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Technical amendments to tax rules for portfolio investment entities: how they will work

Introduction

The Taxation (KiwiSaver and Company Tax Rate Amendments) Bill contains a number of remedial amendments to the recently enacted portfolio investment entity rules.

These technical amendments give effect to the policy intent of the portfolio investment entity rules. They provide greater flexibility in implementing the rules, ensure that different commercial arrangements are able to be accommodated, and make technical corrections to the rules. These changes will enable a smooth introduction of KiwiSaver and the portfolio investment entity rules in October 2007.

Detailed analysis

Calculation of portfolio entity tax liability for an investor as a member of a portfolio investor class

The bill amends section HL 20 to ensure that the portfolio entity tax liability is calculated for a portfolio calculation period and a portfolio investor class and each investor in the portfolio investor class. Currently, the portfolio entity tax liability is calculated for a portfolio calculation period and an investor (that is, as being the sum of the portfolio entity tax liability for each portfolio investor class that the investor is a member of). There is no ability for a portfolio tax rate entity to calculate the tax liability for the investor as a member of a portfolio investor class.

The new approach will provide the flexibility for portfolio tax rate entities to calculate a tax liability for an investor as a member of a portfolio investor class and apply the investor's share of the tax credits for the class (both foreign and New Zealand) accordingly. The provisions relating to utilisation of foreign and New Zealand tax credits are also being amended so that credits can be allocated to an investor and used to reduce their liability as a member of a portfolio investor class. This is discussed in more detail below.

It is important to note that these changes would not generally prevent a portfolio tax rate entity from applying an investor's tax credits to reduce the investor's portfolio entity tax liability across all their classes. That is, in addition to allowing a portfolio investor class-based approach to calculation of tax liabilities and utilisation of credits, the legislation will also support the current approach of allowing an investor's portfolio entity tax liability to be reduced by all of the investor's available foreign and New

Zealand tax credits. The way tax credits can be utilised (especially foreign tax credits) is relevant where a tax liability is triggered when an investor reduces their interest in a portfolio tax rate entity.

The approach adopted in the bill is designed to support the different commercial arrangements that a portfolio tax rate entity may have.

Payment of tax on switches between portfolio investor classes and partial exits

The bill introduces new section HL 23B to allow portfolio tax rate entities that pay tax under section HL 21 or HL 23 to make voluntary payments of tax when an investor fully or partially exits a portfolio investor class.

This change is designed to allow portfolio tax rate entities to pay tax when an investor switches from one investor class to another within the same entity, and also to accommodate partial exits from a portfolio investor class (this may be a reduction in an investor's interest in the entity as opposed to a switch to another class). In both cases the legislation does not currently trigger a tax liability.

Currently, an investor switching between portfolio investor classes does not trigger a taxable event. This is because, for portfolio tax rate entities that pay tax under section HL 21 or HL 23, a taxable event arises mid-period only if there is a so-called "portfolio investor exit period". A portfolio investor exit period arises when an investor's portfolio investor interest (defined in the context of their interest in the entity) is less than their portfolio entity tax liability. Therefore, a switch between portfolio investor classes does not trigger a portfolio investor exit period as it does not result in a reduction in an investor's interest in the entity (that is, a reduction of the interest relating to one class would be offset by an increase in the interest relating to another class).

Similarly, a withdrawal from a portfolio investor class does not currently trigger a taxable event if the interest being withdrawn is not sufficiently significant to give rise to a portfolio investor exit period. That is, a taxable event would not be triggered if the remaining interest in the entity exceeds the tax liability that would otherwise arise in respect of the amount withdrawn. This is what is referred to as a partial exit.

A portfolio tax rate entity that pays tax under section HL 21 or HL 23 would have the option of treating switches between investor classes as a taxable event under section HL 23B and as a result section HL 7. That is, if an investor withdraws from a portfolio investor class (either completely or partially) and reinvests the funds in another portfolio investor class of the same entity, then the entity can elect to pay the tax for the part of the year before the withdrawal.

Similarly, if there is a partial exit from a portfolio tax rate entity that pays tax under section HL 21 or HL 23, the entity could elect to pay tax in respect of the portion of the interest that was withdrawn. This would include switches between portfolio investor classes that are not complete withdrawals.

As the application of section HL 23B is voluntary, a portfolio tax rate entity that pays tax under section HL 21 or HL 23 could choose not to pay tax for investors switching between classes or when there are partial exits from a portfolio investor class or the entity as a whole.

Income allocated by portfolio tax rate entities to partial withdrawals

If an entity elects to make optional payments of tax on reductions of investor interests, the portfolio entity tax liability referred to in the proposed section HL 23B will be up to the portfolio tax rate entity to determine. That is, as the payment of tax is voluntary it would be left to the discretion of the entity to calculate the amount of tax payable. In any case, an accurate tax calculation for the investor as a member of a portfolio investor class would be required at the end of a quarter or a tax year.

This effectively means that a portfolio tax rate entity would have the option of calculating an investor's portfolio entity tax liability either in respect of the actual interest that is redeemed, or it can choose to treat the interest being cancelled as a proportion of the investor's interest in the entity as a whole. In the case of the latter, under section HL 23B the entity would be able to calculate the tax liability in respect of the interest redeemed as a proportionate share of the investor's tax liability for all portfolio investor classes that the investor has an interest in. An example illustrates:

An investor has an interest in Class A and Class B of a portfolio tax rate entity that pays tax under section HL 23. On two days the classes derive portfolio investor allocated income and portfolio investor allocated loss as outlined in the table below. At the end of day two the investor redeems 20% of their interest in Class A. The 20% redemption represents a 10% redemption of the investor's interest in the entity.

	Class A	**Class B**
Day 1	Income = $100	Income = $20
Day 2	Loss = $80	Income = $10

Under the proportionate approach, total income for the investor is $50. Therefore, given the investor redeems 10% of their interest in the portfolio tax rate entity, the entity could pay tax under section HL 23B on $5. Alternatively, the entity could pay tax in relation to the amount actually redeemed. This means that tax could be paid on 20% of income attributable to class A (20% x $20 = $4).

Section HL 23B would allow both approaches to calculating the tax liability when there is a partial exit from a portfolio investor class as outlined above.

Under the proposed changes to the definition of "portfolio investor exit period" (in particular, paragraph (b) of the definition), a portfolio investor exit period would arise where the portfolio entity tax liability for an investor for a portfolio investor class and any other class exceeds the investor's portfolio investor interest for the portfolio investor class and any other class. In other words, a portfolio investor exit period would arise where the total accumulated tax liability for the investor exceeds the value of their interest in the entity as a whole.

If a portfolio investor exit period arises, section HL 23(2) requires a tax payment, the amount of which is the portfolio entity tax liability of the entity for the portfolio investor exit period – that is, the total accumulated tax liability across all classes.

Option for a section HL 21 portfolio tax rate entity to pay tax rather than zero-rate when an investor withdraws

Under new section HL 23B, if an investor in a portfolio investor class of a portfolio tax rate entity that pays tax under section HL 21 withdraws their interest in the class or the entity in a quarter, the entity would have the option of paying the tax relating to the quarter in which the exit occurs, rather than zero-rating the withdrawal.

If this is the case, then a portfolio investor exit period would not arise and the investor would not need to include any income relating to the quarter in which the withdrawal was made in their tax return. This has the benefit of ensuring that the income relating to the period of the withdrawal remains excluded income of the investor.

Again, because the application of section HL 23B would be voluntary, the entity would still have the option to zero-rate the investor. In this case it would be the responsibility of the investor to pay the resulting tax liability.

Timing of optional tax payment

An optional payment of tax under the proposed section HL 23B would need to be made to Inland Revenue by the end of the month following the month in which the investor switch or partial exit occurred, in the case of an investor in a portfolio tax rate entity that pays tax under section HL 23. Optional payments of tax relating to investors in portfolio tax rate entities that pay tax under section HL 21 would be due at the same time as the normal quarterly tax payment.

Rebates under section KI 1 can also arise on investor switch or partial exit from a portfolio tax rate entity that pays tax under section HL 23. The timing for payment of these rebates is the same as would occur if tax was payable. An amendment to section HL 26(2) will be made to provide this rebate mechanism for partial exits.

Consequential amendments to the definition of portfolio investor exit period

The definition of "portfolio investor exit period" in section OB 1 is being consequentially amended to ensure that it applies generally on a portfolio investor class basis, and is therefore consistent with subpart HL.

However, a portfolio investor exit period would continue to arise where there is a reduction in an investor's interest so that the investor's total remaining interest in the entity across all classes is less than the tax liability relating to the reduction.

For portfolio tax rate entities that pay tax under section HL 23, this means that they are only required to pay tax for an investor on a part-year basis if there is a portfolio investor exit period. However, as discussed above, these entities can make voluntary payments of tax under section HL 23B when investors partially exit a class or the entity as a whole.

In the case of investors in portfolio tax rate entities that pay tax under section HL 21, a portfolio investor exit period would not arise if the entity has made a payment of tax under proposed section HL 23B sufficient to meet the relevant portfolio entity tax liability for the investor. This should ensure that any income allocated in the quarter in which the investor withdrew their interest, and on which the entity has paid tax, is still excluded income under section CX 44D.

A section HL 7 adjustment

As the section HL 23B payment gives rise to a portfolio entity tax liability of the entity, an adjustment under section HL 7 to reflect the liability would be required. The maximum period for making this adjustment is discussed in more detail below.

Investor return adjustment in section HL 7 can apply for an investor's interest in a portfolio investor class or their interest in a different class

Section HL 7 is being amended to allow a portfolio tax rate entity to perform an investor return adjustment to reflect the effect of the investor's portfolio investor rate as a member of a portfolio investor class. Currently, the investor return adjustment must be performed in respect of the investor's interest in the entity as a whole.

It should be noted, however, that a portfolio tax rate entity would still have the flexibility to perform the investor return adjustment to whatever portfolio investor interest of the investor that the entity considers is required. This is because, under the proposed amendment to section HL 7(3), the entity would be able to adjust the investor's portfolio investor interest in the relevant class, or their interest in another class. This means that a portfolio tax rate entity would be able to adjust an investor's interest in any way it sees fit to reflect the tax paid. This proposed change, like the proposed changes to section HL 20 and the tax credits provisions (described below), provides greater flexibility for portfolio tax rate entities.

Remedial changes to section HL 7(3) will provide that the investor return adjustment is required to be made within two months of the end of the tax year, if the entity has made an election to pay tax under section HL 23.

The legislation currently allows the investor return adjustment to be made more frequently than within two months of the end of a calculation period or a tax year (depending on the type of portfolio tax rate entity). Section HL 7(3) specifies the maximum timeframe for making the return adjustment. It is not intended to preclude an entity making adjustments to investor interests earlier, if this is desired from a commercial perspective.

Allocation of portfolio investor allocated income to zero-rated portfolio investors aligned with investor's income year

Currently, investors in portfolio tax rate entities that are zero-rated portfolio investors with non-standard balance dates are deemed to derive portfolio investor allocated income (or loss) in an income year, if the relevant income allocation period falls within their income year. Portfolio tax rate entities that pay tax under sections HL 21 and HL 23 must operate on a 31 March tax year basis. This could result in zero-rated portfolio investors having to return income for two tax years of the entity, in their income year.

For example, an investor with a 30 June balance date would need to include all portfolio investor allocated income derived between 1 July 2008 and 30 June 2009 in their 2008–09 tax return. In contrast, the 2008–09 tax year for the portfolio tax rate entity would be from 1 April 2008 to 31 March 2009. The investor would therefore need to include their share of the income in the entity's 2009–10 tax year as well (the three months from 1 April 2009 to 30 June 2009). However, income information for the 2009–10 tax year would not be communicated to the investor until 30 June 2010 and would not separately identify the 1 April – 30 June income.

The bill amends section CP 1 and section HL 24 so that zero-rated portfolio investors with non-standard balance dates only derive in an income year an amount of portfolio investor allocated income from a portfolio tax rate entity that relates to the portfolio allocation periods in the entity's income year that end in the investor's income year.

Similarly, zero-rated portfolio investors with non-standard balance dates will only have in an income year an amount of portfolio investor allocated loss, in relation to a portfolio tax rate entity that pays tax under section HL 21 or HL 23, that relates to the portfolio allocation periods in the entity's income year that end in the investor's income year. No portfolio investor allocated loss arises in relation to a portfolio tax rate entity that pays tax under section HL 22.

Amendments are also being made to section HL 27 to ensure that the allocation of foreign and New Zealand tax credits matches the allocation of the income for non-standard balance date zero-rated investors.

Under the proposed changes, it is intended that the investor in the example above would only be treated as deriving in their 2008–09 income year (that is, the period 1 July 2008 to 30 June 2009) the portfolio investor allocated income or loss that relates to the portfolio tax rate entity's 2008–09 tax year (that is, 1 April 2008 to 30 March 2009). Any portfolio investor allocated income relating to the period 1 April 2009 to 30 June 2009 would not be included in the investor's return of income for 2008–09, as this relates to the portfolio tax rate entity's 2009–10 tax year. Similarly, only the investor's share of New Zealand and foreign tax credits that relate to the portfolio tax rate entity's 2008–09 tax year would be available as a credit in the investor's 2008–09 income year.

Foreign tax credits

Consistent with the changes to sections HL 20 and HL 7, the bill proposes amendments to section HL 27 so that tax credits (both foreign and New Zealand) are allocated to an investor as a member of a portfolio investor class, and are able to be utilised by a portfolio tax rate entity to reduce the investor's portfolio entity tax liability relating to the portfolio investor class. In the case of foreign tax credits, depending on whether application of foreign tax credits is restricted to the tax liability of an investor as a member of a specific portfolio investor class or all portfolio investor classes the investor has an interest in, a different tax result may arise.

The bill proposes a number of amendments to add greater flexibility in the way that a portfolio tax rate entity (particularly entities that pay tax under section HL 23) can use tax credits. The provisions do not remove current options available under the portfolio investment entity tax rules.

Foreign tax credits allocated to investors each day

Under section HL 27(3), foreign tax credits are allocated for each portfolio allocation period (for example, a day) to each investor as a member of a portfolio investor class. The amount of foreign tax credit allocated is based on the investor's share (that is, the investor fraction) of the class's share of the foreign income which gives rise to the credit.

Foreign tax credits can only be used by a portfolio tax rate entity to reduce the portfolio entity tax liability of the investor to which they have been allocated. Therefore, a portfolio tax rate entity would need to track foreign tax credits allocated to each investor in a tax year. This is also necessary because an investor who exits a portfolio investor class during the tax year, but re-enters the class in a future period within the same year, should be able to get the benefit of any foreign tax credit not previously used.

The distinction between the allocation of foreign tax credits to investors (which will occur daily in most cases), and the ability of a portfolio tax rate entity to use the credits to pay the portfolio entity tax liability in respect of an investor, should be distinguished. The ability for a portfolio tax rate entity to utilise foreign tax credits is given under section HL 27(10). Similarly, if the investor is a zero-rated portfolio investor, section HL 27(7) governs the ability of the investor to utilise foreign tax credits to reduce the tax liability on their portfolio investor allocated income. A number of changes are proposed to these sections. These are discussed in greater detail below.

Foreign tax credits can be used to reduce a portfolio entity tax liability for any portfolio investor class of the investor

Foreign tax credits allocated to an investor as a member of a portfolio investor class can be used by a portfolio tax rate entity as a credit against income tax payable by the entity for the investor as a member of that class. Under the proposed amendments to section HL 27(10), a portfolio tax rate entity would also be able to use foreign tax credits that have been allocated to the investor as a member of one portfolio investor class, to reduce the portfolio entity tax liability of the investor for another portfolio investor class.

Therefore, amended section HL 27(10) gives flexibility to portfolio tax rate entities in the way that they make use of foreign tax credits allocated to investors. If foreign tax credits are able to be used across different portfolio investor classes of the same investor, rather than just to reduce the portfolio entity tax liability of the class that gives rise to the credit, a different tax result will arise. The example below illustrates:

	Class A	**Class B**
Day 1	PETL = $10 (FTC = $5)	PETL = $15 (FTC = $10)
Day 2	PETL = -$10 (FTC = $0)	PETL = $10 (FTC = $0)

If an entity chooses to utilise foreign tax credits allocated to an investor only against the portfolio entity tax liability of the portfolio investor class which gives rise to the credit, the total portfolio entity tax liability for Class A would be $0 (and no foreign tax credit would be able to be used). For Class B, a liability of $25 with an available credit of only $10 would arise. On the other hand, if the portfolio tax rate entity chooses to utilise the credits available to the investor as a member of both Class A and Class B to reduce the aggregate tax liability for the investor, the liability would be $25, with total available foreign tax credits of $15. In this case, the investor would benefit from having an extra $5 of tax credit.

The above result would be an absolute tax difference, rather than a tax timing difference, as any excess foreign tax credits are forfeited at the end of a tax year. In other circumstances, a class approach to utilisation of foreign tax credits may be more beneficial (for example, where the overall entity result for the investor is a loss but they have foreign tax credits allocated to investment classes that are profitable).

The legislation will allow both approaches outlined above, to provide greater flexibility to portfolio tax rate entities.

New section HL 27(10B) outlines the amount of foreign tax credit that is available to be used in a portfolio calculation period to reduce an investor's portfolio entity tax liability as a member of the portfolio investor class that gives rise to the credit, or as a member of another portfolio investor class.

The amount of the credit is the lesser of available allocated foreign tax credits (excluding credits used in previous calculation periods) and the amount of the investor's portfolio entity tax liability (again, excluding credits used to meet tax liabilities in previous periods).

Foreign tax credits allowed to be carried back to reduce a portfolio entity tax liability of an investor in previous portfolio calculation periods

The proposed amendments to section HL 27 ensure that foreign tax credits are able to be used for the benefit of an individual investor in a portfolio tax rate entity that pays tax under section HL 23, in a tax year, irrespective of the portfolio calculation period in which they arise.

Under the proposed changes, a portfolio tax rate entity that pays tax under section HL 22 or HL 23 would be able to use foreign tax credits to reduce an investor's portfolio entity tax liability in the portfolio calculation period in which the credit is allocated and earlier portfolio calculation periods in the same tax year.

This would effectively allow foreign tax credits allocated to an investor to be carried back (as well as forward) to previous allocation periods in the tax year. This should allow a more consistent income year approach to the utilisation of foreign tax credits by a portfolio tax rate entity, rather than the use of the credits being limited to the day in which they arise and any future period. Any foreign tax credits unable to be used at the end of the tax year would, as at present, be forfeited.

A broadly similar approach would apply to a portfolio tax rate entity that pays tax under section HL 21 – the main difference being that foreign tax credits could only be carried back within a portfolio calculation period.

Foreign tax credits allocated to zero-rated investors

Under proposed changes to section HL 27(7), foreign tax credits that are allocated to investors in a portfolio tax rate entity that are themselves portfolio tax rate entities can be used by these investor entities without restriction.

This will allow such investors to flow-through the allocated foreign tax credits to their investors each day. Currently, all zero-rated investors in portfolio tax rate entities are restricted to the lesser of the allocated foreign tax credit or the entity's share of the portfolio investor allocated income multiplied by the entity's basic tax rate for the relevant tax year. This would no longer be the case for investors in portfolio tax rate entities that are themselves portfolio tax rate entities.

Section HL 27(8) is being amended to deal with foreign tax credits allocated to zero-rated investors that are not portfolio tax rate entities. For these investors the maximum the investor can use in their income year would be the lesser of the amount of the credit that is allocated or:

- for an investor with a portfolio investor exit period in a portfolio tax rate entity that pays tax under section HL 21, the amount calculated by multiplying the investor's portfolio investor rate by their portfolio investor allocated income for the exit period;
- for a zero-rated portfolio investor in a portfolio tax rate entity that pay tax under section HL 21 or HL 23, the amount calculated by multiplying the basic statutory rate of tax for the investor by their portfolio investor allocated income for the tax year.

As noted earlier, amendments are also proposed to align the foreign tax credits allocated in a tax year of the portfolio tax rate entity to the income year of zero-rated investors with non-standard balance dates.

New Zealand tax credits

Section HL 27(11), which deals with credits other than foreign tax credits under subpart LC, allows New Zealand tax credits to be used by a portfolio tax rate entity in a similar manner to foreign tax credits.

That is, the total amount of New Zealand tax credits available would be able to be used for a portfolio entity tax liability in respect of an investor's interest in a portfolio investor class. This would be relevant in the case of an investor who exits from a portfolio tax rate entity that pays tax under section HL 23 or where an entity elects to make optional payments of tax under proposed section HL 23B. An example illustrates:

	Class A	**Class B**
Day 1	PETL = $50 (NZTC = $33)	PETL = $20 (NZTC = $0)
Day 2	PETL = $50 (NZTC = $0)	PETL = $70 (NZTC = $15)

The investor withdraws 50% of his interest in Class A. The investor's share of the tax liability for the interest redeemed would be $50. The entity would be able to use the investor's total allocation of New Zealand tax credits over both classes – that is, $48 (not just the $33 credit relating to Class A) – to reduce this tax liability to $2.

As any excess New Zealand tax credits that are allocated to individuals can be rebated, providing this flexibility alters the timing of tax payments rather than the amount of tax paid. The rules do not require an entity to follow the above approach – that is, using New Zealand tax credits allocated to an investor as a member of one portfolio investor class to offset the investor's portfolio entity tax liability in relation to another portfolio investor class. This is simply another option that would be available to portfolio tax rate entities.

As noted earlier, consequential amendments are proposed to align New Zealand tax credits allocated in a tax year of the portfolio tax rate entity to the income year of zero-rated investors with non-standard balance dates.

New rules for use of portfolio entity formation loss

The bill:

- Removes the requirement to reduce the amount of any rebate under section KI 1 or a deduction under section DB 43 in relation to portfolio entity formation losses used in a tax calculation period. Portfolio investor allocated losses will be able to be rebated without restriction and similarly there would be no reduction in the amount of loss allowed as a deduction to zero-rated investors in portfolio tax rate entities. The bill repeals sections KI 1(3) and DB 43(2) to achieve this.
- Allows a portfolio tax rate entity to use portfolio entity formation loss without restriction to reduce class net income for a portfolio investor class in a portfolio allocation period, if the total portfolio entity formation loss of the entity is less than 5% of the total market value of the entity's portfolio entity investments. The bill replaces section HL 28(3) with new section HL 28(3)(a) to achieve this.
- Allows a portfolio tax rate entity, whose portfolio entity formation loss exceeds 5% of the entity's market value, to use on each day of the first three years of the entity's existence, up to 1/1095 of the total portfolio entity formation loss of the entity to reduce any class net income for a portfolio investor class of the entity on that day. Under this change:
  - to the extent there is insufficient class net income for a portfolio investor class on a day, the day's allocation of portfolio entity formation loss can be carried forward and added to the succeeding day's allocation of portfolio entity formation loss;
  - if there is an amount of portfolio entity formation loss that has not been used after the end of the three-year period, the total amount of unused portfolio entity formation loss can be used without restriction to reduce class net income for a portfolio investor class and a portfolio allocation period.

  The bill adds new sections HL 28(4) and (5) which contain the formula for calculating the amount of portfolio entity formation loss that may be allocated to a portfolio allocation period.

New Zealand tax credits must be used before portfolio entity formation losses

Portfolio entity formation losses allocated under new section HL 28(3) cannot be used to reduce the class net income of a portfolio investor class of an entity if sufficient New Zealand tax credits are available in a portfolio allocation period to offset the portfolio entity tax liability that would otherwise arise.

New Zealand tax credits are defined as imputation credits, credits for resident withholding tax, dividend withholding payment credits and Māori authority credits. There is no restriction in relation to the use of portfolio entity formation losses where a portfolio investor class has foreign tax credits (that is, credits for foreign NRWT deducted) in an allocation period.

Under new sections HL 28(6) and (7), the amount of portfolio entity formation loss allowed to be allocated to a portfolio allocation period is the lesser of:

- the maximum allowable portfolio entity formation loss for the allocation period (calculated under section HL 28(4)); or
- the amount by which the class net income of a portfolio investor class for the allocation period exceeds the total New Zealand tax credits allocated to the period, grossed up to an amount by dividing by the statutory rate of tax for a company.

Clarification that formation losses can be held at the entity or portfolio investor class level

While section HL 28 treats portfolio entity formation losses as arising at the entity level, a portfolio tax rate entity can choose for portfolio entity formation losses to be held at a portfolio investor class level. When calculating class taxable income under section HL 19, a class's shares of a portfolio entity formation loss should be determined. The methodology for determining each class's share is left to the entity. It therefore follows that the rules would not prevent an entity from dividing the entity's formation losses between classes on becoming a portfolio tax rate entity.

Investor fees to be allowed as a deduction against portfolio entity tax liability for an investor

The formula in section HL 20(4) which calculates the portfolio entity tax liability for an investor in a portfolio investor class is being amended to allow certain fees relating to an investor's portfolio investor interest to be taken into account. That is, a deduction for fees charged to an investor's account (calculated as the amount of fees multiplied by the portfolio investor rate of the investor) can be used to directly reduce the portfolio entity tax liability of the investor. The fees that would be deductible are those that are charged to the investor for ongoing management and administration services in relation to their portfolio investor interest. These fees would need to be spread over each portfolio allocation period the investor is present in a portfolio investor class.

As the fees charged are specific to the investor, section HL 20(4) is the appropriate mechanism to ensure that each investor's individual fee circumstances are accurately reflected. The formula also takes into account any fee rebates credited to the investor's account (these rebates would increase the portfolio entity tax liability of the investor, as they would be taxable if paid directly to the investor).

This change to allow fees to reduce the income tax payable by the entity, on behalf of investors, is designed to prevent investors having to file a tax return to get a deduction separately. Consequently, new section DB 43C is being added to prevent fees charged by portfolio tax rate entities that are included in the portfolio entity tax liability calculation under section HL 20, being deductible separately to the investor. Similarly, new section CX 44E is being added to prevent any fee rebates being separately taxable to the investor. These amounts will be excluded income to the investor.

Consequential changes, to reflect the deduction of fees and addition of fees rebates, are also being made to section HL 24, which calculates the portfolio investor allocated income and portfolio investor allocated loss for an investor.

Unlisted companies allowed to temporarily qualify as a portfolio listed company

New section HL 11B is being introduced to allow certain unlisted companies to temporarily be treated as portfolio listed companies if they meet a number of criteria. These criteria include:

- the company would meet paragraph (a) of the definition of "qualifying unit trust" in section OB 1 (if it were a unit trust); and
- the company has resolved to become listed on a recognised New Zealand exchange if it were to obtain the required consents; and
- the company has applied to the Securities Commission for an exemption to disclose in its prospectus its intention to become a listed company; and
- the company satisfies the Commissioner that it would apply to become a listed company if it obtained the required consents.

The company must be listed on a recognised exchange within two years from when it first elected to be a portfolio investment entity in order to retain portfolio listed company status.

The definition of "portfolio listed company" is being consequentially amended so that a company that is eligible under proposed section HL 11B temporarily qualifies as a portfolio listed company.

Foreign investment vehicles will be able to invest through other foreign investment vehicles

Section HL 5 is being amended to allow a foreign investment vehicle to own more than 20% of another foreign investment vehicle. This will allow a foreign investment vehicle to hold investments through other foreign investment vehicles.

Section HL 5 will also allow foreign investment vehicles to hold their investments through trusts where the foreign investment vehicle is the sole beneficiary.

Other amendments – Income Tax Act 2004

- Amendments are proposed to various sections of the Income Tax Act 2004 to ensure that the New Zealand Superannuation Fund receives the same treatment as a portfolio investment entity. These include amendments to sections CX 44C(1) and (2) to ensure that the New Zealand Superannuation Fund is not taxed on proceeds from the disposal of shares in New Zealand-resident companies and certain Australian-resident listed companies.

- Section CX 44D(3)(a)(i) is being amended to remove the reference to zero-rated portfolio investors as this term is not relevant in relation to portfolio listed companies. The amendment ensures that a natural person, other than a trustee, can elect to treat a distribution from a portfolio listed company as a taxable amount.

- Section CX 44D(3)(b) is being amended to provide that distributions from portfolio listed companies are not excluded income to the extent the distributions are fully dividend withholding payment credited. This will ensure that non-resident investors in portfolio listed companies are still subject to non-resident withholding tax on dividends which carry full dividend withholding payment credits. Section NG 1(2)(a) is being consequentially amended to remove a redundant reference.

- Section HL 8 is being amended to ensure that only portfolio listed companies must attach full imputation credits (to the extent available) to distributions. The current wording of section HL 8 could be interpreted to include other portfolio investment entities, which were not intended to be covered by the provision.

- Section HL 10(2) is being amended to ensure that portfolio investment entities that derive portfolio investor allocated income from investments in other portfolio investment entities and/or distributions from superannuation funds will meet the income type requirement under the eligibility rules.

- Sections HL 10(3) and (5) are being amended so that they refer to the market value of the underlying investment held, rather than voting interests, in the case of investments in unit trusts. Before this change, there was an argument that the entity and class shareholding investment requirements could be circumvented for an investment by a portfolio investment entity in a unit trust.

- Section HL 10(4) is being amended to remove investments in a life insurer from the exception to the entity shareholding investment requirement for a portfolio investment entity.

- Section HL 12 is being amended to ensure that failures to meet the eligibility requirements under section HL 4 are considered when an entity becomes a portfolio investment entity.

- Section HL 15 is being amended to allow portfolio tax rate entities that have a portfolio calculation period of a quarter to elect a portfolio allocation period of a month by giving notice to the Commissioner before the start of a tax year or when the entity chooses to become a portfolio tax rate entity.

- Section HL 16 is being amended to clarify that a portfolio tax rate entity can allocate a portfolio investor interest to an investor for a portfolio allocation period if the investor will have an unconditional entitlement to the interest at the end of a vesting period. The maximum duration of a vesting period, under section HL 16(2)(e)(ii), is also being increased to five years (from three years at present) to align with vesting periods for certain KiwiSaver funds.

- Section HL 31 is being amended to require a portfolio investor proxy to provide information to a portfolio investment entity concerning whether the portfolio investor proxy would cause the portfolio investment entity to breach the eligibility criteria. As a consequence of this amendment, section HL 6(1)(a)(ii) is being removed.

- Section IG 1(2) is being amended to clarify that the rules for determining which companies are treated as a group of companies do not apply for portfolio tax rate entities, rather than portfolio investment entities generally. In particular, a portfolio listed company can be included in a group of companies.

- New section LD 10B is being added to allow a credit to a zero-rated portfolio investor for any income tax paid by a portfolio tax rate entity in relation to the investor's portfolio investor allocated income.

- Sections LD 10(2) and LD 11(2) are being amended to ensure that a taxpayer receives as a tax credit the amount of any income tax actually paid by the portfolio tax rate entity, in relation to an amount of portfolio investor allocated income that is not excluded income under section CX 44D(1)(b) or where the income relates to a portfolio investor exit period under section HL 21(5).

- Section NG 1(2)(f) is being amended to ensure that distributions from portfolio tax rate entities to non-residents are not subject to further tax through deduction of non-resident withholding tax.

- The definition of "income tax liability" is being amended to include income tax that is calculated under subpart HL for a portfolio tax rate entity.

- The definition of "portfolio investor rate" is being amended to allow portfolio tax rate entities to apply an updated rate that the investor has provided before the end of the year and use that rate for amounts that the entity has not yet calculated a liability for the purposes of the rules.

- The definition of "portfolio land company" is being amended to clarify that a company is a portfolio land company if the company owns land or shares in a portfolio land company that comprise 90% of the gross assets of the company on 80% or more of the days in the income year in which the company has gross assets of more than $100,000.

- The definition of "portfolio tax rate entity" is being amended so that it refers to a portfolio defined benefit fund and not a defined benefit fund.

- The definition of "prescribed investor rate" is being amended to clarify that the $60,000 threshold in paragraph (b)(ii) is calculated taking into account both an investor's portfolio investor allocated income and loss. A further clarification to the definition is proposed so that the 0% rate applies if the investor is a portfolio investment entity, other than a portfolio investment entity or superannuation fund which has a trustee that has elected a 33% tax rate.

Amendments to the Tax Administration Act 1994

- Section 31B is being amended to ensure that investors in portfolio tax rate entities that pay tax under section HL 21 and have a portfolio investor exit period, are issued with information that the Commissioner considers relevant in respect of the exit period, at the end of the month following the quarter in which the exit period ends. Section 31B is also being amended to provide that portfolio tax rate entities must give a statement to zero-rated portfolio investors on an annual basis only. References to "income year" are also being changed to "tax year" to better align with core provisions.

- Section 33A(1)(b) is being amended to ensure that zero-rated portfolio investors (or investors in portfolio tax rate entities that pay tax under section HL 21, and have a portfolio investor exit period) receiving small amounts of portfolio investor allocated income do not have to file a return where these amounts, combined with other types of income which have not been correctly taxed at source, is $200 or less.

- The return filing date for portfolio tax rate entities and portfolio investor proxies in section 57B is being amended to cater for non-standard balance dates.

Amendments to other statutes

- Section 53(2) of the Companies Act 1993 is being amended to correct a cross-referencing error.

- The Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 is being amended to ensure that entities can make an election to be a portfolio investment entity from 1 April 2007 (although the date that the election is effective will be on or after 1 October 2007).