

Maximise your deductions this financial year

August 2011



Would you like to own a share portfolio worth \$100,000 for as little as \$4,000 p.a.?

If so, there may be no time like the present to consider equity exposure via the Commonwealth Bank Protected Loan (PL).

Introducing Harry

Harry is a 36 year old IT consultant who has some savings but no investments. He is also paying a significant amount of tax and would therefore like to create wealth in a tax effective manner without risk to any of his savings or funds he may borrow to invest.

Harry decides to invest in ASX listed shares through a PL which allows him to borrow and protect 100% of the portfolio value. To reduce the cost of the PL, Harry limits (or caps) the potential growth of each stock at 70% of its initial price.

Portfolio of shares	ANZ, CBA, CCL, IAG, QAN, SHL, TAH, WBC
Loan amount per share	\$12,500
Total loan amount	\$100,000*
LVR / protection level	100%
Cap level per share	70%
Term	5 years
Interest rate	13.24% p.a.
Est. ATO deductible rate	8.80% p.a.
Annual interest expense	\$13,231
Average net after tax cost p.a.	\$4,049
Interest rate type	Fixed for the 5 year term
Interest payment frequency	Monthly until June 2012 then annually in advance
Harry's marginal tax rate	41.5%

*Excludes establishment costs

In order to maximise his allowable deductions in the 11/12 financial year, Harry decides to pay his interest monthly from August until June 2011 and then prepay 12 months of interest. This means Harry can deduct 23 months of PL interest expense in the 11/12 financial year.

While Harry has an annual interest expense of \$13,231 he is entitled to the ordinary dividends paid (estimated at \$7,047 p.a.) and associated franking credits (estimated at \$2,417 p.a.).

In this example, Harry is also able to deduct a portion of the interest expense (up to 8.80% or \$8,800 p.a.) from his assessable income, thereby reducing his taxable income by this amount. After taking into account the benefits of the interest deduction, dividends and franking credits, the after tax cost of Harry's portfolio is estimated to be approximately \$4,049 p.a. (i.e. 4.05% p.a.). Over the 5 year term this equates to a total cost of around \$20,245.

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Let's assume that at maturity Harry's portfolio has performed as follows:

ASX Code	Initial Protected Value	Market value after 5 years	PL gain/loss after 5 years
ANZ	\$12,500	\$19,500	\$7,000
CBA	\$12,500	\$22,000	\$8,750*
CCL	\$12,500	\$4,500	\$0
IAG	\$12,500	\$23,000	\$8,750*
QAN	\$12,500	\$14,000	\$1,500
SHL	\$12,500	\$30,000	\$8,750*
TAH	\$12,500	\$6,500	\$0
WBC	\$12,500	\$19,500	\$7,000
Total	\$100,000	\$139,000	\$41,750

*Gains are capped at 70% of the Initial Protected Value (i.e. 70% x \$12,500 = \$8,750).

At maturity Harry can instruct CBA to sell his profitable shares and receive cash profits of \$41,750. He can also claim a loss equal to the amount of non-deductible interest as an offset to any gains in the portfolio.

Non-profitable shares can be sold back to CBA at the original purchase price in repayment of the loan.

Other alternatives include being able to roll profitable stocks into another PL which will allow Harry to access the gains on these stocks and lock in a new protection level for each share. Alternatively, Harry can also use a facility such as a margin loan to pay out his PL. Both of these alternatives will avoid crystallising capital gains.

Getting the right advice

As with any financial strategy, using a Protected Loan to borrow and invest is not without its risks. One of the key risks of using a Protected Loan is that your return could be negative, after taking into account the performance of your shares and borrowing costs over the term. That's why it's important to read the Product Disclosure Statement to ensure you are fully informed.

Call us on 1300 786 039 for more information about how you can maximise your client's deductions this financial year.

Important information

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