



Understanding thin capitalisation

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Thin capitalisation rules

What the thin capitalisation rules are and who they apply to.

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About the rules

Under the thin capitalisation rules, the debt deductions of certain foreign entities investing into Australia, Australian entities that are foreign controlled, and Australian entities investing overseas are limited.

A debt deduction is an expense an entity incurs including interest, an amount in the nature of interest, or any other amount that is economically equivalent to interest, where the expense is otherwise deductible if the thin capitalisation rules are disregarded.

The thin capitalisation rules apply to:

- Australian entities with specified overseas investments
- Australian entities that are foreign controlled
- foreign entities with certain investments in Australia, regardless of whether they hold the investments directly or through Australian entities.

The thin capitalisation rules do not apply to an entity for an income year if:

- the total debt deductions of the entity and all its associate entities for that year are \$2 million or less.
- the entity is an Australian entity with overseas operations or investments, or an associate of such an entity, that is not also foreign controlled, and meets the assets threshold test
- the entity is an insolvency-remote special purpose entity established to manage certain risks and the total value of debt interests in the entity is at least half of the total value of its assets.

Who is affected

The thin capitalisation rules affect:

- Australian entities with certain overseas operations, and their associate entities
- Australian entities that are foreign controlled
- foreign entities with operations or investments in Australia.

For income years that commence on or after 1 July 2023, affected entities that are not financial entities or authorised deposit-taking institutions for a period that is all or part of the income year, will be classified as **general class investors**.

The previous law continues to apply for entities that are Australian plantation forestry entities for a period that is all or part of the income year.

The thin capitalisation rules can apply to companies, trusts, partnerships, unincorporated bodies and individuals.

An Australian entity may be affected by the thin capitalisation rules if it is any of the following. An:

- Australian controller of an Australian controlled foreign entity
- entity that carries on business through an overseas permanent establishment, such as a branch
- associate entity of either of the above.

An Australian controller includes:

- an Australian entity holding a thin capitalisation control interest in an Australian controlled foreign entity of at least 10%
- an Australian entity that holds a thin capitalisation control interest of at least 1% in a controlled foreign company (except a corporate limited partnership) and is one of 5 or fewer Australian entities that, together with associate entities, control the foreign company
- an Australian entity that is a general partner of a controlled foreign corporate limited partnership.

An example of an Australian controller is an Australian company that has a 51% shareholding in a New Zealand company. See **Control of your entity**.

An entity may also be affected by the thin capitalisation rules if it is either of the following:

- an Australian entity controlled by a foreign entity; that is, a foreign controlled Australian entity
- a foreign entity (the thin capitalisation rules only affect those with Australian income-producing assets).

An example of the first type entity is an Australian company that is a subsidiary of a United States company. An example of the second type of entity is a foreign entity that owns a rental property located in Australia or a foreign entity that has a permanent establishment in Australia.

Associate entities

The thin capitalisation rules also affect associate entities of Australian entities with certain overseas operations. An associate entity is an entity (Entity A) that is an associate of another entity (Entity B) under

section 318 of the *Income Tax Assessment Act 1936* (ITAA 1936), and at least one of the following apply:

- Entity B holds an interest of 50% or more in Entity A
- Entity A (either directly or indirectly) is accustomed, under an obligation, or reasonably expected to act in accordance with the directions, instructions or wishes of Entity B in relation to whether Entity A retains or distributes its profits or its financial policies.

For more information about the meaning of associate entity, see **Terms we use**.

If Entity A is an associate entity of Entity B, Entity B is automatically an associate entity of Entity A. If 2 separate entities are both associate entities of the same entity, they are also associate entities of each other. An example of this is 2 companies that are subsidiaries of the same parent company. As they are both associate entities of the parent company, they are also associate entities of each other.

There are additional special rules to deal with financing arrangements between associate entities that are not grouped.

Who is not affected

For any given income year, the following entities are not affected by the thin capitalisation rules:

- an entity whose debt deductions, together with those of any associate entities, are less than the de-minimis threshold of \$2 million for the income year (see section 820-35 of the ITAA 1997)
- an Australian resident entity that is neither foreign controlled nor has any overseas operations or investments (unless it is an associate of another Australian entity that does)
- a foreign entity that has no investment or presence in Australia
- an Australian entity with overseas operations or investments, or an Australian entity that is an associate of such an entity that is not also foreign controlled and that meets the Australian assets threshold test. This is explained further in section 820-37 of the ITAA 1997.

Certain special purpose entities are also excluded where all of the following apply:

- The entity is established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments.
- The total value of debt interests in the entity is at least 50% of the total value of the entity's assets.
- The entity is an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency that are applicable to the entity's circumstances. That entity does not have to have been rated by a rating agency.

For more information on special purpose entities, see **section 820-39** of the ITAA 1997.

Note: Entities that are excluded from the general thin capitalisation provisions pursuant to section 820-37 of the ITAA 1997 may still be subject to the debt deduction creation rules in Subdivision 820-EAA of the ITAA 1997.

Australian asset threshold test

Section 820-37 of the ITAA 1997 provides that an entity is excluded from the thin capitalisation regime for an income year if it meets **all** of the following criteria:

- The entity is **one** of the following for all or part of the income year
 - Assuming that the entity were a financial entity for all of that income year, it would be for all of that year, an outward investing financial entity (non-ADI) and not an inward investor (financial)
 - an outward investing financial entity (non-ADI)
 - an outward investing entity (ADI).
- The entity is not also an inward investor (financial) or an inward investing entity (ADI) for all or part of that income year.
- The sum of the entity's average Australian assets and the average Australian assets of its associates (as defined in **section 318** of the ITAA 1936) represents 90% or more of the sum of its average total assets and the average total assets of its associates.

The terms 'average Australian assets' and 'average total assets' are specifically defined for the purposes of this test.

The average Australian assets of an Australian entity means all the Australian entity's assets **other than**:

- assets attributable to any of the Australian entity's overseas permanent establishments
- any asset to the extent it is either controlled foreign entity debt or controlled foreign entity equity
- any asset that is a debt interest or equity interest held in the Australian entity's associates.

The average Australian assets of a foreign entity for the purposes of the Australian asset threshold test:

- **includes** the foreign entity's assets that are
 - located in Australia
 - attributable to any of the foreign entity's Australian permanent establishments
 - debt interests or equity interests held by the entity, to the extent they are issued by or held in an Australian entity and are not attributable to any overseas permanent establishment of the Australian entity.
- **excludes** the foreign entity's assets other that are
 - debt interests or equity interests issued by or held in associates of the foreign entity.

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Entity categories

Find out how to categorise an entity and which thin capitalisation rules apply.

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About this section

This section provides information on how to categorise an entity to determine which thin capitalisation rules apply.

General class investor

Effective for income years beginning on or after 1 July 2023, the new thin capitalisation regime introduces the 'general class investor' definition. Broadly, the general class investor definition represents a consolidation of the previous 'outward investor (general)', 'inward investment vehicle (general)' and 'inward investor (general)' categories. General class investors do not include financial entities and authorised deposit taking institutions (ADIs).

An entity is a general class investor for an income year if, and only if:

- for a period that is all or part of the income year, the entity is not any of the following:
 - an outward investing financial entity (non-ADI)
 - an inward investing financial entity (non-ADI)
 - an outward investing entity (ADI)
 - an inward investing entity (ADI), and
- assuming that the entity were a financial entity for all of the income year, it would be, for the income year, any of the following
 - an outward investing financial entity (non-ADI)
 - an inward investing financial entity (non-ADI).

Note: An Australian entity that is not a financial entity or an ADI will be a general class investor if it is an associate entity of one or more of the following:

- a general class investor that, assuming it were a financial entity, would be an outward investing financial entity (non-ADI)
- an outward investing financial entity (non-ADI)
- an outward investing entity (ADI).

For more information, see:

- General class investors
- subsection 820-46(2) of the ITAA 1997
- subsection 820-85(2) and (2BA) of the ITAA 1997.

Outward investing financial entity (non-ADI)

An entity is an outward investing financial entity (non-ADI) for a period that is all or a part of an income year if satisfies the following 2 conditions throughout that period:

- it is a [financial entity](#), and
- it is one or more of the following
 - an Australian controller of at least one Australian controlled foreign entity
 - an Australian entity that carries on business overseas through one or more overseas permanent establishments
 - an Australian entity that is an associate entity of another Australian entity that is an outward investing financial entity (non-ADI) or an outward investing entity (ADI).

However, an entity is not an outward investing financial entity (non-ADI) for a period that is all or part of an income year if it is a general class investor for that year.

For the purposes of determining whether an Australian entity is an associate entity of another Australian entity that is an outward investing financial entity (non-ADI), assume the other entity is a financial entity for all of the income year. This assumption ensures that an Australian entity will be subject to the thin capitalisation rules if it is an associate entity of a general class investor that, assuming it were a financial entity, would be an outward investing financial entity (non-ADI).

For more information, see subsection 820-85(2) & (2BA) of the ITAA 1997.

Inward investing financial entity (non-ADI)

An entity is an inward investing financial entity (non-ADI) if it is an:

- inward investment vehicle (financial) – an Australian entity that is controlled by a foreign entity or foreign entities
- inward investor (financial) – a foreign entity. Although all foreign entities are inward investors, the thin capitalisation rules only affect foreign entities
 - with an Australian permanent establishment or other Australian income producing assets
 - that are claiming debt deductions.

However, an entity is not an inward investing financial entity (non-ADI) for a period that is all or part of an income year if it is a general class investor for that year.

For more information, see **subsection 820-185(2)** of the ITAA 1997.

Outward investing entity (ADI)

An entity is an outward investing entity (ADI) for a period that is all or a part of an income year if throughout that period the entity is an [ADI entity](#) to which one of the following applies:

- the entity is an Australian controller of at least one Australian controlled foreign entity
- the entity is an Australian entity that carries on a business overseas at or through one or more overseas permanent establishments
- the entity is an Australian entity that is an associate entity of another entity that is one of the following:
 - an outward investing financial entity (non-ADI), or
 - outward investing entity (ADI), or
 - a general class investor that, if it were assumed that it were a financial entity, it would be an outward investing financial entity (non-ADI).

However, an entity is not an outward investing entity (ADI) for a period that is all or a part of an income year if it is a general class investor for that year.

For more information, see **subsection 820-300(2)** of the ITAA 1997.

Inward investing entity (ADI)

An entity will be an inward investing entity (ADI) for a period that is all or part of an income year if throughout that period the entity is a foreign bank which carries on its banking business in Australia at or through one or more Australian permanent establishments.

However, an entity is not an inward investing entity (ADI) for a period that is all or a part of an income year if it is a general class investor for that year.

For more information, see subsection 820-395(2) of the ITAA 1997.

Financial entities and ADI entities

Financial entity

A financial entity is an entity, other than an ADI, that is any of the following:

- a registered corporation under the *Financial Sector (Collection of Data) Act 2001* that carries on a business of providing finance, but not predominantly for the purposes of providing finance directly or indirectly to, or on behalf of, the entity's associates and derives all or substantially all of its profits from that business
- a securitisation vehicle
- an entity that is either
 - a financial services licensee, within the meaning of the *Corporations Act 2001*, whose licence covers dealings in at least one of the financial products mentioned in paragraphs 764A(1) (a), (b) and (j) of that Act or dealings in derivatives
 - both of the following
 - exempt under paragraph 911A(2)(h) or (l) of the *Corporations Act 2001* from the requirement to hold an Australian financial services licence for dealings in at least one of those financial products or dealings in such derivatives
 - carrying on a business of dealings in securities or such derivatives, but not predominantly for the purposes of dealing in securities or such derivatives with, or on behalf of, the entity's associates.

For more information, see subsection 995-1(1) of the ITAA 1997.

ADI entity

An ADI entity is a body corporate that is an authorised deposit taking institution for the purposes of the *Banking Act 1959*.

Certain financial entities can elect to be treated as an ADI under the thin capitalisation rules. The conditions for making this election are explained in [Electing to use the ADI rules](#).

Entities that are both outward and inward investing entities

If an entity is both an outward investing entity and an inward investing entity, the rules for outward investing entities apply. For example, if an Australian resident entity is foreign controlled and carries on business through an overseas permanent establishment, the rules for outward investing entities apply subject to 2 qualifications:

- the entity is not able to apply the assets threshold test in section 820-37 of the ITAA 1997.
- the entity may choose to apply a worldwide gearing debt test provided that certain requirements are met, including a requirement that the entity's Australian assets represent no more than 50% of the entity's statement worldwide assets.

The following tables summarise the rules explained in this section. They also tell you which section explains how to apply the thin capitalisation rules to the type of entity you are dealing with.

Table 2: How to categorise the entity and where to find the rules for different entity types

Entity type	Financial entity	ADI entity
Outward investing entity	Outward investing financial entity (non-ADI)	Outward investing entity (ADI)
Inward investment vehicle	Inward investment	Not applicable

	vehicle (financial)	
Inward investing entity	inward investor (financial)	Inward investing entity (ADI)
Outward investing entity and inward investment vehicle	Outward investing financial entity (non-ADI)	Outward investing entity (ADI)

For general class investors assume the entity is a financial entity and then classify as outward or inward financial entity as above.

Table 3: How to categorise a financial entity that has elected to apply the ADI rules and where to find the rule

Entity type	Elected classification and rules
Outward investing financial entity (non-ADI)	Outward investing entity (ADI). The rules in Subdivision 820-D of the ITAA 1997 apply. Refer to outward investing entity (ADI).
Inward investment vehicle (financial)	Outward investing entity (ADI). The rules in Subdivision 820-D of the ITAA 1997 apply Refer to outward investing entity (ADI).
Inward investor (financial)	Inward investing entity(ADI). The rules in Subdivision 820-E of the ITAA 1997 apply Refer to inward investing entity (ADI).
Outward investing financial entity (non-ADI), and inward investment vehicle (financial)	Outward investing entity (ADI). The rules in Subdivision 820-D of the ITAA 1997 apply

	Refer to outward investing entity (ADI).
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Average values

You must calculate average values for particular matters like assets, liabilities, debt and equity capital.

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Valuing assets, debt, other liabilities, equity and other matters

The value of assets, debt capital, other liabilities, equity capital and other matters requiring a value is calculated by applying the relevant accounting standards. These standards also govern how amounts recorded in foreign currency are converted into Australian currency. The relevant accounting standards are the Australian equivalents to International Financial Reporting Standard (AIFRS) as adopted by the government on 1 January 2005. An entity must comply with the accounting standards when valuing a matter for thin capitalisation purposes, regardless of whether they are otherwise required to apply the standards.

It is to be noted that certain modifications to the application of the accounting standards apply for non-ADI entities and ADI entities for the purposes of making calculations under the thin capitalisation regime.

Find out more in:

- sections 820-682, 820-683 and 820-684 of the ITAA 1997 (for non-ADIs)
- sections 820-300 and 820-310 of the ITAA 1997 (for ADIs).

The value the entity uses in its books of account for accounting purposes and the value it uses for thin capitalisation purposes do not necessarily need to be the same, provided that the value used for thin capitalisation purposes is established by complying with the accounting standards.

Our discretion

To ensure the integrity of the values used, we have the discretion to substitute an appropriate value where we consider that the entity has either overvalued its assets or undervalued its liabilities.

As the exercise of this power may directly affect an entity's assessment, an entity that is dissatisfied with our decision to substitute a value may object to the decision under Part IVC of the Taxation Administration Act 1953.

For more information, see section 820-690 of the ITAA 1997.

Average values

The value of a matter is measured at several points during either the income year or the income period if either:

- the thin capitalisation rules applied for only part of the year
- different thin capitalisation rules applied to different parts of the year.

The value is then averaged over that year or period.

A financial entity (non-ADI) can calculate the average by applying one of the following 3 methods:

- the opening and closing balances method
- the three measurement days method
- the frequent measurement method – this method contains two sub-options: a quarterly option and a more frequent option.

One method must be used to calculate the average value of all matters and must be consistently applied during the period. However, an entity can change the method used from one income year to the next. Also, if an entity changes categories part-way through the year, it can use different methods. For example, if an entity was an inward investment

vehicle (financial) and then becomes an outward investing financial entity (non-ADI) (for example, by acquiring a foreign subsidiary), it can use different methods for each part year period. See **Application to part-year periods**.

An ADI must always use the frequent measurement method.

The different methods are explained in the following table.

Table 6: Methods for valuing matters

Method	Days on which value is measured – measurement days	How to calculate the average value	Special condition
Opening and closing balances	The first day of the period. The last day of the period.	Add the values together and divide by 2.	Cannot be by an ADI Refer to section 82 635 of the ITAA 1997 more information
Three measurement days	The first day of the period. The last day of the first half of the income year. The last day of the period.	Add the values together and divide by 3.	Cannot be by an ADI The period include at either the day of the income ye the last da the income and be at l 6 months l Refer to section 82 640 of the ITAA 1997 more information

<p>Frequent measurement method (quarterly basis)</p>	<p>The first day of the period.</p> <p>The last day of each quarter in that period.</p> <p>The last day of the period, unless the last day was already included.</p>	<p>Add the values together and divide by the number of measurement days.</p>	<p>One of the methods must be used as an ADI entity.</p> <p>Refer to subsection 645(2) of the ITAA 1997 for more information.</p>
<p>Frequent measurement method (more frequent basis)</p>	<p>The measurement days are the days occurring at a regular interval chosen by the entity, for example, monthly, weekly, daily.</p> <p>The first day of the measurement period.</p> <p>The last day of each regular interval for the measurement period.</p> <p>The last day of the measurement period unless the last day was already included in the second dot point.</p>	<p>Add the values together and divide by the number of measurement days.</p>	<p>One of the methods must be used as an ADI entity.</p> <p>The regular interval selected cannot be more than 3 months.</p> <p>An entity can choose to measure its assets and liabilities on a more frequent basis under this method and measure the remainder quarterly for example, measure assets and debt on a more frequent basis and non-debt liabilities on a quarterly basis.</p> <p>However, if an entity has selected to measure its assets and liabilities on a more frequent basis, it must use the same regular interval for all assets and liabilities.</p>

			<p>interval – for example, the entity cannot measure a daily, debt weekly and debt liability monthly.</p> <p>Refer to subsection 645(4) of ITAA 1997 for more information.</p>
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Example 5: Three measurement days

ABC Co uses a standard income year – 1 July to 30 June. It becomes subject to the thin capitalisation rules on 1 November 2014 and remains subject to the rules until the end of the financial year. The company can apply the three measurement days method because the period is at least 6 months and includes the last day of its income year. The 3 measurement days are 1 November 2014, 31 December 2014 and 30 June 2015.

If ABC Co has assets of \$62 million, \$65 million and \$53 million on 1 November 2014, 31 December 2014 and 30 June 2015 respectively, the average value of assets for the period is \$60 million.

Example 6: Frequent measurement method – quarterly basis

XYZ Co has a substituted accounting period running from 1 January to 31 December 2015 and chooses to measure all its matters quarterly in its 2015 income year. On the first day of the measurement period, the value of its assets is \$52 million. On the

last day of each quarter in its income year, the value of its assets is as follows:

- \$61 million – 31 March 2015
- \$65 million – 30 June 2015
- \$63 million – 30 September 2015
- \$64 million – 31 December 2015.

These values are added together and divided by 5. The average value of assets for the year is \$61 million.

Example 7: Frequent measurement method – more frequent basis

LCD Co uses a standard income year (1 July to 30 June) and chooses to measure its debt capital on a monthly basis. The relevant values are as follows:

- On the first day of the year (1 July 2015), its debt capital is \$60 million.
- On the last day of July, August and September, its debt capital is \$65 million.
- On the last day of October, November and December, its debt capital is \$70 million.
- On the last day of January, February and March, its debt capital is \$75 million.
- On the last day of April, May and June, its debt capital is \$80 million.

Adding the amounts together and dividing by 13 (being the number of measurement days) gives an average value of debt capital for that period of \$71.54 million.

LCD Co then measures its remaining matters (debt, non-debt liabilities etc) on a quarterly basis.

Choice to treat specialist credit card institutions as financial entities and not ADIs

Some specialist credit card institutions can elect to be treated as financial entities (non-ADI).

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Specialist credit card institutions

A specialist credit card institution is defined as an ADI, authorised under the *Banking Act 1959*, to conduct banking business that is confined to credit card acquiring and/or credit card issuing and involves participation in a payment system that is a credit card scheme, where that payment system is designated under section 11 of the *Payment Systems (Regulation) Act 1998*.

Specialist credit card institutions are authorised to conduct limited banking business and are supervised differently by APRA compared to other ADIs.

Unlike other ADIs, the capital adequacy of specialist credit card institutions is not determined on a consolidated group basis where a specialist credit card institution is part of a group that does not contain any other types of ADI. In this case, the capital adequacy requirements apply to a specialist credit card institution and its subsidiaries (if any) on a consolidated basis but not the wider corporate group.

The advent of ADIs whose capital adequacy is not determined on a consolidated group basis for prudential purposes was not originally considered when the thin capitalisation rules were first introduced. As such, the thin capitalisation rules in their original form require all consolidated or MEC groups containing ADIs to determine their capital adequacy by considering risk-weighted assets on a group-wide basis.

It is considered that this requirement places unnecessary compliance costs on groups containing ADIs that are only specialist credit card

institutions.

Therefore, provided certain conditions are satisfied, the head company of a consolidated or MEC group containing one or more ADIs is allowed to apply the thin capitalisation rules as if the group did not contain an ADI, if all the ADIs in the group are specialist credit card institutions. Each specialist credit card institution will instead be treated as if it was a financial entity. For more information, see **subsection 820-588(3)** of the ITAA 1997.

Conditions

The 3 conditions that must be met for a choice to be made to treat a specialist credit card institution as a non-ADI for thin capitalisation purposes are:

- At all times in a period, at least one member of the consolidated group or MEC group is an ADI.
- Each ADI that is a member of the group at any time in the period is a specialist credit card institution at that time.
- The head company of the group for the period chooses, before lodging its income tax return for the income year, to apply the thin capitalisation rules as if the group did not contain any ADIs during the period.

For more information, see **subsection 820-588(2)** of the ITAA 1997.

Result of choice

If a choice is made, each specialist credit card institution in the group will be treated for thin capitalisation purposes as a financial entity (non-ADI) during the relevant periods.

The head company of the group will be classified as an outward investing financial entity (non-ADI), inward investor (financial) or an inward investment vehicle (financial), as the case may be – that is, depending on what the usual thin capitalisation classification of the head company would be without the ADI rules applying.

This means Subdivision 820-B or 820-C of the ITAA 1997 will apply to the head company instead of Subdivision 820-D of the ITAA 1997.

For more information, see **subsection 820-588(1)** of the ITAA 1997.

Application to part-year periods

How thin capitalisation rules apply to a financial entity (non-ADI) subject to the rules for part of an income year.

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This section explains how the thin capitalisation rules apply if a financial entity (non-ADI) was subject to the rules for part of an income year or was subject to different thin capitalisation rules throughout an income year.

If your entity is subject to the thin capitalisation rules for only part of the income year, you must work out its adjusted average debt and maximum allowable debt for only that part of the year. The entity will be disallowed debt deductions under the thin capitalisation rules if its adjusted average debt for that period exceeds its maximum allowable debt for that period. The average values used in the calculations are the average values over the relevant period. Likewise, the debt deductions affected are only those incurred during that same period.

If the entity is subject to the rules for non-continuous periods, the calculations apply to each period separately. For example, the entity may be subject to the rules for the first 3 months of the year but not for the next 3 months, and then becomes subject to the rules again for the last 6 months of the year. Calculate any debt deductions disallowed for each period and then add them together to work out the total debt deductions disallowed for the income year.

Alternatively, an entity may be subject to the thin capitalisation rules for a full income year but change status part-way through the year.

Example 8: inward investment vehicle (financial) acquires a controlled foreign entity

An entity is an inward investment vehicle (financial) for the first 6 months of the year. It then acquires a controlled foreign entity. From that point forward, the entity is treated as an outward investing financial entity (non-ADI). For the first 6 months of the year, the rules applying to inward investment vehicles (financial) apply and for the next 6 months the outward investing financial entity (non-ADI) rules apply.

When applying the steps and worksheets to a part-year period, all references to an income year become references to a period.

For more information, see [section 820-120](#) of the ITAA 1997.

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