Unlike equity returns, equity volatility is strongly mean-reverting over time. This allows option overlay managers to estimate a liquidation glidepath with higher confidence than they could estimate forward returns on the underlying stock. A liquidation glidepath is simply an estimated timeline for how long it will take to liquidate the highly appreciated shares — gradually

selling some with every option roll (e.g., monthly). It also enables the overlay manager to analyze how much longer it will likely take to fully liquidate the appreciated shares if some of the premium is distributed as income instead of being used to retire shares.

OUTCOMES BY STRUCTURE

SCENARIO	MARKET OUTCOME	TAX IMPACT	NET BENEFIT
COVERED CALL — EXPIRES WORTHLESS	Stock flat or slightly down	Premium = ordinary income, or capital-loss harvest	Keep premium; lower effective tax on sale
COVERED CALL — EXERCISED*	Stock rises above strike	Sale price = strike; premium received reduces net cost	Controlled exit at pre-set minimum price
PROTECTIVE PUT ADDED	Stock declines sharply	Put gain offsets unrealized loss; no forced sale	Portfolio value preserved during exit timeline
COLLAR (CALL + PUT)	Any direction	Bounded range of gain or loss; call premium can help fund the put	Defined min/max exit price; orderly liquidation

* The risk of early exercise associated with American-style options can be mitigated by an option overlay manager who employs customizable (a.k.a. FLEX) options specified to have European-style settlement only at expiration.

Adding a Protective Put and the Collar Structure

Covered call writing alone does not protect against a significant decline in the underlying stock. A protective put — the right to sell shares at a specified price — sets a floor beneath the position's market value. If the stock declines sharply, the put gains in value, offsetting the paper loss in the shares. The cost of the protective put can often be partially or fully offset by the call premium, creating what practitioners call a **collar**: a defined range within which the investor holds the position while executing their exit plan.

Example: A 12-Month Asymmetrical Collar (3-month puts vs. 1-month calls)

An investor holds 100,000 shares trading at \$100/share — a \$10M position with near-zero basis. They sell monthly covered calls at a \$105 strike (~5% out-of-the-money), collecting approximately \$1.50/share per month. A portion of that premium funds the purchase of a 3-month put at \$95, providing 5% downside protection at near-zero net cost.

FLOOR (PUT)	CEILING (CALL)	MONTHLY PREMIUM
\$95	\$105	~\$1.50

The result: a \$95 floor and a \$105 ceiling, with monthly premium income building a tax-offset pool throughout the exit timeline. Note that a collar strategy will take longer than a simple covered-call strategy to liquidate the concentrated position, because some of the premium income that would otherwise pay taxes on realized gains is instead diverted to purchasing put options for downside floor protection.

Customization and Practical Application

The option overlay framework accommodates a wide spectrum of investor goals and market expectations. An investor who remains bullish on the company's long-term prospects but recognizes the need to begin an orderly exit can sell calls that are further out-of-the-money, sacrificing premium income in exchange for greater upside participation. As conviction diminishes or concentration risk becomes untenable, the strategy can be tightened — strikes moved closer to the current price, exits accelerated, and income generation prioritized. This progressive customization is a fundamental advantage over static hedging or a one-time liquidation.

The strategy also applies more broadly than many investors and advisors recognize. Exchange-listed options are available on thousands of individual equities, including many mid- and small-cap names. For positions in stocks without listed options, over-the-counter (OTC) structures can often be arranged directly with institutional counterparties. OTC options offer additional flexibility in strike price, expiration, and notional size — well suited to concentrated positions that do not conform to standardized contract specifications.

A uniquely important advantage of option overlays for managing the tax liability of holders of highly appreciated shares applies to investors who technically don't own shares, but instead hold unexercised employee stock options. In certain structured arrangements, an investor holding deep in-the-money employee options can use OTC overlay strategies to hedge the embedded gain and manage the tax timing of exercise and sale — without triggering constructive sale rules or violating applicable lock-up or trading-window restrictions.

Perhaps the most underappreciated structural benefit is that the overlay allows the investor to decouple two decisions that are typically forced together: *when and how to exit* the concentrated position, and *where to redeploy* the proceeds. In more commonly used concentrated-stock solutions, these must be decided simultaneously because the solution is focused on diversification rather than after-tax cash realization. An option overlay strategy allows the exit-planning process to be executed independently of reinvestment planning. Premium income can accumulate in a "tax wallet" account during the year to prefund the taxes due when capital gains are realized at year end, be deployed into short-duration fixed income for an interim period, or begin building a target

diversified portfolio in advance of full liquidation — particularly valuable when the reinvestment objective is a private business, real estate, or private credit requiring longer lead times for due diligence and structuring.

Key Implementation Considerations

Advisors and investors considering an option overlay strategy should be aware of several important practical considerations:

Constructive sale rules

Certain option structures can trigger constructive sale treatment under IRC §1259, effectively accelerating gain recognition. Strategies must be carefully designed to avoid crossing these thresholds, and a tax attorney or CPA with options expertise should be involved.

Qualified Covered Calls (QCCs) and the straddle rules

When an investor holds two or more offsetting positions that substantially reduce their risk of loss, they hold a straddle. IRS rules generally prohibit deducting a loss on one leg of a straddle until the offsetting gain is recognized. The IRS provides an exception for Qualified Covered Calls — where an investor is short a call against long shares of the underlying stock. Under this exception, the investor can recognize income from writing the option even if the loss on the stock is not yet realized. Losses on the option are treated differently: the amount of the loss is added to the cost basis of the stock, so that when the highly appreciated shares are sold, the taxable gain is reduced by the earlier option loss. A call is generally treated as qualified if its term is longer than 30 days and it is exchange-traded — but other requirements also apply. For this reason, strategies must be carefully designed and a tax attorney or CPA with options expertise should be consulted.

Holding-period implications

Selling a covered call can, under certain circumstances, suspend or eliminate the long-term holding period of the underlying shares. Properly structured qualified covered calls — typically written out-of-the-money with expirations of 30 days or more on positions already qualifying as long-term — generally do not create this issue, but tax counsel should confirm the analysis for each specific situation.

Account requirements

Covered call writing requires shares to be held in a brokerage account with options approval. Most custodians offer this for qualified clients; the setup process is straightforward.

Employee equity plan coordination

For investors with unexercised employee options, any overlay strategy must be reviewed against the equity plan terms, applicable trading policies, and lock-up agreements. Early coordination with the plan administrator and company counsel is essential.

Concentrated-Stock Solutions Compared

An option overlay to tax-efficiently liquidate highly appreciated shares is not always the best solution for every investor. Exchange funds, §351 ETF conversion funds, long/short extensions, and prepaid forwards can each make sense depending on an investor's priorities. But for investors who want to liquidate highly appreciated stock without rolling the proceeds into a one-size-fits-all, manager-directed strategy — and without simply deferring their reckoning with the tax man over a 5–7 year lock-up — or who hold employee stock options rather than shares, an option overlay can provide a uniquely appealing solution, as shown below.

COMPARATIVE CHARACTERISTICS — FOR ILLUSTRATIVE PURPOSES ONLY

DIMENSION	OPTION OVERLAY (VOLT™)	§351 ETF CONVERSION FUND	EXCHANGE FUND	LONG/SHORT EXTENSION (130/30–250/150)	PREPAID FORWARD
EXPOSURE	Sells down over time	Converted to diversified ETF shares (immediate)	Pooled partnership (single-stock exposure eliminated)	Single-stock risk eliminated over time; transitions to index long/short	Partially monetized; exposure reduced per contract/maturity
CASH ACCESS	Withdrawable as shares are sold	ETF shares (market risk)	Pooled, lockup	Daily liquidity; not a cash-unlock program	Upfront cash (terms apply)
TIMELINE	~1–5y (personalized)	Immediate conversion	Lockup (e.g., 7y)	Glidepath ~5–6y typical	Fixed term (e.g., 3–5y)
BASIS	Reset on proceeds	Original basis (deferral)	Original basis (deferral)	Original basis (deferral)	Original basis (deferral)
FEES OVER TIME	Declining base; ends	Ongoing fund fees	Ongoing fund fees	Ongoing fees on persistent AUM	Embedded economics
CONTROL	Client-directed reinvestment	Manager-directed	Manager-directed	Manager-directed 130/30–250/150 strategy	Contract-directed
TAX TREATMENT	Tax-neutral via Qualified Covered Calls (IRC §1092(c)(4); Treas. Reg. §1.1092(c)-1)	Tax-deferred contribution (IRC §351; Treas. Reg. §1.351-1(c))	Tax-deferred contribution (IRC §721; Treas. Reg. §1.721-1)	Tax-deferred via loss harvesting (IRC §1211)	Tax-deferred at inception (IRC §1259; Rev. Rul. 2003-7)

Sources. Comparative characteristics are drawn from (1) the Internal Revenue Code and Treasury regulations cited herein, including IRC §§351, 721, 1092, and 1259 and the regulations thereunder, together with applicable IRS revenue rulings and authoritative tax-practitioner commentary; (2) publicly available product disclosures, white papers, and sponsor marketing materials describing each category of alternative; and (3) peer-reviewed academic and practitioner research, including Sialm & Sosner, "Taxes, Shorting, and Active Management," *Financial Analysts Journal* 74(1) (2018), and Jeffrey & Arnott, "Is Your Alpha Big Enough to Cover Its Taxes?," *Journal of Portfolio Management* 19(3) (1993). For illustrative comparison only. Each solution has unique merits, limitations, and risk

characteristics. This table should not be used alone to determine which investment strategy to follow or securities to invest in. Consult with legal and tax counsel before selecting an investment strategy. *Tax-neutral*: option premium income or harvested losses are designed to offset the capital gains tax liability associated with share sales. "Tax-neutral" does not guarantee that all taxes will be eliminated; actual tax outcomes depend on the client's specific circumstances. YAM does not provide tax advice. Consult a qualified tax professional.

Conclusion

The concentrated stock problem is one of the most common and consequential planning challenges facing high-net-worth investors. The conventional alternatives — sell and pay the tax, hold and accept the risk, or defer through complex structured products — each carry significant costs or constraints.

An actively managed option overlay strategy offers a fourth path: begin the exit process systematically, on the investor's own terms, with predefined price floors and ceilings, while generating income that partially self-funds the eventual tax liability. Whether each monthly covered call expires worthless or results in a sale, the investor accumulates tax benefit. The strategy is not a binary bet on the stock's direction — it is a calibrated process that can be adjusted to each investor's risk tolerance, time horizon, upside-participation preference, and tax situation. It works for listed equities, for less liquid single-stock positions, and even for investors who hold only unexercised employee options.

For advisors, the opportunity to introduce option overlay strategies to clients with concentrated positions represents both a planning differentiator and a genuine service. The investor who has been paralyzed by a \$3.5 million tax bill does not need to be told to diversify. They need a structured, tax-smart path to begin doing so — and an advisor willing to walk it with them.

IMPORTANT DISCLOSURES

This paper is intended for educational and informational purposes only and does not constitute investment, tax, or legal advice. Option strategies involve risk and are not suitable for all investors. Tax treatment of options transactions is complex and depends on individual circumstances, holding periods, and applicable law. Investors should consult with a qualified tax professional and investment advisor before implementing any strategy described herein. References to tax rates reflect estimates based on 2024–2025 federal and state rates and are subject to change.