

QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

Income tax – portfolio investment entity income from land development activities

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QB 26/03

This question we've been asked considers whether income derived from developing land, dividing it into lots and/or erecting buildings on the land for the purpose of sale is eligible income for a portfolio investment entity under s HM 12 of the Income Tax Act 2007. It concludes that this income is eligible income under s HM 12.

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss HM 11 and HM 12

Question | Pātai

Is income from developing land, dividing it into lots and/or erecting buildings on the land for the purpose of sale eligible income for a portfolio investment entity (PIE) under s HM 12?

Answer | Whakautu

Yes. Income from developing land, dividing it into lots and/or erecting buildings on the land for the purpose of sale is eligible PIE income under s HM 12. These activities give rise to income that is an amount derived from the disposal of property referred to in s HM 11, which includes interests in land, under s HM 12(1)(b)(v).

Explanation | Whakamāramatanga

Portfolio investment entity eligibility requirements

1. Under s HM 2(1), a portfolio investment entity (PIE) is a company or fund that makes investments on behalf of investors, meets and maintains the requirements for PIE status and chooses to become a PIE. For the purpose of determining whether an entity qualifies for PIE status, it is necessary that the entity meets and maintains the requirements for PIE status.
2. Section HM 7 sets out the requirements a PIE must meet and maintain for PIE status. In summary, that section requires the entity to meet the requirements in ss HM 8 to HM 10, HM 10B, HM 11 to HM 19, HM 19B, HM 19C and HM 20, as applicable. For the purpose of this question we've been asked, the relevant requirements are ss HM 11 and HM 12.
3. Under s HM 11, 90% or more of the entity's investments must be in:
 - interests in land;
 - financial arrangements;
 - excepted financial arrangements; and
 - a right or option in relation to property listed above.
4. Under s HM 12, 90% or more of an entity's income must be of a listed type derived from the property listed in s HM 11, as follows:

HM 12 Income types

Nature of income

- (1) Income derived by the entity, to the extent of 90% or more, must—
 - (a) be derived from property referred to in section HM 11; and

- (b) consist of the following:
 - (i) a dividend:
 - (ii) a replacement payment:
 - (iii) an amount of income treated under subpart EW (Financial arrangements rules) as derived by the entity:
 - (iv) an amount of income derived from a lease of land, but this subparagraph does not apply if the lessee under the lease is associated with the entity receiving the amount:
 - (ivb) insurance, indemnity, or compensation amounts replacing income that would be described in subparagraph (iv):
 - (v) an amount derived from the disposal of property referred to in section HM 11:
 - (vi) FIF income:
 - (vii) attributed PIE income:
 - (viii) a distribution from a superannuation fund:
 - (ix) an amount of income under section CW 4 (Annuities under life insurance policies) or CX 40 (Superannuation fund deriving amount from life insurance policy):
 - (x) a rebate on a management fee.

5. The Commissioner has been asked whether income from land development activities could be eligible PIE income on the basis that it is income derived from the disposal of land, which is property referred to in s HM 11, under s HM 12(1)(b)(v).

Section HM 12

6. Section 10 of the Legislation Act 2019 requires that the meaning of an enactment be ascertained from its text and in the light of its purpose and context. The Supreme Court discussed the application of the predecessor to s 10 of the Legislation Act (s 5 of the Interpretation Act 1999) in *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36. The court noted that, even if the meaning of the text may appear plain in isolation of purpose that meaning should always be cross-checked against purpose to observe the dual requirements of s 5 of the Interpretation Act. In determining the purpose of a provision, it is necessary to have regard to both the immediate and general legislative contexts as well as the social, commercial or other

objective of the enactment. However, the text is paramount, and the interpretation given to the words must still be an interpretation they can fairly bear.¹

7. The High Court noted in *Four Midwives v Minister for COVID-19 Response* [2021] NZHC 3,064 that s 10(1) of the Legislation Act 2019 effectively confirms the Supreme Court's approach in *Fonterra*. Taxation statutes are construed purposively in the same manner as any other statute (*Terminals (NZ) Ltd v Comptroller of Customs* [2013] NZSC 139 at [39]).
8. Section HM 12 lists the types of income that a PIE is allowed to derive. Under s HM 12(1)(b)(v), a PIE's income can consist of "an amount derived from the disposal of property referred to in section HM 11". The ordinary meaning of the word "dispose" is wide, covering any scenario where property is got rid of. Given the breadth of the term "dispose", an initial reading suggests this provision would cover amounts derived from **all** disposals of the relevant property. This would appear to include income from the disposal of land that has been subject to land development activities.
9. However, as noted above, even if the meaning of the text may appear plain in isolation of purpose that meaning should always be cross-checked against purpose. Several indications from the scheme and purpose of the legislation arguably support a view that the words should be read more narrowly to refer only to amounts derived from a **subset** of disposals of the relevant property. In particular, the other income types listed are, arguably, all types of income that are derived from holding property (often referred to as passive income):
 - Dividends, replacement payments and foreign investment fund (FIF) income are income from holding shares.
 - Income under the financial arrangements rules is income from holding financial arrangements (usually referred to as interest). This does not include "excluded interest", which is essentially income from associated persons. This exclusion was included to prevent a PIE from "receiving interest income from that associated person that is essentially a transfer of active income into the PIE".²
 - Income derived from a lease of land (rent), an insurance, indemnity, or compensation payment replacing rent, and a rebate on a management fee is all income from holding land. As for financial arrangement income, this also does not include income from an associated person. This exclusion was added to

¹ *Burrows and Carter Statute Law in New Zealand* (6th ed, LexisNexis, Wellington, 2021) at 318.

² Taxation (Annual Rates for 2024–25, Emergency Response, and Remedial Measures) Bill: Commentary on the Bill (Inland Revenue, 2024) at 180.

prevent “a land-owning active business to access the PIE rules in a way that is contrary to policy intent”.³

- Attributed PIE income, distributions from a superannuation fund and an amount of income under s CW 4 (annuities under life insurance policies) or s CX 40 (superannuation fund deriving amount from life insurance policy) are income derived from holding those investments.
10. Reading the phrase “an amount derived from the disposal of property referred to in section HM 11” in the context of the other words of the section, could support a conclusion that this phrase should be read as referring to only a subset of disposals, being disposals that give rise to similar types of income (ie, passive income from holding the relevant property). This could be said to be consistent with the principle of interpretation *noscitur a sociis*, “it is known by its associates”.⁴ This principle requires that a word or phrase should be read in the context of the other words of the section in which it appears. Its exact shade of meaning may be coloured by those other words. The Commissioner considers this could be a legitimate form of “reading in”.⁵
11. The courts have confirmed that extrinsic materials can also be looked to in determining purpose and context.⁶ In this context, Parliament has made statements concerning the purpose of s HM 12. The commentary in Taxation (Tax Administration and Remedial Matters) Bill: Commentary on the Bill (Inland Revenue, 2010) states (at 51):

PIEs are restricted to earning 90 percent or more of their income from the types of income listed in section HM 12 of the Income Tax Act 2007. **The purpose of this restriction is to ensure that PIEs generally earn only passive income, as PIEs are intended to be passive investment vehicles.** Income from life insurance policies was inadvertently not included in this list. Accordingly, the bill amends section HM 12 to include income derived from life insurance policies, with effect from the beginning of the PIE regime. [Emphasis added]

³ Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill: Commentary on the Bill (Inland Revenue, 2008) at 134.

⁴ *Burrows and Carter* at 328 to 330.

⁵ See, for example, the discussion in *Burrows and Carter* on this type of legitimate “reading in” at 412 and the decisions in *Ex parte Goddard* (1940) 40 SR (NSW) 450 and *Vu v Ministry of Fisheries* [2011] 3 NZLR 1 (SC).

⁶ See, for example, *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36 at [22], *Burrows and Carter* at 315, and *Mainzeal Property and Construction Ltd (in liq) v Yan* [2019] NZHC 255 at [152].

12. In addition, the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill: As reported from the Finance and Expenditure Committee: Commentary states (at 16):

The majority of us also consider it is important that a PIE should have the majority of its assets employed in deriving what is known as passive income (such as income from trading shares, dividends, land and rents). We understand that these criteria are designed to replicate the situation of the vast majority of individuals who invest directly (rather than via a managed fund). Officials advised us that if these tests (referred to as bright-line tests) were not satisfied, then direct investors who were share traders would be able to manipulate the PIE rules to gain the advantages of being a PIE, while maintaining control of their trading activities. [Emphasis added]

13. Consistent with the context provided by the other categories of income listed in s HM 12(1)(b)(v), these statements seem to strongly support the view that Parliament intended that PIEs should generally (ie, to the extent of 90% or more) earn only passive income.
14. However, aspects of the scheme and purpose of the legislation arguably more strongly point in a different direction. The words used in s HM 12(1)(b)(v) do not expressly require a narrower interpretation. This is inconsistent with other provisions in the Income Tax Act 2007, such as s CB 4 where the legislation expressly narrows the disposals covered by the provision to those arising where the property was acquired for the purpose of disposing of it. This suggests that if Parliament wanted to limit the application of s HM 12(1)(b)(v) it could have done so expressly.
15. In addition, any requirement that PIEs derive mostly passive income would be ambiguous and arguably hard to apply in practice. In the context of land, for example, it is not clear whether income derived from the sale of land that is developed and then held for rental purposes would be considered passive income from holding the land given the active development activities. Similarly, while Parliament enacted specific rules to ensure capital gains from trading New Zealand and Australian shares would not be taxed because "individual savers would generally not be taxed on capital gains",⁷ it was acknowledged that this rule was necessary because these collective investment vehicles "will generally be in the business of trading in shares".⁸ Trading shares is generally accepted to give rise to active not passive income.

⁷ Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill: Commentary on the Bill (Inland Revenue, 2006) at 8.

⁸ Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill: Commentary on the Bill at 7.

16. Weighing up the various arguments, the Commissioner does not consider that the scheme and purpose arguments to the contrary would displace an interpretation based on the plain meaning of the words. As stated above, the text is paramount.
17. On that basis, the Commissioner does not consider that the indications of context and purpose to the contrary would be sufficiently persuasive to convince a New Zealand court that the wide meaning of the words used in the legislation does not apply. Therefore, on balance, the Commissioner considers that under the wording of s HM 12(1)(b)(v), a PIE can derive income from land development activities on the basis that such income is “an amount derived from the disposal of property referred to in section HM 11”.

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007 – ss CB 4, CW 4, CX 40, HM 2, HM 7, HM 8 to HM 10, HM 10B, HM 11 to HM 19, HM 19B, HM 19C, HM 20

Interpretation Act 1999 – s 5

Legislation Act 2019 – s 10

Case references | Tohutoro kēhi

Commerce Commission v Fonterra Co-operative Group Ltd [2007] NZSC 36

Four Midwives v Minister for COVID-19 Response [2021] NZHC 3,064

Goddard, Ex parte (1940) 40 SR (NSW) 450

Mainzeal Property and Construction Ltd (in liq) v Yan [2019] NZHC 255

Terminals (NZ) Ltd v Comptroller of Customs [2013] NZSC 139

Vu v Ministry of Fisheries [2011] 3 NZLR 1 (SC)

Other references | Tohutoro anō

Burrows and Carter Statute Law in New Zealand (6th ed, LexisNexis, Wellington, 2021)

Taxation (Annual Rates for 2024–25, Emergency Response, and Remedial Measures) Bill: Commentary on the Bill (Inland Revenue, 2024)

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Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill: As reported from the Finance and Expenditure Committee – Commentary (New Zealand Parliament, 2006)

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Taxation (Tax Administration and Remedial Matters) Bill: Commentary on the Bill (Inland Revenue, 2010)

taxpolicy.ird.govt.nz/publications/2010/2010-commentary-tarm

About this document | Mō tēnei tuhinga

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