

Taxpayer's Attempted Characterization of Stock as Debt Rejected: *Aventis, Inc. v. Commissioner*

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In order to facilitate the securitization of non-mortgage debt obligations, such as credit card receivables and auto loans, the Small Business Job Protection Act of 1996 (P.L. 104-188) added sections 860H through 860L to the Internal Revenue Code. These provisions provided favorable income tax treatment for a new vehicle, the Financial Asset Securitization Investment Trust, or FASIT. Not long thereafter, however, Congress determined that the FASIT provisions were not being used widely in the manner anticipated by Congress and were facilitating tax avoidance transactions (H.R. Rep. No. 108-548, at 291 (2004)), and they were repealed by the American Jobs Creation Act of 2004 (P.L. 108-357). The repeal did not apply to any FASIT in existence on the date of enactment of the 2004 Act (October 22, 2004), "to the extent that regular interests issued by the FASIT before such date continue to remain outstanding in accordance with the original terms of issuance" (P.L. 108-357, § 835(c)(2)).

Aventis, Inc. v. Commissioner, 166 T.C. No. 1 (2026), discussed below, concerns tax deficiencies for 2008 through 2011, determined on the basis that an alleged "grandfathered" FASIT did not qualify as such. In light of the 2004 repeal of the FASIT provisions, the court's determination that specific requirements of those provisions were not met is mainly of historical interest. However, the court's discussion of *Aventis's* attempted invocation of the doctrine of substantial compliance and argument that, even if the FASIT rules did not apply, certain securities denominated as preferred stock should be treated as debt for income tax purposes addresses concepts relevant in many other tax contexts.

Facts in *Aventis*

The petitioner in *Aventis* was an indirect subsidiary of a French parent company, Sanofi, S.A., that, collectively with its subsidiaries, engages in a multinational pharmaceutical business.

In the 1990's Sanofi desired to expand its operations in North America, and in 1999 an investment banking firm proposed a FASIT arrangement as a means for Sanofi to provide the needed funds in a tax-advantaged manner. To implement the FASIT, the petitioner entered into an Amended and Restated Asset Management Agreement (the AMA) with various other parties in 2000 under which the petitioner would issue, as required under the FASIT provisions, classes of interests. One class was intended to qualify as the sole "ownership interest" in the FASIT, and the other classes were intended to qualify as "regular interests," as defined in those provisions.

More specifically, the ownership interest in the intended FASIT, evidenced by an instrument identified as the "Class I Note," was issued to Dynamo Investments Inc., a domestic corporation created by the investment bank for this purpose. One of the regular interests, evidenced by the "Class II Note," was issued to a commercial bank for consideration of \$11.5 million. The other regular interest, evidenced by a class of preferred stock of the petitioner, was issued to a French subsidiary of Sanofi for consideration of \$559,500,000.

Intercompany loans of \$571 million to another subsidiary of Sanofi that were held by Aventis were designated as the initial assets of the FASIT.

A presentation on the letterhead of Aventis, titled "Approval of FASIT Transaction," indicated that payments with respect to both of the regular interests would be treated as tax-deductible interest, notwithstanding the form of one of the regular interests as stock. However, it was also expected that, under French tax laws, the recipient of the payments with respect to the regular interest that was denominated as preferred stock would treat them as nontaxable dividends.

Dynamo, on its Form 1120 corporate tax return for the taxable year ending March 31, 2001, elected to treat the arrangement described in the AMA as a FASIT. (Assets can be segregated into a FASIT for income tax purposes even if no separate entity is formed for local law purposes.) The intercompany loans referenced above and a money market account to hold payments received on those loans pending application to obligations of the FASIT were designated as the initial assets of the FASIT. No separate entity was formed to hold these assets, title to which remained with Aventis.

The AMA and the other documentation for the FASIT provided in substance that, after payment of asset management fees to Sanofi affiliates, income from the FASIT assets would be used to pay interest on the Class I Note and then on the Class II Note. Income remaining after those payments could then be distributed by Aventis as dividends with respect to the class of preferred stock associated with the FASIT. Also consistent with the terms of the AMA, Dynamo would be treated as the owner of the assets of the FASIT for U.S. tax purposes, and would deduct the asset management fees and payments on the Class II Note and the preferred stock.

The AMA was revised in 2003, and the term of the FASIT, initially five years, was extended in five-year increments in 2005 and 2010. As the intercompany loans matured, the initial FASIT assets were replaced with other intercompany loans. The FASIT was terminated in 2015.

Following an audit, the IRS asserted that the arrangement was not a FASIT and determined tax deficiencies against Aventis for taxable years 2008 through 2011, primarily on the basis that the income from the assets of the alleged FASIT, as reduced by the payments to Dynamo with respect to the Class I Note and certain expenses of the FASIT arrangement, was taxable to Aventis. The IRS contended that payments on its preferred stock were not deductible.

Analysis

The court found that the arrangement described in the AMA did not qualify as a FASIT for several reasons. First, it found that the preferred stock did not meet the statutory requirement for a regular interest that "such interest unconditionally entitles the holder to receive a specified principal amount." This was so because the preferred stock dividends were subject to the prior claims of the holders of the Class I Note and Class II Note and were effectively limited to the fair market value of the FASIT assets, as reduced by the obligations evidenced by the Notes and the asset management fees. Aventis was not obligated to make up from its other assets any shortfall if the fair market value of the FASIT assets at the time of its liquidation was insufficient to satisfy the liquidation preference of the preferred stock.

Second, the FASIT provisions required that interest payments on a regular interest be determined based on a fixed rate or a permitted variable rate, such as a rate based on the federal funds rate or LIBOR. The court found that the stated yield on the preferred stock did not entitle the holder, as required with respect to a regular interest, to payments based on such a fixed rate or permitted variable rate, because the preferred stock provided for dividends to be paid at the discretion of the board of directors of Aventis (although the obligation to pay dividends was cumulative).

The court also concluded that other circumstances relating to the FASIT arrangement as continued after the repeal of the FASIT provisions in 2004, caused the arrangement not to qualify under the "grandfather" clause related to the repeal.

Aventis argued that, even if the court agreed with the government that the arrangement under the AMA did not comply with all of the FASIT rules, the court should nonetheless find that Aventis "substantially complied" with those rules, and that this should be sufficient to uphold the intended treatment of the arrangement as a FASIT.

It was undisputed that Aventis intended to enter into a FASIT. The court concluded, however, that the arrangement failed to comply with essential requirements of the statute. Citing prior cases, the court observed that, while failure to meet requirements that were "procedural or directory" might be excused under the substantial compliance doctrine, failure to comply with a substantive requirement of the governing Code provisions, such as the failures described above, could not be excused under the doctrine.

Aventis further argued that, even if the FASIT rules did not apply, Aventis should not be treated as the owner of the property identified as the FASIT assets, and that the preferred stock should be treated as debt for tax purposes. The court dismissed both arguments.

As to the ownership of the FASIT assets for tax purposes, the court noted that Aventis had legal title to those assets, which were already owned by it at the time the affiliate purchased the preferred stock; and that Aventis had (and exercised) the right as asset manager to replace the loans initially designated as assets of the FASIT with other loans. The court also concluded that, viewing the arrangement as a whole, Aventis – and not the holders of the Class I Note and Class II Note -- had beneficial ownership of the FASIT assets, in that Aventis bore a risk of loss if the FASIT assets declined in value while the holders of the Notes (in the court's view) did not. Aventis also retained some opportunity for gain (albeit shared with the holders of the Notes) from appreciation of the investment in those assets. Further, Aventis, but not the holders of the Notes, was a party to the intercompany loans and had the right to sell or otherwise dispose of them.

In respect of whether the preferred stock constituted debt or equity for tax purposes, the court reviewed the factors cited by other cases in determining the often-litigated question of whether an instrument should be classified as debt or equity for tax purposes. The court found that most of these factors favored treatment of the stock as equity, including: the form of the interest as equity, and its treatment as equity for accounting purposes; management rights conferred on the stockholder in the form of voting rights on corporate matters and the right of the holder to elect one director of Aventis; the circumstance that the issuer and the holder of the preferred stock were under common control, and that their aligned interest (reflected in the documentation of the arrangement) was to keep the FASIT intact, rather than to provide the holder with meaningful enforcement rights as a creditor; and that, taking into account the subordination reflected in the AMA, Aventis could not have found third party debt financing on terms comparable to those of the preferred stock.

Dividend payments were dependent on earnings with respect to the FASIT assets, with no claim against other assets of Aventis, and the holder of the preferred stock was exposed to numerous financial risks relating to Aventis and the FASIT assets, in particular, but not limited to, diminution in value of the FASIT assets and subordination of the preferred stock to other claims against the

FASIT assets. These circumstances were also noted by the court as favoring characterization of the preferred stock as an equity interest, rather than a debt instrument.

Observations

The detailed analysis in *Aventis* of FASIT provisions is perhaps only of historical interest. More generally, however, the decision underscores that, in distinguishing between debt and equity for tax purposes, labels and treatment for accounting and other non-tax purposes continue to matter, at least where they contradict a taxpayer's desired tax characterization, even though such labels are not necessarily determinative of the result. "Substantial compliance" arguments are unlikely to prevail where the government has a strong position that a taxpayer has failed to comply with a substantive requirement of a controlling Code provision.

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