Protected Loan Taxation Guide

An Explanatory Note

The taxation implications of your Protected Loan (PL) can depend on a number of factors. 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. This guide should not be taken as taxation advice.

Taxation Implications

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) (6.40% p.a. as at June 2016).

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 2015 / 2016 income tax year, you or your accountant may wish to go through the following steps:

<table>
<tr><td>Step A</td><td>Find the RBA Benchmark Rate applicable to the loan
<table>
<tr><th>Effective Date</th><th>RBA Benchmark rate</th></tr>
<tr><td>31-07-15</td><td>6.45%</td></tr>
<tr><td>31-08-15</td><td>6.45%</td></tr>
<tr><td>30-09-15</td><td>6.45%</td></tr>
<tr><td>31-10-15</td><td>6.45%</td></tr>
<tr><td>30-11-15</td><td>6.65%</td></tr>
<tr><td>31-12-15</td><td>6.65%</td></tr>
<tr><td>31-01-16</td><td>6.65%</td></tr>
<tr><td>28-02-16</td><td>6.65%</td></tr>
<tr><td>31-03-16</td><td>6.65%</td></tr>
<tr><td>30-04-16</td><td>6.65%</td></tr>
<tr><td>31-05-16</td><td>6.40%</td></tr>
<tr><td>30-06-16</td><td>6.40%</td></tr>
</table></td></tr>
<tr><td>Step B</td><td>Calculate the deductible and non-deductible component of the interest payment</td></tr>
<tr><td>Step C</td><td>Determine tax treatment of deductible interest and cost base</td></tr>
</table>

More information on the Reserve Bank of Australia's Indicator Variable Rate for standard housing can be found by visiting the following site:

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

Refer to "Indicator Lending Rates - F5".

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

On 3 June 2016, 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.	11.80%
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 3 June 2016 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 6.40%.

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

Interest payment p.a.	$11,800
RBA Benchmark rate (a)	6.40%
PL Interest rate (b)	11.80%
Est. Deductibility Ration (a/b)	54.24%

Deductible Interest	= 54.24% x $11,800	
	= $6,400	*(deductible in current financial year)*
Cost Base of Put Option	= $11,800 - $6,400	
	= $5,400	*(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 1.2

On 30 July 2015, Michael drew down the PL outlined below paying interest fixed monthly in arrears at 12.45%. On 30 June 2016 he switches interest from Fixed Monthly to Fixed Yearly in Advance with a new interest rate of 12.15%.

Loan Size	$100,000
Loan term	3 years
Interest type	Fixed Yearly in Advance
Interest rate p.a.	12.45%
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 30 July 2015. At that time, the RBA Indicator Variable Rate for Standard Housing Loans plus 100 basis points was 6.45%.

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

Total Monthly Interest payments 30 July 2015 to 30 June 2016	$12,450
RBA Benchmark rate (a)	6.45%
PL Interest rate (b)	12.45%
Est. Deductibility Ration (a/b)	51.81%
PL Fixed Yearly Interest rate p.a.	12.15%
Yearly in advance Interest payment made on 30 June 2016	$12,150
RBA Benchmark rate (a)	6.40%
PL Interest rate (b)	12.15%
Est. Deductibility Ration (a/b)	52.67%
Total interest payments made in 15/16 Financial Year	**$24,600**

Deductible Interest = (51.81% x $12,450) + (52.67% x $12,150)
= $6,450 + $6,400
= $12,850 *(deductible in current financial year)*

Cost Base of Put Option = $24,600 - $12,850
= $11,750 *(deductible at maturity against capital gain)*

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 1.3

On 1 July 2015, Michael drew down the Protected Loan outlined below:

Loan Size	$100,000
Loan term	3 years
Interest type	Variable in Advance
Interest rate p.a.	12.05%
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 between 1 July 2015 and 30 June 2016	6.54%

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

Total Monthly Interest payments 30 July 2015 to 30 June 2016	$12,050
RBA Benchmark rate (a)	6.54%
PL Interest rate (b)	12.05%
Est. Deductibility Ration (a/b)	54.29%

Deductible Interest	= 54.29% x $12,050	
	= $6,541	*(deductible in current financial year)*
Cost Base of Put Option	= $12,050 - $6,541	
	= $5,508	*(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.