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THE CASE AGAINST STAPLED SECURITIES*

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Australia is one of a very few jurisdictions where stapled securities are permitted by the authorities, and significant use is made of them by Australian Real Estate Investment Trusts (A-REITS) and Infrastructure Funds.[1] Stapled structures account for approximately ten per cent of ASX market capitalisation.[2] Australian banks have also used stapled securities to raise funds in the past.

At the end of June 2017, 35 out of 54 listed A-REITs were stapled structures (up from 17 in 2007, with most of that increase occurring since 2011). There were 9 stapled listed infrastructure funds, that number having declined from 22 in 2008. So, at least at the ASX listed level, there are opposing trends in terms of usage of stapling by A-REITS and Infrastructure funds.

Figure1 provides an illustration of a simple type of stapled structure, in which a trust holds fixed assets, and then leases them to an operating company that makes rental payments out of the business income derived from use of those assets. The cash flow generated by the business activity thus is channelled largely through the trust to investors, reducing the amount of company tax paid on the business activity. Some part of that cash flow may be "income" (for accounting or tax purposes) while some may be a return of capital (depreciation).

The popularity of stapled structures suggests that their promoters perceive some private gains from their use relative to alternative methods of structuring their businesses or raising funds. To make a case to ban their use, as this paper is tasked with doing, thus requires first demonstrating that there are undesirable associated externalities or social costs. If on the balance of probabilities such social costs outweigh those private gains, then banning is appropriate. If the adverse social costs do not exceed those private gains, then finding ways to reduce such adverse social costs (at the expense of the private gains) would be preferable to banning. These social costs could include: arbitrage of the tax system; socially undesirable redistributions of income and wealth from inadequately informed investors to promoter/operators; impediments to the market for corporate control / governance creating less pressure for efficient investment and operations. Given the difficulties in quantifying such social costs (some of which are subjective in nature) there will naturally be room for disagreement on the merits of the case for banning.

In that regard, the counterfactual is important – what alternative structures are, or could be made, available which would have better social outcomes? It may even be that stapled

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[1] More information on overseas usage and history is available in Kevin Davis "Stapled securities: antipodean anomaly or adaptable innovation?" *Australian Tax Forum*, 2016, Volume 31, Issue 2, 395-417

[2] That figure does, however, overstate the economic significance of the entities since it incorporates some stapled debt financing whereas market capitalisation for other entities is based purely on equity value.

structures have net social (as well as private) benefits relative to currently permitted alternative structures, but not relative to some alternative possibilities. The appropriate comparison thus does not involve banning stapled securities and making no other legal, tax or accounting regulatory changes, but identifying what changes would be appropriate to make in conjunction with banning.

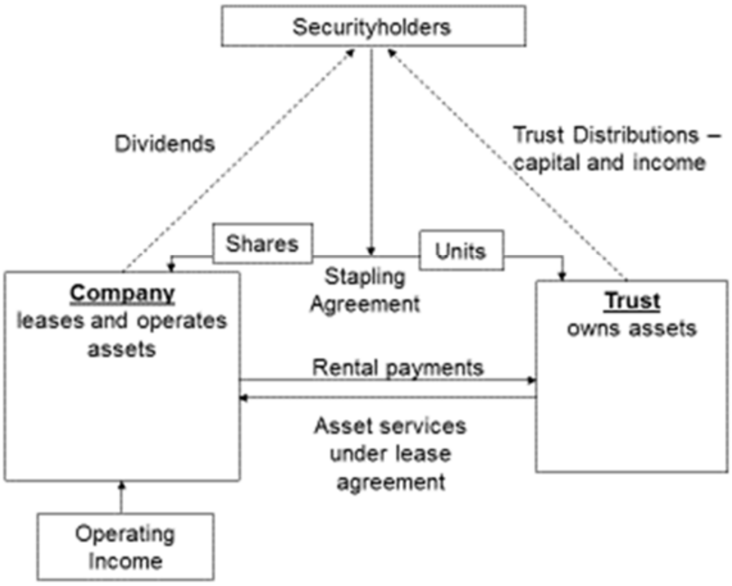

FIGURE 1: SIMPLE STAPLED SECURITY STRUCTURE

To answer this question it is important to have in mind some principles of optimal design of business structures and financial instrument characteristics. In that regard, this paper builds its arguments upon the following three principles.

Allowable business structures and associated financing arrangements should:

- facilitate economically efficient production of goods and services (including via good governance of the enterprise)
- enable (potential) stakeholders to assess the risks and potential benefits from investments in the enterprise and suitability of those investments for their circumstances
- not facilitate socially undesirable avoidance of tax and (sensible) regulatory requirements.

This is an area when a myriad of existing tax, legal and accounting arrangements interact to drive the types of business structures created. In what follows, only the more substantive of those issues are considered, partly because the appropriate question is whether any social benefits from stapling could instead be achieved under alternative feasible arrangements. The focus is thus upon the economic considerations relevant to stapling.

After first considering the reasons given for stapling, it is then convenient to consider the last of these principles (relating to tax), since tax concerns have been the prompt for the recent review of stapled structures.[3] That is followed by a consideration of the governance and transparency issues and then the economic efficiency issues.

WHY STAPLE?

It is useful to look at the rationale for stapling as expressed by users. Transurban (a large infrastructure group, listed on the ASX as TCL) expresses the purpose of its triple staple – of a share in THL (Transurban Holdings Limited), a unit in THT (Transurban Holdings Trust) and a share in TIL (Transurban International Limited) as follows:

- Large initial capital investment and debt funding required for infrastructure development leads to accounting losses during the early years of the project (due to amortisation) which prevents payment of dividends.
- The majority of the Australian operating assets are structured as a Company and a Trust.
- Trusts allow regular distributions to be made to investors in the early years. Each operating Transurban asset Trust pays distributions to THT which then distributes to investors.
- Regular distributions allow a stapled structure to efficiently access equity and debt markets.
- Stapled structures are generally used for infrastructure assets which required large upfront capital investment.

Transurban-overview, https://www.transurban.com.au/investor-centre/investor-toolkit

Transurban also states that the stapled structure is "Critical to investment appeal and ability to fund long term infrastructure projects".

Of course, there must be some benefit to the entity from stapling, since any investor would, *ceteris paribus*, prefer to have two separately tradeable securities rather than having them stapled together. Stapling does however also involve a set of agreements between the entities in the stapled structure, as well as the stapling of securities issued by each. So, an important issue considered later is whether, and why, such agreements need to be accompanied by the stapling of the issued securities.

Transurban provides a good illustration of the complexity which can be involved in stapled structures (although whether there would be different but equivalent complexity in the absence of stapling is an open question). Transurban operates a number of separate toll road projects (such as City Link, Hills Motorway, etc) and many of these subsidiary ventures are structured as involving both a taxpaying corporate entity (paying franked dividends to THL) and a trust (paying distributions to THT). There is no necessary stapling of securities at these subsidiary levels, since the parent entity has control rights over both subordinate entities. A number of the projects have non-recourse debt funding, while Transurban itself has corporate debt outstanding.

Over recent years, around 80 per cent of distributions to investors have been in the form of distributions from the trust (THT) and the remainder being franked dividends paid by THL

Regarding A-REITs, benefits of stapling were recently advanced by Centuria in its restructure into a stapled entity in 2014, as: enabling diversification and additional management and development opportunities; facilitate co-investment and increase recurring revenue; and bring the "structure into line with other listed property fund managers, providing a more transparent

[3] Australian Government *Stapled Structures: Consultation Paper*, March 2017. http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2017/Stapled-Structures

benchmarking of performance". https://centuria.com.au/wp-content/uploads/2016/08/Centuria-to-Create-Stapled-Security-Structure.pdf

Notably, neither of these two explanations of the rationale for stapling refer to tax issues, nor really identify whether the suggested benefits are inherently natural or stem from existing legal, accounting, tax, or regulatory issues!

STAPLING AND TAX ARBITRAGE

Stapling can take a variety of forms, but most common (as depicted in Figure 1) has been the stapling of units in a trust, which holds physical assets, to shares in an operating company which manages those assets (and may undertake other activities). Sometimes a debt type security (a loan note) issued by one of the entities involved might also be stapled. Within the stapled structure, the trust may also provide debt finance to the operating company, although this could run the risk of having the interest payments losing their tax deductible status for the operating company (and treated instead as dividend distributions).[4]

Under current Australian taxation arrangements, net income generated (and distributed) by the trust flows through to unit holders without tax at the enterprise level, to be then subject to tax at the investor level.[5] Income of the company will be subject to corporate tax and dividends paid to shareholders will have tax (franking) credits attached. Holders of the stapled securities will also obtain returns from movements in the market value of those securities. These could reflect retained earnings of the company and/or changes in investor expectations of future possible income likely to be generated by the enterprise.

Some (relatively minor) cash flow timing differences aside, Australian investors should be indifferent to the two sources of distributed income on tax grounds. Total tax paid on the income stream will be the same (due to the franking of the dividend component).[6]

That is not the case for foreign investors who are unable to use franking credits. Their preference will be for a structure which minimises Australian tax paid. If withholding tax on trust distributions is less than the company tax rate (and this difference not offset by tax treatment in foreign jurisdictions), minimising Australian and thus total tax paid is achieved by designing a structure which maximises the proportion of income attributable to the trust rather than the company. Currently, the fifteen percent withholding tax on trust distributions is less than the thirty per cent tax rate, giving an incentive to design structures in this manner, at the expense of Australian tax revenue.

Whether such tax avoidance strategies involve economic inefficiencies or inequities is not *a priori* clear. We live in (at best) a second-best world when considering regulatory and other distortions. To the extent that the company tax rate elsewhere is lower than Australia, such structures could arguably reduce an inter-jurisdictional tax distortion and promote more efficient cross-border investment decisions. To the extent that dominant domestic investors in Australian enterprises are superannuation funds with a marginal tax rate of fifteen per cent,

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[4] This was examined by The Board of Taxation (2015) "Review of the debt and equity rules. A report to the government". Available at http://taxboard.gov.au/files/2015/07/Debt_Equity_Final_Report.pdf.
[5] If the assets held by the trust are investments in other Australian companies which provide dividends paid out of income which has been subject to company tax, then the tax (franking) credits can also flow through to the investor.
[6] They may not be indifferent to earnings retention rather than payment of dividends due to different overall tax consequences which depend upon their tax bracket and the concessional, and deferred, taxation of capital gains associated with retained earnings.

such structures arguably place foreign investors on an equal tax footing to those domestic investors, given the imputation tax system.

There are clearly tax consequences which are different to using alternative structures for conducting those activities. If all of the activities were conducted within a corporate structure for example, the total income stream would be subject to the Australian corporate tax rate, although the ability to defer distributions and provide returns by way of concessionally taxed capital gains would provide potential tax advantages for higher marginal tax rate investors. But other tax complications are also relevant, including the non-concessional tax treatment of long term capital gains on asset sales within a corporate vehicle, as compared to concessional treatment for a trust.[7]

To the extent that use of stapled structures reflects the ability of a trust to access concessional long term capital gains tax treatment, not available to a corporate owner of an asset, there are at least two possible alternatives which would remove the need for a stapled structure.

First, change the tax treatment of capital gains for corporations to be the same as other taxpayers (and thus trusts which distribute such capital gains to investors without incurring tax at the trust level). This would reduce, but not eliminate the tax disadvantage from holding assets which might be subsequently sold for long term capital gains in the corporate structure.[8] It would however introduce other general complications involving incentives for high-tax rate individuals to use corporate structures which hold assets and generate returns as concessionally taxed capital gains rather than franked dividends.

A second solution would be to remove the concessional tax treatment of long term capital gains for all tax payers. Given the widespread distortions this concession creates (such as incentives to negatively gear investments to arbitrage the tax system) this has merit. However, the political will to take such a significant step appears generally lacking.

If neither of the above options is feasible, prohibiting stapling would mean that all business operating enterprises using the corporate structure would be subject to the same tax treatment on assets they hold within the corporate structure. This would remove tax-induced distortions favouring those business activities involving development of physical assets which might be available for subsequent sale. If tax incentives are desired for such activities, it is preferable that these be explicit via targeted legislation rather than indirect as currently occurs under stapling structures.

In fact, it is not clear that companies holding and operating significant physical assets (such as infrastructure) cannot achieve concessional capital gains tax treatment for their shareholders when selling some part of the business (including the assets). For example, spinning-off that part of the business into a separate company in which existing shareholders receive pro-rata shares and then sale of that entity would see any capital gains accruing to the shareholders and taxed according to the rules applying to investors rather than the company.

[7] While a company can distribute the post-tax profits from an asset sale as franked dividends, this means that the overall tax rate paid on the long term capital gain is the shareholder's marginal tax rate rather than effectively half that rate as would occur if the asset were held directly by the shareholder (or in a trust). Retention of the after tax profits in the company, creating capital gains for the shareholder changes but does not eliminate the tax disadvantage.

[8] The company would be able to distribute half of the post-tax profits as a franked dividend, but distribution of the remainder would be as an unfranked dividend, such that the overall tax rate paid on the long term capital gains would still exceed that if the asset were held directly by the shareholder.

More generally, the potential for tax arbitrage arising from use of stapled securities to reduce corporate tax payments is undesirable. For Australian investors, under the dividend imputation tax system, this should be of little consequence, since franking of dividends means that corporate tax is "washed out" via the receipt of tax credits. However, there is ongoing debate about the extent to which franking credits are valued in the market place. If not fully valued, then conversion of business income into trust distributions (sacrificing franked dividend distribution) may increase the market value of the entity. While there are a range of arguments advanced as to why franking credits would not be fully valued by the market, the dominant one is the role of foreign investors for whom such credits have no value.

The tax arbitrage from stapling is thus of most value to foreign investors. Rather than the business income stream being subject to corporate tax at (currently 30 per cent), it is converted into trust distributions which for foreign investors currently attracts only a 15 per cent withholding tax rate. This is to the detriment of Australian tax revenue. Depending on the nature of cross-jurisdictional tax arrangements, this may give foreign investors better tax treatment of such investments than domestic investors other than superannuation funds (and non-taxed charities).

It would be possible to overcome this distortion by changing the managed investment trust withholding tax rate to be the same as the corporate tax rate. However, in the absence of such a change, and given other reasons outlined below, a more direct solution is to ban stapled structures.

INVESTOR UNDERSTANDING AND GOVERNANCE

It is clear from the use of stapled structures, which has prompted the recent consultation, that foreign investors and their advisors are aware of the tax arbitrage which is available. But whether domestic investors in stapled securities of listed entities have a complete understanding of the consequences of such structures is unclear. Complicated business structures can add value by enabling better risk management and incentives, but not all do.

Stapling creates three issues for investor understanding. First, investors receive a distribution which has a number of different components with different tax implications – creating complexity for tax filing. (In this regard, the practice of designating returns of capital as tax deferred income hardly facilitates investor understanding). Second, even financial analysts and advisers interpret the total distribution as a "yield" rather than some mix of a yield and a return of capital. Consequently, investors may mistakenly regard stapled securities as offering higher yields for the risk involved than for alternative investments. (That is, of course, a conjecture warranting testing, and assumes that such investors do not factor in lower expected capital gains due to return of capital). Third, because the ASX uses the value of the stapled securities in calculating market capitalisation, the size of a stapled entity which incorporates some loan note financing in the stapling will appear larger than an unstapled one using separate debt financing.

Stapled structures also have implications for corporate governance. Martin Lawrence and Geoffrey Stapledon[9] were particularly critical of the governance structure of infrastructure funds (although not going so far as US fund manager Jim Chanos who in 2007[10] likened the

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[9] Lawrence, Martin, and Geoffrey P. Stapledon. "Infrastructure Funds: Creative Use of Corporate Structure and Law-But in Whose Interests?." (2008) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092689

[10] Reported in Bethany McLean 2007, 'Would you buy a bridge from this man?', Fortune, October 2

Macquarie infrastructure funds model to a Ponzi scheme). Among other concerns, they pointed to "the existence of 'special shares' in some funds which entitle the external manager to appoint a majority of the fund's directors". It is difficult to easily obtain information about the governance arrangements for stapled security structures and thus whether there are any impediments to market discipline of poorly performing managers via takeover threat or replacement of managers.

A second concern raised was about "insufficient alignment between the interests of the external manager and fund investors". This relates to the role of the Responsible Entity (RE) where that is a separate company to the stapled group. For many A-REITs the RE is part of the group (ie internal management) where investor and management interests may be aligned (although managerial and board entrenchment may limit willingness to support takeover proposals). But some A-REITs and Infrastructure Funds appear to still have RE's which are external to the group. The issue relates to the potential for excessive fees and charges for outsourcing of various management functions, and lack of transparency on the true value of assets purchased and sold into the trust in the stapled group. While this concern could be overcome by requiring stapled groups to have internal management, the complexity of the structures involved means that potential investors are unlikely to be easily able to assess the fair value and risk associated with investment.

The nature of real estate and infrastructure investments is such that use of special purpose vehicles and joint ventures has merit by limiting potential exposure of existing projects to loss from failures of new ventures. It is thus to be expected that any organisational structure involving multiple large projects is likely to be complex. However, the use of stapled securities simply serves to aggravate the complexity and reduce investor understanding.

ECONOMIC AND REGULATORY ISSUES

One reason advanced for stapling, particularly in the case of infrastructure companies, relates to the ability of an entity making tax losses but with free cash flow to make distributions to security holders. Being in a tax loss situation impedes the ability of a company to make distributions of dividends. However, by stapling an operating company and trust together, the rental paid by the operating company to the trust can be paid out by the latter as either returns of capital or earnings.

There is, however, no reason in principle that a loss making, but cash generating, company could not make a return of capital to its shareholders. The Corporations Act (s257A) states that "A company may buy back its own shares if: (a) the buy-back does not materially prejudice the company's ability to pay its creditors" and other procedural matters are met. The latter procedural matters (such as obtaining shareholder approval) may create practical impediments (but which could be easily overcome by legislative change), so the issue turns on whether there is a substantive difference between corporate and stapled structure in terms of s257A (a). I assert that there is not. The return of capital made by the total entity reduces the current financial assets of the stapled group by the same amount in both cases and thus, has equivalent effect on ability to pay creditors.

One economic problem which entities face in dealing with others is the "hold-up" problem, where past investments made have "locked in' that entity to a supplier or demander of goods or services, and weakened its bargaining power in contract negotiation. Stapling involves agreements between the entities involved as well as the stapling of the securities. In this way maintenance of control of the two entities (asset owner and operating business) is achieved. Without stapling, it is conceivable that transactions in the trust units and company shares could lead to quite differential ownership and change of control of one of them. If so, the "hold-up" problem could become relevant, and recognition of this could lead to unwillingness to make investments which would otherwise be socially valuable.

However, it should be noted that this is a problem when supply-demand relationships exist between separate firms. Unstapling of securities, while leaving the separate trust and company entities unchanged could give rise to this problem. But this would not be so if the two entities were merged into one.

A further argument may be that there are economies of scope in an enterprise combining together the activities of property/infrastructure/real asset development with management of established assets. That may be the case, although I am not aware of any evidence to that effect. There is, however, a potential benefit arising from removing moral hazard which can exist when construction and operation of assets is separated. In the presence of imperfect information (such that poor quality construction of an asset does not adversely impact the sale price of the asset), a constructor may have incentives to reduce quality of the constructed asset, causing the subsequent operator to incur higher operating costs. Where construction and operation is undertaken by the same entity, such adverse incentives are removed.

One further consideration is that developers may find it advantageous or necessary to maintain newly constructed assets for some initial period in excess of a year prior to sale, and are not, if operating in a company structure, able to take advantage of the concessional long term capital gains tax rate concession. It is unclear why (if such concessions are not abolished) some special tax treatment could not be provided for such cases where a relatively short term holding period of newly constructed assets occurs.

There would appear to be no obvious reason to prevent distributions from a company which has positive cash flows but negative accounting earnings due to depreciation. These can take the form of a return of capital rather than dividends. A stapled structure is not necessary to achieve this outcome, although uncertainties about director liabilities etc may inhibit such an approach.

ALTERNATIVE STRUCTURES

The preceding arguments have noted that there are a range of factors which have contributed to the popularity of stapled structures in Australia, while the existence of the dividend imputation tax system has reduced the incentives for government to prevent such structures. Unlike other jurisdictions operating a classical tax system, the reduction in company tax resulting from stapled structures is "washed out" if the investors involved are Australian taxpayers.

It has been argued that each of the factors inducing stapling can be readily overcome such that a better social outcome can be achieved by banning stapling.

First, adverse capital gains tax treatment of asset holdings within the corporate structure can be changed to reduce incentives to staple. Similarly, the tax arbitrage available to foreign investors can be removed by changing the withholding tax rate on managed investment trusts to be equal to the corporate tax rate. But an alternative option to avoid tax arbitrage is to remove the ability to create stapled structures – unless there is some other compelling reason.

Second, while operators of stapled structures argue that the form is more attractive to investors, it is far from clear that this attraction does not reflect uninformed investors misinterpreting the nature of the returns they are achieving. Moreover, the complex nature of the arrangements raises concerns about the governance structures and ability for market discipline to be effective.

Third, the argument that a stapled structure is necessary to enable cash flow distributions from projects with positive cash flows but negative accounting earnings does not stand up to scrutiny. The option exists under current legislation for solvent companies to make such distributions, as a return of capital, and if there are uncertainties around this in practice, legislation should be changed to remove such uncertainties. At a group level, a stapled structure making such distributions is reducing funds available for meeting obligations to creditors in exactly the same way as would occur if instead the entity were solely a company.

Jurisdictions overseas have generally adopted a form of REIT structure which facilitates the holding of property assets and allows some limited business activities. It would seem appropriate for Australia to follow the lead of those countries.

The case of infrastructure trusts is perhaps more complex since they arguably involve greater business operating activities associated with the generation of revenues from the fixed assets. But it is difficult to see what net social benefits flow from the use of stapled structures for such activities. Provided that companies are allowed to make returns of capital, that do not increase risk of insolvency, when cash flow is positive there is little reason for not using a corporate structure rather than a stapled structure.

CONCLUSION

This paper was tasked with mounting the case for abolition of stapled securities in Australia. The fact that they are essentially an Antipodean anomaly is not by itself sufficient reason. But it does suggest that other jurisdictions may have found alternative ways of facilitating efficient and fair business structures and tax arrangements suitable for the types of activities for which they are used in Australia.

It has been argued here that the reasons which prompt the use of stapled securities in Australia do not obviously create social (rather than private) value. It has also been argued that any socially worthwhile benefits can be achieved by banning stapling in conjunction with other changes to legislative and taxation arrangements (mostly desirable independently of this issue).

Of course, making such changes may reduce any private benefits from stapling and thus obviate the need for a ban. However, political factors are such that the desirable changes suggested in this paper may be difficult to accomplish. Given that, banning is the appropriate action.