
**Saving Streams through the U.S. Tax Code:
Providing Tax Incentive for the Permanent and
Temporary Donations of Water Rights to Enhance
Stream Flow**



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I. Purpose of Report

The overall objective of this report is to assess the U.S. Tax Code - specifically Section 170 – to determine whether it allows a tax deduction for the permanent or temporary donation of a water right for conservation purposes. The assessment will include the following:

- A summary of the U.S. Tax Code (the “Code”), Section 170’s allowance of a tax deduction for the donation of real property as a charitable contribution for conservation purposes.
- An evaluation whether water rights are “real property,” and whether the Code permits the donation of water, both temporarily and in perpetuity.
- An analysis of the plausible effects of amending the Code.
- An identification of political and public support for amending the Code.
- A brief discussion regarding the process involved for selecting a legislative vehicle to amend Section 170.

II. Research Sources

Research for this report was conducted by review of the following types of literature:

- Case Law
- Law Review Articles
- Legal Treatises
- United States Tax Code
- Newspaper Publications
- Internet Publications
- Internet Website of the United States Senate and Congress

Although the research for this was not exhaustive, limited information is available that directly addresses the tax implications associated with the donation of water rights, thus some educated assumptions will be included. The available published research is included in the appendix of this document.

III. Introduction

State governments throughout the nation are recognizing that streams require water to function. Unfortunately, many of our nations stream suffer from inadequate flow volume. Whether streams are used for farming or for pleasure, water is intrinsically valued in this country. An expanding population is placing new demands on water supply, thus new methods of water management must develop.

The traditional approach to water management in the West - the doctrine of prior appropriation – has historically encouraged the out-of-stream diversion of as much water as possible so that water could be applied to a “beneficial use” on land. Almost all western states now statutorily recognize that having water instream is a beneficial use - beneficial to the environment, the economy, for local aesthetics, and for recreational purposes.

Eastern states have also recognized the importance of protecting instream flows. The riparian doctrine of water use governs eastern water law. Historically under this doctrine, only those who owned land abutting a stream had the right to use the water. These riparian land owners were governed by the “reasonable use” doctrine, which allowed them to divert water so long as they did not unreasonable injure other users. Most eastern states have amended the riparian rule of law to allow for water use on non-riparian land and at least sixteen states have amended their water code or developed common law principles to protect stream flow.

Over the last two decades a variety of water management practices have evolved to encourage and protect minimum flow requirements. For example, instream leasing programs operated by government agencies and non-profit organizations have made progress in enhancing stream flows in the Pacific Northwest. In addition, water banking programs have also been implemented for environmental objectives, although their overall effectiveness has been limited. These market-based management practices will continue to evolve in an attempt to meet new demands; however, the exploration of new water management tools should continue.

A new incentive could be immediately provided by the federal government to further facilitate efforts to protect stream flows. The U.S. Tax Code allows the donation of land for conservation purposes. In return, the donor receives an economic incentive in the form of a tax deduction. These conservation donations and easements have become a valuable and widely excepted land management and tax planning tool. The same tool could be forged for water management if the U.S. Tax Code received a simple amendment.

The following article is an informative overview of how water right donations can help impaired fisheries. In addition, the article provides valuable insight on the U.S. Tax Code and how it can be amended to encourage water right donations.

IV. IRS Deduction for Qualified Conservation Contributions: Creating a Tax Incentive to Provide Water for Fish, by Jamie Morin; Mentor Law Group

Acquiring water rights for instream flow purposes can be one of the most effective ways to ensuring water instream to protect threatened or endangered fish species. This is particularly true in states which follow the prior appropriation doctrine such as those in the Columbia Basin, where the value of a water right depends largely on its seniority to other water rights.

There are many federal, state, and private non-profit agencies actively working around the country to acquire and hold water rights for conservation purposes. However, many water right holders are reluctant to permanently convey their water rights away from the land. The permanent separation of water rights from appurtenant property can result in the loss of viable farmland. Frequently, water rights that could be used for conservation are unaffordable because of other competing potential water uses such as municipal or industrial uses. In many areas, the benefit of additional water instream is more important in dry years and less important in wet years.

A small change in the tax code could help both sides of this problem.

The federal tax code (IRS § 170(f)(3)(B)(iii), (H)) provides a tax credit for contributions of real property interest when that contribution is to a qualified organization and the contribution is exclusively for conservation purposes. In order to qualify for this tax credit, the conveyance can be the donor's entire interest in the property or can be limited to a restriction on future uses of the property (conservation easement). However, to be "exclusively for conservation purposes" the code requires that the conveyance be in perpetuity. While this may be appropriate for property interests in land, this is not appropriate for water rights where the conservation benefit gained through the transfer of water rights to instream purposes, even in a short-term lease, can be immediate and significant.

The current tax code provides a tax benefit only to those who permanently sever the water rights from their property and convey those water rights to a qualified conservation entity or to the state. This results in a choice between the tax benefits of permanent water transfers or the preservation of viable agricultural lands. A simple amendment to provide that the conveyance of water rights to instream flows for the duration of at least one season of use (or calendar years as appropriate) would qualify as "exclusively for conservation purposes."

V. Overview of the U.S. Tax Code

This portion of the report evaluates the provisions of the Code that are applicable to charitable donations. Included under the charitable donation umbrella are the sections of the Code which govern donations for conservation purposes.

Title 26, Subtitle A, Chapter 1, Subchapter B, Part VI, Section 170; “Charitable, etc., contributions and gifts”

Section 170 of the Code allows individuals and corporations a tax deduction for the donation of a “qualified conservation contribution”. A qualified conservation contribution is the donation of a “qualified real property interest” to a “qualified organization” exclusively for “conservation purposes”.

The Code classifies a qualified real property interest as any of the following:

- the entire interest of the donor other than a qualified mineral interest,
- a remainder interest, and
- a restriction (in perpetuity)¹ on the use of which may be made of the real property².

The Code allows a variety of “qualified organization[s]” as recipients of the qualified real property interest, including, but not limited to, government agencies and 501(c)(3) organizations such as the Colorado, Oregon and Washington Water Trusts.³

The term “conservation purpose” means:

- the preservation of land areas for outdoor recreation by, or the education of, the general public,
- the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
- the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or pursuant to clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
- the preservation of an historically important land area or a certified historic structure. A conservation contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.⁴

¹ Language in Section 170(h)(4)

² Section 170(h)(2)(A)(B), and (C)

³ Section 170(h)(3)

⁴ Section 170(h)(4)

Practical Application of the Code

Under Section 170, a donor is allowed a tax deduction for the perpetual donation of her entire interest in her real property, so long as the donation is for conservation purposes. “Conservation purposes” can be framed as intent to preserve natural habitat or historically important land areas. Alternatively, Section 170 allows a tax deduction for the donation of a partial interest in real property coupled with a restriction on the use of the property. The restriction on the property must facilitate the “conservation” intent. This type of donation is commonly referred to as a “conservation easement.” Conservation easements placed on the use of the land must also be in perpetuity.

VI. Are Water Rights “Real Property”?

The most important legal question presented within this report is whether water rights are real property. Due to certain constraints placed upon this report, the research in this area is not exhaustive. The following is a brief review of property issues related to water rights.

Overview: The Nature of Water Rights

It is unlikely that the drafters of Section 170 contemplated water donations for conservation purposes. The code allows for the donation of a “qualified real property interest”. “Real property” almost always means land. The nature of water ownership is inherently different from land ownership. “[T]he right of property in water is usufructuary, and consists not so much of the fluid itself as the advantage of its use.”⁵ “Unlike real property rights, usufructuary water rights are limited and uncertain” since climactic conditions determine water supply⁶. In addition, most Western states constitutionally claim all water as a “property of the public”.⁷ Because of these differences between land and water ownership, courts and state legislatures have been faced with deciding whether a water right is actually a “real” property interest at all.

Definition of “Real Property”

Black’s Law Dictionary defines “real property” as: “Land and generally whatever is erected or growing upon or affixed to land. Also rights issuing out of, annexed to, and exercisable within or about land. A general term for lands, tenements, and hereditaments; property which, on the death of the owner intestate, passes to his heir.”⁸ Real or immovable property consists of: “Land; that which is affixed to land; that which is incidental or appurtenant to land; that which is immovable by law; except that for the purposes of sale, emblements, industrial growing crops and things attached to or forming part of the land which are agreed to be treated as goods and be governed by the regulating the sales of goods.”⁹

Water Rights are “Real Property”

While it is questionable whether water can be categorized as real property within the definitions presented above, many states across the country provided an answer. Idaho, Utah, and Kansas are just a few examples of states which recognize water rights as real property through statute.¹⁰ In other states such as Nevada and Colorado, common law doctrines protect water rights as real property.¹¹ In addition, Federal courts as early as 1931 have

⁵ Eddy v. Simpson, 3 Cal. 249, 252-253 (1853).

⁶ State water Res. Control Bd., 227 Cal. Rptr. At 170.

⁷ Colorado Constitution, Article XVI, § 5.

⁸ Black’s Law Dictionary.

⁹ California Civil Code, § 658; as quoted in Black’s Law Dictionary.

¹⁰ Utah Code Ann. § 57-1-1(3) (1994); Kansas Water Appropriation Act of 1945; Idaho Code § 55-101;

¹¹ Town of Eureka v. State Engineer, 108 Nev. 163, 167, 826 P.2d 948, 951 (1992); Southeastern Colorado Water Conservancy District v. Twin Lakes Association, 770 P.2d 1231, 1239 (Colo. 1989).

recognized water rights as real property under a “takings” analysis.¹² Subsequently, an assumption may be made, premised on the information reviewed in this report, that a water right, either riparian or appropriative, may be interpreted as a “qualified real property interest” for the purpose of a charitable donation.

It must be noted that each state has the ability to classify and regulate water rights to whatever extent it pleases, subject to a 5th Amendment takings claim. There is evidence that not all Western jurisdictions view water rights as real property. Some states may consider water rights as partial property interests rather than whole property interests.

The IRS’s View of Water Rights as “Real Property”

It is becoming an increasingly common practice to claim a permanent water donation as a charitable contribution under Section 170. Many people within the tax and water communities believe that a permanent water donation is perfectly acceptable under Section 170. A statement by the IRS either confirming or denying such practice would be helpful for the purpose of assessing the applicability of Section 170 for water donations. Other than the IRS’s silence on the issue, no information is available to clarify the Internal Revenue Service’s stance on water rights as “real property.” The IRS has issued a non-binding field service advisory opinion that discussed charitable contribution deductions for the donation of water rights. The deductions were disallowed due to timing of the actual donation and how it coincided with the tax filing deadlines. Nowhere in the opinion does the author question the legality of donating water rights to obtain a charitable contribution deduction.

Since the IRS has had the opportunity, but has not challenged the validity of water donations as charitable contributions, the IRS’s silence on the issue is construed as approval.

It is possible that the IRS may clarify its stance as early as 2004. The Colorado Water Trust, a non-profit organization, has requested an official ruling for the 2003 tax year. If the IRS decides to refuse permanent donations of water rights as charitable contributions, an amendment to Section 170 becomes much more vital. If the IRS refuses to recognize permanent water right donations, it certainly will not recognize donations of a temporary duration.

Conclusion

Although scholarly debate over whether water rights are “real property” continues, some states have clarified the issue by statutorily declaring water rights as “real property”. Other states, along with Federal courts, have adjudicated water rights as “real property”. The IRS has been silent on the issue, thus allowing water rights to be treated as “real property”. Overall, the majority of legal literature leads to the premise that water rights are “real property”.

The following sections are a brief review of the nature of riparian and appropriative water rights and how the current U.S. tax code would apply if the rights were transferred for conservation purposes.

¹² Int’l Paper Co. v United States, 282 U.S. 399 (1931). Held that water rights were recognized by New York law as real property.

VII. Application of Section 170 to the Donation of Riparian and Appropriative Water Rights

Although the majority of instream flow protection efforts are located in the western United States, riparian jurisdictions in the East can also utilize water donations as a tool for conservation. The eastern United States has its own water issues that can be addressed with water donations. Wetlands preservation and flow augmentation are just two of the conservation challenges that eastern jurisdictions face. Water donations can provide an immediate tool to help meet these challenges.

Permanent Donations of Riparian Rights

The entitlement to water under a riparian system is granted by the ownership of the land abutting a watercourse. Historically, the property interest in riparian water rights was not an independent interest, but rather a property interest connected to the ownership of the land. Because a riparian right was not an independent property right, the permanent donation of a riparian right would not qualify for a “qualified real property interest” for the purposes of “qualified conservation contribution.”

However, in the majority of riparian jurisdictions, water rights are severable from the riparian land either by grant or reservation, and conveyed separately.¹³ In riparian jurisdictions that recognize water rights as “real property” and recognize the right to sever the water from the land, water rights are donatable as a charitable contribution under Section 170.

Permanent Donations of Appropriative Rights

Western water law is governed by the doctrine of “prior appropriation”. To establish a typical appropriative right, a person must divert water out of the stream channel and put the water to beneficial use. Unlike riparian rights, the ownership of land is not a factor in perfecting an appropriative right. Appropriative water rights are easily severable from the land. Additionally, most western states recognize appropriative water rights as “real property.” Therefore, an appropriative water right may qualify for a “qualified real property interest” for the purposes of “qualified conservation contribution” so long as the donation is in perpetuity.

Temporary Donations of Water Rights (Donative Leases); Riparian Rights and Appropriative Rights

Under the current Code, it would seem owners of riparian and appropriative rights cannot donate water leases as a “qualified real property interest” for the purposes of “qualified conservation contribution”. First, a lease is not in perpetuity. Second, leases of real property are not considered a transfer of the “entire interest” because the owner of the property still retains interest in the property.

¹³ Water Resource Management, A Case Book in Law and Public Policy, Fifth Addition, pg 144

The Perplexing Question: Can a Water Right Holder Donate An Entire Water Interest “Temporarily”?

Generally, the property interest associated with water is the right to use the water. If a person donates away the right to use the water, is that a donation of the entire water interest, even if the donation is merely temporary? If a person gives away all the property he has, but with a guarantee that he will get the property back at a future date, did he temporarily give away his entire interest? Under land lease law, the owner of the land retains an ownership interest in the property while it is leased. But water ownership is different. In the West, the states own the water. What property interest does a water right holder retain when he leases away his water right? Is the retained interest an “ownership” interest even though the state owns the water?

Criteria to Determine if a Donation May Qualify for a Tax Deduction:

- The donation is made with the intent to protect natural habitat of fish, wildlife, plants, or similar ecosystems.
- The water right is donated to a governmental agency or a 501(c)(3) organization that will then apply the water right to the conservation purpose.
- The donation of the water right is permanent and the donor relinquishes all property interest in the water right.

It is possible that a donation may not be valid if made in a jurisdiction that does not fully recognize water rights as real property. Someone interested in donating a water right should contact a licensed attorney who can advise them on the laws of their jurisdiction.

Required Changes to Section 170 to Encourage Temporary Donations

Unless the Code is amended to allow for the temporary donations of partial interest in water, the donation of a water lease for conservation purposes does not qualify as “qualified real property interest” for the purposes of “qualified conservation contribution”.

The following section outlines plausible effects of amending the U.S. tax code to provide incentives for the donation of water leases as charitable contributions for conservation purposes.

VIII. Potential Effects of Amending the Code

This section explores the plausible effects of amending the Code.

Increased Conservation Participation

Due to the increasing value of water, few individuals or corporations are interested in permanently donating away a water asset. Amending the Code to provide incentives for the donation of water leases means more water consistently instream. When viewed economically, permanent donations are discouraged. The theory behind amending the Code to provide the incentive for temporary water donations is that more individuals will participate in conservation that does not require a permanent loss their water asset.

Mitigating the Effects of the Endangered Species Act

Municipalities, manufacturing, agriculture, and the energy sector have all felt the economic impact of the Endangered Species Act (ESA). Sufficient stream flow is necessary to protect critical habitat so that economic progress is not staled by ESA actions. Amending the Code to encourage the temporary donation of water for conservation purpose may be an effective way to minimize the impact of the ESA upon water dependant entities. Rather than facing the expensive proposition of purchasing extra water for stream augmentation, public and private organizations can develop a cooperative program of water lease donations within the basin.

Stabilizing Municipal Water Supplies

Albuquerque, New Mexico can attest that low stream flow is a critical issue. Albuquerque's water supply from the Rio Grande was put into question when the U.S. 10th Circuit Court of Appeals held that the U.S. Bureau of Reclamation must consider endangered fish when it releases water or operates any federal program along the Rio Grande.¹⁴ In drought conditions Albuquerque may not be able to divert water that it had purchased from the Bureau of Reclamation. A secondary effect of temporary donations for conservation would help maintain stream flow, and would, subsequently, enable Albuquerque to continue divert Rio Grande water during drought conditions.

Communities in Oregon, Washington, and California along critical salmon and sucker habitat may benefit from temporary donations in their region. In drought conditions, those communities that receive Bureau of Reclamation water will be less likely to have their water supply withheld to protect endangered fish habitat if temporary donations for instream flow are already providing sufficient flow. Municipalities will not benefit from the tax incentives per se, but would receive a benefit from the secondary effects of temporary donations.

Conservation of Agriculture Lands

Water donations can be used in agricultural regions where over-appropriation has drawn down streams to unhealthy levels. Theoretically, in a basin with 20 irrigators, each irrigator

¹⁴ Rio Grande Silvery Minnow v. Keys, 333 F.3d 1109 (2003).

could donate water for a single season and receive a tax deduction. The Agricultural community is much more likely to support and participate in conservation programs that allow for the retention of water assets. In addition, viable agricultural land will maintain its water supply and agricultural classification.

Federal and State programs already spend millions of dollars in the west for the fallowing of agricultural lands to maintain stream flow. The Bureau of Reclamation spent \$4,000,000 during the summer of 2003 for land fallowing programs in the Klamath Basin alone.¹⁵ Federal water managers paid irrigators \$187.50 an acre in 2001 to fallow farmland in the Klamath County, Oregon.¹⁶ In addition, non-profit organizations such as the Oregon Water Trust also pay irrigators to seasonally fallow lands for instream flows. Amending the Code to provide donative incentive may reduce the overall cost of obtaining instream water. Paid leasing will certainly remain a more economically viable option, but some irrigators may opt to donate for tax planning purposes.

Reduction of Administrative Costs Associated With Government Programs

While the overall offset cost to the IRS is unknown, the governmental administrative costs of operating land fallowing programs may be reduced if the Code is amended. If temporary donations become as popular as land donations, the government may be able to do away with its land fallowing programs and allow non-profit groups such as the Washington Water Trust to facilitate the instream programs.

Effects in the Eastern United States

While the major impact of amending the Code should be felt in the arid west, eastern states can certainly benefit as well. A perception exist that eastern rivers do not need additional stream flow for conservative purpose. However, many eastern states have water quality and supply problems. Temporary donations can help dilute aquatic pollution, raise dissolved oxygen levels for impaired fisheries, and provide ascetic value for recreational purposes. Sufficient instream water is becoming a concern across America. Georgia is in the process of trying to protect stream flow. The Wildlife Resources Division (WRD) of the Georgia Department of Natural Resources (DNR) developed recommendations for protecting instream flows throughout the state, and published them in December 1995. Florida, Louisiana, Arkansas, Mississippi, Texas, South Carolina, Tennessee, and Oklahoma are also examples of other states which have attempted to deal with low flow problems.¹⁷

¹⁵ Feds Offer Money to Klamath Farmers Not to Irrigate; March 2003, U.S. Water New Online.

¹⁶ US Bureau of Reclamation, 2001 Irrigation Demand Reduction Program with the Klamath Basin, Klamath County, Oregon

¹⁷ Presentations from the 1997 Southern Division of the American Fisheries Society Midyear Meeting held in San Antonio, Texas.

IX. Conclusion

Instream water is critical to protect and conserve the nation's river systems. One potential method to maintain instream water for habitat management is through the charitable donation of water rights for conservation purposes. However, due to the rising economic value of water, few individuals are willing to permanently donate away their water asset. Unfortunately, the current U.S. Tax Code, Section 170 only allows a tax deduction for the permanent donation of the donor's entire real property interest in the water right. Amending the U.S. Tax Code to provide an incentive for the "temporary" donation of a "partial" interest in water could be an effective measure to increase instream water.

The preliminary steps to amending Section 170 are:

- finding a constituent base that supports the proposed amendment,
- finding a political sponsor, or multiple sponsors, to author and submit the proposed amendment to Section 170, and
- identifying a legislative bill likely to succeed, that can be altered to contain the proposed amendment to Section 170.

