Palmolive Building Investors, LLC v. Commissioner, 149 T. C. No. 18 (2017)

In a landmark ruling, the U. S. Tax Court denied Palmolive Building Investors, LLC a charitable contribution deduction for its donation of a facade easement, ruling that the easement deed did not meet the perpetuity requirements of the tax code. The court found that the deed failed to subordinate existing mortgages to the easement, undermining the conservation purpose's protection in perpetuity. This decision reinforces the necessity for clear and complete subordination of mortgage interests to ensure the validity of conservation easement deductions.

Parties

Petitioner: Palmolive Building Investors, LLC (Palmolive), DK Palmolive Building Investors Participants, LLC, Tax Matters Partner. Respondent: Commissioner of Internal Revenue.

Facts

In 2004, Palmolive, owning the Palmolive Building in Chicago, Illinois, donated a facade easement to the Landmarks Preservation Council of Illinois (LPCI), a qualified organization. At the time of the donation, the building was subject to two mortgages held by Corus Bank, N. A. (Corus) and the National Electrical Benefit Fund (NEBF), each with an outstanding balance of approximately $55 million. Before the easement deed was executed, Palmolive obtained mortgage subordination agreements from both lenders. However, the deed stipulated that in the event of extinguishment through judicial proceedings, the mortgagees would have prior claims to any proceeds from condemnation until their mortgages were satisfied. Palmolive claimed a charitable contribution deduction for this easement for the tax year 2004. The Internal Revenue Service (IRS) issued a notice of final partnership administrative adjustment (FPAA) disallowing the deduction and asserting penalties.

Procedural History

The IRS issued an FPAA to Palmolive on July 28, 2014, disallowing the charitable contribution deduction for the facade easement donation and asserting penalties. DK Palmolive Building Investors Participants, LLC, as the tax matters partner, filed a petition in the U. S. Tax Court challenging the FPAA. The Commissioner filed a motion for partial summary judgment under Rule 121 of the Tax Court Rules of Practice and Procedure, arguing that the easement deed did not satisfy the perpetuity requirements under the Internal Revenue Code (IRC) and Treasury Regulations. Palmolive filed a cross-motion for partial summary judgment.

Issue(s)

Whether Palmolive's easement deed satisfied the perpetuity requirements of IRC section 170(h)(5)(A) and Treasury Regulations section 1. 170A-14(g)(2) and

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(g)(6)(ii)?

Rule(s) of Law

IRC section 170(h)(5)(A) requires that a conservation purpose be protected in perpetuity for a charitable contribution to be deductible. Treasury Regulations section 1. 170A-14(g)(2) stipulates that no deduction will be permitted for an easement on property subject to a mortgage unless the mortgagee subordinates its rights to the easement. Section 1. 170A-14(g)(6)(ii) requires that the donee of a conservation easement be entitled to a portion of the proceeds from a subsequent sale or exchange of the property at least equal to the proportionate value of the easement at the time of the gift.

Holding

The U. S. Tax Court held that Palmolive's easement deed did not satisfy the perpetuity requirements of IRC section 170(h)(5)(A) and Treasury Regulations section 1. 170A-14(g)(2) and (g)(6)(ii). Consequently, Palmolive was not entitled to a charitable contribution deduction for the facade easement donation.

Reasoning

The court's reasoning centered on the interpretation and application of the relevant statutory and regulatory provisions. Firstly, regarding section 1. 170A-14(g)(2), the court found that the mortgages were not truly subordinated to the easement. The mortgage subordination agreements referenced the easement deed, which in turn provided mortgagees with prior claims to insurance and condemnation proceeds, contradicting the requirement for full subordination. The court rejected Palmolive's argument that preventing extinguishment through foreclosure was sufficient, emphasizing that actual subordination of the mortgagees' rights, including to insurance proceeds, was necessary to protect the easement in perpetuity.

Secondly, concerning section 1. 170A-14(g)(6)(ii), the court found that the deed did not confer a guaranteed property right to the donee to receive a proportionate share of proceeds upon extinguishment. Instead, the deed prioritized the mortgagees' claims, which could potentially leave the donee with nothing in the event of a condemnation or sale. The court distinguished this case from *Kaufman v. Shulman*, declining to follow the First Circuit's interpretation that only required the donee's entitlement to proceeds vis-à-vis the donor, not against all parties with interests in the property.

The court also dismissed Palmolive's reliance on section 1. 170A-14(g)(3), which allows for the possibility of remote events not defeating a deduction, as this section does not excuse non-compliance with explicit requirements like those in sections 1. 170A-14(g)(2) and (g)(6).

Lastly, the court found that the saving clause in the deed, which purported to

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retroactively reform the deed to comply with the perpetuity requirements, was ineffective. The clause required mortgagee consent for amendments that would materially affect their rights, thus failing to ensure the donee's perpetual interest at the time of the gift.

Disposition

The court granted the Commissioner's motion for partial summary judgment and denied Palmolive's cross-motion for partial summary judgment.

Significance/Impact

The *Palmolive* decision underscores the strict interpretation of the perpetuity requirements for conservation easement deductions under IRC section 170. It clarifies that mortgage subordination must be complete and effective, including with respect to insurance and condemnation proceeds, to ensure the donee's interest is protected in perpetuity. This ruling may impact how future conservation easement donations are structured and documented, emphasizing the need for clear subordination agreements and the avoidance of clauses that could undermine the donee's rights. It also highlights a split in judicial interpretation of the Treasury Regulations, as the Tax Court declined to follow the First Circuit's decision in *Kaufman v. Shulman*, potentially leading to further appeals and clarification at higher judicial levels.

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