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**BY EMAIL & FIRST CLASS**

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**RE: Trout Unlimited IRS Revenue Ruling and 2021-22 Priority Guidance Plan**
**Federal Tax Deductibility of Gifts of Water Rights**

Dear Associate Chief Counsel:

On behalf of Trout Unlimited, this letter is submitted to request a Revenue Ruling to confirm that a gift of a taxpayer's entire interest in an Appropriative Water Right, and the gift of an undivided portion of a taxpayer's entire interest in an Appropriative Water Right, to an organization described in § 170(c) of the Internal Revenue Code (the "Code") qualifies for a charitable deduction under § 170(a).[1]

**BACKGROUND**

This 2021-22 Revenue Ruling request follows up on an identical request (Request) submitted by Trout Unlimited, Resource Renewal Institute, and other public interest organizations dated October 30, 2012.

On August 15, 2016, the U.S. Department of the Treasury 2016-2017 Priority Guidance Plan included under its "GENERAL TAX ISSUES" section at page 12 the following: "22. Guidance under §170 regarding charitable contributions of appropriative water rights."

TU has, in the years since, followed up with the IRS Office of Chief Counsel to clarify the status of the Request. While on the IRS 2016-17 Priority Guidance List, the Request has never been issued nor categorically denied, nor delisted or inactive. Instead, it appears to have been tracked among a breadth of IRS and Treasury officials, yet remains idle.

TU sees these immediate opportunities to issue an IRS Revenue Ruling:

1) 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 (see attached Conserving and Restoring America the Beautiful (2021) report). Protecting and

[1] Hereinafter, all section references refer to the Code unless otherwise noted.

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restoring stream and river flows in the West is a key element of preserving biodiversity and providing for climate resilience.

2) The 2020 passage of the Land and Water Conservation Fund (LWCF) with a permanent annual federal appropriation of $900 million with $360 million for conservation acquisitions magnifies the opportunity to push for an IRS Revenue Ruling. A charitable donation or bargain sale of appropriative water rights combined with LWCF funding would extend the impact of LWCF project funding. The scale of the LWCF fund will likely implicate western water rights worth tens of millions of federal tax dollars over time.

There is a substantial and overwhelming need for written guidance on these questions because the lack of written guidance is inhibiting donations of Appropriative Water Rights for charitable purposes. As explained below, Appropriative Water Rights are prevalent in the Western United States, and it is increasingly important now, in times of climate change and drought, to obtain clarity regarding these questions.

Trout Unlimited is the lead applicant of a coalition of charitable organizations requesting this Revenue Ruling. Many state agencies are interested in obtaining formal clarification with regard to these gifts for the purpose of administering their programs. Accompanying this request is a letter from numerous charitable organizations and state agencies indicating their interest in obtaining written guidance.

## A. RULING REQUESTED

**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).

**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).

## B. SUMMARY OF REVENUE RULING REQUEST

The donation of an Appropriative Water Right is eligible for a charitable contribution deduction under § 170(a) because it is the gift of an entire—not partial—interest in property. Likewise, the donation of an undivided portion of a taxpayer's interest in an Appropriative Water Right is also eligible for the deduction under § 170(a) because it is the gift of an undivided portion of a taxpayer's entire interest in the property. The fundamental nature of Appropriative Water Rights as whole, independent interests is supported by three lines of legal authority: (1) binding case law from the U.S. Supreme Court, the Colorado Supreme Court and other state supreme courts; (2) the distinction between Appropriative Water Rights and the partial interests discussed in Revenue Ruling 88-37 and General Counsel Memorandum No. 39729; and (3) the legal characteristics of the doctrine of prior appropriation, especially in contrast to the riparian doctrine.

First, the U.S. Supreme Court has held that state law, as articulated by a state's highest court, is controlling on issues regarding the nature of property that are determinative of federal tax outcomes. *Comm'r of Internal Revenue v. Bosch*, 387 U.S. 456, 465 (1967). Here, the issue of whether an Appropriative Water Right is a whole, independent and separate property right is determinative of eligibility for a federal deduction. On this issue, several states' high courts have spoken. For example, the Colorado Supreme Court has declared repeatedly and plainly that an Appropriative Water Right "is a property right separate and apart from the land on which it is used." *Nielson v. Newmyer*, 228 P.2d 456, 458 (Colo. 1951). The high courts of other Western states that have Appropriative Water Rights have also issued similar holdings.[2] Thus,

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[2] For example, in Montana, "[o]ne who has appropriated water . . . acquires a distinct property right; this water right is a species of property in and of itself . . . ." *Harrer v. N. Pac. Ry. Co.*, 410 P.2d 713, 715 (Mont. 1966). Water rights are considered property of the "highest order." *Id.* These concepts are so established and self-evident that they "require no citation of authority." *Id.*

In Nevada, "[w]hen a right to use water has become fixed either by actual diversion and application to beneficial use or by appropriation as authorized by the stat[e] water law, it is a right which is regarded and protected as real property." *Carson City v. Estate of Lompa*, 501 P.2d 662, 662 (Nev. 1972) (citing *In re Application of Filippini*, 202 P.2d 535 (Nev. 1949); *Nenzel v. Rochester Silver Corporation*, 259 P. 632 (Nev. 1927); *Adams-McGill Co. v. Hendrix*, 22 F. Supp. 789, 791 (D. Nev. 1938); *Dalton v. Bowker*, 8 Nev. 190, 201 (Nev. 1873)).

In New Mexico, "[t]he prior appropriation doctrine governs . . . ." *Walker v. United States*, 162 P.3d 882, 888 (N.M. 2007) (citing N.M. Const. art. XVI, § 2) (citations omitted). Under this doctrine, "the right to use water is considered a property right which is separate and distinct from ownership of the land." *Id.* (citations omitted). "A water right is separate and distinct from a right to adjacent land because it is derived not from the rights in the land, but 'from appropriation for beneficial use.'" *Id.* (citing *Olson v. H & B Props., Inc.*, 882 P.2d 536, 539 (N.M. 1994)).

In California, "an appropriative right is the right to take water from a watercourse that does not run adjacent to a landowner's property." *Cal. Farm Bureau Fed'n v. State Water Res. Control Bd.*, 247 P.3d 112, 118 (Cal. 2011), *as modified* (Apr. 20, 2011), *reh'g denied* (Apr. 20, 2011).

the IRS must adhere to state law and the state high courts' holdings that Appropriative Water Rights are separate and distinct whole property rights, independent of the land on which they are used.

Second, Appropriative Water Rights are distinct from the partial interests discussed in Revenue Ruling 88-37 and General Counsel Memorandum No. 39729, which interests were "carved out" from the fee title to land. Appropriative Water Rights originate entirely independently of fee title to land through diversion and beneficial use, and they are never "carved out" of a larger interest, such as fee title to land.

Third, the legal principles underlying Appropriative Water Rights reveal that such rights are whole, independent property rights. This is particularly apparent when comparing them with riparian water rights that are prevalent in the Eastern United States. Whereas riparian rights are inherently part of the land and inseparable such that riparian rights automatically pass with ownership of the land, Appropriative Water Rights are separately alienable.

An Appropriative Water Right is an independent and whole interest in property, which can be donated separately from the land upon which it is used and is therefore eligible for a charitable deduction. Additionally, when a taxpayer makes a gift of an undivided portion of an Appropriative Water Right, this donation is also eligible for a charitable deduction because 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 in the property conveyed.

## C. DEFINITION OF AN APPROPRIATIVE WATER RIGHT

An Appropriative Water Right is a whole, independent property right that is entirely separate from the land upon which it is used in Alaska, Arizona, California, Colorado, Idaho, Kansas, Montana, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, and Wyoming. JOSEPH L. SAX ET AL., LEGAL CONTROL OF WATER RESOURCES: CASES AND MATERIALS 111 (3d ed. 2000) ("SAX, ET AL."). An Appropriative Water Right gives its owner the right to divert a specific amount of water from a given water source. For example, an appropriative water right typically confers on its owner the right to divert and beneficially use a defined quantity of water from a particular river or stream.

The origin of title to an Appropriative Water Right is the appropriator's act of placing water, theretofore unappropriated, to the appropriator's beneficial use. Confirmation of title may be

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In Oregon, a water right becomes a protected property right upon appropriation for domestic, mining, irrigation, or other purposes. *Dry Gulch Ditch Co. v. Hutton*, 133 P.2d 601, 607, 610 (Or. 1943) (citing *Mattis v. Hosmer*, 62 P. 17, 19 (Or. 1900)).

obtained by means of a court decree or a state administrative action. The Appropriative Water Right "estate" and the "estate" of fee simple title to the land on which the water is used may coexist by virtue of ownership by the same owner. However, the estates of the Water Right and fee simple title to the land arise independently and separately and never merge. The Appropriative Water Right retains its identity as separate property and never becomes part of the fee simple interest in land. This is a fundamental distinction from a riparian water right which is a partial interest in land. An Appropriative Water Right is separate property that can be sold and conveyed separately from the land on which it is used.

This request for a Revenue Ruling pertains only to gifts of water *rights*. This request does not include the donation of water itself, such as water in bottles or barrels.

## D. STATEMENT OF LAW

### 1. Statutes and Regulations

Section 170(a) provides, subject to certain limitations, a deduction for any charitable contribution (as defined in subsection (c)), payment of which is made within the taxable year. Section 1.170A-1(c)(1) of the Income Tax Regulations ("Regulations") provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property, reduced as provided in § 170(e).

Section 170(f)(3) denies a charitable contribution deduction for certain contributions of partial interests in property. Section 170(f)(3)(A) provides that no charitable deduction is allowed for a contribution of less than the taxpayer's entire interest in property unless the value of the interest contributed would have been allowed as a deduction under § 170(f)(2) had it been transferred in trust.

By its terms, § 170(f)(3)(A) does not apply to a contribution of an interest that, even though partial, is the taxpayer's entire interest in the property. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid § 170(f)(3)(A), a deduction is not allowed. Regulations, § 1.170A-7(a)(2)(i).

Section 170(f)(3)(B)(ii) of the Code and § 1.170A-7(b) of the Regulations provide that a deduction is allowed under § 170 for a contribution not in trust of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest. An undivided portion of the donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property. A charitable contribution in perpetuity of an interest in property not in trust will not be considered a contribution of an undivided portion if the donor transfers some specific rights and retains other substantial rights.

In enacting § 170(f)(3), Congress was concerned with situations in which taxpayers might obtain a double benefit by taking a deduction for the present value of a contributed interest while also excluding from income subsequent receipts from the donated interest. In addition, Congress was concerned with situations in which, because the charity does not obtain all or an undivided portion of the significant rights in the property, the amount of a charitable contribution deduction might not correspond to the value of the benefit ultimately received by the charity. The legislative solution was to guard against the possibility that such problems might arise by denying a deduction in situations involving partial interests unless the donation is cash in certain prescribed forms. *See* H.R. Rep. No. 91-413, 91st Cong., 1st Sess., 57-58 (1969), 1969-3 C.B. 200, 237; S. Rep. No. 91-552, 91st cong., 1st Sess. 87 (1969), 1969-3 C.B. 423, 479.

### 2. IRS Guidance

The Revenue Rulings, Private Letter Rulings, and General Counsel Memorandum summarized in this section evidence the IRS's position with regards to charitable contribution deductions of partial interests, as well as the nature of water rights as separate property rights.

#### a. Revenue Ruling 88-37 and General Counsel Memorandum No. 39729

The IRS has expressed concern with the donation of partial interests because they may subvert the purposes of the charitable deduction. In Revenue Ruling 88-37, the IRS denied a charitable contribution deduction under § 170(a) for the gift of an overriding royalty interest or a net profits interest by the owner of a working interest under an oil and gas lease. The IRS determined that while the donated interests were freely transferable, they were "carved out" of a larger working interest property right, making them non-deductible partial interests. The principles articulated in the Revenue Ruling were also discussed in a 1988 General Counsel Memorandum No. 39729 (GCM).

In both the Revenue Ruling and the GCM, the IRS expressed its particular concern for adhering to the legislative purposes of the 1969 Tax Act: (1) to prevent taxpayers from obtaining a double benefit by taking a deduction for the present value of the contributed interest while excluding from income subsequent receipts of that donated interest; and (2) to avoid a mismatch in the amount of a charitable contribution deduction and the benefit ultimately received by the charity that might be caused by the charity not receiving the entire interest. *See also* H.R. Rep. No. 91-413, 91st Cong., 1st Sess., 57-58 (1969), 1969-3 C.B. 200, 237; S. Rep. No. 91-552, 91st cong., 1st Sess. 87 (1969), 1969-3 C.B. 423, 479.

#### b. Revenue Ruling 55-749 and Private Letter Ruling 2004-04044

The IRS has recognized that water rights are independent property rights that are comparable to fee simple interests. In Revenue Ruling 55-749, the IRS ruled that the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of like-kind property

within the meaning of § 1031. The fee interest in land was exchanged for perpetual water rights considered comparable property rights under the applicable state law. Revenue Ruling 55-749 states that "where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of property of like kind within the meaning of [§] 1031(a)."

In Private Letter Ruling 2004-04044, the IRS also ruled that an exchange of water rights for a fee interest in farm land qualified as a tax deferred exchange of like-kind property under § 1031. The taxpayer's water rights were a perpetual interest in real property under applicable law and were distinguished from the water rights in *Wiechens v. United States*, 288 F. Supp. 2d 1080 (D. Ariz. 2002), which were not Appropriative Water Rights.[3]

**3. Binding Case Law**

The United States Supreme Court's decision in *Comm'r of Internal Revenue v. Bosch*, 387 U.S. 456 (1967), instructs that where federal tax liability turns on the character of a property interest held and transferred under state law, "the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." *Id.* at 465. In another case, the Court further explained that

> [w]hether the interests . . . constitute[] "property and rights to property" for the purposes of the federal tax lien statute . . . is ultimately a question of federal law. The answer to this federal question, however, largely depends upon state law. The federal tax lien statute itself "creates no property rights but merely attaches consequences, federally defined, to rights created under state law."

*United States v. Craft*, 535 U.S. 274, 278 (2002) (citing *United States v. Bess*, 357 U.S. 51, 55 (1958); *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722 (1985)). *See also Bd. of Regents of State Coll. v. Roth*, 408 U.S. 564, 577 (1972) ("Property interests, of course, are not created by the Constitution. Rather they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state-law rules . . .")

[3] In *Wiechens*, the District Court found that because the taxpayer's water rights were narrowly restricted in priority, quantity, and duration, although the taxpayer's water rights constituted an interest in real property, the water rights were not sufficiently similar to the fee simple interest that it acquired in the farm land to qualify as like-kind property within the meaning of § 1031. The water rights in that case were contractual, not perpetual, and were not Appropriative Water Rights.

Accordingly, states define the nature of their own water rights, and the IRS must follow the state supreme court decisions that interpret appropriative water rights as "entire," "separate," "severable," or "transferable" property interests. For example, the Colorado Supreme Court has declared repeatedly and plainly that a "water right is a property right separate and apart from the land on which it is used." *Nielson*, 228 P.2d at 458. Indeed, "[i]t is elementary learning in Colorado that a water priority is a property right—not a mere revocable privilege . . . ." *Brighton Ditch Co. v. City of Englewood*, 237 P.2d 116, 120 (Colo. 1951). In short, the Colorado Supreme Court has recognized that Appropriative Water Rights are separate and distinct property interests, independent of the land on which they are used. *See also* JAMES N. CORBRIDGE & TERESA A. RICE, VRANESH'S COLORADO WATER LAW 31 (1999) ("[An Appropriative Water Right] is a property right with inherent incidents of ownership that can be sold independent of land.").

## E. ANALYSIS

There is a substantial and overwhelming need for the IRS to clarify and affirm the federal tax deductibility of gifts of entire and undivided portions of Appropriative Water Rights. In the absence of formal and clarifying administrative guidance, taxpayers are reluctant to donate Appropriative Water Rights because they are concerned that the IRS will not view these as eligible for deduction under § 170(a).

Based on the statutes, regulations, IRS guidance, and case law set out above, as well as the historical and contemporary information set out below, it is clear that an Appropriative Water Right is an independent whole property right, separate from the land on which it is used, and not a partial interest. Thus, a gift of an Appropriative Water Right does not violate the prohibition on deductions for partial interests set forth in § 170(f)(3)(A). Likewise, a gift of an undivided portion of an Appropriative Water Right complies with the requirements of § 170(f)(3)(B)(ii) because it is a conveyance of every substantial interest or right of the donor, and the donor does not retain substantial rights to the donated property.

### 1. Case Law Analysis

In *Bosch*, the U. S. Supreme Court held that a state's highest court is the final authority on questions of the character of property that are determinative of federal tax consequences. 387 U.S. at 465. Furthermore, the Tenth Amendment of the U.S. Constitution reserves to the States all powers not expressly delegated to the Federal Government, which includes the right to regulate, allocate, and distribute water. In the leading case *California Oregon Power Co. v. Beaver Portland Cement Co*., the U.S. Supreme Court held that after 1877, "all nonnavigable [sic] waters then a part of the public domain became *publici juris*, subject to the plenary control of the designated states . . . ." 295 U.S. 142, 164–65 (1935). The Court recognizes that "[e]very State is free to change its laws governing riparian ownership and to permit the appropriation of flowing waters for such purposes as it may deem wise." *Connecticut v. Massachusetts*, 282 U.S.

660, 670 (1931) (citing *United States v. Rio Grande Dam & Irrigation Co.*, 174 U.S. 690, 702 (1899)). Specifically, the Court has held that every state "may determine for itself whether the common-law rule in respect to riparian rights or that doctrine . . . of the appropriation of waters . . . shall control." *Kansas v. Colorado*, 206 U.S. 46, 94 (1907).

Seventeen western states have adopted some, if not all, aspects of Appropriative Water Rights systems.[4] SAX, ET AL., at 111. Colorado and eight other states have chosen to recognize only rights gained by prior appropriation, rejecting riparian doctrines completely—these states are known as "pure appropriation" states.[5] *Id.* California recognizes a dual system of riparian rights and appropriative rights. *See, e.g.*, *Lux v. Haggin*, 4 P. 919, 924 (Cal. 1884). Oregon, Washington, and other states have by legislation grandfathered riparian rights into state-administered appropriative right systems.

The state with the most fully developed law regarding Appropriative Water Rights is Colorado. As explained above, Colorado's Supreme Court has repeatedly and plainly held that an Appropriative Water Right is an independent interest in property "separate and apart from the land upon which it is used." *Nielson*, 228 P.2d at 458. The Colorado Court's holdings are rooted in the Colorado Constitution, which declares that all the surface waters of the State are subject to appropriation and conditioned on beneficial use. COLO. CONST. art. XVI, §§ 5, 6. The Constitution provides that this right to use shall never be denied. *Id.* § 6.

The three elements of a Colorado appropriation are: (1) intent to apply water to a beneficial use, (2) diversion of water from a natural water course, and (3) application of the water to beneficial use without waste within reasonable time. *Id.*; COLO. REV. STAT. § 37-92-103(3) (2010) (Definitions – "Appropriation"); § 37-92-103(7) (Definitions – "Diversion"); CRS § 37-92-103(4) (Definitions –"Beneficial use"); *Colo. River Water Conservation Dist. v. Rocky Mountain Power Co.*, 406 P.2d 798, 800 (Colo. 1965). The date of the appropriation determines the water right's priority, with the earliest appropriations having the superior right.

In Colorado and in other pure appropriation states, it is clear that Appropriative Water Rights are separate property interests, distinct from the land on which they are used. *High Plains A&M, LLC v. Se. Colo. Water Co.*, 120 P.3d 710 (Colo. 2005) (citing *Strickler v. Colo. Springs*, 26 P. 313, 316 (Colo. 1891)) ("water rights, as property, may be sold and transferred to another type and place of use, so long as the rights of others are not injuriously affected"). In fact, a Colorado statute requires an Appropriative Water Right to be conveyed and transferred like real estate, independent from the land where it was historically used. COLO. REV. STAT. § 38-30-

[4] These seventeen states are Alaska, Arizona, California, Colorado, Idaho, Kansas, Montana, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, and Wyoming.

[5] Nine states adhere to the pure appropriation doctrine, also referred to as the "Colorado Doctrine": Alaska, Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, and Wyoming.

102; *Strickler*, 26 P. at 316; *Navajo Dev. Co. v. Sanderson*, 655 P.2d 1374 (Colo. 1982); *Lower Latham Ditch Co. v. Bijou Irrigation Co.*, 93 P. 483, 484 (Colo. 1907); *Child v. Whitman*, 42 P. 601 (Colo. App. 1896).

According to the binding legal precedent from the U.S. Supreme Court, the IRS must use the state supreme courts' holdings to determine the status of Appropriative Water Rights when determining their eligibility for charitable deductions. *See Bosch*, 387 U.S. 456. Because several states' supreme courts, including the Colorado Supreme Court, have declared that Appropriative Water Rights are independent, separate, and whole interests in property, the IRS must consider them to be whole interests. Therefore, Appropriative Water Rights are eligible for a charitable contribution deduction under § 170(a).

### 2. Comparative Analysis of Appropriative Water Rights and Partial Rights Discussed in Revenue Ruling 88-37 and GCM No. 39729

Appropriative Water Rights are indisputably entire interests, unlike the overriding royalty interests or net profit interests that were determined to be partial interests ineligible for deduction in Revenue Ruling 88-37 and GCM No. 39729. *Nielson*, 123 Colo. at 192–193. As a result, none of the concerns articulated in that Revenue Ruling or GCM apply.

First, there is no possibility of a taxpayer obtaining a double benefit because his donation of Appropriative Water Rights is a full transfer. Unlike the oil and gas overriding royalty interest or net profit interest, the donor of Appropriative Water Rights is left with no interest from which he might receive income subsequent to the conveyance. Second, there is no risk of the value of the taxpayer's deduction being greater than the value of the charity's benefit because the whole interest is transferred.

Moreover, the overriding royalty interest and net profits interest, which are the subject of the Revenue Ruling and GCM, are partial interests of partial interests. That is, an oil and gas lease is a partial interest in itself, carved out of an interest in a mineral estate, which mineral estate is carved out of the fee simple interest in land. A working interest is a partial interest carved out of an oil and gas lease. The overriding royalty interest or net profits interest represents only a portion of the working interest, and was thus carved out of the working interest.

In contrast, Appropriative Water Rights are entire interests in property that originated and exist independent of fee title ownership of land and are freely transferable. Appropriative Water Rights are not carved out of some larger interest. *See, e.g.*, *Coffin v. Left Hand Ditch Co.*, 6 Colo. 443, 447 (Colo. 1882) ("Instead of being a mere incident to the soil, it rises, when appropriated, to the dignity of a distinct . . . right of property."); *Child*, 42 P. at 602 (an Appropriative Water Right is an "independent right, which may be the subject of sale and conveyance").

Accordingly, allowing Appropriative Water Rights to qualify as charitable contributions is in line with the plain language and the legislative purpose of § 170.

### 3. Comparative Analysis of Appropriative Water Rights and Riparian Water Rights

In addition to being distinct from the partial interests discussed in Revenue Ruling 88-37, the legal nature of Appropriative Water Rights indicates that they are whole, not partial interests, especially when compared to riparian rights. In particular, they are distinct from riparian water rights because they are not inherently tied to the land.

#### a. Doctrine of Appropriation

States west of the 100th Meridian (a north-south line running from the middle of North Dakota to Texas) use the doctrine of prior appropriation to establish a priority of use based on seniority. This doctrine arose with the discovery of gold in California in 1848. To recover gold from placer deposits, miners diverted water from natural creeks, streams, and rivers with ditches and flumes for hydraulic mining. As these mining operations moved away from the water source, miners diverted water from its natural course and conveyed it to remote mining areas.

The principle of "first in time, first in right" arose as an orderly system of protecting and allocating water rights developed by the miners, spreading east and north from California across the Western United States. This rule of law provided that Appropriative Water Rights could be obtained by those who first diverted water for beneficial use for mining, agricultural, industrial, municipal or other purposes at a particular place, regardless of ownership of adjoining land. This furthered the public policy of the day, which was to facilitate the development of the Western United States.

#### b. Riparian Doctrine

The riparian doctrine is used predominantly in the Eastern United States. A riparian water right is a right to use the natural flow of water within a natural watercourse on riparian land, i.e., land that touches a lake, river, stream, or creek. A riparian right, subject to certain exceptions, cannot be used on non-riparian land. A riparian water right is "part and parcel" of land ownership, entirely dependent on the ownership of land adjacent to a water course and an inseparable partial interest of real property. All riparian land owners have equal rights to use the water in a stream, but cannot interfere with the reasonable use of others, nor can they separately transfer ownership of their riparian water rights.

The Eastern States enjoy more precipitation on average than the Western States. Because of this history of relative abundance of water in the East, the riparian doctrine instructs that in times of shortage, no user has priority over others and water use reductions are shared equally.

This right is inextricably tied to the ownership of the land. This is fundamentally different from an Appropriative Water Right, which is alienable and independent from the land upon which it is used.

**4. Current Usage of Appropriative Water Rights**

The current usage of Appropriative Water Rights also demonstrates their whole, independent nature. The scarcity of water in the Western United States has created a market where Appropriative Water Rights are increasingly transferred from low value uses, such as flood irrigation to grow hay, to higher value uses, such as manufacturing, oil and gas development, and municipal use. As cities grow, their need for water grows with them. Currently, a prominent regional trend is for western cities to purchase Appropriative Water Rights from farmers for municipal water supplies. There is accordingly an active market for Appropriative Water Rights, separate and apart from the land on which they have been used.

The appropriation of water for municipal and industrial use demonstrates that the creation of an Appropriative Water Right is not part of a fee simple estate in land. The brewing of beer is an example of the use of a water right appropriated for commercial purposes. The water ends up in the beer can, is never part of the fee simple estate of land on which it is brewed, and is consumed after it enters the stream of commerce.

## F. REVENUE RULING IN PRACTICE

TU now presents this additional information for your consideration and understanding:

1. Scenarios with Statements of Generally Applicable Facts
2. Law and Analysis
3. Drafting Guidance

Scenarios with Statements of Generally Applicable Facts

Trout Unlimited presents the following scenarios to help keep the legal discussion grounded in meaningful factual examples.

A. 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.

**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.

B. <u>Partial Interests</u>

**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*.

**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.

**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.

Law and Analysis

Section 170(a) of the Code provides, subject to certain limitations, a deduction for any charitable contribution (as defined in subsection (c)), payment of which is made within the taxable year.

Section 1.170A-1(c)(1) of the Income Tax Regulations provides that if a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property, reduced as provided in section 170(e) of the Code.

Section 170(f)(3) of the Code denies a charitable contribution deduction for certain contributions of partial interests in property.

Section 170(f)(3)(A) provides that no charitable deduction is allowed for a contribution of less than the taxpayer's entire interest in property unless the value of the interest contributed would have been allowed as a deduction under section 170(f)(2) had it been transferred in trust. By its terms, section 170(f)(3)(A) does not apply to a contribution of an interest that, even though partial, is the taxpayer's entire interest in the property.

If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), a deduction is not allowed. Section 1.170A-7(a)(2)(i) of the regulations.

Section 170(f)(3)(B)(ii) of the Code and section 1.170A-7(b) of the regulations provide that a deduction is allowed under section 170 of the Code for a contribution not in trust of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property. A charitable contribution of an interest in property not in trust will not be considered a contribution of an undivided portion if the donor transfers some specific rights and retains other substantial rights.

In enacting section 170(f)(3), Congress was concerned with situations in which taxpayers might obtain a **double benefit** by taking a deduction for the present value of a contributed interest while also excluding from income subsequent receipts from the donated interest. In addition, Congress was concerned with situations in which, because the charity does not obtain all or an

undivided portion of the significant rights in the property, the amount of a charitable contribution deduction might not correspond to the value of the benefit ultimately received by charity. The legislative solution was to guard against the possibility that such problems might arise by denying a deduction in situations involving partial interests unless the donation is cash in certain prescribed forms. See H.R. Rep. No. 91-413, 91st Cong., 1st Sess., 57-58 (1969), 1969-3 C.B. 200, 237; S. Rep. No. 91-552, 91st Cong., 1st Sess. 87 (1969), 1969-3 C.B. 423, 479. The scope of section 170(f)(3) thus extends beyond situations in which there is actual or probable manipulation of the non-charitable interest to the detriment of the charitable interest, or situations in which the donor has merely assigned the right to future income. Compare *Estate of Brock v. Commissioner*, 71 T.C. 901 (1979), aff'd per curiam, 630 F.2d 368 (5th Cir. 1980).

In Rev. Rul. 81-282, 1981-2 C.B. 78, an individual donated stock in a corporation to a charitable organization but **retained the right to vote the contributed shares**. The ruling notes that the right to vote stock is **inherent in the ownership of common stock** and, as such, is a property right. This right gives the holder a voice in the management of the corporation and is crucial in protecting the stockholder's financial interest. Therefore, the ruling concludes that the right to vote the stock is a **substantial right** in that stock. The ruling points out that although the taxpayer's retention of the right to vote the stock would not defeat the donee's interest in the transferred property, nevertheless, the taxpayer did not transfer all substantial rights in the stock to Y. The ruling holds that a deduction under section 170 is not allowed because the taxpayer transferred only a partial interest in the property and the interest assigned was not an undivided portion. See also Rev. Rul. 76-143, 1976-1 C.B. 63.

An undivided portion of a donor's entire interest in an appropriative water right **must consist of a fraction or percentage of each and every substantial interest or right owned by the donor** in the water right and **must extend over the entire term of the donor's interest in the water right** and in other property into which such property is converted.

In **Scenario 4** outlined above, the donated 50% interest is a partial interest of the appropriative water right, but it is the taxpayer's undivided or fractional interest of the entire appropriative right and real property interest. If a taxpayer owns an appropriative water right to use 1000 acre-feet of water and makes a permanent contribution of 500 acre-feet to a charitable organization, the charitable contribution is allowed as a deduction under section 170.

A deduction is allowed under section 170 for a contribution of property to a charitable organization whereby such organization is given the right, as a **tenant in common** with the donor, to **possession, dominion, and control of the property** for a **portion of each year** appropriate to its interest in such property.[6]

[6] Treas. Reg. § 1.170A-7(b)(1)(i) (Undivided portion of a donor's entire interest).

Assuming, therefore, that the Donee enjoys "free and exclusive use" and **possession, dominion, and control of the appropriative water right** for a **portion of each year** appropriate to its interest in such property and the donated portion of the appropriative water right was not previously divided in order to avoid section 170(f)(e)(A), and assuming that the other requirements of section 170 were met, a deduction would be allowable for the contribution of all or an undivided portion of the appropriative water right. See sections 1.170A-7(a)(2)(i) and 1.170A-7(b)(1)(i) of the regulations; Rev. Rul. 76-523, 1976-2 C.B. 54.

In Appropriative Water Right **Scenarios 2, 3, 5, and 6**, however, the Donor did not contribute the donor's entire interest in the appropriative water right, but **carved out** and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest in the appropriative water right because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. In both lease or gift agreements for a term, the donor has retained the full reversionary **right inherent in the ownership** of the appropriative water right to control or to participate in the control of, the development and operation of the appropriative water right. This right to control or to participate in control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion.

In Scenarios 2, 3, 5, 6, therefore, the contributed interest is less than the taxpayer's entire interest within the meaning of section 170(f)(3) of the Code, and is not an undivided portion of the taxpayer's entire interest.

**A gift of the entire interest of a taxpayer's appropriative water right is tax deductible as a charitable contribution pursuant to state-defined water and real property legal authorities.**

**A gift of an undivided portion of a taxpayer's entire interest in an appropriative right is tax deductible as a charitable contribution pursuant to state-level water and real property legal authorities.**

Drafting Guidance

The gift of an undivided portion of a taxpayer's entire interest in an appropriative water right qualifies as a charitable contribution and is tax deductible:

1. Because an appropriative water right is a separate and entire real property interest, a fractional interest could be donated to a charitable organization through an

agreement which fractionally divides the water right between the Donor and the Donee in any manner in which the parties agree.[7]

2. The gift of the Donor's undivided interest must necessarily extend over the entire term of the donor's interest in the donated water right property.[8]

3. The undivided portion of the Donor's entire interest in the water right must necessarily consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property.[9]

4. Any temporary gift of the water right in which the Donor retains a substantial interest in the full reversionary interest in the right, would not qualify as a partial interest exception.[10]

5. However, if the Donor *permanently* relinquished their full right of possession, dominion and control over the donated portion of the water right, the Donor would retain an insubstantial interest with a *de minimis* value.[11]

6. As applied to an appropriative water right, the Donor's right to a deduction would accrue at the time when she granted the Donee the right to use the water, not necessarily when the Donee took actual control and possession of the water right.[12]

7. Persuasive factors (considered for §1031 exchanges) include: (1) the respective interests in the physical properties, (2) the nature of the title conveyed, (3) the

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[7] *Greene v. U.S.*, 864 F. Supp. 407, 412 (S.D.N.Y. 1994) (commodities futures contracts split into 60% long-term capital gain and 40% short-term capital gain); *Winokur v. Comm'r*, 90 T.C. 733 (1988), 1989-1 C.B. 1 (20% interest in artwork donated to charity through two separate 10% gifts); Rev. Rul. 75-420, 1975-2 C.B. 78 (deed of gift reserved to the donor the right to free and exclusive seasonal use of the property from August 1 through September 15 of every year); *Mast v. Commissioner*, T.C. Memo 1989-119 (35% interest in stereoscopic negatives and prints donated to charity through two separate fractional 25% and 10% gifts); *Ashkar v. Commissioner*, T.C. Memo 1989-119 at 9 (gift of 5/22 fractional interest in a collection of Biblical fragments); PLR 2002-23014 (50% interest in a collection of artwork donated fractional interests through three stages, until the taxpayers transferred their full interest to an art museum).

[8] Treas. Reg. § 1.170A-7(b)(1)(i) (Undivided portion of a donor's entire interest).

[9] Treas. Reg. § 1.170A-7(b)(1)(i) (Undivided portion of a donor's entire interest)

[10] *Stark v. IRS*, 86 T.C. 243, 252 (1986); Rev. Rul. 76-331 at 1, 1976-2 C.B. 52 (retained mineral or lease rights.) *Peters v. Comm'r*, 35 T.C.M. (CCH) 770 (1976); Rev. Rul. 81-282, 1981-49; 1981-2 C.B. 78; (voting stock)

[11] *Stark v. IRS*, 86 T.C. 243, 252 (1986).

[12] *Winokur v. Comm'r*, 90 T.C. 733 (1988), 1989-1 C.B. 1.

rights of the parties, and (4) the duration of the interests."[13] An appropriative water right, whatever its size, is in perpetuity, as distinguished from a right to a specific total amount of water or to a specific amount of water for a limited period.[14]

8. The Donor may take a deduction even if she retains some exclusive right to the property during the year. If the Donee enjoys "free and exclusive use" for some part of the year and the Donor does not retain a right that infringes on the Donee's use, or retain a power or economic benefit that the Donee would enjoy as a tenant in common with the Donor.[15]

9. The gift should be granted a federal tax deduction.

## G. CONCLUSION

For the reason that an Appropriative Water Right is separate property, and not part of some larger estate, the gift of the water right does not violate the prohibition on charitable deductions for gifts of partial interest under § 170 (f)(3)(A).

For the reason that the Appropriative Water Right is not a partial interest, a gift of an undivided portion of a taxpayer's entire interest in the Appropriative Water Right qualifies for a charitable deduction under § 170(f)(3)(B)(ii). Unlike the overriding royalty interest or net profits interest discussed in Revenue Ruling 88-37 and GCM No. 39729, a gift of an undivided portion of a taxpayer's entire interest in a Western Appropriative Water Right is a conveyance of a fraction of each and every interest or right owned by the donor. Such a gift does not result in the retention by the donor of *any* interest in the donated property.

A special thanks is extended to these individuals who have contributed to this Revenue Ruling request: Huey Johnson, Resource Renewal Institute (deceased); William M. Silberstein, Esq. and Lala T. Wu, Esq., Kaplan Kirsch & Rockwell LLP; and William T. Hutton, Esq.

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[13] *Wiechens v. United States*, 228 F.Supp.2d 1080, 1085 (D. AZ. 2002) (citing to *Koch v. Commissioner*, 71 T.C. 54, 65 (1978)).

[14] Rev. Rul. 55-749, 1955-2 C.B. 295.

[15] Rev. Rul. 75-420, 1975-2 C.B. 78 (deed of gift reserved to the donor the right to free and exclusive seasonal use of the property from August 1 through September 15 of every year).

For these reasons, we respectfully request the issuance of a Revenue Ruling concerning the two statements set forth in Section A, above.

Please call any of us directly if you have any questions or we can be of any further assistance.

Sincerely,

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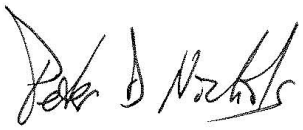

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**Tom Hicks, Attorney**
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Tom Hicks is a California water law, real property, and conservation attorney who represents a variety of public interest organizations, landowners, and others on select public policy, transactional, administrative, regulatory, and litigation matters. He works across California and select western states on multiple public interest projects that enhance streamflow as well as large-scale conservation easements to protect watershed conservation values in perpetuity. He is the author of the Water Education Foundation *Layperson's Guide to Water Rights Law*, recognized as the most thorough explanation of California water rights law available to non-lawyers.

Before law school Tom was an energy and water policy analyst at the Natural Heritage Institute and the founder and Executive Director of the Headwaters Institute. He has interned at the San Francisco Office of the City Attorney, California State Water Resources Control Board, and American Rivers. Tom founded and chaired the inaugural 2005 California Water Law Symposium still sponsored by leading northern California law schools and is a Board member. Tom is a former whitewater raft guide, kayaker, and Colorado Outward Bound School instructor. He holds a JD from the University of San Francisco School of Law and a BA from the University of Vermont.

**Laura Ziemer, *Attorney***
**TU Western Water and Habitat Program**
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Laura Ziemer initiated Trout Unlimited's water efforts by establishing the Montana Water Project office in 1998. She has helped grow TU's water work to nine states, (Montana, Colorado, Washington, Wyoming, Idaho, Utah, Oregon, New Mexico, and California), to restore and maintain streamflows for healthy coldwater fisheries by addressing water allocation issues.

In Montana, Mrs. Ziemer has expanded TU's water leasing program. She has helped establish new watershed restoration funding in the 2008 and 2013 Farm Bills, protected flows on the Bitterroot River, initiated a successful drought response plan on the Blackfoot River, and obtained favorable rulings from the Montana Supreme Court recognizing instream flow rights under the prior appropriation doctrine (known as the *Bean Lake III* case), and limiting new groundwater development that comes as the expense of river flows (*TU v. DNRC, April 2006)*. In 2007, Laura worked with a broad coalition of ranchers and conservation interests to pass comprehensive reform legislation for Montana's management of groundwater, based on the recognition of ground and surface water as one resource.

Mrs. Ziemer served as a judicial clerk to the Honorable Barbara J. Rothstein of the United States District Court for the Western District of Washington in Seattle. She is a 1990 graduate of the University of Michigan, graduating *cum laude* from the Law School while earning a Master's Degree in Resource Ecology *with honors* from the School of Natural Resources.

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A Coloradoan, Peter Nichols practices water law, water quality law, environmental law, and land and water conservation law. In addition to water law and water quality issues, Peter has particular expertise in the federal Clean Water Act and water rights, conservation easements involving water rights, and the temporary use of agricultural irrigation water rights to meet municipal needs.

Peter has handled water rights and environmental matters for numerous municipalities, water conservancy districts, natural resources companies, and farmers and ranchers, as well as western states in long-running litigation involving federal deference to state water laws. He was the co-founder of the Colorado Water Trust and has advised many conservation organizations with regard to water law and conservation. He was the lead co-author of *Water Rights Handbook (for Colorado Water Trust Professionals)*.