“Federal Tax Deductibility of Water Right Donations”
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Federal Tax Deductibility of Water Right Donations

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30x30
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Presentation Goals
1. Educate participants concerning the donation of appropriative water rights, including the deductibility of entire and partial interests for conservation purposes.
2. Discuss the use of donated water rights to further conservation values, including transactional issues and alternatives.
3. Inform participants of efforts to resolve legal questions about the deductibility of donated water rights.
4. Identify common opportunities for conservation professionals to engage with water right issues.

Background
“Can you donate an appropriative water right for a tax deduction?” – Huey Johnson – founder of the Trust for Public Land, former Secretary California Resources Agency

“Entire Interest”, or:
Three “partial interest” deductions:
1. Contribution of a remainder interest in a personal residence or farm;
2. Contribution of an undivided portion of the taxpayer’s entire interest in property, and;
3. A qualified conservation contribution.

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Peter Nichols, Berg, Hill, Greenleaf, Ruscitti LLP, Colorado
Bill Silberstein, Kaplan Kirsch & Rockwell LLP, Colorado
Bill Hutton, Coblentz, Patch, Duffy & Bass, California

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What is a Donation?

Fair Market Value – Cash Sale = “Bargain Sale Donation”

$1,000,000 - $750,000 = $250,000 (donation)

FMV - $0.00 (no cash) = “Outright Donation”

$1,000,000 - $0.00 = $1,000,000 (donation or gift or charitable contribution)

Gifts of $5,000 or more trigger IRS Form 8283 (Qualified Appraisal)

Donative Project Opportunities

Examples of project types:

- Water Transactions
  - Purchase or long-term transfer of water from a willing seller
  - Water rights instream dedication to instream flow
  - Forbearance agreements
  - Conservation easements

Water Law in the Watershed

A Revenue Ruling is the “gold standard in tax-payer guidance from the IRS most broadly applicable to all U.S. taxpayers.

Distinguished from the narrower "Private Letter Ruling" applicable to an individual taxpayer.

What is a Revenue Ruling?

I.R.C. § 170(f)(3) Deductions for Contributions of Partial Interests in Property

Generally, under Internal Revenue Code (I.R.C.) § 170(f)(3) deductions for contributions of partial interests in property are disallowed unless an express exception applies.

(B) Exceptions.—Subparagraph (A) shall not apply to—

(i) a contribution of a remainder interest in a personal residence or farm,
(ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and
(iii) a qualified conservation contribution.


Legal Focus: Narrow Scope

- The Request does not concern a gift of either:
  - a remainder interest in an appropriative water right under I.R.C. § 170(f)(3)(B)(i)
  - a qualified conservation contribution of the qualified real property interest in an appropriative water right to a qualified organization given exclusively for conservation purposes in perpetuity under I.R.C. § 170(f)(3)(B)(iii) and I.R.C. § 170(h).
- The Request does not concern gifts of riparian rights or groundwater rights.
Revenue Ruling Focus: Entire Interest

Threshold Question #1: A gift of taxpayer’s entire interest in an Appropriative Water Right to an organization described in § 170(c) qualifies for a charitable deduction under § 170(a).

For example, a taxpayer owns the right to divert two cubic feet per second of water from a stream for taxpayer’s use. Taxpayer makes a gift of this water right to an organization described in § 170(c). This qualifies as a charitable deduction under § 170(a).

Seventeen western states have adopted appropriative water rights systems: Oregon, Washington, Idaho, Montana, Wyoming, Colorado, New Mexico, Arizona, Nevada, Utah, California, North Dakota, South Dakota, Nebraska, Kansas, Oklahoma, and Texas.

Colorado and other pure appropriative right states have rejected riparian right systems altogether, choosing instead to recognize only rights gained by prior appropriation:

“Use it or lose it” & “First in time, first in right”

California is a hybrid of both riparian and appropriative rights.

Revenue Ruling Focus: Partial Interest

Question #2: A gift of an undivided portion of a taxpayer’s entire interest in an Appropriative Water Right to an organization described in § 170(c) qualifies for a charitable deduction under § 170(a).

For example, a taxpayer owns the right to divert two cubic feet per second of water from a stream for taxpayer’s use. Taxpayer makes a gift of a fifty percent undivided interest of this right to an organization described in § 170(c). The taxpayer has conveyed a fraction or percentage of each and every interest or right owned by the taxpayer in such property. The taxpayer has not retained any right, not even an insubstantial right, in the property conveyed. This qualifies as a charitable deduction under § 170(a).


- **Scenario**: Owner owns an entire interest in an appropriative water right. Owner makes a charitable contribution of an undivided 50% interest in his/her appropriative water right to an organization described in I.R.C. § 170(c).
- **Donor permanently transfers all his/her interest in the 50% undivided interest in the appropriative right to the donee.
- **Owner maintains and retains an unencumbered interest in the remaining 50% interest in his/her appropriative water right.
- **Deductible.**
Convergence with Federal Initiatives: "30 x 30"

- The Biden Administration seeks to conserve at least 30% of land and water in the United States by 2030 to confront the threats of climate change and biodiversity loss.
- Protecting, enhancing, and restoring stream and river flows in the West is a key element of preserving biodiversity and providing for climate resiliency.

Land and Water Conservation Fund (LWCF)

- Permanent annual federal appropriation of $900 million with $360 million for conservation acquisitions;
- The scale of the LWCF fund will likely implicate western water rights worth hundreds of millions of federal tax dollars over time;
- A charitable donation or bargain sale of appropriative water rights combined with LWCF funding would extend the impact of LWCF project funding;
- Magnifies the impact and importance of an IRS Revenue Ruling.
Federal Tax Policy and Agencies

1. Federal Tax Policy thru Revenue Ruling
2. Transactional: western states with appropriative water rights

Western States Water Transactions

Donated Entire Interest: National Precedent

On Thursday, August 17, 2017, a formal ceremony brought Trout Unlimited, Kinross Gold, Inc., and the Rocky Mountain Elk Foundation together to celebrate two conservation transactions that included:
(1) a donated conservation easement on the fee interest from Kinross to RMEF; and
(2) an “outright donation” of the Jardine Mine water right from Kinross to TU.
The conclusions of the Water Rights Due Diligence:

1. **Pine Creek Water Right**: Evidence supported protection of the Pine Creek water right with up to 2.5 cfs of consumptive use from April 1 - August 31, and 1.4 cfs from September 1 – March 31, with a volume of up to 1,345 acre-feet.

2. **Bear Creek Water Right #1**: Evidence supported protection of Bear Creek's contribution to 4.0 cfs of consumptive use with a volume of 1,079 acre-feet.

3. **Bear Creek Water Right #2**: Evidence supported protection of up to 10 cfs of non-consumptive use based on historic mine hydropower production, relying on the Bear Creek water right of up to 6,404.0 acre-feet.

4. **Valuation of the donation**: Valuation was based on the aggregate total of approximately 8,828 acre-feet of protected volume, or approximately 2.88 billion gallons of water.

5. **The proposed protected reach**: The proposed protected reach will extend from the upstream-most point of diversion on Bear Creek and Pine Creek to their confluence with the Yellowstone River and beyond.
Permanent Forbearance or Fractional Use Agreements

- To qualify for a federal tax deduction the water right owner must permanently relinquish a fractional or partial interest in an appropriative water right.
- Fractional Use Agreements can be considered an evolutionary progression of and are permanent Forbearance Agreements.
- Bargain sale transactions (that have both cash and donative components) or outright donations of a partial right can be structured for:
  1. full temporal use and limited quantity, e.g. April 1 - October 15 and 25% of the total water diversion; or
  2. limited temporal use of the entire quantity, e.g. August 1 - October 15 and 100% of the total water diversion; or
  3. limited temporal use and limited quantity, e.g. August 1 - October 15 for 25% of the total water diversion.

Distinctions Between Permanent Forbearance Agreements and Conservation Easements

- Exclusive focus on gift of the real property interest pursuant to state law, measured as the fractional reduction of the full right of diversion, at the time of the gift.
- Not contingent upon the secondary state administrative transfer of the water right to an instream fish and wildlife reasonable and beneficial use or other conservation purposes, which can take years.
- The burden of monitoring a non-diversion in perpetuity is an obligation that should not casually be taken on by private, non-profit, or public entities.
- The difficulty of attaching an "exclusively conservation purpose" in perpetuity to a particular right, which may accomplish multiple municipal, environmental or agricultural beneficial uses as water flows downstream.

Drafting Guidance: Permanent Forbearance Agreements

- Separate real property interest.
- Permanent Term.
- Fraction or percentage of each and every substantial interest.
- No Retained Substantial Interest.
- Right of possession, dominion and control.
- Time of accrual of right of deduction.
- Perpetual Nature of Appropriative Water Right.
- Retained Uses of Water Right.
- Deductible

Entire and Partial Interests

- A partial interest is any interest in property that consists of less than the donor’s entire interest in the property.
- If a donor who owns property outright transfers every right and interest that the donor has in the property to a permissible donee, the issue of a partial interest does not arise.
- If a donor retains some right or interest or control over donated property, there is potential the deduction will be disallowed because the donee only received a partial interest.

Scenarios: Entire Interests

Scenario 1: Taxpayer and water right owner (Donor) owns an entire interest in an appropriative water right. Donor makes a permanent gift of her entire interest in the water right to a charitable organization described in I.R.C. § 170(c).

Deductible as a charitable contribution.

Scenario 2: Donor owns an entire interest in an appropriative water right. Donor makes a gift for a term (e.g., this year only, five-ten-twenty years) of an undivided 100% interest in her appropriative water right to an organization described in I.R.C. § 170(c).

The terms of the gift provide that the Donor retains the reversionary interest in the entirety of the donated portion of the appropriative water right.

Non-Deductible because the Donor retains a substantial interest in the donated property.
Scenarios: Entire Interests

Scenario 3: Donor owns an entire interest in an appropriative water right. Donor leases for a term (e.g., this year only, five-ten-twenty years) an undivided 100% interest in her appropriative water right to an organization described in I.R.C. § 170(c). The terms of the gift provide that Donor retains the reversionary interest in the entirety of the leased portion of the appropriative water right.

Non-Deductible because a lease is not a gift or a charitable contribution.

Scenarios: Partial Interests

Scenario 4: Donor owns an entire interest in an appropriative water right. Donor makes a permanent gift of an undivided 50% interest in her appropriative water right to an organization described in I.R.C. § 170(c). Donor retains an insubstantial interest and permanently transfers all her interest in the 50% undivided interest in the appropriative right to the donee. Donor maintains and retains the entirety of the ownership interest in the remaining 50% interest in his/her appropriative water right.

Deductible as a charitable contribution.

Scenarios: Partial Interests

Scenario 5: Donor owns an entire interest in an appropriative water right. Donor makes a gift for a term (e.g., this year only, five-ten-twenty years) of an undivided 50% interest in her appropriative water right to an organization described in I.R.C. § 170(c). The terms of the gift provide that the Donor retains the reversionary interest in the entirety of the donated portion of the appropriative water right. Donor maintains and retains the ownership interest in the remaining 50% interest in his/her appropriative water right.

Non-Deductible because the Donor retains a substantial interest in the donated property.

Scenarios: Partial Interests

Scenario 6: Donor owns an entire interest in an appropriative water right. Donor leases for a term (e.g., this year only, five-ten-twenty years) an undivided 50% interest in her appropriative water right to an organization described in I.R.C. § 170(c). The terms of the gift provide that the Donor fully retains the reversionary interest in the leased portion of the appropriative water right. Donor maintains and retains the ownership interest in the remaining 50% interest in his/her appropriative water right.

Non-Deductible because a lease is not a gift or a charitable contribution.

Temporary: Forbearance Agreement

- Simply a contract between a landowner/water user and a local land trust or water trust (or other entity)
- Water user agrees to forego withdrawal of water pursuant to the terms and conditions set forth in the contract.
- The main advantage of a forbearance agreement is its simplicity and efficiency, as the terms of the agreement can be structured to fit the needs of the parties.
- Often, the key term is seasonal (not year-round) forbearance from withdrawing water. That is, the landowners retain the right to withdraw water during the wetter or higher-flow seasons, but give up the right to withdraw water during the dry season when flows are critically low.
- Forbearance Agreements are not permanent. They typically extend for a term of years agreed to by the parties.
- Non-deductible.
Conservation Easements and IRC 170(h)

The Request does not concern a gift of a qualified conservation contribution of the qualified real property interest in an appropriative water right to a qualified organization given exclusively for conservation purposes in perpetuity under I.R.C. § 170(f)(3)(B)(iii) and I.R.C. § 170(h).

I.R.C. § 170(h): Qualified Conservation Contribution

The I.R.S. provides income tax and estate tax deductions for a qualified conservation contribution:

- of a qualified real property interest;
- to a qualified organization; and
- donated exclusively for conservation purposes.

I.R.C. § 170(h)(2): Easement must be a Qualified Real Property Interest

A qualified real property interest is any of the following interests in real property:

1. The entire interest of the donor other than qualified mineral interest;
2. A remainder interest; and
3. A restriction (granted in perpetuity) on the use which may be made of the real property.

State Defined Property Right

- Conservation easements are negotiated, voluntary agreements to permanently restrict an otherwise full right of future, potential uses of the real property interest, e.g. subdivision, commercial development, etc., enforceable under state law.

I.R.C. § 170(h)(3): Easement must be given to a qualified organization

- A qualified conservation contribution of the qualified real property interest in an appropriative water right must be permanently dedicated to either:
  - A government unit or
  - A publicly supported 501(c)(3) charitable organization or
  - Both.

Local Cooperative Agreement

A “Coordinating Entity” is an entity with the expertise and the ability to evaluate and require performance of the agreement, for example with the California Department of Fish and Wildlife, the National Marine Fisheries Service, the Scott Valley and Shasta Valley Watermaster District, a nonprofit organization with expertise and experience in water-saving transactions, or similar qualified entity.
I.R.C. § 170(h)(4)-(5): Easement must be donated exclusively for "conservation purposes"

- The qualified conservation contribution of the qualified real property interest in an appropriative water right permanently dedicated to a qualified organization is donated for conservation purposes when it will:
  - (1) preserve land areas for outdoor recreation by, or the education of, the general public;
  - (2) protect a relatively natural habitat of fish, wildlife, or plants or similar ecosystem; or
  - (3) preserve open space.

Perpetuity

- The conservation purpose must be protected in perpetuity.

I.R.C. § 170(h)(4)(A)(i): Outdoor Recreation or Education

- The preservation of a water area for the use of the public for boating or fishing is a conservation purpose.
- The preservation of a land area [or an instream appropriative right, e.g. river] will not meet the conservation purposes test unless the recreation or education is for the substantial and regular use of the general public.

I.R.C. § 170(h)(4)(A)(ii): Relatively Natural Habitat/Protection of Environmental System

- The protection of a relatively natural habitat of fish is a conservation purpose.
- Significant habitats or ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of fish.
- The donated property must contribute to the ecological viability of a local, state, or national park or other conservation area or otherwise represent a high quality aquatic ecosystem.
- The fact that habitat has been altered to some extent by human activities will not result in a denial of a deduction if fish continue to exist in a relatively natural state.


- The preservation of open space (including farmland or forest land) qualifies where such preservation is
  - (I) for the scenic enjoyment of the enjoyment of the public, or
  - (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit.

- The preservation of open space for the scenic enjoyment of the public is a conservation purpose.
- Preservation may be for scenic enjoyment if development would impair the scenic character of the landscape or significantly interfere with the "scenic panorama" that could be enjoyed from a road, waterbody or transportation way utilized by the public.
- Regional variations require flexibility in the application of the scenic enjoyment test, which balances and evaluates different scenic factors.


- The preservation of open space pursuant to clearly delineated governmental conservation policy that states it is in the public interest to preserve a certain type of property is a conservation purpose.

TU Resources #1

- Model Forbearance Agreements: TU has west wide split season lease examples and continues to refine a multi-state Model Permanent Forbearance Agreement for permanent forbearance and non-diversion of a water right for instream use for—typically—just the second half of an irrigation season when low stream flows are most critical. TU is working to advance the familiarity and use of temporary and permanent seasonal use agreements by conservation professionals.

TU Resources #2

- Tax Deductible Donative Transactions: TU can coordinate and provide appropriate assistance to conservation professionals and/or water right donors so as to promote use of federal tax deductions to incentivize water right donations.
- Together, TU and partners can expand capacity to generate new conservation transactions - easements, fee simple acquisitions, temporary leases, and donations which receive a federal tax deduction.

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