The Role of the Private Sector in Water Transfers:

“Federal Tax Deductions for Water Rights Donated to Instream Conservation Purposes”

Western Governors’ Association & Western States Water Council
Innovative Water Transfers Workshop
Ceasar’s Palace, Las Vegas
Tuesday, December 13, 2011
2:00 p.m. – 3:00 p.m.
Private Sector Players Involved

- Water right holders: farmers and ranchers (not necessarily water or irrigation districts)
- 501(c)(3) non-profit, voluntary water transfer organizations or “Water Trusts”
- Land Trusts
- “Conserved water” infrastructure investors
Public Sector Players Involved

- State water rights and water transfer administrative agencies;
- State and federal fish and wildlife agencies;
- Municipalities
- Internal Revenue Service?
Voluntary v. Regulatory

- Voluntary Transfer v. Involuntary Regulatory Re-Allocation without Compensation
  - Reasonable and beneficial use (waste & unreasonable use)
  - Public Trust Doctrine (California)
  - Water Quality
  - Area of Origin Protections
  - Fish & Game Code § 5937 and § 5946
  - Endangered Species Act (“ESA”)
  - Nuisance
Types of Voluntary Water Transfers

- Sale or acquisition
- Temporary lease
- Temporary Donation
- Permanent Donation
  - Without Tax Deductions (“The right thing to do”)
  - With Tax Deductions (“The smart right thing to do”)
INTERNAL REVENUE CODE

TAX DEDUCTION FOR:

1. THE VOLUNTARY
2. CHARITABLE CONTRIBUTION
3. IN PERPETUITY
4. OF AN ENTIRE OR PARTIAL PROPERTY INTEREST IN
5. AN APPROPRIATIVE OR RIPARIAN WATER RIGHT
6. FOR INSTREAM CONSERVATION PURPOSES


- Generally, Internal Revenue Code ("I.R.C.") § 170(f)(3) disallows deductions for contributions of partial interests unless an express exception applies.

- There are three express exceptions whereby a partial interest deduction is allowable:
  1. Contribution of a *remainder interest* in a personal residence or farm;
  2. Contribution of an *undivided portion of the taxpayer's/donor's entire interest* in property; and
  3. A *qualified conservation contribution* [see: I.R.C. § 170(h)]
Partial Interest: Qualified Conservation Contribution
The I.R.S. provides income tax and estate tax deductions for a qualified conservation contribution:

1. of a qualified real property interest;
2. to a qualified organization; and
3. 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, e.g. conservation easement agreement.
Voluntary Restriction of 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.
Water Rights as State-Defined Real Property Interests

- The nature and extent of property interests are primarily defined by state law.

- "Every 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."

Private Property Right

- While there is no private property right in the corpus of water, the right of use is recognized as real property.
- The right of use, though not an interest in the corpus of the water itself, is "unquestionably a species of real property."
- Water rights are considered rights in real property.
- An appropriative right is an interest in real property.
- "The ownership of water, as a substantive and valuable property right, distinct sometimes, from the land through which it flows...may be transferred like other property."
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
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.
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 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 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.
Recommendation to WGA/WSWC

- Washington State Department of Ecology:
- **Revised Code Washington 90.42.080:**
  - Trust water rights — Acquisition, donation, exercise, and transfer
    Appropriation required for expenditure of funds.
- (7) Any water right conveyed to the trust water right system as a gift that is expressly conditioned to limit its use to instream purposes shall be managed by the department for public purposes to ensure that it qualifies as a gift that is deductible for federal income taxation purposes for the person or entity conveying the water right.
Permanent Donative
Instream Water Transfers

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