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**PROPOSED CHANGES TO TREATMENT OF WATER RIGHTS AS
PROPERTY ELIGIBLE FOR CHARITABLE DEDUCTION UNDER
IRC § 170^{1, 2}**

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² Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participants have been specifically engaged by a client to participate on this paper.

EXECUTIVE SUMMMARY

This paper proposes the issuance of a revenue ruling, regulation, or other guidance, setting forth the Federal tax treatment of charitable donations of water rights. Clarification confirming that a water right is not a partial interest in property for purposes of section 170 will greatly support instream water conservation efforts both in California and throughout the Western States. States west of the Mississippi commonly use an appropriative water right system causing further ambiguity with regard to the proper tax treatment of transfers and donation of water rights.

American water rights are generally based on common law riparian rights that are appurtenant to the land. As water rights in the Western States began to take shape and escalate in value, more states began to recognize appropriative rights which grant the right to take surface or subsurface waters in excess of that reasonably used by riparian or overlying owners. Appropriative rights are rights in gross that are separate and distinct from the land.³ California utilizes a hybrid of both riparian and appropriate water rights. California policies currently permit the voluntary transfer of water and water rights.⁴ To that end, California's Water Code clearly demonstrates an effort to encourage the conservation of its limited water supply with an aim towards promoting more permanent instream flow.⁵

A charitable deduction is generally allowed where property is gifted to a charitable entity as defined by statute.⁶ This statute operates to exclude donations of partial interests in property to qualified charitable entities unless they satisfy section 170(f)(2) for specific contributions transferred in trust.⁷ When adding section 170(f)(3), Congress sought to ensure taxpayers would not be able to exploit a double benefit by donating partial interests in property.⁸ The type of exploitation Congress aimed to prevent was situations in which taxpayers would donate the use of a property for a limited time and claim a charitable deduction for their entire interest in the property.⁹ Currently, the Service has issued no formal interpretation as to

³ See, *North Kern Water Storage Dist. V. County of Kern*, 179 Cal.App.2d 268, 279 (1960).

⁴ Cal. Water Code § 109 (2010).

⁵ Cal. Water Code § 1101(b) (2010).

⁶ IRC § 170(c).

⁷ IRC § 170(f)(3)(A); Treas. Reg. § 1.170A-7(a)(1).

⁸ Rev. Rul. 88-37.

⁹ Thomas Hicks, *An Interpretation of the Internal Revenue Code and Treasury Regulations Supporting the Tax Deductibility of the Voluntary Charitable Contribution in Perpetuity of a Partial Interest in an Appropriative or Riparian Water Right Transferred Instream for Conservation Purposes (with an Emphasis on California Water Law)*, 17 Hastings Env'tl. L. J. 92 (2011).

whether a water right, particularly an appropriative water right constitutes a “partial interest in property” for purposes of section 170.

Understandably, this has caused uncertainty as to whether a donation of water right for beneficial instream conservation purposes qualifies for the charitable deduction under IRC section 170.

Western water resources have become over-appropriated because of the many competing demands for water, including agricultural, municipal and traditional out-of-stream consumptive uses. California has been at the forefront of providing for the preservation of instream flow, employing a combination of statutory guarantees, common law protections and regulatory directives that, at a minimum, require the State Water Resources Board to consider the effects of instream uses of the water rights subject to its jurisdiction.¹⁰ To that end, California does allow an existing water user to devote all or a portion of its water to instream uses. Clarification of the charitable deduction will greatly support instream water conservation efforts both in California and throughout the Western States that use an Appropriative water rights system.¹¹

Congress has recognized the importance of this issue, as part of the Water and Energy Sustainability through Technology Act that sought “to provide drought relief through innovation, increased water supply, and regional adaptation and self-sufficiency, and for other purposes.” Specifically, the bill as proposed would have required, among many other provisions, “not later than 2 years after the date of the enactment of this Act, the Secretary of the Treasury shall clarify, though a revenue ruling, regulation, or other guidance, the Federal tax treatment of charitable donations of water rights acquired by appropriation.”¹² Unfortunately, this bill remained in committee.

The only certain method available to gift an Appropriative water right that qualifies for a charitable deduction is via a qualified conservation easement.¹³ Qualified conservation contributions are generally conducted through conservation easements, which require the land be exclusively used for conservation purposes among many other strict requirements.¹⁴

¹⁰ Kelly A. Cole, *A Market-Based Approach to the Protection of Instream Flow: Allowing A Charitable Contribution Deduction for the Donation of A Conservation Easement in Water Rights*, 14 *Hastings W.-N.W. J. Envtl. L. & Pol'y* 1153 (2008).

¹¹ Dave Owen, *Water and Taxes*, 50 *U.C. Davis L. Rev.* 1559, 1582-83 (2017).

¹² Water and Energy Sustainability through Technology Act, H.R. 3275, 115th Cong. § 2011 (2017).

¹³ IRC § 170(f)(3)(B)(iii); Rev. Rul. 88-37.

¹⁴ IRC § 170(h)(1)(C); Treas. Reg. §1.170A-14(a), (c)(2).

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.¹⁵ California law recognizes that an appropriative right is a kind of real property for at least some purposes, whether or not it is appurtenant to a particular dominant estate, and is severable and alienable from the land.¹⁶ While California law is not in dispute, nor that of many other Western States that use appropriative water rights, it remains far from certain to most holders of appropriative water rights whether the charitable donation of these rights would be respected under existing federal tax law, compelling any party interested in donating appropriative water rights to obtain a legal opinion on whether such rights will be respected. For many holders of appropriative water rights, legal counsel is not an option. “Consequently, one of the most powerful tax incentives for land conservation is available for water only on a limited and uncertain basis.”¹⁷

¹⁵ *Commissioner of Internal Revenue Service v. Bosch*, 387 U.S. 456, 465 (1967).

¹⁶ *See, Great Oaks Water Co. v. Santa Clara Valley Water Dist.*, 242 Cal. App. 4th 1187, 1210 (2015); *see, also, Wright v. Best*, 19 Cal.2d 368, 380-382 (1942) (“a water right by appropriation is independent of ownership and possession of land and subject to sale separately from it . . .” Such right being “severable and alienable from the land to which it is appurtenant”).

¹⁷ Owen, *supra*, note 11 at 1583.

DISCUSSION

I. BACKGROUND

A. Introduction

Internal Revenue Code section 170¹⁸ generally provides a tax deduction for contributions of money or property, tangible or intangible, to a qualified charitable organization as statutorily defined.¹⁹ Before passage of the Tax Reform Act of 1969,²⁰ taxpayers could take a charitable deduction for the fair-rental value of property given to a charity for a specified time period and provided an exclusion from income the amount that would have been received had the property been rented.²¹

Through the Tax Reform Act of 1969, Congress enacted section 170(f)(3) to disallow a double tax benefit to taxpayers who donated to a charity the use of property for a limited period of time.²² The scope of section 170(f)(3) 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.²³ With the addition of section 170(f)(3)(A), Congress denied deductions for charitable gifts consisting than less than the donor's entire interest in the property.²⁴

Several exceptions apply to the general requirement to gift an entire interest. Partial interest charitable deductions are allowed for gifts of (1) a personal residence or farm; (2) an undivided portion of the taxpayer's entire interest in property, or (3) a qualified conservation contribution.²⁵ The Code currently does not address the charitable gifting of water rights separately from the land. In Eastern States where water is abundant, water rights are based on common law riparian rights.²⁶

Most Western States, where water has always been a limited resource, have incorporated an appropriative water system that provides the owner the right to take surface or subsurface waters in excess of that reasonably used by Riparian overlying owners.²⁷ Nine Western States (i.e., Alaska, Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah and Wyoming) have completely replaced the riparian system with a pure appropriative water rights regime.²⁸

¹⁸ Unless otherwise indicated, all section references in are to the Internal Revenue Code of 1986.

¹⁹ IRC §§ 170(a)(1), (c).

²⁰ Tax Reform Act of 1969, Pub. L. No. 91-172 (1969).

²¹ *Id.*

²² See, *Greene v. United States*, 864 F. Supp. 407, 412 (S.D.N.Y. 1994), *aff'd* in part & *rev'd* in part, 79 F.3d 1348 (2d Cir. 1996); *Stark v. Commissioner*, 86 T.C. 243, 249-50 (1986); *Logan v. Commissioner*, T.C. Memo 1994-445.

²³ *Cf. Estate of Brock v. Commissioner*, 71 T.C. 901 (1979), *eff'd per curiam*, 630 F. 2d 368 (5th Cir. 1980).

²⁴ Treas. Reg. 1.170A-7.

²⁵ IRC § 170(f)(3)(B).

²⁶ See, *Rancho Santa Margarita v. Vail*, 11 Cal.2d 501 (1938).

²⁷ See, California Water Code 1201; *Modesto Prop. Co. v. State Water Rights Bd.*, 179 Cal.App.2d 268, 279 (1960).

²⁸ Joseph L. Sax, et al., *Legal Control of Water Resources: Cases and Materials*, 111 (3d Ed. 2000).Sax

Appropriative water rights are ordinarily appurtenant to land.²⁹ Water diverted from a stream for beneficial use on a parcel of land is a species of real property, and the right to take it and use it is appurtenant to the land on which it is to be used.³⁰

Appropriative water rights are generally usufructuary, consisting of the right to use, but not own, the water.³¹ Appropriative water rights are also generally conditional because such rights may be forfeited or abandoned by non-use.³² Though there are minor variations in Appropriative rights on a state-by-state basis, the common elements of appropriative rights amongst the states that recognize them are the right to divert water in a specified amount, from a specified source, for a beneficial use within a reasonable time.³³ The beneficial use requirement varies state-by-state but generally is satisfied by diverting the water for agricultural, industrial, or household use. In contrast to riparian rights, appropriative rights can be tied to any parcel of land, not just land adjacent to water.³⁴ Consistency is needed in the treatment of transfers of water rights, whether riparian or appropriative whether for purposes of IRC section 170 as well as other tax provisions, including IRC section 1031.

While most Western States, including California, have identified appropriative water rights as a separate property right, the use of both a riparian and appropriative regime raises doubt whether the charitable gift of an appropriative water right separate from the riparian water right is a partial interest running afoul of section 170(f)(3)(A). The usufructuary nature of appropriative water rights also raises the question whether such a property right rises to the level of possession and dominion, typical for ordinary property rights. The owner of a usufruct does not have exclusive dominion over it; rather, he or she only has a right to uses that are compatible with the community's dependence on the property.³⁵

Given the lack of clear guidance, many holders of appropriative water who wish to donate the rights for conservancy efforts have opted for qualified conservation contribution exemption under section 170(f)(3)(B)(iii) to allow for the charitable deduction of a partial interest. Such qualified conservation contributions, however, impose very strict requirements requiring substantial time and cost.

This paper takes the position that clear guidance from the Service will provide taxpayers a financial incentive to donate water rights, including appropriative water rights, which in turn will

²⁹ *Abatti v. Imperial Irrigation District*, 52 Cal. App. 5th 236, 266 Cal. Rptr. 3d 26 (4th Dist. 2020), as modified on denial of reh'g, (Aug. 5, 2020) and review denied, (Oct. 28, 2020) and cert. denied, 141 S. Ct. 2856 (2021).

³⁰ *Northern California Power Co., Consolidated, v. Flood*, 186 Cal. 301, 199 P. 315 (1921).

³¹ Wells A. Hutchins, *Selected Problems in the Law of Water Rights in the West*, Misc. Pub. No. 418 at 27 (USDA 1942).

³² Robert Emmet Clark, et al., *Waters and Water Rights: A Treatise on the Law of Waters & Allied Problems: Eastern, Western, Federal* § 405, 40-41 (1972).

³³ Hicks, *supra*, note 9 at 98.

³⁴ Barton H. Thompson, Jr. et al., *Legal control of Water Resources* 170 (5th Ed.).

³⁵ Kelly A. Cole, *A Market-Based Approach to the Protection of Instream Flow: Allowing a Charitable Contribution Deduction for the Donation of a Conservation Easement in Water Rights*, 14 *Hastings W. N.W. J. Envtl. L & Pol'y* 1153, 1157 (2008); see also Joseph L. Sax, *Property Rights and the Economy of Nature: Understanding Lucas v. South Carolina Coastal Council*, 45 *Stan. L. Rev.* 1433, 1452 (1993).

substantially increase water conservancy efforts in Western States that increasingly suffer from droughts and shortages with growing populations, thereby increasing the conservation of water resources.

B. Appropriative Water Rights in California and Other Western States

Riparian water rights provide its owner to the use of surface water on a specific piece of property. Riparian rights are rights appurtenant to the land and dependent upon ownership of the land contiguous to a natural watercourse.³⁶ Riparian rights cannot be lost due to nonuse because they are part and parcel of the land. Appropriative rights in water entitle its owner to a specified volume of groundwater that the owner may divert and put to a beneficial use. Unlike riparian rights, which are appurtenant to the land, appropriative rights are rights in gross that entitle the owner to a specific and finite amount of water from a particular source.

Appropriative water rights and title to the land itself can be acquired and sold separately from one another. Similarly, requiring timely beneficial use of appropriative water rights is a key distinction from riparian rights. There are statutory revocation provisions in place if the beneficial use requirement is not satisfied.³⁷

There can be multiple appropriators from the same water source with varying volumes of entitlement. In this case, the various appropriative rights are prioritized based on the date the right was acquired, similar to the first in time, first in right doctrine. California, among several other Western States, implement a hybrid system recognizing both riparian and appropriative water rights. In California, the adoption of riparian and appropriative water rights was adopted shortly after California became a state.³⁸ The hierarchy of appropriative rights remains the same with the exception that the owner of the riparian rights has first priority; those riparian rights are still limited to the diversion of the natural flow of the watercourse.

In California, until the Water Commission Act of 1914, no formal permission was required for water appropriators. Mostly farmers and miners simply took used as much water as needed. The Water Commission Act of 1914 created the agency that later evolved into the State Board and granted it the authority to administer permits and licenses for California's surface water.³⁹ California does not recognize new appropriations for instream use but allows an existing water user to devote all or a portion of its water rights to instream use.⁴⁰

C. Appropriative Water Rights Support Water Conservancy

Appropriative water systems only work if there is a continuous flow of water. Over appropriation reduces flow that affects animal habitats and reduces the quality of the water.⁴¹ Incentivizing the donation of water to increase "instream" flow is the best means to protect

³⁶ *Rancho Santa Margarita v. Vail*, 11 Cal.2d 501 (1938).

³⁷ Cal. Water Code §§ 1675(a); 1410(a).

³⁸ https://www.waterboards.ca.gov/waterrights/board_info/water_rights_process.html

³⁹ *Id.*

⁴⁰ *See, California Trout v. State Water Resources Control Board*, 90 Cal. App. 3d 816, 153 Cal. Rptr. 672 (1979).

⁴¹ Cole, *supra*, note 35 at 1153.

increasingly scarce water resources in Western States.⁴² While owners of Appropriative water rights may make current use of conservation easements, such easements are complicated and costly. Landowners claim on average a billion dollars in donations to conservation groups each year.⁴³ Most purchases of conservation water have been short-term and accordingly ineligible for federal tax deduction under section 170.⁴⁴ Water trusts have been less successful than land trusts in using tax deductions to promote transactions.⁴⁵

Even Congress has recognized the need for clarification of appropriative water rights in support of water conservancy efforts. In 2017, the House of Representatives introduced H.R. 3275, “to provide drought relief through innovation, increased water supply, and regional adaption and self-sufficiency, and for other purposes.” The Bill was co-sponsored by representatives from California and several other Western States. Among its many provisions, section 2011 specifically provided that

Not later than 2 years after the date of the enactment of this Act, the Secretary of the Treasury shall clarify, through a revenue ruling, regulation, or other guidance, the Federal tax treatment of charitable donations of water rights acquired by appropriation.⁴⁶

While the Bill did not pass committee, it clearly demonstrates the recognition by representatives from California and other Western States.

Guidance recognizing appropriative water rights need not only benefit Western States. Several Eastern States are moving away from the traditional riparian system and adopting a “regulated riparianism” that would move closer to the appropriative system used in the Western States.⁴⁷

II. CHARITABLE DEDUCTION UNDER SECTION 170

A. Section 170 Generally

Section 170(a) provides a deduction for any charitable contribution in property other than money. The deduction is disallowed if the contribution is less than the taxpayer’s entire interest in the property, subject to certain exceptions.⁴⁸ These exemptions include the following:

⁴² *Id.* at 1154-55.

⁴³ See, Nancy A. McLaughlin, *Perpetual Conservation Easements in the 21st Century: What Have We Learned and Where Should We Go From Here?*, 3 Utah L. Rev. 687 (2013).

⁴⁴ Mary Anne King, *Getting Our Feet Wet: An Introduction to Water Trusts*, 28 Harv. Envtl. L.Rev. 495, 512-13 (2004).

⁴⁵ King, *supra*, at 512.

⁴⁶ Water and Energy Sustainability through Technology Act, H.R. 3275, 115th Cong. § 2011 (2017).

⁴⁷ Owen, *supra*, note 11 at 583 n. 147

⁴⁸ IRC §170(f)(2).

1. ***Transfers in trust.*** No deduction is allowed for a contribution of a remainder interest in trust unless the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.⁴⁹
2. ***Nontrust transfers.*** A contribution of a partial interest in property, not in trust, is generally nondeductible.⁵⁰ A right to use property is treated as a nondeductible contribution of a partial interest.⁵¹ Three types of contributions are exempted:
 - a. A remainder interest in a farm or personal residence (including a summer home or cooperative apartment);⁵²
 - b. An undivided portion of the taxpayer's entire interest in the property (e.g., an undivided one-half interest, creating a tenancy in common),⁵³ and
 - c. Certain contributions for conservation purposes, including outdoor recreation, the preservation of historically important property, and environmental protection.⁵⁴
3. ***Contributions of Donor's Entire Interest.*** No restrictions apply if the donated partial interest is the donor's entire interest in the property, such as a gift by a remainderman of her entire interest.⁵⁵

B. Federal Tax Law Does Not Address or Define Appropriative Water Rights

1. Usufruct Nature of Appropriative Water Rights

California, and many other Western States, have incorporated an appropriative water rights regime along with the common law riparian rights. California law recognizes that an appropriative right is a kind of real property for at least some purposes, whether or not it is appurtenant to a particular dominant estate, and is severable and alienable from the land.⁵⁶ The U.S. Supreme Court has held that state law as decided by a state's highest court is controlling on issues relating to the nature of property held in that state.⁵⁷ Although water rights are viewed as property under California law, those rights are limited to the "beneficial use" of the water involved, as set forth explicitly in the California Constitution.⁵⁸

⁴⁹ IRC § 170(f)(2)(A).

⁵⁰ IRC § 170(f)(3).

⁵¹ *Patel v. Comm'r*, 138 TC 395 (2012) (nonacq. on another issue).

⁵² *See*, Rev. Rul. 87-37.

⁵³ *Winokur v. Comm'r*, 90 TC 733, 739 (1988) (acq.).

⁵⁴ *See*, Treas. Reg. § 1.170A-7.

⁵⁵ *Stark v. Comm'r*, 86 TC 243 (1986).

⁵⁶ *See, Great Oaks Water Co. v. Santa Clara Valley Water Dist.*, 242 Cal. App. 4th 1187, 1210 (2015); *see, also, Wright v. Best*, 19 Cal.2d 368, 380-382 (1942) ("a water right by appropriation is independent of ownership and possession of land and subject to sale separately from it . . ." Such right being "severable and alienable from the land to which it is appurtenant").

⁵⁷ *Comm'r of Internal Revenue v. Bosch*, 387 U.S. 456, 4665 (1967).

⁵⁸ Cal. Const. Art X, sec 2.

At this time, the Service has not specifically acknowledged whether water rights constitute an undivided interest in property or an “entire interest in property.” The usufruct nature of appropriative water rights ostensibly bears more in common with the type of property interests that Congress sought to disallow under section 170(f)(3).⁵⁹

Regardless of the recognition of rights under state law as a separate property interest, its status as a separate property right under federal law is unsettled. Appropriative water rights provide only a usufructuary right to water rather than complete dominion over the water. Without having the ultimate right over the property, the owner does not have exclusive dominion over it.⁶⁰ California law, in fact, rarely applies the term “ownership” to water in its natural state.⁶¹ Once water is removed from its natural state and physically separated from the land and contained, water is generally considered personal property.⁶²

2. Appropriative Water Rights Count as Real Property for Purposes of Section 1031 Exchanges

While Federal Tax Law similarly does not explicitly recognize appropriative water rights in the context of section 1031, the broad definition of real property under the current definition of real property would include appropriative water rights. For purposes of section 1031, property is real property if, on the date it is transferred in an exchange, the property is real property under the law of the State or local jurisdiction in which that property is located.⁶³ For property not otherwise so defined under state law real property is “land and improvements to land, unsevered natural products of land, and water and air space superjacent to land.”⁶⁴

These changes are effective as of December 2, 2020. The new Treasury Regulation section 1.1031-3(a) clarifies that property defined as real property under state law is real property for purposes of section 1031. Intangibles that are treated as real property under section 1031 include fee ownership; co-ownership, leaseholds, options to acquire real property, easements, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir, or irrigation company that is treated as real estate under state law, and land development rights. Licenses and permits in the nature of a leasehold, easement or similar right, that are solely for the use, enjoyment or occupation of the land or permanent structure are also deemed to be real property. Section 1031 previously applied to both personal and real property, however, now is only available to like-kind exchanges of real property that is now more broadly defined under the current section 1.103103(a).

The Service has previously held that perpetual water rights for a fee interest in land qualifies as like-kind if the applicable local law treats water rights as real property rights and the water rights are in perpetuity, as distinguished from a right to a specific total amount of water or to a specific total amount of water for a limited period.⁶⁵ Perpetual water rights consisting of the

⁵⁹ Tax Reform Act of 1969. Pub. L. 91-172 (1969).

⁶⁰ Cole, *supra*, note 35 at 1157-58.

⁶¹ Cal. Water Code 1001; *Hargrave v. Cook*, 108 Cal. 72, 77 (1895); *Big Rock Mut. Water Co. v. Valyermo Ranch Co.*, 78 Cal.App 266, 274 (1926).

⁶² *Palmer v. Railroad Comm'n*, 167 Cal. 163, 168 (1914).

⁶³ Treas. Reg. § 1.1031(a)-3(a)(6).

⁶⁴ Treas. Reg. § 1.1031(a)-3(a)(1).

⁶⁵ Rev. Rul. 55-749

right to pump ground water from an aquifer for irrigation purposes were like-kind with a fee interest in farm land. The water rights were not considered to be limited in duration even though the state retained the authority to make reasonable diversions to the maximum diversion rate and the quantity pumped as may be in the public interest.⁶⁶

If the water rights are limited in duration or amount, they are not considered like kind to real property for purposes of section 1031. For example, water rights limited in priority, quantity, and duration for a 50-year term were not like kind to a fee interest in real property even though the water rights were real property under state law.⁶⁷ The 1031 exchange was disallowed on the basis the water rights were restricted as opposed to unlimited use of real property.⁶⁸ In Private Letter Ruling 200404044, the Service ruled in favor of a decision where water rights were limited to a maximum diversion rate and quantity per calendar year, but not duration, to be like-kind to a farm.

Congress has recognized the need for purposes of 1031 to broaden the definition of real property to apply in certain situations. For example, section 1031(a)(2)(B) provides that “stocks, bonds or notes” may not be exchanged in a 1031 exchange. Thus, an exchanger cannot sell stock in a corporation that owns real property even if the underlying real property would qualify as like-kind property. Clearly intended to allow for like-kind exchanges of water rights, on May 22, 2008, however, Congress enacted the Food, Conservation and Energy Act of 2008.⁶⁹ Among other things, the Act amends IRC Section 1031(a)(2)(B) to exclude mutual ditch, reservoir or irrigation company stock from the definition of “stock.”

The limitation of water rights under 1031 based on duration or amount is consistent with the legislative intent behind the partial interest limitation under section 170(f)(3). Appropriate water rights can accordingly constitute real property for purposes of section 1031 and should be given consistent treatment under section 170 and allowed to be donated as a separate property.

C. Partial Interests Authority Insufficient with Regard to Riparian and Appropriative Water Rights

Section 170(f)(3) generally denies the deduction for the contribution of an interest “which consists of less than the taxpayer's entire interest in such property,” except to the extent that the deduction would have been allowable if the interest had been transferred in trust. If a donor retains some right or interest in donated property, or control over donated property, there is a potential that a deduction will be disallowed under section 170(f)(3) because the donee received only a partial interest.

⁶⁶ PLR 200404044

⁶⁷ *Wiechens, v. U.S.*, 228 F. Supp. 2d 1080 (D Ariz 2002),

⁶⁸ *Id.*

⁶⁹ The Food, Conservation, and Energy Act of 2008, Pub. L. 110–246 (2008).

If the interest retained by a donor is insubstantial, then the donor is considered to have contributed the donor's entire interest and the deduction is not disallowed.⁷⁰ The retention of a substantial interest will be considered the retention of a partial interest and the interest contributed will be a nondeductible partial interest.⁷¹ While not addressing water rights specifically, the Service has addressed what constitutes a partial interest in the context of a donation of a royalty interest by the owner of an oil and gas lease. Because such rights are “carved out” of a larger property right, the right was a partial interest and accordingly not deductible under section 170.⁷²

California law holds that appropriative water rights allow its owner the right to take surface or subsurface waters only to the extent not reasonably used by riparian or overlying owners.⁷³ Such an appropriative property interest would appear to be “carved out” of the dominant riparian interest that would apparently be disallowed under existing rulings.

Without clear guidance, many potential donors may chose instead to donate as part of a conservation easement instead of a direct donation to a qualified entity. Conservation easements continue to provide the best incentive

Any substantial donation of water rights requires an appraisal to be deductible under section 170.⁷⁴ Further guidance on the appropriate means of valuating water rights would support conservation efforts toward instream use.⁷⁵

D. Conservation Easements Are Inadequate to Incentivize Donation of Instream Rights

Section 170(h) sets for the requirements for a charitable conservation contribution that allows the donation of a partial interest limitation so long as it meets the following requirements:

1. Must consist of a “qualified real property interest,” which may be (a) a remainder interest, (b) a perpetual restriction on the property’s use, or (c) the donor’s entire interest except for a retained interest in subsurface minerals (including a right of access to the minerals).⁷⁶
2. Must be made to a “qualified organization,” which may be a publicly supported charity, a government, or an organization controlled by a publicly supported charity or government.⁷⁷
3. Must be “exclusively for conservation purposes.”⁷⁸

⁷⁰ *E.g.*, PLR 8514028 (where taxpayer leased real property to a charitable organization under a 99-year lease for \$1 rent per year, a subsequent contribution of taxpayer's entire interest in the property was deductible; the amount deductible was the full fair market value of the property on the date of the gift).

⁷¹ *See* TAM 200610017 (contribution by railroad company of its railway right-of-way to a qualified trail provider under a rails-to-trails federal statute was a nondeductible gift of a partial interest because the taxpayer's retention of the right to reactivate the rail service in the future was a substantial interest).

⁷² Rev. Rul. 88-37; see, also, GCM 39729 (05/23/88).

⁷³ Cal. Water Code § 1201; *Modesto Prop. Co. v. State Water Rights Bd.*, 179 Cal.App.2d 856, 860 (1960).

⁷⁴ Treas. Reg. §§ 1.170A-16(d)(3), 1.170A-16(d)(4), 1.170A-16(d)(5).

⁷⁵ Hicks, *supra*, note 9 at 158-59.

⁷⁶ IRC §§ 170(h)(2), 170(h)(6).

⁷⁷ IRC § 170(h)(3).

⁷⁸ IRC § 170(h)(1)(C).

Therefore, if an individual taxpayer wishes to receive a charitable deduction for a donation of water rights to a qualified charitable organization but remains concerned about the uncertainty whether such a donation will be disallowed as a partial interest, a qualified conservation easement is the best option. Further guidance will encourage more charitable donations of water rights which in turn will support greater instream use.⁷⁹

III. THE SERVICE SHOULD PROVIDE GUIDANCE CLARIFYING THAT APPROPRIATIVE WATER RIGHTS OR OTHER WATER RIGHTS THAT ARE SEVERABLE FROM THE LAND ARE NOT PARTIAL INTERESTS FOR PURPOSES OF SECTION 170(f)(3)

The Service should accordingly set forth a regulation, ruling or other guidance that the gift of an entire interest or undivided portion of a water right qualifies for the charitable deduction under section 170.

⁷⁹ Owen, *supra*, note 11 at 1583.