

Easement donation disqualification for reserved rights of surface mining methods

Recent advice from the IRS Office of Chief Counsel reiterates the IRS's position on perpetual conservation easements on land where the landowner retains the rights to extract minerals using *surface* mining methods. The IRS announced its position that a landowner's retention of rights to use surface mining methods of their *unsevered* mineral interests would disqualify the easement donation as a charitable deduction. This position could significantly impact conservation easements on working lands allowing agricultural "borrow pits" and the removal or extraction by surface mining methods of gravel, sand or other surface mining materials to build or maintain roads on the protected property.

Office of Chief Counsel Internal Revenue Service [Memorandum, 202236010 \(9/9/2022\)](#) states:

- If the easement deed permits the landowner as owner of an unsevered mineral interest to extract or remove minerals by a surface mining method then the conservation easement does not satisfy the requirements of section 170(h) because the contribution is not treated as "made exclusively for conservation purposes."
- Donee approval of a surface mining method does not rectify the problem.
- Treas. Reg. §1.170A-14(g)(4)(i), which provides an exception to the disallowance rule where the impact of the mining has a limited, localized impact but is not irremediably destructive of significant conservation interest does not apply to surface mining methods of unsevered mineral interests.
- The only exception to the IRS rule would be if the mineral rights were severed from the surface estate and the likelihood of using surface mining methods to extract minerals passes the "remoteness test" (with the possibility of the mineral rights being exercised being so remote as to be negligible, as required by I.R.C. section 170(h)(5)(B)(ii)).

The IRS's Memorandum bases its analysis on the [Great Northern Nekoosa Corp. v. United States](#), 38 Fed. Cl. 645 (Fed.Cl.1997), a case in which the court held that the grantor of the easement retained a "qualified mineral interest" pursuant to §170(h)(6) because sand and gravel were "subsurface minerals." Therefore, the easement was not "exclusively for conservation purposes," under §170(h)(5)(A) and (B), and the grantor's charitable deduction was denied in its entirety.

According to the court, the so-called "limited and localized" exception under Treas. Reg. §1.170A-14(g)(4)(i) was incongruous with the statute. The statute prohibits "extraction or removal of minerals by any surface mining method." §170(h)(5). The regulations, in contrast, provide a limited exception for mining that has a "limited, localized impact on the real property but that are not irremediably destructive of significant conservation interests." The court did not factor into its determination elements such as pre-existing uses, state law definitions of minerals, or the size and scale of the surface extraction.

Despite the holding of *Great Northern Nekoosa*, many deductible easements in the ensuing years did continue to include a reserve right for limited and localized sand and gravel extraction, and the IRS did not seem interested in challenging deductions on that ground. However, the recent IRS Memorandum may signal a renewed focus on this issue, and heightened risk of a denied deduction.

Practical and legal considerations

Land trusts that address removal or extraction of materials such as gravel, sand, or hard rocks by surface mining methods in their templates or that are working with a specific donor interested in such removal or extraction may wish to reassess. Talk with the landowner and explain the risks without giving tax or legal advice. The decision about what to include in the easement as to extraction and removal will be determined by how much risk the donor is willing to take that their deduction might be audited and disallowed on this basis. Without more guidance from the IRS, land trusts and landowners must evaluate the risks and options in the context of these practical and legal considerations:

- *The definition of subsurface minerals and surface mining under state real property and federal tax law.* The IRS's Memorandum refers to "surface-mining methods" and "subsurface minerals" but does not define those terms creating confusion about what uses and substances might fall into these categories. The interaction between state real property and federal tax law definitions of minerals and/or surface mining is unclear. For example, what happens if the right to remove or extract is of substances not classified as minerals under state law? What constitutes a prohibited "surface mining method"?
 - The court in *Great Northern Nekoosa* did not look to state real property law definitions of these terms. Instead, it looked to the federal tax code and regulations and ultimately applied an ordinary meaning analysis to "minerals," but the IRS's analysis may conflict with the ordinary meaning of critical definitions under state laws.
 - Are there ways to draft conservation easements to allow de minimis removal of surface materials by methods that should not be considered surface mining? For example, state law may not regulate small-scale gravel pits, especially if the materials produced are not sold commercially or transported off the property. Those activities are not considered regulated "surface mining" under state law. Could a conservation easement state that sand and gravel produced as by-products of permitted activities shall not be considered surface mining, and the by-products can be removed from the property?
- *The interplay between the conservation purposes and surface mining.* How will the IRS treat a surface mining method of subsurface minerals which supports a protected conservation value? Can the conservation easement, for example, allow gravel extraction to maintain agricultural roads on an agricultural conservation easement conducted pursuant to a clearly delineated governmental conservation policy and that creates a significant public benefit?
- *Surface mining method as a pre-existing use.* Can the continuation of surface mining of subsurface minerals as historically practiced on farms and ranches meet the pre-existing use language of Treas. Reg. §1.170A-14e3 ("A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.")? Or does the

explicit prohibition against surface-mining methods in the statute take precedence over the more general language of 14e3?

- The pre-existing use exception in the regulation likely would fail a contest with the statute's surfacing mining prohibition if the *Great Nekoosa* rationale is used. The court said the *limited and localized* exception in the regulation contradicted the statute and the statute prevails over regulations. The *pre-existing use* regulation would, most likely, have the same problem.
- *The size of the area, scope or scale for surface mining.* Would small-sized individual "Maintenance Areas" where materials are gathered and not necessarily mined, with a capped percentage of the eased property and a remediation requirement be treated differently by the IRS than a large-scale commercial aggregate operation?

Land trusts, attorneys and landowners cannot know in advance how the IRS would respond to these queries so uncertainty and risk exist. The following risk spectrum may assist you in your analysis.

Risk Spectrum

The uncertainties associated with what the IRS might consider for disqualifying reserved rights to engage in surface mining methods, the holding in *Great Northern Nekoosa Corp.* and the IRS Memorandum cause concern about drafting tax-deductible conservation easements. Factors to consider are the landowner's risk tolerance for potential audit and disqualification of the easements for deduction, the amount of deduction at stake, land trust stewardship preferences, land trust missions and the particular attributes of the protected properties.

LOWER RISK APPROACHES

- Prohibit extraction of unsevered mineral interests by any surface mining method
- Meet the severance requirements found in §1.170A-14(g)(4)(ii) (A) and (B) (severance needed to occur pre-1976) and pass the remoteness test of I.R.C. section 170(h)(5)(B)(ii)
- Exclude extraction site from the conservation easement protected property. Consider restricting that site with a nondeductible easement or restrictive covenant that is tied to the deductible easement to prevent division of the property (but see risks with commercial operations below)

HIGHER RISK APPROACHES

- Allow continuation of pre-existing use that does not conflict with the conservation purposes of the gift e.g., use of gravel from an already-existing small pit to fill potholes on agricultural or forest management roads.
- Allow surface mining methods with explicit provisions in the easement addressing scale and scope of surface mineral extraction and use to assure scale and scope of removal pose no

adverse impact to the conservation purposes. Tie to managing the resources and to complement land conservation goals but in a manner that will not adversely impact the deductible easement to avoid an IRS claim of an inconsistent use.

- Allow private, noncommercial surface operations. State that surface minerals may be produced as a by-product of other permitted reserved rights such as excavations of foundations for permitted residences, barns, or other structures, or development of ponds and wetlands for wildlife habitat enhancement.
- Exclude a perimeter lot with historic commercial surface extraction. Commercial surface operations present serious and substantial risks. The excluded lot might be controlled by a restrictive covenant that runs to the benefit of the conservation easement, which is a real property interest. There is a benefitted property which should make the covenant enforceable. The covenant could provide for restoration and revegetation with native species, building restrictions, a restriction on selling the land separate from the conservation easement protected property, and a promise to add the land into the conservation easement after restoration.

HIGHEST RISK APPROACHES→NO DEDUCTION

- Allow surface mining methods with holder approval
- Allow surface mining methods with the application of the limited and localized exception
- Allow surface mining methods for future use such as reserving the right to engage in development of new gravel or sand sources for commercial sale for off-site uses, or uses on the property that do not complement protection of conservation goals.
- Allow interior commercial gravel extraction or any other extraction for commercial use.

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Date last revised: 1/11/2023

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