Drilling and Deductions: Making the Section 170(h) Conservation Easement Work in the Shale Boom Era

Michael T. Fulks
Jackson Kelly PLLC

Follow this and additional works at: https://researchrepository.wvu.edu/wvlr

Part of the Administrative Law Commons, Energy and Utilities Law Commons, Environmental Law Commons, Natural Resources Law Commons, and the Tax Law Commons

Recommended Citation
Available at: https://researchrepository.wvu.edu/wvlr/vol116/iss3/10

This Article is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact researchrepository@mail.wvu.edu.
While the United States' recent shale gas boom has made oil and gas drilling more lucrative and prevalent, it has also, at times, pitted surface owners and mineral owners against each other. Such strife gives a surface owner who does not own the minerals underlying her property one more obstacle in her attempt to receive an income tax deduction pursuant to section 170(h) of the Internal Revenue Code, which allows deductions for the donation of qualified conservation contributions to certain non-profit and governmental organizations. This Article examines the proper tax treatment under section 170(h) of easement-burdened properties that may in the future be subject to the hydraulic fracturing of hydrocarbons. Finding extant law to be unspecific and inconclusive, it suggests allowing mineral owners to share in the tax benefits of section 170(h). Adding a provision to section 170(h) or its regulations that allows mineral owners a conservation easement deduction will facilitate cooperation between surface and mineral owners, encourage increased qualified conservation contribution activity, and allow for the responsible development of shale gas and other underground minerals.
A. A Provision Calling for Income Tax Deduction for Mineral Owners Will Increase Cooperation Among Landowners and Promote Conservation Easement Donations ........................................ 1067

B. A Safe Harbor Would Promote Conservation Interests Better than the Status Quo .................................................................................................................. 1070

C. A Safe Harbor Would Be Appropriate from the Standpoint of Federal Tax Law ......................................................................................................................... 1070

IV. CONCLUSION ........................................................................................................ 1072

I. INTRODUCTION

Enacted as part of the Tax Reform Act of 1976,\(^1\) section 170(h) of the Internal Revenue Code ("the Code") allows taxpayers to deduct from their income "qualified conservation contributions" made to certain charitable organizations or governmental entities.\(^2\) Commonly called "conservation easements" in property and contract law, qualified conservation contributions allow a landowner to donate an interest in his property to a charitable organization while retaining possession and enjoyment of the property.\(^3\) In effect, a landowner donates the right to develop her property to a charitable land trust in perpetuity and receives a charitable deduction in an amount equal to the decrease in property value due to the permanent loss of these rights.\(^4\) The combination of a charitable deduction and the continued enjoyment and possession of one's property have made section 170(h) conservation easements a popular tool both for tax planners and for conservationists, and recent decades have witnessed the increased use of these transactions: in 1990, United States conservation easements covered about 500,000 acres, while in 2011, nearly 30 million acres were burdened by conservation easements.\(^5\) States have also

---

3 References to "conservation easements" in this Article are interchangeable and synonymous with references to "qualified conservation contributions" under section 170(h) of the Code.
4 See Treas. Reg. § 1.170A-14(h) (as amended in 2009) (providing that the deduction allowed under section 170(h) is equal to the fair market value of the easement restrictions contributed).
gotten in on the act, offering their own tax incentives for owners who have burdened their properties with conservation easements.\textsuperscript{6}

The rapid rise of conservation easements has occurred alongside a coincident increase in subsurface mineral development in the United States. Recent technological, geologic, and economic developments—particularly the combination of hydraulic fracturing and horizontal drilling techniques—have resulted in higher domestic oil and natural gas production.\textsuperscript{7} Since the 1950s, oil and gas drillers have used a process known as hydraulic fracturing (sometimes called "fracking," especially by critics of the practice), which involves "creat[ing] vertical fractures in the rock through the high-pressure injection" of a fluid consisting of water, sand, and many chemicals.\textsuperscript{8} Due to its ability to uncover oil and natural gas from deep wells drilled into layers of shale rock, which, when fractured, release oil and/or natural gas, hydraulic fracturing has become widely used over the last decade and has led to large increases in the United States' production of oil and natural gas. Shale gas production is estimated to grow from 5.0 trillion cubic feet per year in 2010 to 13.6 trillion cubic feet per year in 2035,\textsuperscript{9} and in 2012 the International Energy Agency estimated that the United States would become the world's largest oil producer by 2020 and a net oil exporter around 2030, a prediction unthinkable a decade ago.\textsuperscript{10}

Since the 1970s, environmentalists have assailed hydraulic fracturing for its effect on drinking water and the airborne pollution caused by the fuel-intensive drilling process, as well as its contamination of locally available water through its addition of chemicals during the fracturing process.\textsuperscript{11} As Jesica Rivero Gilbert points out, "Shale reserve exploration and production creates [sic] tension between two critical resources... : low carbon fuel and water[,]... highlight[ing] the tension between our national energy and environmental policies."\textsuperscript{12} Drilling by hydraulic fracturing also involves

\textsuperscript{6} See, e.g., ALASKA STAT. § 34.17.010 (2007); ARIZ. REV. STAT. ANN. § 33-272 (2009); OKLA. STAT. tit. 60, § 49.3 (2010). Many states' requirements for receiving a tax preference are different from those set forth in section 170(h).


\textsuperscript{11} See Gilbert, supra note 8, at 187-208 (discussing criticisms of and litigation over hydraulic fracturing).

\textsuperscript{12} Id. at 172.
massive input materials, such as large vehicles, aboveground oil derricks, and roads to drilling sites, which disturb the potentially scenic, open, and/or natural current states of the property on which the drilling activity takes place, and also may create air and water pollution in the immediate vicinity of the drilling activity. As of January 2014, hydraulic fracturing remains unregulated by the federal government or the United States Environmental Protection Agency ("EPA"); rather, states and localities have regulated the practice.

The rapid proliferation of these modern, input- and land-intensive drilling techniques impinges upon the implicitly rural, anti-development ethos of conservation easements and their champions, and this clash threatens the efficacy of conservation easements placed on properties likely to experience mineral exploration and imperils their continued use on such properties. The Code identifies varying objectives a conservation easement may achieve: preservation of land for recreation by the public; protection of a "relatively natural habitat" of fish, wildlife, or plants; or the preservation of open space that will yield a significant public benefit in accord with a federal, state, or local conservation policy. Though there does not appear to be a scientific consensus, modern drilling techniques may be antithetical to the protection of a natural habitat of fish, wildlife, or plants. Drilling also may conflict with some of the stated goals of the preservation of open space, such as the "relief from urban closeness," and the "harmonious variety of shapes and textures." A hydraulic fracturing well involves an estimated 6,790 truck trips to the site, as

---

13 See generally Zachary Bray, Reconciling Development and Natural Beauty: The Promise and Dilemma of Conservation Easements, 33 HARV. ENVTL. L. REV. 119, 120 (2010) (identifying the dilemma between “development and open space” and seeking ways “to reconcile their heretofore conflicting goals”).
14 See Keith Johnson & Tennille Tracy, U.S. Gas Exports Clear Hurdle, WALL ST. J., Dec. 6, 2012, at A6 (Sierra Club spokesman criticizes report on gas production “that omits the serious threats increased fracting and gas production pose to our water, our air, and the health of our families.”); James William Gibson, How the North Dakota Fracking Boom Shook a Family, GUARDIAN (Dec. 4, 2012), http://www.guardian.co.uk/environment/2012/dec/04/north-dakota-fracking-boom-family (North Dakota family owning surface but not mineral rights claims that hydraulic fracturing killed trees and produced health-harming air pollution).
18 Treas. Reg. § 1.170A-14(d)(4)(ii)–(iv) (as amended in 2009) (discussing the factors used to evaluate if open space provides public benefit).
well four to five weeks of around-the-clock construction, activities that strike one as contrary to the values contemplated by the Code or Treasury Regulations ("Regulations"). This may conflict with the implicit values of section 170(h): the preservation of open and undeveloped landscapes. In keeping with these objectives, the Code prohibits surface mining on properties with qualified conservation contributions, while the Treasury Regulations under section 170(h) require that other mining and drilling activities have a limited and localized impact and not irremediably destroy significant conservation interests. These special mentions of mineral development, combined with strenuous environmental criticisms, jeopardize the tax-preferred status of conservation easements on properties where hydraulic fracturing and other input- and space-intensive drilling techniques may occur. As outlined below, however, there is no law, regulation, or piece of guidance creating substantive standards for the type, nature, and extent of drilling that may occur. This is problematic because the shale gas boom is economics-driven: increased available shale supplies and decreased barriers to tapping those supplies have caused the gas glut the economy is currently experiencing. Hydraulic fracturing will not go away and it appears to skirt the limits of section 170(h)’s range of acceptable post-contribution uses, making greater certainty of the utmost importance for taxpayers who own the surface above shale fields who wish to make a conservation easement contribution.

In this Article I explore the relationship between hydraulic fracturing and other land-intensive shale drilling techniques, on one hand, and section 170(h) of the Code, on the other (Part II), illustrating how section 170(h) fails to adequately treat the realities of future hydrocarbon drilling on split estates and fails to provide meaningful guidance to taxpayers owning only the surface of a split estate (Part III). I then propose a safe harbor solution (Part IV) that balances the interests of the four relevant parties involved: the surface owner, the mineral owner, the charitable or governmental easement donee, and the federal Treasury. This solution creates a more coherent, broadly beneficial regime than the status quo and does not pervert Congress’ intent in enacting section 170(h). I conclude with some thoughts about the possible ramifications to the Code if my proposed safe harbor is enacted (Part V).


21 "In the United States, land may be horizontally severed into surface and subsurface estates. Where such a severance has occurred, a split estate is formed such that the mineral and surface rights to a single plot of land are held by different parties." Andrew C. Mergen, Surface Tension: The Problem of Federal/Private Split Estate Lands, 33 LAND & WATER L. REV. 419, 419–20 (1998).
II. SECTION 170(H)'S LAND USE ETHIC

The Code is not agnostic regarding the ethics and aesthetics of land use: section 170(h) provides a deduction from income to taxpayers willing to forever give up some of their property rights in order to conserve the qualities of their property that section 170(h) arbitrarily favors. Conservation easements may only receive a charitable deduction if they are contributed for a "conservation purpose" under section 170(h). For purposes of that section, a conservation purpose includes

(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,
(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
(iii) the preservation of open space (including farmland and forest land) where such preservation is—
   (I) for the scenic enjoyment of the general public, or
   (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
(iv) the preservation of an historically important land area or a certified historic structure. 22

In addition to the requirement of a qualified conservation purpose, only "qualified organizations" under the meaning of section 170(h)(3) may be the donees of a qualifying conservation contribution. Section 170(h)(3) provides that a donee must meet the requirements under section 501(c)(3) and one of either 509(a)(2) or 509(a)(3), which require the organization to be publicly-supported. 23 The conservation easement provisions also require that qualifying organizations have the resources and avowed purposes necessary to effectively enforce the conservation easement. 24 Most importantly, section 170(h) requires that conservation easements be granted in perpetuity, precluding the possibility that unapproved activities—activities that destroy a "significant conservation interest"] 25—will ever take place. 26

By putting in place several complex requirements that must be met in order for a taxpayer to receive a conservation easement deduction, Congress bestowed a special tax benefit to those qualifying under section 170(h):

---

23 Id. § 501(c)(3).
26 I.R.C. § 170(h)(5)(A) (2012) ("A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.").
typically a "partial interest[ ]" gift of less than a taxpayer's entire interest in property is not deductible. However, a partial interest gift made pursuant to section 170(h) is deductible. That is, although the taxpayer is not releasing his entire property interest to the qualified organization, because he has complied with section 170(h)'s requirements, Congress will nonetheless allow the partial gift to be deductible in the amount of fair market value lost via the donation, because that section's requirements effectively ensure that a neutral, independent, and publicly-supported organization will monitor the easement, and because the requirements also place a limit on the range of acceptable uses of the property post-contribution. But by building up a regime of complex statutory and regulatory requirements, Congress and the IRS bestow legislative and administrative grace on those taxpayers who have made the substantial (and possibly expensive and time-consuming) efforts of box-ticking in order to fulfill section 170(h)’s significant requirements, as such requirements better ensure that the conservation-minded purposes of section 170(h) have been realized by those taxpayers who have complied with the section’s myriad requirements.

Despite these stringent requirements, however, it is clear that some amount of development may occur on a property subject to a qualified conservation contribution. Indeed, section 170(h) makes it possible for an easement to qualify for a deduction despite the possibility that underground mineral development may occur on the easement-burdened property. A qualified conservation contribution subject to the possibility of current or future mineral production would still be valid if the mineral interest was a "qualified mineral interest." A qualified mineral interest is a property interest in "subsurface oil, gas, or other minerals, and the right to access to such minerals." A deduction may still be granted to a donor giving away his "entire interest" in the property other than a qualified mineral interest. In other words, a taxpayer owning a fee simple interest in a property may donate his entire interest in the property to a qualified organization and retain only subsurface oil, gas, and mineral rights and the right to produce them, and in doing so, he will still be qualified to receive a deduction under section 170(h).
Section 170(h), by not requiring a conservation-donating taxpayer to release her underground oil and gas interest to the qualified organization, implies that surface property may be donated to a qualified organization and future mineral development may occur on that property without jeopardizing the taxpayer’s section 170(h) deduction.

The Code and the Regulations place limits, however, on the kind and degree of mineral extraction that may occur on an easement-burdened property, and falling outside these safe harbors precludes the taking of a deduction under section 170. Possible future surface mining activity, for example, disqualifies a contributed easement from receiving tax-favored treatment. A provision added in 1997’s Taxpayer Relief Act effectively ensured that no surface mining may take place on a property receiving a charitable conservation easement deduction: section 170(h)(5)(B) bars a qualified conservation contribution in cases where surface mining was not prohibited by the conservation easement agreement and where the minerals had been severed from the surface estate on or after June 13, 1976; for properties where the minerals were severed before that date, the possibility of future surface mining must be “so remote as to be negligible” and this conclusion must be supported by evidence, such as geological and economic findings. The prohibition on surface mining is construed rather strictly: in the one major court case dealing with the surface mining prohibition, a taxpayer who had allowed for gravel extraction on the surface of an easement-burdened property was denied a deduction under section 170(h).

Nonetheless, many conservation easements have qualified for tax-preferred treatment despite allowing for oil and gas drilling or other mineral exploration on the easement-burdened property due to section 170(h)’s allowing “qualified mineral interests” on properties where easements have been donated. These subsections and the regulations accompanying them reveal a somewhat more ambivalent relationship between section 170(h) and future mineral development on easement-burdened properties than the surface mining prohibition suggests at first blush. Most conspicuously, a “qualified mineral interest” that has been severed from the surface property may be developed without destroying the tax-favored treatment of the easement contribution. However, other than the absolute ban on surface mining under section 170(h)(5)(B)(i), section 170(h) articulates no clear prohibition or safe harbor

31 See id. § 170(h)(5)(B); Treas. Reg. § 1.170A-14(g)(4)(ii).
34 See I.R.C. §§ 170(h)(2)(A), (6)(B) (allowing for deduction when taxpayer’s entire interest except a qualified mineral interest—and its implied right to develop minerals—is donated to a qualified organization).
regarding what sort of post-contribution activities are allowed—and in particular, little to no guidance is available regarding what sort of development of a "qualified mineral interest" would allow an easement to qualify for section 170(h) treatment.

All would-be qualified conservation contributions must jump through an additional ill-defined hoop in order to receive a tax deduction: while under section 170(h)(5)(B)(ii) the donor need not own the minerals beneath her property for her contribution to produce charitable deductions, under the Regulation, "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."35 C. Timothy Lindstrom provides anecdotal examples of questions Internal Revenue Service ("IRS") agents asked regarding inconsistent use in an audit, such as the donor's right to chop down trees for domestic firewood and his right to keep pets on the property.36 These examples suggest that an audit of a contributed property which reserves the right for future energy exploration activities would attract the strict scrutiny of the IRS on audit.37

The regulations under section 170(h) provide that no denial of a deduction will occur if an otherwise qualified conservation contribution reserves the right of the taxpayer or others to engage in some form of mining other than surface mining

in the case of certain methods of mining that may have limited, localized impact on the real property but that are not irremediably 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.38

Unfortunately for taxpayers seeking a deduction under the conservation easement provisions, no assurance that these standards will be met can necessarily be made without an agreement with the party that holds the rights to the mining activity: the subsurface owner's right to drill reasonably is protected by state property law and cannot be restricted by a contract made between two other parties. As Lindstrom writes,

[T]he principal problem with mineral interests is the potential donor's lack of control over such rights. When mineral rights

37 Id.
38 Treas. Reg. § 1.170A-14(g)(4)(i).
have been separated from the surface, assuming that commercially recoverable mineral deposits exist on the property, the requirements of the tax law cannot be met by merely inserting controls over extraction in the easement. Such provisions will not bind anyone who obtained (or retained) title to the mineral prior to the conveyance of the conservation easement. To be bound by the terms of a conservation easement the owner of any minerals whose claim to the minerals predate the easement must subordinate his interest in the minerals to the easement.\(^{39}\)

Lindstrom properly notes the dearth of guidance regarding what constitutes inconsistent uses, providing instead an example where a mineral owner of a split estate voluntarily subordinates certain aspects of his mineral rights—agreeing, for example, to “limit[] mineral extraction to no more than one well per 160 acres,” to reclaim the property, and to generally minimize the impact of his or her drilling activities.\(^{40}\) Though the lack of guidance does not assure that such subordination will be sufficient to allow for a deduction, Lindstrom writes that “[t]he agreement . . . to subordinate to this provision binds [the mineral owners] . . . and should satisfy the Regulations.”\(^{41}\)

There are two problems with relying on Lindstrom’s example. First, the example demonstrates a compromise by the mineral owners regarding the development of the mineral rights that is unlikely to occur in real-life split estate situations: an oil and gas company that purchases mineral rights with the express intent of developing them should be expected to assert its property interests to the full extent of state law. Second, Lindstrom admits that the Code lacks clarity regarding permissible mineral extraction activities: he points out that the example “ha[s] not been tested” and merely proffers that mitigation and subordination provisions “should satisfy the Regulations,”\(^{42}\) illustrating the need for a well-defined regulation identifying what sort of future mineral production will or will not meet the three-part requirements of the Regulations. Private letter rulings issued by the IRS to taxpayers reserving mineral rights confirm Lindstrom’s conclusion that an easement may lead to a deduction while mineral interests are reserved by the donor, but distressingly, none of these rulings specify the expected extent or nature of mineral development. Easements with abstract prohibitions granted by taxpayers retaining a qualified

\(^{39}\) LINDSTROM, supra note 37, at 81.

\(^{40}\) Id. at 82–83.

\(^{41}\) Id. at 83.

\(^{42}\) Id. at 82–83 (emphasis added).
mineral interest earn the approbation of the IRS, but the IRS’s rulings have not treated a transaction involving split estates, nor is there guidance regarding specific future drilling for a developable mineral interest retained by the surface owner.

III. SECTION 170(h)’S INCOMPLETE TREATMENT OF SPLIT MINERAL AND SURFACE ESTATES

The recent renaissance of shale drilling has exposed its potential for polluting air, as well as the larger footprint of modern oil and gas wells. Some states and localities have passed legislation and ordinances banning the practice of hydraulic fracturing and/or horizontal drilling in their jurisdictions with varying success, while private parties have brought litigation against drillers claiming theories of, inter alia, nuisance, trespass, and violation of environmental statutes. Without analyzing all of the possible environmental critiques of shale drilling in minute detail, I restrict myself to discussion of the possible problems that such activities pose with respect to section 170(h). The characteristics of modern shale wells and drilling activities most relevant to an analysis of section 170(h) deductions are the following: first, pollution of water and air that may harm “natural” plant and animal habitats; second, air pollution and inconspicuous production or development activities that hamper an area’s status as “scenic” or “open space” property under the Code and Regulations. While the Regulations’ test for “limited” and “localized” impact that does not “irremediably destroy” significant conservation interests suggests that these characteristics and products of modern wells are contrary to the significant conservation interests of section 170(h), the Regulations’ lack of guidance as to the extent and nature of permissible drilling and mining activities leaves taxpayers owning the surface of a split estate with little idea of what sort of drilling will disallow a deduction under the Code, as the following two sections’ analyses of the inconsistent uses doctrine demonstrate.

43 See, e.g., sources cited supra note 33 (private rulings allowing deductions for easements reserving mineral interests but restricting mining and drilling activity according to the limits imposed by the Code and Regulations regarding deductibility).
44 See id.
45 See generally Gilbert, supra note 8, 187–208, on criticisms of and litigation regarding hydraulic fracturing. See also Paige Anderson, Reasonable Accommodation: Split Estates, Conservation Easements, and Drilling in the Marcellus Shale, 31 VA. ENVTL. L.J. 136, 161–64 (2013) (noting the increased size and inputs of modern drillsites and wellpads, and asserting that “the extent of [shale drilling] operations... is incompatible with the preservation of land” and that “it is well-established that drilling in the Marcellus is having far from a de minimis impact on the land”).
46 See id. at 194–201 for an overview of litigation relating to hydraulic fracturing.
47 See supra note 37 and accompanying text.
In a split estate, the mineral owner has the implied right to explore and develop the underground minerals to the full extent of state property law.\(^{48}\) This implied right includes the ability of the mineral owner to use the surface overlying the mineral property to access the belowground mineral estate.\(^{49}\) This right of access has combined with drillers' newfound ability to tap into shale strata to result in high degrees of mineral exploration and drilling in areas that have traditionally been rural and undeveloped.\(^{50}\) This state of affairs has created strife between surface owners and mineral owners,\(^{51}\) while environmentalists' concerns such as water and air contamination have been exposed in a variety of publications, including, most prominently, the documentary *Gasland*.\(^{52}\) Though it seems possible for a taxpayer to know that drilling may interfere with a conservation purpose—such as when a natural fish habitat is the conservation purpose for the easement but it can be determined that hydraulic fracturing would contaminate groundwater and kill off the fish's habitat\(^{53}\)—it is a considerably more difficult task to be certain that no "other significant conservation interest[]" will be destroyed by the mineral production, because precisely what other significant conservation interests are, and how they might be destroyed, is a matter left to the taxpayer to determine.\(^{54}\) This would not be such a difficult task if the extant sources of law under section 170(h) set out limits, thresholds, or rules that created standards for acceptable

\(^{48}\) See 53A AM. JUR. 2D Mines and Minerals § 186 (2006) ("When a deed grants or reserves the minerals, but does not specifically mention the grant or retention of the right to explore for and extract the minerals, such a right is implied.").

\(^{49}\) See, e.g., Whiteman v. Chesapeake Appalachia L.L.C., 729 F.3d 381, 388 (4th Cir. 2013) (noting that the Supreme Court of Appeals of West Virginia has adopted "the principle that ownership of a mineral estate carries with it an implied right to use the surface in such manner and with such means as would be fairly necessary for the enjoyment of the mineral estate" (citing Porter v. Mack Mfg. Co., 65 W. Va. 636, 64 S.E. 853 (1909))).

\(^{50}\) See, e.g., SEAN O'LEARY, W. VA. CTR. ON BUDGET & POLICY, POLICY BRIEF: IMPACTS OF GAS DRILLING IN WETZEL COUNTY (2014) (recounting various changes wrought by gas drilling in rural Wetzel County, West Virginia, where natural gas production increased more than 6,000 percent between 2000 and 2012).

\(^{51}\) See, e.g., WEST VIRGINIA SURFACE OWNERS' RIGHTS ORGANIZATION, http://www.wvsoro.org (last visited Mar. 1, 2014) (website for the West Virginia Surface Owners' Rights Organization, "whose mission is to protect landowners from abuses by oil and gas drillers").

\(^{52}\) GASLAND (HBO Documentaries 2010); see also SPLIT ESTATE (Red Rock Pictures 2009), available at http://www.splitestate.com (documentary about hydraulic fracturing in the western United States which claims that "the oil and gas industry has left this idyllic landscape and its rural communities pockmarked with abandoned homes and polluted waters").

\(^{53}\) See, e.g., Herman v. Comm'r, 98 T.C.M. (CCH) 197, *8 (2009) (disallowing a deduction for an easement burdening historic structure where easement agreement did not preclude the possibility that part of historic structure may be altered or demolished).

\(^{54}\) See Treas. Reg. § 1.170A-14(e)(2).
mineral development activities; however, as outlined, below, this is not the case.

A. A Limited, Localized Impact on Property Experiencing Shale Drilling

Under the inconsistent uses rule in the Regulations, a method of mining that has a limited, localized impact on property will not preclude a deduction under section 170(h).\textsuperscript{55} Certain characteristics of hydrocarbon drilling arguably do not have a limited and localized impact on the property above and around the drilling activity, but the meaning of this phrase is left to taxpayers to interpret. One example in the Regulations expressly allows a deduction for a property where oil and gas production will take place so long as the mineral owner “covenants and can ensure that, although drilling for gas and oil on the property may have some temporary localized impact on the real property, the drilling will not interfere with the overall conservation purpose of the gift, which is to protect the unique bottomland hardwood ecosystem.”\textsuperscript{56} However, no more guidance is available as to what makes impact “temporary [and] localized”\textsuperscript{57}; in such a situation, the taxpayer is left to plan his transaction behind a veil of uncertainty, leading to increased risk-taking which will lead to an aggressive response by the IRS, whose audit or denial of the deduction will result in wasted resources by both government and taxpayers. This situation is not ideal for either the taxpayer or the federal government, while mineral owners are in the difficult position of covenanting that they will not produce an “impact” that is ill-defined in the law and regulations used to interpret that covenant. Requiring such qualitative assessments by surface owners seeking to take a conservation easement deduction and by mineral drillers seeking to robustly develop natural resources is unrealistic, messy, and unlikely to produce greater conservation activity or increased harmony and cooperation among surface owners and mineral owners of split estates. By providing concrete guidance with definite standards for the deductibility of an easement burdening a split estate, the IRS will allow surface and mineral owners to negotiate and interact with the comfort of knowing the expected tax outcome of their transactions.

B. Shale Drilling and the Irremediable Destruction of Significant Conservation Interests

In order to allow a property to enjoy the benefits of federal tax deductions, future drilling activities also must not be irremediably destructive

\textsuperscript{55} Treas. Reg. § 1.170A-14(g)(4)(i) (as amended in 2009).
\textsuperscript{56} Id. § 1.170A-14(g)(4)(ii).
\textsuperscript{57} Id.
of significant conservation interests.\footnote{Id. § 1.170A-14(g)(4)(i) (as amended in 2009).} By way of example, the Regulations note that "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."\footnote{Id.} This provision, which accords with section 170(h)'s ban on surface mining, illustrates a definite preference for land's "original state" and for production facilities that are "compatible with existing topography and landscape," but it says no more than this. It is uncertain, under the Regulations, whether a state-permitted drilling operation, which will undertake extensive reclamation, will do enough to restore land to its original state. The example, while comforting to those owning part of a split estate or a qualified mineral interest, fails to give any meaningful guidance or substantive standard for property owners to rely on beyond the taxpayers' own interpretation of the language of the Code and Regulations: in other words, taxpayers are forced to make covenants and assurances promising not to harm certain ecosystems and ineffable qualities of a property without being able to specifically identify how protecting those qualities that constitute a conservation interest might occur. Just as they fail to articulate a set of coherent and conservation-minded standards regarding the localized and limited impact of mineral drilling or mining, the Code and Regulations also neglect to provide what constitutes "irremediable destruction of significant conservation interests."\footnote{Id.} The result is that again taxpayers and the IRS are left blowing in the wind, with the government and private parties creating their own incongruent standards of these concepts.

The lack of administrative guidance for mineral production suggests one of two states of affairs: a failure by the IRS to enforce the standards of the regulations relating to the production of mineral interests, or an inhibition by taxpayers to engage in easement transactions involving mineral interests that the taxpayers do not own for fear of not qualifying under the Regulations. Either situation fails to advance the overriding purpose of section 170(h): to incentivize conservation activities by taxpayers.

In the next Part, I suggest that the IRS should promulgate detailed, standards-based regulations that will help both surface owners and mineral owners feel certain that a deduction is proper in spite of the possibility that shale wells may be drilled on the property in question. My proposed regulation will also promote the use of charitable conservation easement contributions generally for owners of split estates, easing owners' inhibitions that the IRS will audit the tax returns showing easements in areas where oil and gas development takes place.

\footnote{Id. § 1.170A-14(g)(4)(i) (as amended in 2009).} \footnote{Id.} \footnote{Id.}
IV. A PROPOSED SOLUTION FOR TREATING MINERAL ESTATES UNDER SECTION 170(h)

The relationship between section 170(h) and hydrocarbon exploration, including hydraulic fracturing, is fraught with ambiguity and uncertainty for several reasons. First, some of the environmental effects of mineral development seem to contradict the spirit of the section, suggesting that mineral development might fall outside the fuzzy safe harbor provided in the Regulations. Moreover, development activities such as drilling or mining are protected by state law, forcing surface owners to demand subordination of property rights in order to ensure tax-deductibility of their conservation easements. Additionally, the Code’s and Regulations’ specific mentions of mineral development and absolute ban on surface mining suggest that Congress and the IRS worried about mineral development without fully ensuring that their vision would be carried out successfully in everyday conservation easement transactions. These reasons combine to demonstrate that Code section 170(h) in its current form unsuccessfully regulates the surface landowner whose land might one day be the setting for oil and gas drilling done by modern, resource-intensive techniques: the limited, localized, and not irremediably destructive “test” under the Regulations is really not a test at all, providing no standard for mineral production activities and inhibiting surface owners from donating conservation easements to qualified organizations.

In order to ameliorate this problem, I propose a safe harbor addressing the IRS’s three stated concerns. A safe harbor for future mineral development must be based around the theory that tax benefits should only be available for properties on which drilling activities will be (1) limited; (2) localized; and (3) “not irremediably destructive of significant conservation interests.” My analysis of the environmental impacts of shale drilling will consist only of broad brushstrokes, focusing instead on what sort of tax result for both surface and mineral owner would be desirable and what, on the other hand, would produce an unacceptable result contrary to the overriding spirit of section 170(h).

A. A Provision Calling for Income Tax Deduction for Mineral Owners Will Increase Cooperation Among Landowners and Promote Conservation Easement Donations

A simple solution to the split estate problem is for the Code to encourage mineral interest owners to become partners in conservation easements, offering them conditioned tax breaks or deductions that will

61 See id.
62 See id.
incentivize cooperation among oil and gas producers, land trusts, and surface owners. I propose inserting a safe harbor in section 170(h) of the Code that provides the following:

(a) A deduction shall be allowed under this section for an owner of a qualified mineral interest that grants a qualified conservation organization the right to monitor and restrict mineral production activities that will destroy significant conservation interests. The owner of the qualified mineral interest and the owner of the surface of the relevant property do not have to be the same person or entity for a deduction under this subsection to be allowed.

(b) The amount of the allowable deduction under this section shall be rationally related to the additional burdens and obligations taken on by the owner of the qualified mineral interest and shall be determined by the Secretary.

The provision may also provide for restrictions on the amount of deduction allowable under that subsection and may provide additional standards that the IRS's regulations must take into account. Specifically, the provision ought to mention that the regulations should allow a deduction for a qualified mineral interest owner whose use of the land will substantially impair the conservation purposes of section 170(h). Once Congress decides what section 170(h) is ultimately about—wilderness, pollution, water quality, habitat, scenery, open space, historical property, carbon neutrality, or mere beauty (or some combination of these, or some set of entirely different values)—it may go about further regulating the deductibility of restrictions on the development of qualified mineral interests. For example, if the EPA chooses to regulate hydraulic fracturing under the Clean Water Act or some other authority, mineral owners' behavior under those permits might be used as a baseline for determining the value of any possible deduction or for determining whether or not hydraulic fracturing or other regulated drilling activities violate section 170(h) and does not merit an income tax deduction. Emphasis on clean air might provide an addition deduction for amounts spent on reducing air pollution beyond what state and federal environmental laws require. Moreover, activities that obviously conflict with conservation values—the destruction of protected habitats, for example, or of the historic aspects of property—may continue to be non-deductible, while standards such as well spacing and permissible levels of pollution may be regulated through the safe harbor. These provisions would not in any way disrupt the current statutory and regulatory regime, but rather would be layered on top of the current provision and regulations.

The practical effects of such a provision will be great, causing oil and gas producers who are otherwise indisposed to make concessions to surface owners and land trusts amenable to entering into three-party agreements with
them in order to reap the tax benefits of doing so. More importantly for the
continued success of the conservation easement deduction, such a provision
will advance the conservation purposes behind section 170(h) but will
recognize the economic undesirability and the legal impossibility of completely
disallowing mineral extraction. The Code already allows for such extraction,
but its implicit insistence that surface owners force mineral owners to
subordinate their property rights voluntarily is unrealistic and produces
unnecessary antagonism between two constituencies whose current relationship
is uncooperative, and whose interests are frequently adverse.63

There are several reasons why this proposed safe harbor makes sense
both for oil and gas developers and for surface owners. Surface owners benefit
by increased restrictions on drilling activity that would take place regardless of
federal tax law’s treatment of conservation easements: mineral extraction by
the subsurface owner on a split estate would not be chilled by reason of the
surface owner’s inability to take an income tax deduction as ceasing or limiting
the drilling’s impact would not accrue any benefits to the subsurface mineral
owner. Additionally, a governmental unit or 501(c)(3) non-profit, which has
strict requirements of public support, impartiality, and non-lobbying,64 must
sign off on the easement, providing a check on mineral developers’ power that
is already built into the statute. That is, not just any conservation easement may
receive federal tax benefits: there are already established procedures, sources of
law, and expectations built into qualified conservation contributions under
section 170(h) that will not be disturbed by the safe harbor I propose.

By imposing their own private, contract-based restrictions on
exploration and drilling activities, 501(c)(3) charities provide a large degree of
front-end incentivizing to owners of qualified mineral interests hoping to enjoy
the safe harbor’s tax benefits. They also buttress IRS administration and
compliance efforts by serving as an independent, arm’s-length transaction
participant with the easement donor. Seeking to maximize contractual
concessions made by the mineral owner through tax breaks is much more likely
than making mineral exploration impossible altogether, as this would only be
possible by abrogating the property rights or significantly strengthening
environmental laws. In other words, under the status quo, there are no negative
repercussions under the Internal Revenue Code for a mineral owner engaging
in drilling activities deemed by the IRS to fall outside the requirements of
section 170(h): instead, only the surface owner must worry about his deduction
being taken away by the IRS. Bringing mineral owners within the ambit of
section 170(h) will force them to meet substantive conservation standards under
the Code and to work with independent charitable conservation organizations in
an attempt to minimize drilling’s environmental impact and thereby achieve a

63 See supra notes 48–49 and accompanying text.
tax-favored result. As a party to a contract with the mineral owner, the land trust will also have contract rights that it may assert against a flagrant violator of the terms of the easement agreement. Any provision granting a mineral owner tax deductions should require that the charitable organization have rights of inspection of the property during mineral development, making compliance with the easement's terms more likely.

B. A Safe Harbor Would Promote Conservation Interests Better than the Status Quo

Providing a charitable deduction for responsible oil and gas drillers will also provide some amount of comfort to environmentalists concerned about environmental destruction in regions where shale gas drilling will occur. By restricting their activities above and beyond the degree required by state and federal environmental authorities, mineral developers are ensuring that the conservation interests championed by section 170(h) will be furthered. The areas where drilling activity is heavy are those that most need a legal device incentivizing responsible land-use planning. The safe harbor for drillers will ensure that drilling that would still otherwise occur will involve little permanent or widespread damage to surface property, historical interests, native flora and fauna habitats, open space, and scenic views, reducing the shale gas boom's potential for environmental destruction. Although providing an income tax deduction for contract and property restrictions and post-mining and -drilling mitigation and reclamation efforts does not accord with the general requirement under section 170 that partial interest deductions are not allowable, this proposal would fall under section 170(f)(3)'s exceptions to this general rule, qualifying such interests as qualified conservation contributions and therefore not wreaking havoc on the coherence of section 170 as a whole. Section 170(h)'s concern with conservation will be preserved by drillers' agreements to restrict the impact of their drilling activities within the scope of the new safe harbor through obligations imposed by contracts with qualified organizations.

C. A Safe Harbor Would Be Appropriate from the Standpoint of Federal Tax Law

Several possible approaches would produce both a favorable result from a conservational standpoint and from the Code's attempt to give

---

65 See also Douglas M. Humphrey, The "Interior" Revenue Service: The Tax Code as a Vehicle for Third-Party Enforcement of Conservation Easements, 37 B.C. ENVTL. AFF. L. REV. 425 (2010) (suggesting the IRS add a provision to section 170(h) allowing citizen suits that will provide an additional mechanism for enforcing conservation easements).
deductions based on the actual value of transactions that cause a taxpayer to incur an economic loss: (1) compensate for some portion of foregone profits due to decreased production, or (2) give a deduction tied to the amount of production from wells. In other words, the tax treatment will reflect that of the rest of section 170(h): compromises promoting significant conservation interests that entail something other than the owner’s full exercise of his or her property rights should be deductible in an amount that can be proven to equal the amount of economic value foregone by virtue of the voluntary restrictions (or additional costs) of promoting such conservation interests. Like the Code’s accelerated depreciation regime, however, in order to properly incentivize conservation activity, some slight divergence from economic reality may be necessary: for instance, 110% of the economic loss may be compensated for in tax savings, or the Code and Regulations may provide for a liberalized view of “economic loss” that includes transaction and marketing costs.\footnote{In the 1980s, Congress adopted an “accelerated cost recovery” system of depreciation which provides for depreciation deductions designed to be in excess of the probable decrease in fair market value of the property being depreciated. \textit{See} S. Rep. No. 144, 97th Cong., 1st Sess. 41 (1981) (explaining that accelerated depreciation methods were being adopted to simplify the more complicated then-existing depreciation methods, which did not provide “the investment stimulus that is essential for economic expansion”); \textit{see generally} I.R.C. §§ 167, 168 (2012) (allowing taxpayers to deduct an allowance for the wear and tear, exhaustion, and obsolescence of property used in a trade or business or held for the production of income).}

A safe harbor for drilling activities would also be in accord with some of the implicit concerns of section 170(h): irremediable, permanent topological changes wrought by development activities. This concern is best exemplified by the Regulations’ ban on surface mining. Oil and gas drilling, however, is finite in duration and does not involve significant alteration of the topography of the landscape being drilled. The inputs and impacts of actual drilling activities last only a bit longer than the activities themselves. This suggests that either a similar deduction for mineral developers—or at least a provision that drilling activities are \textit{per se} not irremediably destructive of significant conservation interests—is appropriate under current law.

Section 170(h)’s status as a conspicuous exception to the general rule prohibiting partial interests in property to qualify as charitable donations also justifies this otherwise anomalous approach to rewarding mineral owners. The conservation easement rule is a rare instance of the Code’s granting of a charitable contribution deduction to a taxpayer who has donated less than a full interest in his or her property, most likely due to the considerable substantive standards that section 170(h) imposes on owners seeking to deduct a conservation easement donation, which ensures that partial interest gifts are not being abused such that no real restriction of use occurs after the donation.

As the safe harbor proposed in this Article would create similar substantive standards for mineral developers, forcing them to conduct their
drilling in ways not inconsistent with the conservation purposes of section 170(h), these partial gifts, whether measured in property right restrictions or by the additional costs of post-drilling reclamation and mitigation, is similarly deserving of a charitable deduction under section 170. The land trust and the mineral owner could each submit estimates of compliance and reclamation costs and come to an agreed-upon value of the foregone extraction activities and the additional reclamation costs. Furthermore, the safe harbor will only permit a deduction for additional costs and foregone revenues that can be substantiated with certainty and which can be proved to advance the conservation interests detailed by section 170(h). While the question of how other similar incomplete property and contract rights should be treated under the Code is outside the scope of this Article, allowing mineral owners a deduction for the voluntary restrictions and forbearances that promote the statutorily-provided conservation interests comports with section 170(h) as a whole.

IV. CONCLUSION

Section 170(h)’s treatment of mineral development does not do enough to incentivize the donation of conservation easements where a split estate exists on the relevant property. In this Article I have proposed a balanced, reality-based, and mutually beneficial safe harbor applicable to estates where future mineral development is likely. It will allow mineral owners to participate in the tax benefits of section 170(h) by being third parties to qualified conservation contributions by surface owners or through bilateral agreements with qualifying charitable organizations. The safe harbor should provide substantive environmental, aesthetic, and conservational standards that will give concrete meaning to the Regulations’ requirement that drilling activities be localized, limited, and “not irremediably destructive of significant conservation interests.” Such a safe harbor aligns with the remainder of section 170, subsection 170(h), and the Code in general by allowing a deduction or credit only to the extent of the foregone economic gain or some other amount rationally related to the drilling’s damage of the property. Adopting this provision would yield significant non-tax benefits as well, promoting cooperation among adverse stakeholders and leading to greater conservation activity among landowners. It would provide economic benefits to the interested private parties without unduly hampering the federal government’s ability to raise revenue. At this critical time, as the nation begins to drill for shale gas and oil on a large scale, a simple tax provision may relieve many of the worries of the nation’s surface owners and conservation organizations. While the precise contours of IRS guidance may depend on its analysis of the

threats posed by hydraulic fracturing or other gas drilling to conservation interests, what is clear is that by failing to revisit section 170(h), drilling on these properties will continue apace, and Congress and the IRS will not have fulfilled the Code’s commitment to advancing conservation, responsible land development, and natural beauty. By finally aligning the tax goals of the mineral and surface owners on split estates, Congress and the IRS will ensure the responsible production of minerals located below properties eligible for the section 170(h) conservation easement deduction.