CONSERVATION EASEMENTS AND MINERALS

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I. Mineral Rights in the Context of the Real Property Rights

A. **What are minerals**?

1. The legal definition of "minerals" varies from state to state as part of the property law regime and therefore the law of mineral rights is determined on a state-by-state basis. Generally, minerals are anything that may be extracted from on or below the surface that have commercial (and, in some cases, non-commercial) value.

a. Hard rock minerals, oil and gas, and other hydrocarbons
b. Geothermal rights, sand and gravel, decorative rock, peat, etc.

2. Especially important for conservation land transactions are minerals that, when extracted by their owners, may destroy the surface of the land and thereby the conservation purposes behind long-term land protection.

B. Mineral right ownership and the "**Bundle of Sticks**"

1. Mineral ownership is an important aspect of property rights, which is treated differently than other rights, and has a very complex, independent body of governing law.

a. Economic rationale behind treatment of the two estates—encouraged development of property.
b. Development of the law promoted economic opportunity—and maximized the use of land.

2. Because of economic importance and a long history of separation of mineral ownership and surface ownership the ownership of the two rights in the same land are often referred to as two "estates" in land.

a. The *surface* and the *mineral* estates for one parcel of land may be owned by different people, thereby creating the proverbial "rub" during conservation transactions.

3. Generally, less valuable minerals located at or near the surface of the land, such as sand and gravel, are defined as belonging to the surface estate and therefore are appurtenant to and transfer with the surface rights.

4. If an instrument that conveys land (e.g. a deed or lease) is silent with respect to transfer of minerals, ownership of the mineral estate generally passes with ownership of the surface estate.

5. If an instrument specifically reserves mineral rights, the mineral estate is considered "severed" from the surface estate.

II. **Severance** of Mineral and Surface Estates

A. **Types of conveyances** in which the mineral and surface estates may be severed:

1. Federal and state land patents.

a. Federal and state governments often severed the mineral and surface estates to maximize revenue and to promote economic development in areas of high mineralization.

b. Railroad land grants and reservation of "mineral lands".

2. Express reservations by deed.
3. Leases.
4. Royalty interests.

B. When the mineral and surface estates are severed, what are the **rights of the owners** of these respective estates?

1. **Mineral rights** owners have the right:

a. To enter the surface estate for mineral exploration and extraction; and
b. To disturb as much of the surface of the land as is reasonably necessary to obtain access to and to extract minerals, with reasonable accommodation of surface owners.

2. **Surface rights** owners and conservation easement donors have the right:

a. To "reasonable accommodation" of their use of the surface, including conservation easements (?) by the mineral owners;
b. Generally cannot prevent extraction of minerals by the mineral rights holder.

3. **Conservation easement** holders have the following rights:

a. To take a conservation easement or interest in land that is subject to prior reservations of mineral rights;
b. But not to prevent destruction of conservation values on the lands on which they hold easements because the owner of the mineral rights has a legal entitlement to retrieve those minerals;
c. However, they may be able to obtain specific rights to control such mineral extraction, through **surface use agreements** and establishing and pursuing their rights as **property interest holders**.

III. **Severed Mineral Rights** and Charitable Donations of **Conservation Easements**

A. I.R.C. § 170(h)(5) states that although "qualified mineral interests" may be severed or reserved by conservation easement donors, a charitable deduction for a conservation easement gift is *not* available if "at any time there may be extraction or removal of the minerals by **any surface minin**g method."

1. This rule was amended in 1997 to create a major exception: a deduction is available even if the mineral estate has been severed, as long as the taxpayer shows that the "**probability of surface mining is so remote as to be negligible**."

2. What does it take to make this showing of probability?

a. Treasury regulation §1.170A-14(g)(4)(ii)(3) states that this probability is "**a question of fact** and must be determined on a case by case basis." Relevant factors to such an inquiry cited by the regulation include: geological, goephysical, or economic data showing absence of minerals or lack of commercial feasibility of extraction at the time the easement is contributed.

i. Note that minerals may be present on the property, but an easement can still qualify for deduction if the minerals are **not commercially feasible** to extract.
ii. Note also that the test depends on the commercial feasibility of extraction **as of the date of easement donation**. An easement will qualify for a deduction even if its minerals later become very valuable.
iii. Consider whether there is a **reasonable market** for the minerals and whether there are other sources in close proximity that would be cheaper and less difficult to extract.

B. If there is a severed mineral issue, the standard prescription to preserve a tax deduction is a **geologist's report** that concludes that the probability of surface mining is so remote as to be negligible.

1. There is no standard template for such a report.
2. Such reports can be costly.

C. **Ambiguity** in the tax law.

1. Treasury Regulation §1.170A-14(g)(4)(i) perhaps is the most difficult conservation easement regulation to apply because of internal inconsistencies.

a. The first two sentences of the regulation state in affirmative language that "no deduction is allowed . . . if at any time there may be extractions or removal of minerals by any surface mining method." The regulation states also that ***any*** **method of** ***mining***—not only surface mining—that is inconsistent with the conservation purposes of the easement will jeopardize the easement deduction.
b. The last two sentences of the regulation create an apparent exception to the foregoing rule by stating that a deduction will not be denied if "certain" mining methods used have "**limited, localized impacts**" on the property and do not "**irremediably**" destroy "**significant conservation interests**."
c. This practical interpretation of the regulation **balances** landowner needs with public interests in preserving landscapes.
d. But the internal inconsistency begs the questions:

i. Mineral production facilities that may be **hidden or concealed** will not threaten an easement deduction?
ii. An obligation to **reclaim**
iii. the area of mineral extraction "**to its original state**" also will preserve a deduction?
iv. Is the intent of the exception to allow oil and gas extraction, or shaft mining, where surface disturbances generally are **localized** anyway?
v. If so (and the examples provided by the Treasury Department appear to confirm this interpretation), how does **coalbed methane extraction**, which arguably may have more than a "limited, localized impact" fit in to this standard?

D. Courts interpretation of tax law

1. Great Northern Nekoosa v. Commissioner, 97-2 USTC ¶50,591 (Aug. 1. 1997). The court interprets that the intention of Congress was to grant deductions for conservation easements only if easements completely prohibited extraction of

minerals by surface mining methods. The court expressly rules against reading the last two sentences of Treasury Regulation §1.170A-14(g)(4)(i) as creating an exception to the surface mining prohibition, even if limited localized surface mining had no detrimental effect on conservation values protected by easements. The court states that the regulation "should not be interpreted to permit even localized surface mining of qualified mineral interests, whether or not the production facilities can be concealed, are compatible with existing topography, or even if it is possible to restore the lands to their original state."

a. Bad facts make bad law:

i. Case involved an IRS challenge to the deductibility of two conservation easements, totaling about 8,000 acres, donated by Great Northern Nekoosa (GNN) along branches of the Penobscot River in Maine

ii. Prior to making the deduction, GNN entered into a 20-year management plan with the State allowing it to extract minerals from certain areas for "road purposes" where such mineral extraction was "incidental to the construction of a hydroelectric facility."

iii. Subsequent to executing the management plan, GNN granted two conservation easements reserving: "the right to construct and maintain roads (including the extraction from the Easement Lands of gravel to be used in such construction and maintenance) as necessary for ingress and egress to [adjacent lands] . . . ."

iv. One of the easements also allowed GNN to construct burrow pits and to excavate from such pits materials necessary to develop hydroelectric facilities.

v. Between 1986 and 1993, GNN operated 8 gravel pits in the easement protected area.

vi. The IRS denied the charitable deduction of $19,274,000.00 claimed by GNN, asserting, among other reasons, that the right to remove gravel from the easement area constituted surface mining, which violated §179(h) of the Internal Revenue Code.

b. Experts disagree on how to apply the decision.

i. Some advocate adherence to the established approach to reading and interpreting the regulations, reasoning that the GNN decision was a preliminary ruling in a partial summary judgment, issuing from a court of claims with limited precedential value, and was not related to Congress' policy and conservation goals in passing favorable tax treatment for conservation easement donations.

ii. Others advocate strict adherence to the case, reasoning that it the most definitive judicial pronouncement on how to interpret the regulations.

2. Virginia Vermiculite, Ltd. v. W. R. Grace & Co., 156 F.3d 535, (4th Cir. 1998) *cert. denied* 119 S. Ct. 1458 (1999). The court reverses district court's dismissal; nonprofit land preservation organization not exempt from federal antitrust laws in receiving donations where the transaction is fundamentally commercial. The court rules that donation of 1400 acres of land containing the rare mineral vermiculite by WR Grace to Historic Green Springs, Inc., a local

nonprofit land organization in Green Springs, Virginia, with restrictive covenants prohibiting the development of vermiculite could be the basis for an antitrust violation and conspiracy to monopolize a segment of commerce. The court notes that Historic Green Springs, Inc. is subject to anti-trust laws because its deal with Grace was essentially commercial in nature. The court rejects summary judgment motions stating that there is sufficient evidence indicating Grace's intent to keep VVL from mining that could lead a reasonable jury to find that HGSI stood to gain separately from Grace's acquisition of monopoly power in the alleged market for vermiculite concentrates, and in that sense can be deemed to share in Grace's alleged specific intent to obtain a monopoly. After the rejection of summary judgment, the case currently proceeds . . .

IV. Strategies for addressing mineral rights severance problems

A. Determine whether the **surface and mineral estates** are unified or severed.

1. If the chain of title to property, including state and federal patents, does not contain any mineral right reservations or conveyances, the estates probably are unified.
2. However, if there has been even a single reservation (with the exception of following a vein or lode), the estates are severed and any reservation may be a cause for concern.

B. Identify **common problems** of mineral rights severances:

1. **Forgotten** reservations: if a mineral estate owner dies without specifying an estate distribution for reserved mineral rights, the ownership of minerals usually passes to heirs on a proportional basis, with each heir receiving a fractional share.

2. **Serial** reservations: sloppy legal drafting may result in fractured mineral rights ownership, particularly when a legal description in a deed states "reserving a 50% interest in all oil, gas and other hydrocarbons and the right to explore for and extract the same" and that description is transcribed in every new transaction, creating a series of deeds with ever diminishing shares of ownership of minerals and an increasing number of mineral rights owners.

3. **Searching** public records is tedious and difficult because every deed in the chain of title must be examined. Title insurance companies are best equipped for this task.

4. If reservations are found, they should be reviewed to determine if they still are valid.

    a. Some reservations expire if not exercised within a certain amount of time.
    b. Some reservations may be royalty reservations that grant no affirmative right to extract minerals to the holder of the royalty.
    c. Some reservations may have been re-conveyed to the original owner.

5. Conservation easement **holders can protect** surface resources and control the mineral estate by:

    a. Participating in surface use agreements or leases, or their negotiation as property interest holders;
    b. Reacquiring the mineral rights;

c. Subordinating mineral rights to the land trust's conservation interest; or
d. Determining and documenting that there is no practical threat of mineral development even if the mineral and surface estates have been severed.

C. Evaluate the **likelihood** that mineral rights will be exercised.

1. Is the possibility of surface mining "so remote as to be negligible"? If not, land trust may want to consider involvement in surface use agreements, or lease re-negotiations by establishing itself as a property interest holder, partnering with landowners in managing mineral extraction, having mineral estate subordinated to conservation values, or reconsolidating title.

2. Will reserved oil and gas rights (including coalbed methane and deep shaft mining) destroy significant conservation values protected by the land trust? If so, may want to consider involvement in surface use agreements or lease re-negotiations by establishing itself as a property interest holder, partnering with landowners in managing mineral extraction, having mineral estate subordinated to conservation values, or reconsolidating title.

3. Is ownership so fractured that it would not be worth anyone's time or effort to extract the minerals, knowing that all proceeds will be split among owners? If so, this may fall under the "so remote as to be negligible" standard.

4. If a land trust determines that severed mineral rights might someday be exercised to the detriment of conservation values, the land trust should consider having mineral estate subordinated to conservation values, or reconsolidating title.

5. Strategies for involvement in **leases and surface use agreements**:

   a. Establish easement holder as a holder of a property interest in the deed of conservation easement;
   b. Require notice to the holder of lease renegotiation, surface use agreement; and
   c. Partner with landowner as co-owners of the surface estate to assist landowner with renegotiations of leases and surface use agreements with consideration and accommodation of conservation easement and conservation values.

6. Strategies for **re-unification** of mineral and surface estates:

   a. Identify current owners and either land trust or surface owner buys back mineral rights.
   b. Remember it may be difficult to identify all owners or convince them to sell at less than an exorbitant rate.

7. Strategies for **subordination** of mineral to surface estate:

   a. Identify current owners and obtain mineral rights subordination agreement to allow for extraction or exploration of minerals only in conformance with conservation easement held by the land trust.
   b. Remember it also may be costly to acquire a subordination agreement if the mineral owners require compensation in exchange for subordination of their right.

V. Issues to consider

A. Mineral production as a by-product of permitted activities

1. Some permitted activities may create marketable minerals (usually sand and gravel) by using surface mining methods, but the intention of the landowner may not be to produce these minerals at all. How should a land trust deal with this by-product situation?
   a. Excavation of foundations for permitted development?
   b. Excavation of ponds for wildlife habitat and healthy ecosystems?

B. Is coalbed methane exploration and extraction feasible while still protecting conservation values?
   a. By-products include large amounts of contaminated water.
   b. Sustainability of impact is estimated to be 160 acres per well. ♠

VI. In a Nutshell:

A. Conservation easements can be placed on properties with split estate;

B. Minerals can be extracted from properties encumbered with conservation easements;

C. Surface mining always is prohibited;

D. Subsurface mining may be allowed if limited and localized; properly spaced; does not irremediably damage the conservation values of the property; facilities are concealed within the existing topography; and reclamation to prior state;

E. Conservation easement donor and holder should partner in all regards relating to mineral extraction and operations on protected properties, including: determining landowner's rights; understanding impacts to surface and conservation values; negotiating lease and surface use agreements; ensuring compliance with terms of agreements and leases for mineral operations, spacing, extraction, collection, facilities, bonds, and reclamation.

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