A06. Building Envelopes and Permitted Improvements: Best Practices CLE RM

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Session Faculty:
Tamara Galanter
Michelle Albert

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Pointers for Balancing Risk on Conservation Easement Permitted Structures
Following the Full Tax Court Decision in Pine Mountain Preserve v. Commissioner

In the December 2018 Pine Mountain Preserve decision, the U.S. Tax Court ruled that certain provisions regarding building areas and other permitted rights disqualified the deductibility of two separate conservation easements. The case summary and the following Pointers reflect Land Trust Standards and Practices and can help drafters avoid IRS challenges while addressing uncertainty and future needs in light of the Pine Mountain decision. The Land Trust Alliance has taken steps to address this situation on behalf of its members, but we do not yet have a favorable resolution, and it may take some time to reverse or limit the erroneous building rights aspect of the decision. While we press our case in the courts, please evaluate your easement template with your land trust attorney in light of the issues and options below.

Summary
The background and details underpinning the drafting pointers below follows in the next pages. The Risk Spectrum on page 9 lays out the various approaches across a spectrum from lower risk to higher risk to non-deductibility of the easement. Whatever approach you select in consultation with your attorney and the landowner, explicitly emphasize and document that the exercise of permitted rights are at least not inconsistent with the conservation purposes. Here is a summary of the drafting pointers:

(1) Avoid any specific boundary adjustment, building area relocation or land substitution provision in your conservation easements.
(2) Avoid inconsistent or excessive permitted structures.
(3) Address errors or problems by a post-conservation boundary adjustment or relocation.
(4) Consider alternative included building areas.
(5) Consider fixing the location of major structures and surface alterations.
(6) Consider slightly larger or multiple small building areas to add flexibility.
(7) Cluster building areas regardless of exclusion or inclusion in the easement.
(8) Protect intact blocks of undeveloped land, not interstitial areas between developed lots.
(9) Combine conservation purposes and holder’s sole discretion as the approval standard.
(10) Assess the additional risk from partially floating included building areas.
(11) Consider documenting how the potential zones do not affect the conservation purposes.
(12) Consider the risks of excluding or including building areas.

Background to Pine Mountain
Three earlier cases led to the Tax Court’s decision in Pine Mountain. These cases dealt with similar issues, starting with the 2013 Belk decisions, where the Tax Court held, and the Fourth Circuit affirmed, that a conservation easement did not qualify for a federal income tax deduction because it included a land substitution provision.
In *Belk*, the provision allowed the landowner to substitute land outside, but contiguous with, the original protected property for equal or lesser areas of land within the original protected property. Any such substitution required the easement holder’s approval, which the land trust could not unreasonably withhold, and was based on several different criteria, such as no adverse effect on the conservation purposes of the easement or on any environmental features. The IRS contended, and the courts agreed, that this substitution provision rendered the restrictions a “floating easement,” and as such, it failed to constitute a “qualified real property interest” under Internal Revenue Code (IRC) §170(h)(2)(C) because the restriction on the original protected property was not “granted in perpetuity.”

The Fourth Circuit framed its ruling to state that there must be a “specific piece of real property” identified in the easement in order to qualify under §170(h)(2)(C). Also in *Belk*, the Tax Court stated that it was *not* opining on the conditions under which the land trust might later review a request to amend the conservation easement boundaries. Therefore, most practitioners view *Belk* in the limited and narrow context of its unusual substitution provision on the external boundary of the easement.

*Balsam Mountain* followed *Belk* in 2015. The Tax Court extended the *Belk* holding to a substitution provision with even more conditions but still found it noncompliant. The *Balsam Mountain* easement included a provision that allowed for limited adjustments to the external boundary of the protected property. These adjustments had to meet the following conditions: (1) no net loss of acreage to the easement’s protected property; (2) any land added to the protected property had to be contiguous to the rest of the protected property; (3) any land added to the protected property had to have an equal or greater contribution to the conservation purposes than the removed land; (4) the aggregate land removed from the protected property could not exceed 5 percent of the original acreage; (5) the adjustment must be made within five years of the easement’s original grant date; and (6) the holder could reject the adjustment if it resulted in a material adverse effect on the conservation purposes. Even with these additional limitations, the Tax Court ruled that the easement did not qualify for a charitable deduction because, as in *Belk*, there was no specified “qualified real property interest” as required by §170(h)(2)(C).

*Bosque Canyon* followed later in 2015, and the Tax Court again extended *Belk* on different facts related to the boundaries of building areas excluded from the easement’s defined protected property, but located within the geographic perimeter of the protected property. In *Bosque Canyon*, the Tax Court disallowed deductions for two easements because of a provision allowing for adjustments to the boundaries of 47 five-acre “Homesite Parcels” that were clustered in an area within the exterior perimeter boundaries of, and thus geographically surrounded by, the

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1 For consistency throughout this document, “excluded” building areas are those completely removed from the definition of an easement’s protected property description; “included” building areas remain a part of the protected property but subject to looser restrictions. An “exterior” building area is one that is sited outside the geographic boundaries of the protected property; an “interior” building area is wholly sited within the perimeter of the protected property. Using these terms, the Homesite Parcels in *Bosque Canyon* were *excluded* and interior, while the building areas in *Pine Mountain* were *included* and interior.
protected property. The adjustment provision prohibited any material adverse effect on any of the conservation purposes and any increase in size of a HomesiteParcel.

However, the Fifth Circuit reversed in a split two-to-one decision in 2017, finding that allowing limited changes to the boundaries of the Homesite Parcels was supportive of, and not inconsistent with, the perpetuity requirements of §170(h). In a key section citing earlier D.C. Circuit and First Circuit appellate decisions, the Fifth Circuit wrote, “The common-sense reasoning that [Simmons and Kaufman] espoused, i.e., that an easement may be modified to promote the underlying conservation interests, applies equally here. The need for flexibility to address changing or unforeseen conditions on or under property subject to a conservation easement clearly benefits all parties, and ultimately the flora and fauna that are their true beneficiaries.”

The Fifth Circuit also noted approvingly that the 2005 easement generally clustered Homesite Parcels around the only existing road, and thus it was highly unlikely that the adjustment provision could be abused to allow the Homesite Parcels to be scattered throughout the protected properties. Moreover, because the potential boundary adjustments were to areas that were fully within the protected property’s geographic exterior boundaries, the Fifth Circuit distinguished the situation from the Fourth Circuit’s decision in Belk. In a dissenting opinion, one Fifth Circuit judge failed to see any material distinction between adjustments to the exterior perimeter boundaries and those made to the interior boundaries.

What Pine Mountain Says
Together, Belk, Balsam Mountain and Bosque Canyon frame the Tax Court’s decision in Pine Mountain. A brief overview of how the Tax Court regarded the building areas and the other permitted rights will assist drafters. The Tax Court articulated five major holdings, as follows:
(1) Contrary to the Fifth Circuit in Bosque Canyon, there is no distinction between changes to the exterior boundaries of the easement’s protected property (as in Belk and Balsam Mountain) and changes to the interior boundaries (as in Bosque Canyon).
(2) Similarly, based on the facts of Pine Mountain, the Tax Court found that because the permitted structures within and around the building areas were so extensive and did not have sufficient restrictions, there was no substantive distinction between excluded and included building areas.
(3) Following these principles, the Tax Court rejected the deductibility of the 2006 easement because it did not fix the initial location of the six building areas.
(4) In a direct comparison to and repudiation of the Fifth Circuit in Bosque Canyon, the Tax Court rejected the deductibility of the 2005 easement because the land trust could permit a change in the building areas.
(5) The totality of the other permitted structures and surface alterations (including roads and ponds, utilities and so forth) within and outside the building areas also prevented the 2005 easement from constituting a “qualified real property interest” under IRC §170(h)(2).

Key Drafting Pointers
The Pine Mountain decision is very likely to be appealed to the 11th Circuit, and additional
cases are likely to refine these issues further in Tax Court and in the appeals courts. The Alliance will be filing amicus briefs on behalf of its members in these cases. The process is lengthy, quite possibly years. If your donors or their advisers fear an IRS audit, they can reduce audit risk of the overall easement transaction by ensuring the appraisal is moderate and fully substantiated, having fully substantiated documentation of the entire easement transaction and, finally, drafting all clauses with conservation purposes as the first priority. This includes specified limited permitted rights that comply with §170(h) and are at least not inconsistent with the stated conservation purposes.

The following pointers provide a checklist for analysis to assist drafters and land trust personnel in crafting permitted building rights that uphold perpetuity and survive scrutiny by the IRS. Land trusts may wish to consider some of the following alternatives, worded as developed by your attorney, staff and board and informed by your state law, policies and experiences.

1. **Avoid any specific boundary adjustment, building area relocation or land substitution provision in your conservation easements.**
   - Despite numerous limitations on a substitution provision in the easement, the IRS is likely to challenge it, and the Tax Court is likely to disallow the deduction based on Belk.
   - Fixed exclusions, fixed building areas and nondeductible easement s overlaid on fixed exclusions probably are lower risk.

2. **Avoid inconsistent or excessive permitted structures.**
   - The *Pine Mountain* majority opinion emphasizes the numerous permitted rights allowed in the 2005 and 2006 easements as a significant aggravating factor in why the easements did not merit charitable deductions. For example, the Tax Court likened the right to allow numerous residential buildings outside the building areas to allowing “extra acres of holes in the cheese.” Inconsistent permitted rights are a specified factor in determining whether an easement actually protects conservation purposes in perpetuity under §170(h)(5) and Reg. §1.170A-14(e)(2). Neither the Tax Court in *Pine Mountain* nor the Regulations establish any measurable formula or rubric for determining when permitted rights are excessive, and thus specific guidance is not possible. However, the Alliance expects the IRS to continue pressing the inconsistent rights argument. Although the vast majority of land trusts already appropriately limit the scope of landowner rights, use extra caution now.
   - Limit permitted structures in whatever ways are appropriate to protect the conservation purposes and to minimize or eliminate the opportunity for adverse impact to the conservation purposes.

3. **Address errors or problems by a post-conservation boundary adjustment or relocation.**
   - The absence of an express adjustment or substitution provision does not mean that the land trust can never adjust the boundaries of a conservation easement or a building area. As the Tax Court stated in *Belk II*, “Belk I does not speak to the ability of parties to modify the real property subject to the conservation easement; it simply requires that there be a specific piece of real property subject to the use restriction granted in perpetuity.” The *Pine Mountain* decision did not upset this holding. The easement’s general amendment and termination provisions apply to any adjustment proposal.
Still, by insisting that the parties fix a building area in a specific location from the outset, the Tax Court’s decision will increase the likelihood of amendment requests as landowners and easement holders discover that a different configuration or location would be more suitable from an ecological or practical perspective.

Of course, treat any amendment that removes land from the protected property with an abundance of caution as discussed on pages 34-36 of Amending Conservation Easements: Evolving Practices and Legal Principles. With the exception of de minimis adjustments or clear errors, treat any such amendment as a partial extinguishment. As such, it requires court approval as dictated by state law and Treasury Regulation §1.170A-14(g)(6) (assuming the donor claimed an income tax deduction).

4. Consider alternative included building areas.

If a landowner cannot decide between competing building areas, and to avoid a large partially floating building area, consider whether it makes sense for the easement to establish two or more alternative and fixed included building areas. In the future, the landowner selects one of these building areas, and the other(s) automatically extinguish. This strategy arguably has no floating or adjustability aspect to the building areas.

Alternatively, the easement could restrict uses allowed only within a building envelope to one building envelope at any given time. These strategies arguably have no floating or adjustability aspect to the building areas but provide flexibility.

5. Consider slightly larger or multiple small building areas to add flexibility.

The Tax Court steers easement drafters toward establishing larger or multiple building areas in which all or most structures reside, discouraging floating or adjustable building areas, or building zones within which the landowner may later select a site.

Size the building area appropriately to the circumstances. Somewhat expanded or multiple building areas may reduce the need for future adjustments. Drafters cannot fully eliminate the future need to address violations, errors and changed zoning laws and siting requirements.

6. Consider fixing the location of major structures and surface alterations.

A cautious reading of Pine Mountain is that the Tax Court is uneasy with any major structures or surface alterations that could be sited or relocated anywhere within the protected property, regardless of whether they are within or outside any building area.

Drafters might consider specifying locations for all additional structures permitted by the easement outside building areas. Proceed cautiously if the easement permits additional structures in any unspecified location, and be sure to specify other meaningful limits on scope and scale.

When addressing mineral extraction pads and infrastructure and recreation, silvicultural, agricultural, habitat or other dispersed structures, consider fixed areas or fixed exclusions. Alternatively, consider substantial limits on scope and scale if the permitted rights remain dispersed. Another potential option to consider is a group of fixed areas that may be used one at a time in succession but only after the prior area is reclaimed with all structures removed, the use stopped and the area extinguished.

Address the development of pre-existing severed mineral rights with a separate surface use agreement.
7. **Cluster building areas regardless of exclusion or inclusion in the easement.**
   - Clustering of buildings and other structures is usually good conservation practice. Clustering is also expressly identified as a positive factor in an example in the Regulations (see §1.170A-14(f) Ex. 4). Recently, the courts have highlighted the degree of clustering (or lack thereof) as a factor in whether an easement will qualify for a tax deduction. For instance, the relative clustering of the Homesite Parcels was a big factor in the Fifth Circuit’s decision to uphold the deduction in *Bosque Canyon*. If clustering is not possible, then carefully document protection of the conservation purposes in the location of permitted rights.
   - In contrast, the fact that the building areas in the *Pine Mountain* easements could at least in theory be sited or relocated anywhere on the protected property was a major flaw in the Tax Court’s view. Moreover, the dissent in *Bosque Canyon* and the Tax Court in *Pine Mountain* repeatedly used a “Swiss cheese” analogy to describe a conservation easement that allows excluded or included building areas. Using this analogy, the more holes, and the more scattered those holes, and then the ability to create more holes by moving them, the less likely that courts will view the easement as achieving conservation goals. According to the *Pine Mountain* majority, it does not matter whether these “holes” are included building areas or excluded parcels, or whether the areas affect the interior or exterior boundaries of the protected property.
   - If building areas are not clustered, document in the baseline how the location of permitted building areas and the improvements allowed in the building areas support and protect the conservation values. For example, an agricultural conservation easement might locate a building area for agricultural improvements and structures in two or more different areas of the property. The baseline would then document how the separate locations and the improvements within each building area are necessary for agricultural operations.

8. **Protect intact blocks of undeveloped land, not interstitial areas between developed lots.**
   - As the Fifth Circuit stated in *Bosque Canyon*, “a picture is worth more than 10,000 words.” In addition to the clustering of Home Sites that the Fifth Circuit noted, the protected properties in the two *Bosque Canyon* easements were relatively simple geometric shapes with straight boundaries. In contrast, the *Pine Mountain* protected properties appear to fill the interstices between the developed areas and is itself fragmented. In particular, the 2006 *Pine Mountain* easement protects 499 acres overall, but the protected property is comprised of eight noncontiguous parcels, many of which have irregular boundaries and long thin strips.
   - The motivation discernible in the delineation of the protected property in a conservation easement should be conservation purposes and not business goals.

9. **Combine conservation purposes and holder’s sole discretion as the approval standard.**
   - A key theme in the court opinions discussed above is whether easement holders should be trusted to make pro-conservation decisions with respect to building areas and other rights. Courts appear to disfavor approval provisions that pressure holders to approve landowner requests. The most common of these are approval formulations that require the holder to be “reasonable” or, conversely, that the holder’s approval “shall not be unreasonably withheld.” Land trusts should avoid these reasonableness standards and
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insist on sole discretion based on whether a requested activity is consistent with the conservation purposes. Be sure to state both the sole discretion review and consistency with conservation purposes of any approval. Such language can support the taxpayer’s claimed deduction.

10. **Assess the additional risk from partially floating included building areas.**
- Since *Belk*, a fully floating or partially floating excluded building area (even if subject to holder approval) has been risky. *Pine Mountain* appears to increase the risk to a fully or partially floating included building area. In a typical partially floating building area, the easement identifies a portion of the protected property (sometimes called a “potential building area,” a “future building area” or a “building zone”) within which the landowner, with the holder’s prior approval, may delineate a specific included building area later.
- In *Belk II*, denying the taxpayer’s motion for reconsideration, the Tax Court distinguished *Belk* from the facts in PLR 200403044 and PLR 9603018. In both of these private letter rulings, the taxpayers reserved the limited right to establish building areas in the future on the protected property, subject to the holder’s written approval and consistency with the conservation purposes. The holding in *Pine Mountain* appears to directly overturn these nonbinding PLRs, as well as conflict with a specific example in the Treasury Regulations, see Example 4, §1.170A-14(f).

11. **Consider documenting how the potential zones do not affect the conservation purposes.**
- After *Pine Mountain*, any degree of a floating building area carries higher risk. One way to lower such risk might be for the parties to document in advance of executing the easement why the degree of allowed float is consistent with the conservation purposes. The easement could reference or perhaps even include a “consistency report” as an exhibit. The level of formality and substance of this report could range from a land trust project manager’s one- or two-page analysis to a third-party consultant’s lengthy documentation. The more substantial the documentation, the higher the preparation costs, and landowners should contribute to or fully pay for these costs. It would also help if the appraisal demonstrates that any eventual location of the partially floating building area would have no effect on the fair market value of the easement.
- Whether such documentation avoids an IRS challenge is unknown, but a thoughtfully reasoned and methodically presented analysis could distinguish the facts sufficiently from those in *Pine Mountain*.

12. **Consider the risks of excluding or including building areas.**
- Even without the challenges presented by the *Pine Mountain* decision, there are significant pros and cons of including or excluding building areas from the protected property in the conservation easement. Some land trusts prefer the stewardship simplicity of excluded building areas. Other land trusts always include building areas in order to prevent division of the land and to maintain some degree of control over those areas, especially when sited in the interior of the protected property. Additionally, stewardship is likely to encounter difficulties with either choice when landowners want to change locations or build outside exclusions or envelopes.
- Drafters will want to discuss the implications and organizational preferences inherent in any choices. The *Pine Mountain* decision seemingly removes the ability to allow building areas to partially or fully float.
The Risk Spectrum appears on the next page.

QUESTIONS?
Please call or write to Leslie Ratley-Beach, Conservation Defense Director, at 802-262-6051 or Sylvia Bates, Director of Standards and Educational Services, at 603-708-1073.

DISCLAIMER
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**So where does this leave us? A risk spectrum approach.**

Given the uncertainties and nuances of the building areas and reserved rights issues in *Pine Mountain* and the related cases, there remain gray areas as to what provisions will disqualify a conservation easement charitable deduction. Rather than try to predict exactly which provisions the IRS would disqualify, land trusts and landowners might use a risk analysis. The degree of acceptable risk will depend on the landowner’s risk tolerance, the amount of deduction at stake, land trust stewardship preferences and the particularities of the protected property. Please note that this spectrum may change after any appeals of the tax court opinion.

<table>
<thead>
<tr>
<th>Lower Risk</th>
<th>Medium Risk</th>
<th>Higher Risk</th>
<th>No Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>No major structures or surface alterations permitted.</td>
<td>Partially floating sites to be located within a fixed included larger building area. Alternative fixed included building area.</td>
<td>Floating included building area even with express limitations and approval. (Lower risk with suitable documentation?)</td>
<td>Expressly adjustable building area.</td>
</tr>
<tr>
<td>Fixed excluded or included building area in which all major structures must be sited. Only minor structures outside building area. Fixed overlay easement on a fixed exclusion.</td>
<td></td>
<td>Fully or partially floating excluded building area. Fully floating included building area.</td>
<td></td>
</tr>
<tr>
<td>Building areas, structures and other reserved rights are appropriately limited in location, number and size.</td>
<td>Unsited minor structures limited in number or size.</td>
<td>Unsited minor structures not limited in number or size.</td>
<td>Unsited minor and major structures not limited in location, number and size.</td>
</tr>
<tr>
<td>Building areas and additional reserved rights are clustered.</td>
<td>Additional dispersed permitted rights with substantial limits on scope and scale.</td>
<td>Dispersed unlimited building areas and additional permitted rights.</td>
<td>Expressly adjustable conservation easement boundary.</td>
</tr>
<tr>
<td>Protected property composed of large intact blocks of undeveloped land.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Holder has sole discretion over all approval rights.</td>
<td></td>
<td>Holder’s discretion limited by reasonableness or other standard.</td>
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Tamara Galanter, Shute, Mihaly & Weinberger LLP

Suggested Language for Conservation Easements

1. Definition of improvements:

“Any buildings, structures, facilities, or other physical improvements, whether temporary or permanent, located on, above, or under the Conservation Property.”

2. General catchall provision in reserved rights/permitted use section that ensures improvements are not inconsistent with conservation values or purpose:

“The permitted uses allowed by this conservation easement are limited to those that are not inconsistent with the purpose of this conservation easement.”

3. For unforeseen future occurrences or improvements that you might want to allow:

“Holder and Owner acknowledge that, in view of the perpetual nature of this Conservation Easement, they are unable to foresee all potential future land uses, future technologies, future evolution of the land and other natural resources, and other future occurrences, such as changes in climate, affecting the purposes of this Conservation Easement. Holder therefore may in its sole discretion approve (or disapprove) a Proposed Activity not expressly contemplated by or addressed in this Conservation Easement, provided that such Proposed Activity is consistent (or inconsistent, in the case of disapproval) with the purposes of this Conservation Easement.”

4. To better ensure conservation friendly interpretation of easement:

“Controlling Law and Interpretation. The interpretation and performance of this Easement shall be governed by the laws of the State of _______. Any general rule of construction to the contrary notwithstanding, this Conservation Easement shall be broadly construed in favor of the Conservation Easement to effect the conservation purposes of this Conservation Easement and the policy and purposes of [any relevant state of local statutes]. If any court finds that any provision in this Conservation Easement might conflict with another, an interpretation consistent with the conservation purposes of this Conservation Easement shall govern. If any court interprets that the Conservation Easement is silent, ambiguous, inconsistent or otherwise deficient on any point in dispute, an interpretation consistent with the conservation purposes of this Conservation Easement shall govern. The legal doctrine of construing instruments as against the drafting party shall have no application, and this Conservation Easement shall not be construed against either Party on the basis that that Party prepared this instrument.”