Oil and Gas CAN Work with Conservation Easements

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Texas Agricultural Land Trust (TALT)

The mission of the Texas Agricultural Land Trust is to protect private working lands, thus conserving Texas’ heritage of wide open spaces and natural resources.
History of the Texas Agricultural Land Trust

Created in 2007 by leaders from three statewide agricultural organizations (TWA, TSCRA, and TFB), TALT has partnered with landowners to conserve 98,600 acres of prime working lands for future generations of Texans.
Stephen J. Small is recognized as the nation's leading authority on private land protection options and strategies. Steve wrote the Federal income tax regulations on conservation easements as attorney-advisor in the Office of Chief Counsel of the Internal Revenue Service. He is in private practice now in Boston.
Code Section 170(h)(5) and (6)

• (5) **Exclusively for conservation purposes**

For purposes of this subsection—

(A) Conservation purpose must be protected

A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.
Code Section 170(h)(5) and (6)

(B) No surface mining permitted

(i) In general

Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

(ii) Special rule

With respect to any contribution of property in which the ownership of the surface estate and mineral interests were separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.
Code Section 170(h)(5) and (6)

• (6) **Qualified mineral interest**

For purposes of this subsection, the term “qualified mineral interest” means—

(A) subsurface oil, gas, or other minerals, and

(B) the right to access to such minerals.
Excerpts from Treasury Regs:

• **1.170A-14(d)(v) Limitation.**

A deduction will not be allowed for the preservation of open space under section 170(h)(4)(A)(iii), if the terms of the easement permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation. See section 1.170A-14(e)(2) for rules relating to inconsistent use.
Excerpts from Treasury Regs: (continued)

• 1.170A-14(e) Exclusively for conservation purposes.
  (1) In general.
To meet the requirements of this section, a donation must be exclusively for conservation purposes.
  (2) Inconsistent use.
Except as provided in paragraph (e)(4) of this section, a deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests.
  (3) Inconsistent use permitted
A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation that are subject of the contribution.
1.170A-14(g)(4) Retention of qualified mineral interest

(i) In general.

Except as otherwise provided in paragraph (g)(4)(ii) of this section, the requirements of this section are not met and no deduction shall be allowed in the case of a contribution of any interest when there is a retention by any person of a qualified mineral interest (as defined in paragraph (b)(1)(i) of this section) if at any time there may be extractions or removal of minerals by any surface mining method. Moreover, in the case of a qualified mineral interest gift, the requirement that the conservation purposes be protected in perpetuity is not satisfied if any method of mining that is inconsistent with the particular conservation purposes of a contribution is permitted at any time. See also section 1.170A-14(e)(2). However, a deduction under this section will not be denied in the case of certain methods of mining that may have limited, localized impact on the real property but that are not irreremediably destructive of significant conservation interests. For example, a deduction will not be denied in a case where production facilities are concealed or compatible with existing topography and landscape and when surface alteration is to be restored to its original state.
1.170A-14(g)(4) Retention of qualified mineral interest (continued)

1.170A-14(g)(ii) --Whether the probability of extraction or removal of minerals by surface mining is so remote as to be negligible is a question of fact and is to be made on a case by case basis. Relevant factors to be considered in determining if the probability of extraction or removal of minerals by surface mining is so remote as to be negligible include: Geological, geophysical or economic data showing the absence of mineral reserves on the property, or the lack of commercial feasibility at the time of the contribution of surface mining the mineral interests.
IRC 170(h)—Conservation Easements
The Federal Tax Rules

• No surface mineral extraction
• Protection of conservation values in perpetuity 170(h)(5)(a)
• LIMITED oil & gas exploration & extraction subject to certain conditions 170(h)(5) and 1.170A-14(g)(4)
• Deductions?
• Probabilities?
Who “owns” the Resource?

• Landowner? Third party?
• Leased? Existing SUAs?
• Royalty interest? Ownership interest? Combination?
• Abiding by Texas Law—Joseph Fitzsimons
• Protecting the conservation values VERSUS the potential consequences of O&G activity
• Demonstrating control of exploration for and extraction of the resource. Must agree to some limitations.
Landowner owns the resource; wants deduction:

• NO surface mineral extraction
• How limited will the exploration & extraction have to be? Possible analogy: limited residential development
• Potentially receiving a deduction based upon your protection of the property’s conservation values. Do your production plans (Oil & Gas, minerals) present any inconsistencies to that end? 170(h)(5)
Third party owns resource; landowner wants deduction

Minerals:

Satisfying the “so remote as to be negligible” test (Special Rule)

Geologist’s report

Oil and Gas:

Third party agreement regarding limitations

What are the existing SUAs, if any? And what do they provide for?

Difficulties? Position to negotiate?
Building the Record

How much intrusion is too much? Building a record of conservation minded intentions

A. Fact and science intensive
B. Wildlife experts, habitat, wildlife corridors, flora & fauna, etc.
C. Geologists-where is the resource?
D. Current and historical uses of property-habitat compatible?
E. Baseline Documentation Report
Important Pieces to Consider (with counsel)

- Who “owns” the resource?
- Ownership interest? Royalty interest? Combination?
- Does any of the resource actually exist on or under the property?
- If so where?
- Particular habitat or other important conservation values on the property, and if so, where?
- Existing lease or SUA? What do they say?
- What does state law say about the extent to which the owner of the resource can exercise rights to explore for it and extract it to the detriment of the landowner and to the detriment of the conservation values of the property?
- Does the landowner have any control over the degree of exploration or extraction?
- BOTTOM LINE: if the landowner does not “own” the resource, can the landowner control the degree of intrusion/exploration/extraction in a way that protects the conservation values of the property?
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Mineral Lease

• Definition: A legal agreement, typically an oil and gas lease (“OGL”), pursuant to which a mineral lessee is granted possession of the mineral estate for a fixed term “and so long thereafter as oil, gas and other minerals are produced,” for the purpose of exploring for, developing and removing the oil, gas and other minerals from the land.

• OGL creates a fee simple determinable estate in the minerals which will revert to the mineral estate owner upon cessation of production. Under Texas law, an oil and gas lease is both a conveyance and a contract.

• In the absence of express provisions in an OGL and Surface Use Agreement, the surface rights of the mineral lessee will be governed by common law doctrines.
Mineral Lease (cont’d)

Common Law Doctrines:

“Dominant Estate Doctrine”

- The mineral estate owner has an implied right, or an implied easement, to use so much of the surface of the property as may be reasonably necessary to enjoy the mineral estate. *Harris v. Currie* (1943).

- Water Usage: Absent agreement, Lessee has the right to use water from wells and surface

- *Sun Oil Co. v. Whitaker* (1972): Surface owner tried to prevent mineral estate from using groundwater from aquifer. Texas Supreme Court held that “to hold that sun can be required to purchase water from other sources or owners of other tracts in the area would be in derogation of the dominant estate.”
Mineral Lease (cont’d)

“Accommodation Doctrine”

• Developed as an implied limitation on the *Dominant Estate Doctrine*.

• *Getty Oil Co. v. Jones* (1972): The rights implied in favor of the mineral estate must be exercised with *due regard*:
  1. Lessee’s use of surface must substantially interfere with a preexisting surface use; and
  2. Lessee has reasonable alternative methods to access the minerals.
Mineral Lease (cont’d)

- “Accommodation Doctrine” (cont’d)
  - The Court’s ruling may signal a shift towards accommodating a surface owner’s future uses of the surface, not just existing use.
  - Mineral owner was barred from drilling at a particular location to accommodate the surface owner’s planned future expansion of its existing landfill.
  - The Court seemed to give weight to the fact that the surface owner had documented and demonstrated plans that showed their intended future use of the surface was more than a mere statement of intent.
  - “To conserve and protect the Conservation Values forever”: Existing Use?
Mineral Lease (cont’d)

- **INTERPRETATION OF “OTHER MINERALS”:**

  - **“Surface Destruction” Test (Acker case, 1971; Reed case 1980):**

    1. If the deposit lies near the surface, the substance will not be deemed granted or retained as a mineral if it is shown that any reasonable method of production would destroy or deplete the surface.

    2. A deposit which is within 200 feet of the surface is “near-surface” as a matter of law, and thus, part of the surface estate.

    3. If the surface owner satisfies the tests set out above, and establishes ownership of the substance at or near the surface, he owns the substance beneath such land at whatever depth it may be found.

    4. In determining whether the method of mining would necessarily deplete or consume the surface estate, the availability of restoration or reclamation processes is immaterial.

    5. Only applies if the mineral estate was severed prior to June 8, 1983.
Mineral Lease (cont’d)

• INTERPRETATION OF “OTHER MINERALS” (cont’d):

• “Ordinary and Natural Meaning” Test (Moser case, 1984):
  
  – “[A] severance of minerals in an oil, gas and other minerals clause includes all substances within the ordinary and natural meaning of that word, whether their presence or value is known at the time of the severance.”

  – Only applies if the mineral estate was severed after June 8, 1983.

  – Uranium deemed a mineral as a matter of law.

  – The following substances are owned by the surface owner as a matter of law: sand, gravel, building limestone, surface shale, caliche, water, and near surface lignite, iron ore and coal.
Mineral Lease (cont’d)

- INTERPRETATION OF “OTHER MINERALS” (cont’d):

  If minerals were severed prior to June 8, 1983
  “Surface Destruction Test”

  If minerals were severed after June 8, 1983
  “Ordinary and Natural Meaning Test”
SCENARIO #1
Grantor (Landowner) Owns Minerals; Minerals Are Not Leased

• Grantor may subordinate its mineral interest to the conservation easement.

• Grantor may enter into a preemptive Surface Use Agreement which protects the conservation values in the event of future development.

• Grantor may enter into an oil and gas lease with adequate surface use protections.
SCENARIO #2
Grantor Owns Minerals; Minerals Are Leased to a Third Party

• Look to the OGL for specific surface protections.

• If OGL has no specific surface protections, only common law protections (i.e. dominant estate doctrine, accommodation doctrine).

• Request subordination of OGL or execution of Surface Use Agreement.
SCENARIO #3
Grantor Does Not Own Minerals; Minerals Are Not Leased

• Control of surface mining determined by language and date of mineral severance.
  – Pre June 8, 1983 → “Surface Destruction” Test
  – Post June 8, 1983 → “Ordinary and Natural Meaning” Test

• Deductibility of donation will depend on who controls surface mining, and protection of conservation values through a Surface Use Agreement.
  – If Grantor/Surface Owner controls surface mining and has a Surface Use Agreement, there is less risk.
  – If Mineral Estate Owner controls surface mining and there is no Surface Use Agreement restricting other mineral development, then there may be greater risk.
SCENARIO #4
Grantor Does Not Own Minerals; Minerals Are Leased to a Third Party

• Look to the OGL for specific surface protections.

• If there are no specific surface protections, only common law protections (i.e. dominant estate doctrine, accommodation doctrine).
Drilling Pad
Eagle Ford Frac Pond
Slope/Topography
Reclamation
Stockpiled Topsoil
Reclamation
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Questions & Answers
Thanks!

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