

Protected Loan Taxation Guide

An Explanatory Note

The taxation implications of your Protected Loan (PL) can depend on a number of factors, including the date on which you entered into the PL. In order to assist you in identifying the implications of your PL we have prepared a guide which sets out some of the more common tax implications.

As tax implications can be complex and are invariably specific to your circumstances you should discuss any taxation issues with an independent tax adviser.

The first step for determining the tax implications of your PL is to identify when you entered into the PL. There is currently no ATO guidance as to what constitutes entry into a PL, however, the date the loan is drawn down is likely to constitute entry. If the loan has been approved and a binding commitment exists, that may also constitute entry. You should check with your tax adviser on this point if you require further advice. This guide is based on the relevant entry date.

Your PL entry date

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Entered into on or prior to 30 June 2007	1	2
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For further information please contact your Financial Adviser.

Important Information

This document has been prepared without taking account of the objectives, financial situation or needs of any particular individual. Because of that, before acting on the information in this document, you should consider its appropriateness to your circumstances, having regard to your objectives, financial situation and needs. Some of the information in this document is based on income tax legislation and practice as outlined in ATO Product Rulings PR 2002/41 and PR 2005/78 which are applicable only to investors who entered into a Protected Loan (PL) before 1 July 2007. Some of the information in this document is based on the income tax legislation outlined in PR 2007/67 and is applicable only to investors who enter into a PL from 1 July 2007 onwards. The information in this guide is of a general nature only and is neither exhaustive nor definitive. The information in this guide is not intended to be advice - in particular financial or tax advice - and should not be relied upon as such. You should consult your professional adviser about the tax implications of any products to your own particular circumstances. Commonwealth Bank's Protected Loan is a product of Commonwealth Bank of Australia ABN 48 123 123 124 AFSL 234945 (Commonwealth Bank) administered by its wholly owned but non-guaranteed subsidiary Commonwealth Securities Limited ABN 60 067 254 399 AFSL 238814 (CommSec), a Participant of the ASX Group. A Product Disclosure Statement for the PL is available by calling CommSec Direct on 13 15 20 and should be considered when making any decision about this product. Bank and Government charges apply. Applications for a PL or an Interest in Advance Loan are subject to the Commonwealth Bank's normal credit approval.

Section 1: Entered into on or prior to 30 June 2007

Investors who entered into their PL prior to 16 April 2003 should be able to deduct the entire amount of interest paid under their PL.

Investors who entered into their PL from 16 April 2003 to before 1 July 2007 are covered by ATO Product Rulings PR 2002/41, PR 2005/78 and Division 247 of the Income Tax (Transitional Provisions) Act 1997. These provide that generally (subject to the assumption that the investor is an Australian tax resident and is not holding the securities on revenue account) if the predominant purpose of entering the PL is for dividend income or assessable trust distributions, then the maximum amount of allowable interest deduction will be the lower of:

1. a percentage, according to the term of the Loan, of the interest charged, as set out below:

Term of the Loan	% of the Interest Charged
1	60.0%
2	72.5%
3	80.0%
4	82.5%
5	85.0%

and

2. depending on the interest payment type of your PL;

- Where the Loan is a variable rate loan the applicable indicator is the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – Variable rate at the time the first interest payment was incurred (for most investors this is when paid) for the 30 June 2011 year. This requirement to use the rate at the time of the first interest payment is provided in Division 247 but the two rulings, which you may have relied upon in prior periods, are silent on this point.
- Where the Loan is a fixed rate loan the applicable indicator is the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – Fixed Rate at the time the borrowing was entered into. We have provided the Reserve Bank Indicator Lending Rates for the period July 2010 to June 2011 in the table below:

Effective Date	Fixed Rate	Variable Rate
31/07/2010	15.05%	15.00%
31/08/2010	15.05%	15.00%
30/09/2010	15.00%	14.75%
31/10/2010	15.00%	15.00%
30/11/2010	14.90%	15.25%
31/12/2010	14.90%	15.25%
31/01/2011	14.65%	15.25%
28/02/2011	14.45%	15.25%
31/03/2011	14.45%	15.25%
30/04/2011	14.55%	15.10%
31/05/2011	14.50%	15.10%
30/06/2011	14.50%	15.10%

Deductions for the Deductible Component of the Interest Payments should arise as and when amounts are incurred (for most investors this is likely to be when paid).

The portion of the interest that is not deductible is added to the cost base of either the put option or the securities acquired. Please refer to the Tax Opinion in the PL PDS and the relevant Product Ruling for more information on the application of the Put Option cost.

For additional Reserve Bank Interest rate information, please visit:

http://www.rba.gov.au/statistics/tables/index.html#interest_rates

Refer to “Indicator Lending Rates - F5”.

Examples for Taxpayers

How to calculate the interest deduction and cost base of the Put Option

To calculate the amount of interest that may be claimed as a deduction in the 2010/2011 income tax year, you or your accountant may wish to go through the following steps:

Step A	Find the RBA Benchmark Rate applicable to the Loan http://www.rba.gov.au/statistics/tables/index.html#interest_rates Refer to “Indicator Lending Rates - F5”.
Step B	Calculate the deductible and non-deductible component of the interest payment
Step C	Apply the appropriate tax treatment

Other considerations

Interest in Advance Loan (IAL) interest deductibility

A portion of the interest payments on the IAL should be deductible. You should apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the deductible component of the IAL interest payments.

Interest refunds tax treatment

Under certain circumstances, such as corporate actions, you may receive an interest refund during the term of your PL. You should include a portion of this refund in your assessable income. Simply apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the assessable income component of the interest refund.

Example 1.1 – Fixed yearly in Advance

On 20 May 2007, Linda drew down the PL outlined below:

Loan Size	\$100,000
Loan term	5 years
Interest type	Fixed Yearly in Advance
Interest rate p.a.	12.88%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Determine the interest rate that can be used for deduction for the PL

Linda will take the lower of:

- (i) 85% of the PL interest paid (i.e. the apportionment defined by the Product Ruling for a 5 year PL); and
- (ii) The Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans (RBA Benchmark Rate) applicable at the time the PL was drawn down (12.35% p.a as per the RBA website). Please note that Linda will use the fixed RBA Benchmark Rate as she has a fixed PL interest rate.

Choose the lower of these two:		Interest rate that can be deducted
85% of the PL Interest Rate	RBA Benchmark Rate	
10.948% p.a.	12.35% p.a.	10.948% p.a.

NB. If 85% of the PL interest rate worked out to be greater than the RBA Benchmark Rate, you would apply the RBA Benchmark Rate to calculate your interest deduction.

Step B – Calculate the potential dollar interest deduction and put option for the PL

Following from Step 1, Linda will then multiply:

Portfolio Loan Amount	Deductible ratio of Interest Payments (A)	PL Interest Paid (B)	Deductible Interest (C) = (A) x (B)	Cost Base of the Put Option (B) – (C)
\$100,000	10.948% / 12.88%	\$12,880	\$10,948	\$1,932

Deductible Interest = \$10,948 *(deductible in current financial year)*

Cost Base of Put Option = \$1,932 *(incl. in CGT cost base at Expiry)*

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible Interest Component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Example 2.1 – Variable in arrears

On 20 May 2007, Linda drew down the PL outlined below:

Loan Size	\$100,000
Loan term	5 years
Interest type	Variable in arrears
Interest rate p.a.	12.80%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Determine the interest rate that can be used for deduction for the PL

Linda will take the lower of:

- (i) 85% of the PL interest paid (i.e. the apportionment defined by the Product Ruling for a 5 year PL); and
- (ii) The Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans (RBA Benchmark Rate) at the time of the first interest payment in the year ended 30 June 2011. Please note that Linda will use the variable Reserve Bank Benchmark Rate as she has a variable PL interest rate. In Linda's case her first interest payment during the year ended 30 June 2011 was paid in July 2010 (this was in respect of June 2010 interest).

Choose the lower of these two:		Interest rate that can be deducted
85% of the PL Interest Rate	RBA Benchmark Rate	
10.88% p.a.	15.00% p.a.	10.88% p.a.

Step B – Calculate the potential dollar interest deduction and put option for the PL

Following from Step 1, Linda will then multiply:

Portfolio Loan Amount	Deductible ratio of Interest Payments (A)	PL Interest Paid (B)	Deductible Interest (C) = (A) x (B)	Cost Base of the Put Option (B) – (C)
\$100,000	10.88% / 12.80%	\$12,800	\$10,880	\$1,920

Deductible Interest = \$10,880 *(deductible in current financial year)*

Cost Base of Put Option = \$1,920 *(incl. in CGT cost base at Expiry)*

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible Interest Component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Section 2: Entered into from 1 July 2007 to 13 May 2008

Borrowings entered into on or after 1 July 2007 are subject to the rules in Division 247 of the Income Tax Assessment Act 1997. These rules are modified by the Treasurer’s Budget announcements on 13 May 2008 and 11 May 2010 and Tax Laws Amendment (2010 Measures No 5) Act 2011 which apply to borrowings entered into after 7.30pm on 13 May 2008. As a result, where the borrowing was entered into between 1 July 2007 and 7.30pm on 13 May 2008 the rules set out below apply. In addition we draw your attention to PR 2007/67.

The benchmark for the amount of interest that can be deducted is the Reserve Bank of Australia’s (RBA) Indicator Rate for Personal Unsecured Loans (“RBA Benchmark Rate”).

For tax purposes, the interest paid is split into two components:

1. a deductible interest portion – the Deductible Component; and
2. a component that relates to the capital protection feature which is treated as a non-deductible CGT cost base amount – the Capital Protection Component.

Depending on the interest payment type (fixed or variable) on your PL, the Deductible Component of the Interest payments is to be ascertained as follows;

- Where interest is charged on the Loan from CBA at a fixed rate for all or part of the term of the PL, the amount of the loan multiplied by, the RBA Indicator Rate for Personal Unsecured Loans – Variable Rate at the time when the first Interest payment was incurred (for most investors this is likely to be when paid).
- Where interest is charged on the Loan from CBA at a variable rate for all or part of the term of the PL, the amount of the loan multiplied by the average of the benchmark rates published by the RBA during the term of the PL or the relevant part of the term.

The Capital Protection Component will be treated as the cost of the Put Option and will become part of the cost base of the Put Option.

Examples for Taxpayers

How to calculate the interest deduction and cost base of the Put Option

To calculate the amount of interest that may be claimed as a deduction in the 2010/2011 income tax year, you or your accountant may wish to go through the following steps:

Step A	Find the RBA Benchmark Rate applicable to the Loan http://www.rba.gov.au/statistics/tables/index.html#interest_rates Refer to “Indicator Lending Rates - F5”.
Step B	Calculate the deductible and non-deductible component of the interest payment
Step C	Apply the appropriate tax treatment

Other considerations

Interest in Advance Loan (IAL) interest deductibility

A portion of the interest payments on the IAL should be deductible. You should apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the deductible component of the IAL interest payments.

Interest refunds tax treatment

Under certain circumstances, such as corporate actions, you may receive an interest refund during the term of your PL. You should include a portion of this refund in your assessable income. Simply apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the assessable income component of the interest refund.

Example 2.1

On 10 May 2008, Michael drew down the PL outlined below:

Loan Size	\$100,000
Loan term	4 years
Interest type	Fixed Yearly in Advance
Interest rate p.a.	16.15%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark Rate applicable to the Loan

Michael is paying a fixed interest rate on his Protected Loan. Therefore he should use the RBA Benchmark Rate as at the time the first interest payment is incurred. Michael's first interest payment was made in May 2008. As per the RBA website, the Indicator Rate for Personal Unsecured Loans – Variable Rate in May 2008 is 14.65%.

Step B – Calculate the potential dollar interest deduction and put option for the PL

Interest payment p.a.	\$16,150
RBA Benchmark Rate (a)	14.65%
PL Interest rate (b)	16.15%
Est. Deductibility Ratio (a/b)	90.71%

Deductible Interest = 90.71% x \$16,150
 = \$14,650 *(deductible in current financial year)*

Cost Base of Put Option = \$16,150 – \$14,650
 = \$1,500 *(incl. in CGT cost base at Expiry)*

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible Interest Component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.

- where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Example 2.2

On 1 December 2007, Michael drew down the PL outlined below paying interest fixed monthly in arrears at 14.35% p.a. On 1 June 2011 he switches interest rates from Fixed Monthly to Fixed Yearly in Advance with a new interest rate of 14.05%.

Loan Size	\$100,000
Loan term	5 years
Interest type	Fixed Monthly in Arrears
Interest rate p.a.	14.35%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark Rate applicable to the Loan

Michael is paying a fixed interest rate on his Protected Loan. Therefore he uses the RBA Indicator rate as at the time the first interest payment is incurred. As per the RBA website, the Indicator Rate for Personal Unsecured Loans – Variable Rate in December 2007 is 13.85%.

Step B – Calculate the potential dollar interest deduction and put option for the PL

PL Fixed Monthly Interest rate per annum	14.35%
PL interest rate per day	0.039%
Number of day between 1 July 2010 to 1 Jun 2011	335
Monthly Interest payments from 1 July 2010 to 1 June 2011	\$13,065
RBA Benchmark Rate (a)	13.85%
PL Interest rate (b)	14.35%
Est. Deductibility Ratio (a/b)	96.52%
PL Fixed Yearly Interest rate per annum	14.05%
Yearly in advance Interest payment made on 1 June 2011	\$14,050
RBA Benchmark Rate (a)	13.85%
PL Interest rate (b)	14.05%
Est. Deductibility Ratio (a/b)	98.58%
Total interest payments made in 10/11 Financial Year	\$27,115

$$\begin{aligned}
 \text{Deductible Interest} &= (96.52\% \times \$13,065) + (98.58\% \times \$14,050) \\
 &= \$12,610 + \$13,850 \\
 &= \$26,460 \quad \text{(deductible in current financial year)}
 \end{aligned}$$

$$\begin{aligned}
 \text{Cost Base of Put Option} &= \$27,115 - \$26,460 \\
 &= \$655 \quad \text{(incl. in CGT cost base at Expiry)}
 \end{aligned}$$

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible interest component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Example 2.3

On 1 August 2007, Michael drew down the PL outlined below:

Loan Size	\$100,000
Loan term	4 years
Interest type	Variable in Arrears
Interest rate p.a.	15.76%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark Rate applicable to the Loan

Michael is paying variable interest rate on his Protected Loan. Therefore he should use the average of the benchmark rates published by the RBA during the term of the PL or the relevant part of the term (i.e. July 2010 through to June 2011).

Effective Date	Variable Rate
31/07/2010	15.00%
31/08/2010	15.00%
30/09/2010	14.75%
31/10/2010	15.00%
30/11/2010	15.25%
31/12/2010	15.25%
31/01/2011	15.25%
28/02/2011	15.25%
31/03/2011	15.25%
30/04/2011	15.10%
31/05/2011	15.10%
30/06/2011	15.10%
Average	15.11%

Average RBA Benchmark Rate	15.11%
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Step B – Calculate the potential dollar interest deduction and put option for the PL

Interest payments from 1 July 2010 to 30 June 2011	\$15,760
RBA Benchmark Rate (a)	15.11%
PL Interest rate (b)	15.76%
Est. Deductibility Ratio (a/b)	95.88%

$$\begin{aligned} \text{Deductible Interest} &= 95.88\% \times \$15,760 \\ &= \$15,111 \quad (\text{deductible in current financial year}) \end{aligned}$$

$$\begin{aligned} \text{Cost Base of Put Option} &= \$15,760 - \$15,111 \\ &= \$649 \quad (\text{incl. in CGT cost base at Expiry}) \end{aligned}$$

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible interest component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- Where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- Where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Section 3: Entered into after 7.30 pm on 13 May 2008

Borrowings entered into on or after 1 July 2007 are subject to the rules in Division 247 of the Income Tax Assessment Act 1997. These rules were modified by the Treasurer's Budget announcements on 13 May 2008 and 11 May 2010 and Tax Laws Amendment (2010 Measures No 5) Act 2011 which apply to borrowings entered into after 7.30pm on 13 May 2008.

The potential application of these modified rules to your PL is dependent upon whether you entered into the PL after 13 May 2008. There is currently no ATO guidance as to what constitutes entry into a Commonwealth Bank Protected Loan, however, the date the loan is drawn down is likely to constitute entry. If the loan has been approved and a binding commitment exists, that may also constitute entry. You should check with your tax adviser on this point if you require further advice.

The modified rules provide that the benchmark for the amount of interest that can be deducted is the Reserve Bank of Australia's Indicator Variable Rate for standard housing loans plus 100 basis points (RBA Benchmark Rate) (8.80% p.a. as at June 2011).

For tax purposes, the interest paid is split into two components:

1. a deductible interest portion – the Deductible Component; and
2. a component that relates to the capital protection feature which is treated as a non-deductible CGT cost base amount – the Capital Protection Component.

Depending on the interest payment type (fixed or variable) on your PL, the Deductible Component of the Interest payments is to be ascertained as follows:

- Where interest is charged on the Loan from CBA at a fixed rate for all or part of the term of the PL, the amount of the loan multiplied by the RBA Indicator Variable Rate for Standard Housing Loans plus 100 basis points at the time when the first Interest payment was incurred (for most investors this is likely to be when paid).
- Where interest is charged on the Loan from CBA at a variable rate for all or part of the term of the PL, the amount of the loan multiplied by the average of the RBA Indicator Variable Rate for Standard Housing Loans plus 100 basis points during the term of the PL or the relevant part of the term.

The Capital Protection Component will be treated as the cost of the Put Option and will become part of the cost base of the Put Option.

Examples for Individual Taxpayers

How to calculate the interest deduction and cost base of the Put Option

To calculate the amount of interest that may be claimed as a deduction in the 2010/2011 income tax year, you or your accountant may wish to go through the following steps:

Step A	Find the RBA Benchmark Rate applicable to the Loan http://www.rba.gov.au/statistics/tables/index.html#interest_rates Refer to "Indicator Lending Rates - F5".
Step B	Calculate the deductible and non-deductible component of the interest payment
Step C	Determine tax treatment of deductible interest and cost base

Other considerations

Interest in Advance Loan (IAL) interest deductibility

A portion of the interest payments on the IAL should be deductible. You should apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the deductible component of the IAL interest payments

Interest refunds tax treatment

Under certain circumstances, such as corporate actions, you may receive an interest refund during the term of your PL. You should include a portion of this refund in your assessable income. Simply apply the same percentage used to calculate the deductible interest component on the PL interest payments to determine the assessable income component of the interest refund.

Example 3.1

On 10 June 2011, Michael drew down the PL outlined below:

Loan Size	\$100,000
Loan term	3 years
Interest type	Fixed Yearly in Advance
Interest rate p.a.	16.15%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark Rate applicable to the Loan

Michael entered into the PL on 10 June 2011 and paid interest in advance on that date. At that time, the RBA Indicator Variable Rate for Standard Housing Loans plus 100 basis points was 8.80%.

Step B – Calculate the potential dollar interest deduction and put option for the PL

Interest payment p.a.	\$16,150
RBA Benchmark rate (a)	8.80%
PL Interest rate (b)	16.15%
Est. Deductibility Ratio (a/b)	54.49%

Deductible Interest = 54.49% x \$16,150
 = \$8,800 *(deductible in current financial year)*

Cost Base of Put Option = \$16,150 – \$8,800
 = \$7,350 *(deductible at maturity against capital gain)*

Step C – Determine tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible interest component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- Where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- Where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Example 3.2

On 20 May 2011, Michael drew down the PL outlined below paying interest fixed monthly in arrears. On 30 June 2011 he switches interest from Fixed Monthly to Fixed Yearly in Advance with a new interest rate of 15.05%.

Loan Size	\$100,000
Loan term	3 years
Interest type	Fixed Monthly in Arrears
Interest rate p.a.	15.35%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark rate applicable to the Loan

Michael entered into the PL on 20 May 2011. At that time, the RBA Indicator Variable Rate for Standard Housing Loans plus 100 basis points was 8.80%.

Step B – Calculate the potential dollar interest deduction and put option for the PL

Monthly Interest payments from 20 May 2011 to 30 June 2011	\$1,724
RBA Benchmark Rate (a)	8.80%
PL Interest rate (b)	15.35%
Est. Deductibility Ratio (a/b)	57.33%
PL Fixed Yearly Interest rate p.a.	15.05%
Yearly in advance Interest payment made on 30 June 2011	\$15,050
RBA Benchmark Rate (a)	8.80%
PL Interest rate (b)	15.05%
Est. Deductibility Ratio (a/b)	58.47%
Total interest payments made in 10/11 Financial Year	\$16,774

$$\begin{aligned}
 \text{Deductible Interest} &= (57.33\% \times \$1,724) + (58.47\% \times \$15,050) \\
 &= \$988 + \$8,800 \\
 &= \$9,788 \qquad \qquad \qquad (\text{deductible in current financial year})
 \end{aligned}$$

$$\begin{aligned}
 \text{Cost Base of Put Option} &= \$16,774 - \$9,788 \\
 &= \$6,986 \qquad \qquad \qquad (\text{deductible at maturity against capital gain})
 \end{aligned}$$

Step C – Tax treatment of deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible interest component of the Interest payments (the Capital Protection Component) will constitute the cost of the Put Option. At maturity:

- Where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- Where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.

Example 3.3

On 1 July 2010, Michael drew down the Protected Loan outlined below:

Loan Size	\$100,000
Loan term	3 years
Interest type	Variable in Arrears
Interest rate p.a.	16.76%
Stocks	NAB and BHP
Loan Amounts	\$50,000 per Stock

Step A – Find the RBA Benchmark Rate applicable to the Loan

Michael is paying variable interest rate on his Protected Loan. Therefore he uses the average of the benchmark rates published by the RBA during the term of the Protected Loan or the relevant part of the term.

Average RBA Benchmark Rate	8.67%
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Step B – Calculate the potential dollar interest deduction and put option for the Protected Loan

Interest payments from 1 July 2010 to 30 June 2011	\$16,760
RBA Benchmark Rate (a)	8.67%
PL Interest rate (b)	16.76%
Est. Deductibility Ratio (a/b)	51.73%

Deductible Interest = 51.73% x \$16,760
 = \$8,670 *(deductible in current financial year)*

Cost Base of Put Option = \$16,760 – \$8,670
 = \$8,090 *(deductible at maturity against capital gain)*

Step C – Determine the tax treatment of the deductible interest and cost base

The deductions for the Deductible Component of the Interest payments should arise as and when amounts were incurred (for most investors this is likely to be when paid).

The Non-deductible interest component of the Interest payments, the Capital Protection Component, will constitute the cost of the Put Option. At maturity:

- Where the put option expires, most investors are entitled to a capital loss for the aggregate of the Capital Protection Components of the Interest payments paid up until that point. Note: capital losses can only be offset against capital gains and can be carried forward indefinitely.
- Where the put option is exercised, most investors are entitled to include in the Capital Gains Tax cost base of the securities (NAB and BHP in the above example) the aggregate of the Capital Protection Components of the Interest Payments.