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*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)*

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*Why California Failed to Meet Its RPS Target*

Article by Deborah Behles

*Watery Grave: Why International and Domestic Lawmakers Need to Do More to Protect Oceanic Species From Extinction*

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## **I. Introduction: Open Questions in Federal Tax Law**

Can the voluntary charitable contribution of an entire or partial interest in either an appropriative or riparian water right be permanently transferred instream for beneficial conservation purposes and receive federal income or estate tax deductions under the Internal Revenue Code (“I.R.C.”)?<sup>1</sup>

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1. The Resource Renewal Institute hosted a discussion in November 2008 to explore and probe the intersection between federal tax and California water laws. This paper is an offshoot *pro bono* research project. It is not intended to answer questions regarding the deductibility of state or local taxes, or the question of

In recent years, a handful of water right holders in the western United States have received a federal tax deduction from the Internal Revenue Service ("IRS") in exchange for the permanent charitable contribution of entire and partial interests in water rights. However, these deductions have been individual, one-off tax transactions which create no precedent regarding the various rights, interests, and values implicated at the intersection of state water and federal tax laws.

Even though the IRS has recognized these deductions, lingering uncertainty regarding the prospective interpretation of the I.R.C., as applied to water rights permanently donated and transferred to instream beneficial uses, could be lifted through formal IRS interpretive guidance such as a private letter or revenue ruling. A private letter ruling is a narrow advisory ruling that only affects the tax payer and their particular tax transaction and may not be cited or relied upon for precedent. A revenue ruling is binding on all taxpayers and the IRS, and would provide broader precedential value.

This article concludes that, notwithstanding the present lack of IRS guidance, the I.R.C. and Treasury Regulations do not need amendment in order to allow a federal tax deduction for a permanent donation of an entire or partial interest in either an appropriative or riparian water right.

The donation of an entire interest triggers a different analysis than a donation of a partial interest. Both interests have different combinations with state-defined appropriative or riparian water rights. For example, partial interest riparian rights do not exist in pure appropriation states. This article will touch on entire interests, but will mainly focus on a partial interest analysis in five representative appropriative and/or riparian right states with an emphasis on California water law.

This article concludes that a partial interest donation of an appropriative or riparian water right permanently transferred to beneficial instream conservation purposes *already* meets existing federal tax deduction criteria for qualified conservation contributions. Accordingly, the qualified conservation contribution of an appropriative or riparian water right should receive consistent federal income and estate tax treatment.

Formal IRS guidance affirming a tax deduction for a donation of a water right permanently transferred instream will reinforce and complement the surveyed States' contemporary water law and conservation policy reforms related to instream flows. Clarifying federal tax guidance will diminish existing uncertainty and provide a new market signal that publicly values donative voluntary water transfers to instream flows. This new increment of federal tax consideration will incentivize an increase in water right donations transferred instream for beneficial conservation purposes

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general deductibility of a donation of a water right to a non-profit 501(c)(3) charitable organization.

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and, importantly, create significant new conservation and stewardship opportunities in the years ahead.

## **II. Locating the Intersection Between Federal Tax and State Water Laws**

### **A. Appropriative and Riparian Water Rights**

Water rights in California can most broadly be categorized as groundwater or surface water rights. Surface rights are either riparian or appropriative, which are in turn either pre-1914 or post-1914, the year in which the precursor to the State Water Resources Control Board (“SWRCB”) was established to regulate surface water appropriations.<sup>2</sup> California incorporates both riparian and appropriative rights into a hybrid or dual-system to create what is known as the “California Doctrine.”<sup>3</sup>

In 1850, the California legislature adopted the common law of England as the rule of decision in California courts and thereby adopted riparian water rights.<sup>4</sup> Riparian rights depend entirely on the ownership of land adjacent to a water course.<sup>5</sup> Accordingly, such rights are not created by actual use or lost by nonuse of water, but are “part and parcel” of the land.<sup>6</sup> Traditionally, riparian rights must be used on the property during a defined season and must be reasonable in use and quantity, although more recently, a riparian right can be left instream to enhance environmental flows.<sup>7</sup> Riparian rights are correlative in time of shortage, such that no user has priority over others and water use reductions are shared equally.<sup>8</sup> While not easily quantified, riparian rights generally have priority over appropriative rights, excepting an unexercised riparian right.<sup>9</sup> Colorado and other pure appropriative right states have rejected riparian right systems altogether,

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2. *United States v. SWRCB*, 227 Cal. Rptr. 161, 167-69 (Ct. App. 1986).

3. California, Oregon, and Washington (among others) recognize appropriative and riparian rights. David Getches, *Water Law in a Nutshell* 8 (1997).

4. 1850 Cal. Stat. 219.

5. CAL. WATER CODE § 101 (2010) (Riparian rights).

6. *Lux v. Haggin*, 10 P. 674, 754 (Cal. 1886); *Title Ins. & Trust Co. v. Miller & Lux*, 190 P. 433, 437 (Cal. 1920).

7. *People v. Shirokow*, 605 P.2d 859, 864-66 (Cal. 1980); CAL. WATER CODE § 1707 (2010) (Changes for purposes of preserving or enhancing wetlands habitat, fish and wildlife resources, or recreation in, or on, the water).

8. *Pleasant Valley Canal Co. v. Borrer*, 72 Cal. Rptr. 2d 1 (Ct. App. 1998).

9. *Id.* See also *Haight v. Costanich*, 194 P. 26 (Cal. 1920); *In re Water of Hallett Creek Stream System*, 749 P.2d 324 (Cal. 1988); *In re Determination of Water Rights to Waters of Long Valley Creek Stream System*, 158 Cal. Rptr. 350 (1979) (decree in statutory stream system adjudication may assign a lower priority to unexercised riparian rights than to currently active rights).

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choosing instead to recognize only rights gained by prior appropriation.<sup>10</sup>

The appropriative right system originated in California and spread east and north across the West when miners diverted water from natural creeks, streams, and rivers passing through federally owned lands. Water was severed from riparian use on public lands and redirected overland towards capital-intensive mining claims across land the miners did not own.<sup>11</sup> Ever since, the appropriative water right does not arise from land ownership, but instead from the beneficial use of water for a particular purpose.<sup>12</sup>

Nonetheless, appropriative water rights are often *appurtenant* to land, meaning that the right has been added or appended to a property and has become an inherent part of the property that usually passes with the property when title is transferred.<sup>13</sup> A search of recorded title records in a county's office should (but does not always) locate all transfers in the chain of title and whether any interest in an appurtenant right has been severed or transferred from its historic place and purpose of use.<sup>14</sup>

A central maxim of the prior appropriation doctrine is "first in time, first in right," which, unlike riparian rights, does not apportion water shortages equally. Senior rights, relative to when water was first appropriated for that stream or creek, are prioritized and satisfied in full before junior rights receive any water, if at all.<sup>15</sup> Such rights have absolute or strict priority. The essential elements of an appropriative right are: (1) intent to take the water and apply it to a use, (2) actual diversion from the natural channel, and (3) application of the water within a reasonable time to beneficial use.<sup>16</sup>

Pre-1914 water rights are fixed by amount claimed, but the appropriator must be able to prove continuous, beneficial use of the water.<sup>17</sup>

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10. *Coffin v. Left Hand Ditch Co.*, 6 Colo. 443, 447 (1882).

11. *Irwin v. Phillips*, 5 Cal. 140 (1855); *Cal.-Or. Power Co. v. Beaver Portland Cement Co.*, 295 U.S. 142 (1935).

12. CAL. CONST. art. X, § 2; CAL. WATER CODE §§ 1240-41 (2010); *Erickson v. Queen Valley Ranch Co.*, 99 Cal. Rptr. 446 (Ct. App. 1971).

13. Appraisal Institute, *The Dictionary of Real Estate Appraisal* 5th ed. 11 (Chicago Appraisal Institute, 2010).

14. *See Adaven Mgmt, Inc. v. Mountain Falls Acquisition Corp.*, 191 P.3d 1189 (Nev. 2008) (statute allowing water rights to be severed from the land to which they are appurtenant and put to beneficial use elsewhere when certain conditions are met does not require severance of appurtenant water rights before the water rights become separately alienable).

15. CAL. CIV. CODE § 1414 (2010) (Priority Between Appropriators); *City of Barstow v. Mojave Water Agency*, 5 P.3d 853, 864 (Cal. 2000).

16. CAL. CIV. CODE § 1415 (2010) (Appropriation Notice - Posting at Diversion Point - Contents); *Fullerton v. SWRCB*, 153 Cal. Rptr. 518 (Ct. App. 1979).

17. *Smith v. Hawkins*, 52 P. 139 (Cal. 1898); *Wood v. Etiwanda Water Co.*, 81 P. 512 (Cal. 1905).

An appropriator would originally post notice at the point of diversion and locally record a copy of the notice indicating amount, place of use, purpose of use and point of diversion.<sup>18</sup> The date of the posted notice would be the priority date.<sup>19</sup> If the notice was not recorded, the right would not attach or vest until the water was actually put to beneficial use.<sup>20</sup> In some river basins, court-administered *adjudications* have been used to “quiet title” and sort out priorities and quantities of use which are established by court *decree*. In adjudicated basins, superior courts retain jurisdiction over pre-1914 rights instead of the SWRCB.<sup>21</sup>

An application to the SWRCB for a post-1914 appropriative right identifies: (1) annual quantity measured in acre-feet; (2) rate of diversion (often measured in cubic feet per second (“cfs”)); (3) season of diversion; (4) point(s) of diversion; (5) purpose of use; and (6) place of use.<sup>22</sup> The date of the application becomes the priority date.<sup>23</sup>

All appropriative rights can be lost or reduced through: (1) abandonment;<sup>24</sup> (2) forfeiture;<sup>25</sup> or (3) prescription.<sup>26</sup> Abandonment requires relinquishment of control or possession (often nondiversion) and the permanent intent to abandon. Once the right is abandoned there can be no reversion of the right to the owner, since it ceases to exist. Forfeiture is found when all or part of a right is not put to beneficial and reasonable use and the right has been unused for five years. A hearing is required prior to forfeiture. Prescription requires an adverse, continuous, open, notorious, and exclusive use of another’s water right, uninterrupted for five years.<sup>27</sup>

Diversions of *wet water* based on actual diversion and beneficial use of water can be contrasted with a full claim of *paper water*, which is a water right held on paper, but which has not been continuously and beneficially

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18. CAL. CIV. CODE § 1415 (2010) (Appropriation Notice - Posting at Diversion Point - Contents).

19. CAL. CIV. CODE § 1418 (2010) (Relation Back to Date of Notice).

20. CAL. CIV. CODE § 1415 (2010) (Appropriation Notice - Posting at Diversion Point - Contents).

21. *Edson Foulke Yreka Ditch Co. v. Robinson*, Siskiyou County Sup. Ct. Case No. SCSCCV 01-0001864, Ruling on Motion for Summary Adjudication (Jan. 7, 2010).

22. CAL. WATER CODE § 1260 (2010) (Required contents).

23. CAL. WATER CODE § 1450 92010) (Application date; continuance of priority).

24. *Wood v. Etiwanda Water Co.*, 81 P. 512, 514 (Cal. 1905).

25. CAL. WATER CODE § 1241 (2010) (Reversion of unused water).

26. CAL. CIV. PROC. CODE § 318 (2010) (Five-year time limit for possessory actions).

27. A downstream use will not be adverse to an upstream use, unless the diversion for the downstream use is upstream of the upstream user’s diversion point. After *Shirokow*, prescription is not as important in California as it is generally limited to cases where one riparian or pre-1914 right is in conflict with another riparian or pre-1914 right.

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applied.<sup>28</sup> In most appropriative water right states, the historic, continuous application of water is the amount of the defensible right.

State agency-administered water allocation systems have generally over-appropriated water throughout California and most every western stream.<sup>29</sup> The demand for water exceeds the amount of water available for diversion at all levels of supply, except for the intermittent years when high flows exceed all surface storage capabilities and cannot be captured - such flood flows are historically considered *waste* as they flow to the sea.

### **B. Water Transactions**

In recent decades, water law and policy reforms across the western United States have fostered an increasing number of *private, voluntary water transfer transactions* between agricultural and other water users including: (1) purchase; (2) temporary lease agreements; and (3) charitable contributions or donations.

These distinct tools have increasingly been used in conservation transactions to protect, conserve, and restore minimum instream flows in seasonal periods that coincide with important stages in a fishery's lifecycle such as migration, spawning, and rearing. A central premise of these market-based transactions is that farms and fish can coexist in a productive working landscape. This conservation strategy fundamentally recognizes local landowners as an essential stewardship partner to achieve increased instream flows.

While often *appurtenant* to the real property fee interest and transferred during sale with the underlying fee interests, appropriative water rights can also have transferable value independent from a particular parcel. However, the property interest in an appropriative or riparian water right is a function of state law and express limitations can be placed on the ability of the owner of a fee interest to sever the appurtenant right from a particular parcel and transfer it from its place of historic continuous use.<sup>30</sup>

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28. Ellen Hanak, *Who Should be Allowed to Sell Water in California? Third Party Issues and the Water Market*, at 9 (PUBLIC POLICY INSTITUTE OF CALIFORNIA 2003); hereinafter "Water Market."

29. For example, in California the SWRCB estimates that there are at least three times as many paper claims as actual water available in the system, with an approximate 4.8 MAF of upstream water rights applications *pending* for additional out-of-stream diversions upstream from the Delta. Blue Ribbon Task Force, *Delta Vision: Our Vision for the California Delta* 34 (Nov. 2007); Hanak, *Water Market*, *supra* note 28, at 9.

30. *Locke v. Yorba Irrigation Co.*, 217 P.2d 425, 428-29 (Cal. 1950) (appropriative water right severed from portion of real property during sale and retained for exclusive use on portion of property that was not sold).

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### **1. Permanent Acquisition or Sale of an Entire Interest in a Water Right**

The permanent acquisition or sale of an entire interest in a water right is a complete transfer of all interests from one party to another in exchange for a cash payment or other consideration. In many instances, a sale involves both land and water rights, which may be separate taxable property interests of an estate, even if jointly appraised. The sales price is established by the *fair market value* ("FMV"), which is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts.<sup>31</sup> FMV is the value of property sold at its *highest and best use*.

The fair market valuation of a water right asset provides the most cash income to sellers, but may be prohibitively expensive for buyers.<sup>32</sup> In some instances, a *bargain sale* transaction will combine cash and donative components that add up to the FMV and provide full compensation to the water right holder for the value of their asset.

### **2. Temporary Water Right Leases**

A lease is a *temporary* or nonpermanent water transfer transaction that provides a water right holder financial consideration to reduce their full appropriative or riparian diversion for the benefit of temporary instream flows. A lease does not constitute an outright sale or transfer of the right. At the end of the term, the full unencumbered right reverts to the water right holder. A lease provides a water right holder the maximum flexibility regarding future use of the right without restriction, since the lease does not diminish the water right holder's ownership interest, instead only limiting use for a defined period of time. Leases are a temporally limited partial interest in the holder's real property interest in the use of water and are the most common instream water transaction instrument.<sup>33</sup>

*Short-term* or *annual leases* pay a water user to forego water use for part of or an entire irrigation season. Farmers or ranchers may switch to crops that use less water, rotate crops, or fallow for the length of the lease agreement.

*Split-season leases* allow an irrigator to use their water right during a portion of the growing season, often the first half, then lease the remaining right in the second half of the season (usually the drier half towards fall) for

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31. Treas. Reg. § 1.170A-1(c)(2) (Value of a contribution of property).

32. The Trust for Public Land, *Using Land Conservation to Protect Drinking Water Supplies: Source Protection Handbook* 63 (2005); hereinafter "TPL Handbook".

33. Steve Malloch, Trout Unlimited, *Liquid Assets: Protecting and Restoring the West's Rivers and Wetlands through Environmental Water Transactions* 20 (March 2005); hereinafter "Liquid Assets."

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instream purposes.<sup>34</sup> *Rotational pooling agreements* compensate irrigators on a shared ditch system who take turns leasing water rights for instream purposes. *Long-term leases* pay a water user who is willing to forego the use of a water right as originally beneficially used, yet is unwilling to permanently relinquish ownership of the right.<sup>35</sup>

A *forbearance* or *diversion reduction agreement* compensates a water user to reduce or cease water diversions when instream water levels fall below a certain threshold, e.g., in critically dry years. As a short-term instream transfer, a forbearance agreement does not need SWRCB approval.

A *dry-year lease option* compensates a water right holder every year for the right to exercise the option to change the point of diversion or the place and purpose of use in dry or critically dry years, e.g., annual payments of \$10/AF coupled with full payments of \$190/AF for delivery of water during dry or critically dry years.

Distinct from short-term leases and other agreements are water transfers between buyer and seller in the *spot market*. These transactions are generally more expensive than leases, forbearance or option agreements, since their timeframe is much more contemporaneous and reflects a different urgency to acquire water at “whatever price” it may be available.

### 3. Charitable Contributions or Donations of Water Rights

Internal Revenue Code § 170(a) allows federal tax deductions for *charitable contributions* made within a given taxable year. A charitable contribution includes a gift of property to a charitable organization, made with charitable intent and without receipt or expectation of receipt of adequate consideration.<sup>36</sup> The expectation of any quid pro quo *negates the donative intent required for a charitable contribution*.<sup>37</sup>

If a charitable contribution is made in property other than money, the *value of a contribution in property* is the FMV of the property at the time of the contribution, subject to certain adjustments, depending on the nature of the contributed property and/or the status of the donee organization.<sup>38</sup> An effective lifetime charitable contribution removes the gift property from the

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34. *Id.* See also OR. REV. STAT. § 537.348(3) (Purchase, lease or gift of water right for conversion to instream water right; priority dates, expressly authorizing split season leasing for instream flow beneficial uses).

35. Malloch, *Liquid Assets*, *supra* note 33, at 20.

36. I.R.C. § 170(c) (Charitable contribution defined); *Hernandez v. Comm’r*, 490 U.S. 680, 690 (1989).

37. “The legislative history of the ‘contribution or gift’ limitation, though sparse, reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services. Only the former were deemed deductible.” *Hernandez*, 490 U.S. at 690.

38. Treas. Reg. § 1.170A-1(c)(1) (Value of a contribution of property).

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donor's potential gross estate, thus producing both income and wealth transfer tax savings.<sup>39</sup>

A permanent *outright donation* is a donation by a landowner of all interests in property.<sup>40</sup> Donations of an entire right extend to both full temporal use (with no retained future right of use) and entire quantity, e.g., April 1 - October 15 extending to 100% of the total water right diversion. A temporary donation retains the full future interest in the right of use, e.g., August 1 - October 15 for one year only.

The relinquishment of *at least part* of the full use of the entire right can be permanently donated as a partial interest in a water right. Donations of a partial right can be structured for: (1) full temporal use and limited quantity, e.g., April 1 - October 15 and 25% of the total water diversion; or (2) limited temporal use of the entire quantity, e.g., August 1 - October 15 and 100% of the total water diversion; or (3) limited temporal use and limited quantity, e.g., August 1 - October 15 for 25% of the total water diversion.

### III. Internal Revenue Code § 170(f)(3)(B)(iii): Deductions for Certain Charitable Contributions of Partial Interests in Property

#### A. I.R.C. § 170(f)(3)(A): Background and General Rule

Generally, I.R.C. § 170(f)(3) disallows deductions for contributions of partial interests in property unless an express exception applies.<sup>41</sup> A taxpayer cannot donate less than the full value of property while taking a deduction for the full value.<sup>42</sup> Prior to this statutory prescription, such a deduction had been allowed pursuant to a judicial precedent. Section 170(f)(3) was incorporated in the *Tax Reform Act of 1969* to disallow a double tax benefit to taxpayers who donated to a charity the use of a property for a limited period of time.<sup>43</sup> If a deduction for a charity's rent-free use of property were allowed, then the property owner would receive a double benefit through both the exclusion of the foregone rental income and the deduction of the fair rental value of the space donated.<sup>44</sup>

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39. William T. Hutton, *Charitable Giving, Conservation Strategies: Outright Gifts and Bargain Sales* 1-1 (2008).

40. TPL *Handbook*, *supra* note 32, at 63.

41. Treas. Reg. § 1.170A-7 (Contributions not in trust of partial interests in property); Tax Management Portfolios, *Charitable Contributions: Income Tax Aspects*, 521-3rd at A-68; hereinafter, "*Income Tax Aspects*."

42. *Greene v. U.S.*, 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).

43. H.R. Rep. No. 91-413, at 57-58 (1969); S. Rep. No. 91-552, at 87 (1969).

44. *Income Tax Aspects*, *supra* note 41, at 521-3rd at A-68.

A partial interest is any interest in property that consists of less than the donor's entire interest in the property.<sup>45</sup> If a donor who owns property outright transfers every right and interest that the donor has in the property to a permissible donee, the issue of a partial interest does not arise.<sup>46</sup> If a donor retains some right or interest or control over donated property, there is potential the deduction will be disallowed because the donee only received a partial interest.<sup>47</sup> If the retained interest is insubstantial, the donor is considered to have donated his entire interest and the deduction is allowed.<sup>48</sup>

### **B. I.R.C. § 170(f)(3)(B): Exceptions**

There are three express exceptions whereby a partial interest deduction is allowable.<sup>51</sup>

The first two are outside the full scope of this analysis. The first is for a contribution of a *remainder interest* in a personal residence or farm, whereby a present deduction is allowed for a present gift followed by a future transfer, measured as a life estate in years or as tenants for life, from the donor to the designated organization or donee.<sup>52</sup> However, a contribution of the temporary rent-free right to use a water right property interest, i.e., constituting a rent-free lease, is considered a gift of a partial interest and is nondeductible.<sup>53</sup>

A second partial interest deduction is allowed for a contribution of an *undivided portion of the taxpayer's/donor's entire interest* in property.<sup>54</sup> 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 and in other property into which such property is

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45. Treas. Reg. §1.170A-7(a)(1) (Contributions not in trust of partial interests in property - In general).

46. Income Tax Aspects, *supra* note 41, at 521-3rd at A-69.

47. *Id.*

48. *Stark v. IRS*, 86 T.C. 243 (1986).

51. Treas. Reg. §1.170A-7(b) (Contributions of certain partial interests in property for which a deduction is allowed).

52. I.R.C. § 170(f)(3)(B)(i) (Remainder interest); Treas. Reg. § 1.170A-7(b)(3) (Contribution of a remainder interest in a personal residence); Treas. Reg. § 1.170A-7(b)(4) (Contribution of a remainder interest in a farm).

53. I.R.C. § 170(f)(3)(A) (Denial of deduction in case of certain contributions of partial interests in property); Treas. Reg. § 1.170A-7(a)(1) (Contributions not in trust of partial interests in property).

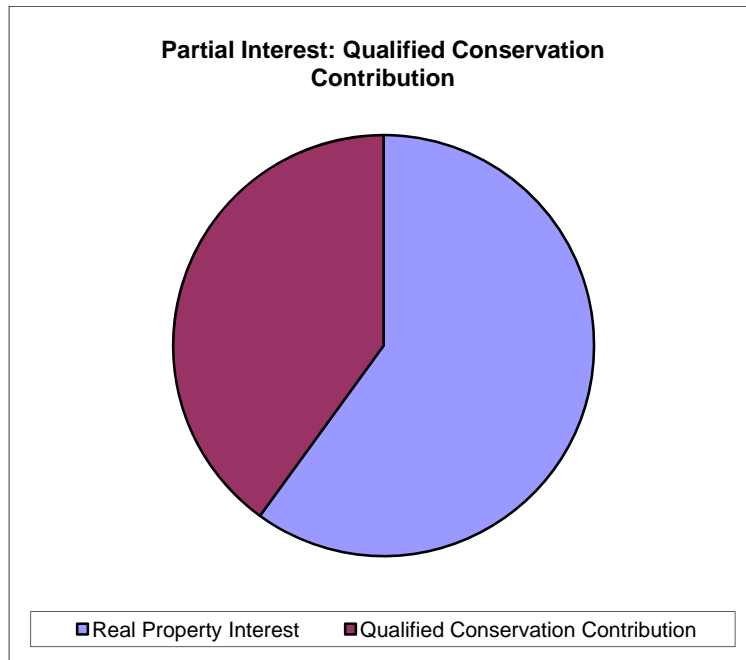
54. I.R.C. § 170(f)(3)(B)(ii); Treas. Reg. § 1.170A-7(b)(1)(i) (Undivided portion of donor's entire interest).

converted.<sup>55</sup> An undivided portion is a quantity as opposed to a temporal interest. Assuming an appropriative water right is a separate property interest, a fraction could be donated and supported (in valuation) by an agreement, which might divide use seasonally. The donor cannot retain any substantial interest such as a future interest in the right.

The third concerns the partial interest deduction exception for a *qualified conservation contribution*.<sup>56</sup>

**GRAPH I:**

Partial Interest: Qualified Conservation Contribution



**C. Conclusion: Fitting Water Rights into Entire or Partial Interests**

**1. Entire Interest: Appropriative Right**

Depending on state restrictions on the severance of appurtenance

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

56. I.R.C. § 170(f)(3)(B)(iii) (Qualified conservation contribution); Treas. Reg. § 1.170A-7(b)(5) (Qualified conservation contribution); Treas. Reg. § 1.170A-14 (Qualified conservation contribution).

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requirements, appropriative water rights can be separate, whole, entire, and independent real property interests distinct from the underlying fee interest where it is beneficially used. An entire water right is not a fraction or percentage carved out of a larger property right.

The donation of an entire right to charity is not subject to the same statutory requirements for deductibility as a partial interest qualified conservation contribution.<sup>57</sup> Donations of entire interests can be more broadly applied without the narrowing limitation or restriction of a partial interest donated to an instream conservation purpose in perpetuity.

While a donation of an entire interest of an appropriative right will likely be rare, these donations have already and will continue to occur. Entire interest donations include donations with or without a conservation purpose and donations that include or do not include an IRS deduction.

Examples of a donation of an entire interest with a conservation purpose which did not include an IRS deduction come from Nevada's Truckee River.<sup>58</sup> Valuable water assets were donated and transferred instream because it was "the right thing to do."<sup>59</sup> While these valuable donations seem irrational, they are evidence that pure donative intent exists without a federal tax deduction benefit.

An example of a donation of an entire interest without a conservation purpose which included an IRS deduction comes from an industrial to municipal use transfer in Washington State.<sup>60</sup> In 2007, another entire interest (without a stated purpose) was donated and transferred to Washington's Department of Ecology accompanied by an unchallenged \$160,000 deduction on an IRS Form 8283 (*Noncash Charitable Contributions*) on Washington's Yakima River.<sup>61</sup> The donated water right was identified as an interest in "real estate."

An example of a donation of an entire interest with an instream conservation purpose which included an IRS deduction comes from Oregon.<sup>62</sup> The donation was made to a non-profit organization, which lawfully received the donated property. The donor claimed an IRS deduction, which went unchallenged.

In each of these examples, the entire interest of the water asset was

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57. Treas. Reg. § 1.170A-7(a)(2)(ii) (Contributions not in trust of partial interests in property - interest given to charitable organization).

58. Telephone conversation with Rob Scanland, Great Basin Land & Water (Jan. 31, 2011).

59. *Id.*

60. Telephone conversation with Harry Sealy, WestWater Research (Jan. 31, 2011).

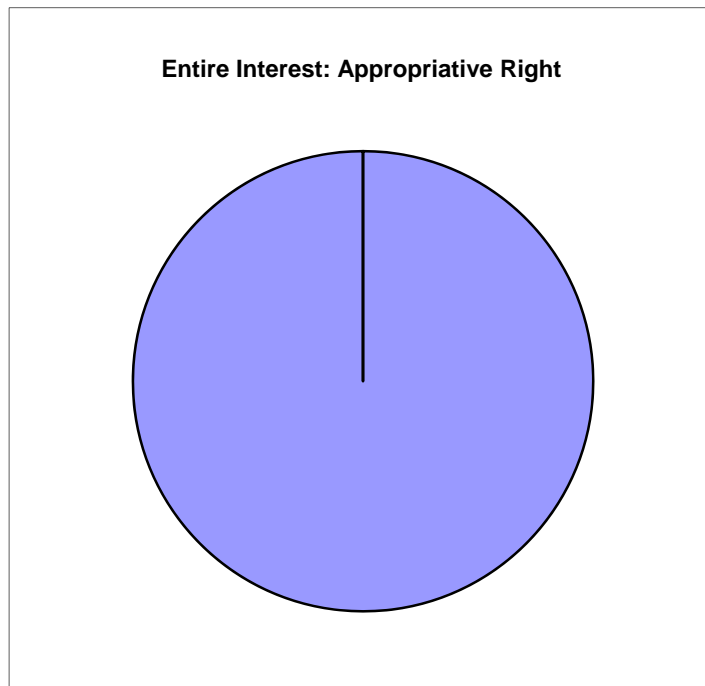
61. IRS Form 8283, Wash. Dep't of Ecology (on file with author).

62. Telephone conversation with Andrew Purkey, former Executive Director of the Oregon Water Trust (Feb. 15, 2011).

donated whether for conservation benefit or not. The lawful donation and transfer of the entire interest in an appropriative water right should qualify for IRS recognition as a federal deduction.<sup>63</sup>

**GRAPH 2:**

Entire Interest: Appropriative Right



**2. Partial Interest: Temporary Lease**

Leases are not permanent transfers of the entire interest and only convey a temporal interest in a water right while retaining a future interest in the full right. A lease retains a substantial interest and is therefore a partial interest. A lease is in conflict with the perpetuity requirement of a qualified conservation contribution and is not deductible. Any attempt to claim a federal tax deduction for a donation of a temporary, nonpermanent, lease ought to be denied.

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63. The issues associated with donation of an entire interest of an appropriative water right are complex and distinct from the partial interest analysis under I.R.C. § 170(f)(3)(B)(iii). The conclusions reached do not reflect a full legal analysis of the entire interest deduction, since the partial interest deduction is the primary focus of this article.

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### **3. Partial Interest: Donative, Long-Term, Nonpermanent Transfer**

Distinct from a temporary lease, there are long-term water transfers that have an instream conservation component in which the donor retains some future right of control over the donated property interest. The failure to relinquish such a substantial future interest is the retention of a partial interest and is not deductible.

An example of a nonpermanent donative instream transfer comes from Boulder Creek in Colorado. The municipal donor made the instream dedication subject to conditions permitting water withdrawal in the event of drought conditions, a potentially substantial future interest.<sup>64</sup>

### **4. Partial Interest: Riparian Right**

As discussed, riparian water rights are part and parcel of an associated real property interest and are not independent, stand-alone or entire interests unto themselves. Riparian rights are traditionally nonseverable partial interests in property that cannot be permanently transferred. Pure appropriations states like Colorado and Montana do not recognize riparian rights.

The consumptive use of a riparian right can be temporarily curtailed or foregone and transferred, generating either direct or indirect instream flow benefits. Since a riparian water right is generally not severable from the riparian fee interest, it is not possible to reserve or exclude riparian rights from a land-based conservation easement. Land-based conservation easement transactions often include riparian rights which have direct impacts on water quality and instream flow.<sup>65</sup> Some states may statutorily allow a riparian right to be permanently transferred instream.<sup>66</sup>

Whether it can be transferred permanently or not, a riparian right can only be a partial interest and never an entire interest. Therefore the

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64. *Instream Water Transfer Agreement* between the Colorado Water Conservation Board and the City of Boulder and related *Findings of Fact, Conclusions of Law, Judgment and Decree*, District Court, Water Division No. 1, Case No. 90CW193 (Dec. 2, 1992) (both on file with author).

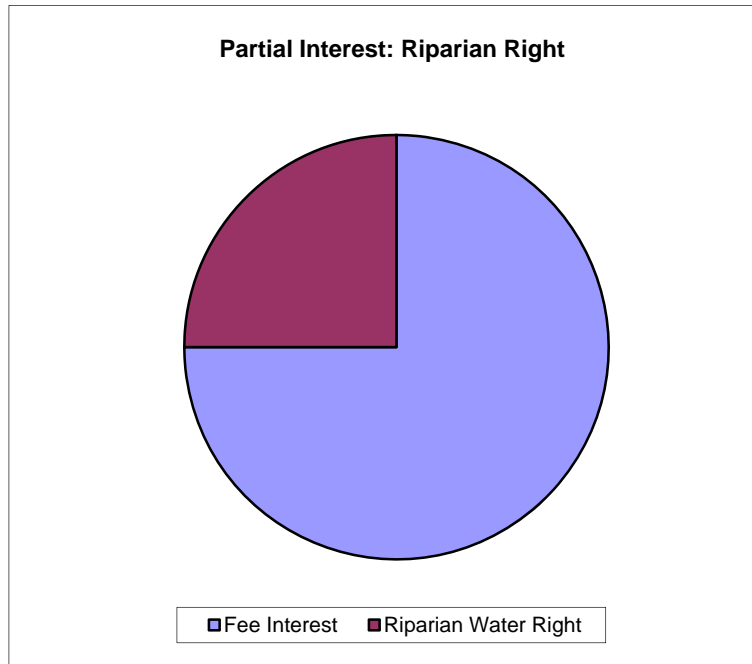
65. Mary Ann King and Sally K. Fairfax, *Beyond Bucks and Acres: Land Acquisition and Water*, 83 TEXAS L. REV. 1941, 1966 (2005).

66. CAL. WATER CODE § 1707 (2010). Section 1707 would allow for a permanent dedication of a riparian right, and the dedication would occur via a petition for change under the transfer provisions specified in the water code. So one could permanently *transfer* the water right to instream flow (change its purpose and place of use under a transfer provision of the water code), without *severing* the right from the land and/or changing ownership. The right would remain a partial interest.

donation of a riparian right can only qualify as a partial interest and, if so, it must be for a conservation purpose.

**GRAPH 3:**

Partial Interest: Riparian Right

**5. Partial Interest: Conserved Water Transferred Instream**

The conserved part of the appropriative or riparian right which is derived from agricultural water use efficiency and eligible for transfer is a partial interest of less than the entire interest in the full right of use.<sup>67</sup> The conserved partial interest can be precisely quantified and measured as a percentage of the entire right. This conserved partial interest is not severed from or splintered off the “parent” right and will presumably continue to enjoy the same seniority instream as waters applied to appurtenant historic beneficial agricultural uses with less water.

However, not all conserved water will include a dedicated instream

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67. The partial interest in conserved water transferred instream is representative and resembles other partial interest possibilities not derived from agricultural water use efficiency such as industrial or other discontinued consumptive uses that no longer need the full original right and where the donor does not relinquish their entire interest, nor is the right split.

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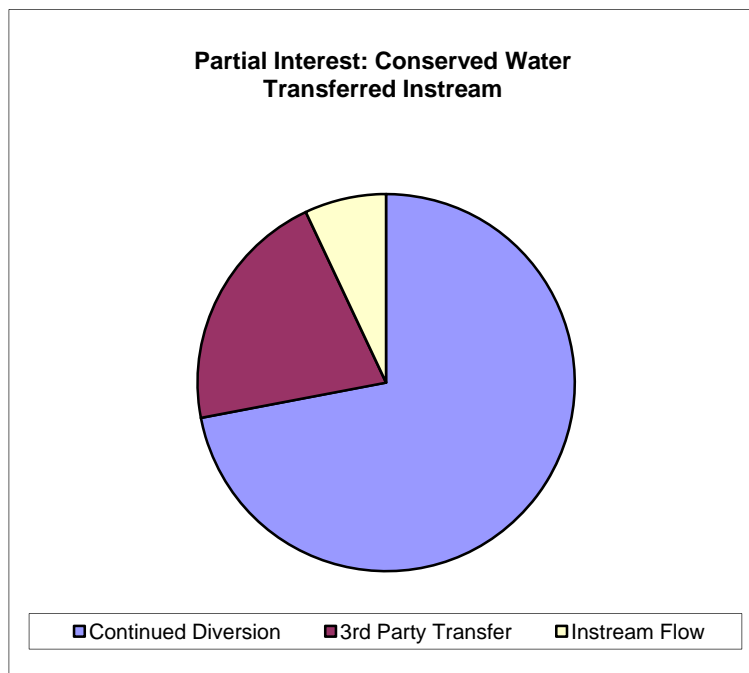
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flow component. Municipal or agricultural water agencies seeking increments of reliable supply may find that the spot market acquisition costs to bridge drought-related gaps between supply and demand, even if only needed one out of ten or three out of twenty years, are more expensive than an outright purchase of the entire right with the fee interest or other longer-term lease arrangements to secure full use of all conserved water. Accordingly, a significant portion of the water potentially available for instream conservation purposes at the drought-induced times when it is needed most may be entirely rediverted out-of-stream by other entities.

Nonetheless, some conserved water transactions will include the potential for a permanent charitable contribution of a partial interest restriction on the entire right which is transferred instream for beneficial conservation purposes with the same senior priority and without risk of forfeiture or abandonment.

**GRAPH 4:**

Partial Interest: Conserved Water Transferred Instream



#### IV. Internal Revenue Code § 170(h): A Qualified Conservation Contribution of a Partial Interest in an Appropriative or Riparian Water Right

Added to the I.R.C. in 1976 and amended in 1980, the IRS 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.<sup>68</sup>

##### A. I.R.C. § 170(h)(2): The Qualified Conservation Contribution Must be a Qualified Real Property Interest

A *qualified real property interest*<sup>69</sup> is any of the following interests in real property: (1) the entire interest of the donor other than qualified mineral interest;<sup>70</sup> (2) a remainder interest;<sup>71</sup> or (3) a restriction (granted in perpetuity) on the use which may be made of the real property.<sup>72</sup>

A conservation easement is a negotiated, voluntary legal agreement between a landowner and a qualified organization to perpetually restrict an otherwise full right of *future, potential* uses of the real property interest, e.g., subdivision, commercial development, etc., in order to protect identified conservation values, which is enforceable under state law.<sup>73</sup>

When a donation of a conservation easement is made, traditionally to protect farms, open space and other conservation values, the donor generally retains the existing uses of the property, which are compatible with the conservation values.<sup>74</sup> A donated partial interest restriction on the

68. I.R.C. § 170(h)(1)(A)-(C) (Qualified conservation contribution); Treas. Reg. § 1.170A-14 (Qualified conservation contribution).

69. Treas. Reg. § 1.170A-14(b) (Qualified real property interest).

70. I.R.C. § 170(h)(2)(A) (Entire interest); Treas. Reg. § 1.170A-14(b)(1)(i) (Entire interest of donor other than qualified mineral interest).

71. I.R.C. § 170(h)(2)(B) (Remainder interest); *see also* I.R.C. § 170(f)(3)(B)(i) (Remainder interest); Treas. Reg. § 1.170A-7(b)(3) (Contribution of a remainder interest in a personal residence); Treas. Reg. § 1.170A-7(b)(4) (Contribution of a remainder interest in a farm).

72. I.R.C. § 170(h)(2)(C) (Restriction granted in perpetuity); Treas. Reg. § 1.170A-14(b)(2) (Perpetual conservation restriction); Treas. Reg. § 1.170A-14(g) (Enforceable in perpetuity).

73. Janet Diehl and Thomas S. Barrett, *THE CONSERVATION EASEMENT HANDBOOK*, Chapter 4: An Attorney's Checklist (1988 edition); CAL. WATER CODE § 1020 *et seq.* (2010) (Water Leases); Elizabeth Byers and Karin Marchetti Ponte, *THE CONSERVATION EASEMENT HANDBOOK*, 14 (2d Ed. 2005); *see also* Peter D. Nichols, *Do Conservation Easements and Water Mix (in Colorado)*, 5 U. DENV. WATER LAW REV. 504 (2001).

74. To conceptually frame some of the nuanced distinctions between a donation of the partial interest in a water right under the conservation exception and a donation of the entire interest in the water right consider: (1) Is the donor giving an

full use of a water right will result in nondiverted water to be transferred instream. The retained existing uses of the water right are not the same as the retained uses of a fee interest encumbered by a traditional easement. However, the preservation or enhancement of instream conservation values will create a new and legally recognized instream beneficial use, which does not preclude the donor from a continued reasonable and beneficial use of the water right. The water right would not need to be severed from the fee interest, if appurtenant, in order to qualify for a potential tax deduction.

A partial interest donation of an easement restricting or encumbering the full use of a water right is legally distinct from a donation of an entire and unencumbered real property interest in a water right. The mechanism for a donation of an entire interest in a water right to instream flows would be a transfer petition under California state law, while the mechanism for a donation of a partial interest would be a conservation easement restriction on the full use of a water right, which is not an instream dedication. A combination of an enforceable conservation easement restriction plus a transfer petition that dedicates the partial interest restriction to an instream conservation purpose/beneficial use would be necessary to fully effectuate the donor's intent.

### **1. Appropriative and Riparian Water Rights as State-Defined Real Property Interests**

The nature and extent of property interests are primarily defined by state law.<sup>75</sup> "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."<sup>76</sup> In addition, the IRS is bound by state court decisions interpreting state law where the outcome of a tax matter depends on the application of state law to a property rights issue.<sup>77</sup>

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affirmative right to a qualified organization to enforce a conservation restriction or is the organization restricting the right of the donor to unfettered and valuable future uses of the real property interest? (2) Is the donor donating a bundle of sticks to a qualified organization or is the organization restricting the use of certain sticks?

75. *Webb's Fabulous Pharmacies v. Beckwith*, 449 U.S. 155, 161 (1980); *Board of Regents v. Roth*, 408 U.S. 564, 577 (1984); *Phillips v. Washington Legal Foundation*, 524 U.S. 156, 183 (1998).

76. *Connecticut v. Massachusetts*, 282 U.S. 660, 670 (1931).

77. *Estate of Bosch v. Comm'r*, 387 U.S. 456 (1967).

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**CHART 1:**  
State Water Law Basic Characteristics

<b>Law</b>	<b>California</b>	<b>Oregon</b>	<b>Washington</b>	<b>Montana</b>	<b>Colorado</b>
Public ownership of water	Yes	Yes	Yes	Yes	Yes
Right conditioned on reasonable and beneficial use	Yes	Yes	Yes	Yes	Yes
Right of use is real property interest	Yes	Yes	Yes	Yes	Yes
Riparian rights	Yes	Yes*	Yes*	No	No
Year of state agency regulation and permitting of surface flow	1914	1909	1917	1973	1969
Appurtenant right can be severed and transferred independently of fee interest	Yes	Yes	Yes	Yes	Yes

\* Vestiges of riparian rights.

#### **a. California**

All water within California is the property of the people of the state, but the right to the *use* of water may be acquired by appropriation in the manner provided by law.<sup>78</sup> The running waters of the state are public property and the state may properly condition a private individual's use of such property, the title to which remains in the public.<sup>79</sup> Both riparian and appropriative rights are *use* or *usufructuary rights* only and confer no right of

78. CAL. WATER CODE § 102 (2010) (State ownership of water; right to use); CAL. WATER CODE § 1201 (2010) (Public water of state; appropriation).

79. *Schaezlein v. Cabaniss*, 67 P. 755, 757 (Cal. 1902).

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private ownership in the water course.<sup>80</sup> There is no right, title or interest in the corpus of water.<sup>81</sup>

While there is no private property right in the corpus of water, the right of use is recognized as real property.<sup>82</sup> The right of use, though not an interest in the corpus of the water itself, is “unquestionably a species of real property.”<sup>83</sup> Water rights are considered rights in real property.<sup>84</sup> An appropriative right is an interest in real property.<sup>85</sup> A riparian right is “part and parcel” of riparian land and the right to flow is real property.<sup>86</sup> “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.”<sup>87</sup>

**b. Oregon**

All water within Oregon from all sources belongs to the public for appropriation for beneficial use without waste.<sup>88</sup> The Oregon Water Code was established in 1909. Persons may not use, store, or divert any waters without a state permit authorizing appropriation.<sup>89</sup> Riparian rights are recognized, but are vestiges from an earlier era.

An appropriative right is appurtenant to the premises upon which it is used and the right of use is considered real property.<sup>90</sup> A water right

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80. *People v. Shirokow*, 605 P.2d 859, 864 (Cal. 1980); *Rancho Santa Margarita v. Vail*, 81 P.2d 533, 560 (Cal. 1938) (right of use).

81. CAL. WATER CODE § 1001 (2010) (Title to water).

82. *Locke v. Yorba Irrigation Co.*, 217 P.2d 425 (Cal. 1950).

83. *State v. Super. Ct. of Riverside Cnty.*, 96 Cal. Rptr. 2d 276, 281 (Ct. App. 2000).

84. *City of San Bernardino v. City of Riverside*, 198 P. 784, 787 (Cal. 1921); *City and County of San Francisco v. Alameda County*, 54 P.2d 462, 464 (Cal. 1936).

85. *Wright v. Best*, 121 P.2d 702, 711 (Cal. 1942); *Thayer v. Cal. Dev. Co.*, 128 P. 21 (Cal. 1912); *Santa Fe Trail Ranches Prop. Owners Ass'n v. Simpson*, 990 P.2d 46, 53 (Colo. 1999).

86. *Title Insurance & Trust Co. v. Miller & Lux*, 190 P. 433, 437 (Cal. 1920).

87. *McDonald v. Bear River & Auburn Water & Mining Co.*, 13 Cal. 220, 232-33 (1859).

88. OR. REV. STAT. § 537.110 (2010) (Public ownership of waters); OR. REV. STAT. § 537.120 (2010) (Right of appropriation; vested rights protected); OR. REV. STAT. § 536.310(1) (2010) (Purposes and policies to be considered in formulating state water resources program); OR. REV. STAT. § 537.120 (2010) (Right of appropriation; vested rights protected); OR. REV. STAT. § 540.610 (2010) (Use as measure of water right; forfeiture for nonuse; confirmation of rights of municipalities).

89. OR. REV. STAT. § 537.130 (2010) (Permit to appropriate water required).

90. OR. REV. STAT. § 540.510 (2010) (Appurtenancy of water to premises; restrictions on change of use, place of use or point of diversion; application for transfer of primary and supplemental water rights; right to use conserved water).

becomes a private property right upon establishing control.<sup>91</sup> When land is sold, appurtenant water rights attach with the conveyance, unless specifically excluded. Even if such rights are excluded, they remain appurtenant to the land until a water rights transfer is approved. Instream transfers are expressly exempt from and can otherwise sever the appurtenance requirement.<sup>92</sup>

### **c. Washington**

In Washington, all waters belong to the public with the right of use limited to appropriations for beneficial use subject to priority.<sup>93</sup> The Washington Water Code for surface water rights was established in 1917. Vestiges of riparian rights remain, but such rights acquired prior to 1917 had to be perfected through beneficial use by 1932 or were lost.<sup>94</sup> Washington courts have found that the 1917 water code essentially converted pre-1932 riparian rights to appropriative rights, but no new riparian rights can be created.

The use of water is an appurtenant property right, which can be transferred without loss of priority, so long as the change can be made without detriment or injury to existing rights.<sup>95</sup>

### **d. Montana**

The waters within Montana are the property of the state for use by the people subject to appropriation for beneficial uses.<sup>96</sup> As a pure prior appropriation state, Montana also operates under the shorthand "first in time, first in right."<sup>97</sup> In 1973, Montana passed the *Water Use Act* instituting a permit system for new appropriation applications.

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91. *Dry Gulch Ditch Co. v. Hutton*, 133 P.2d 601 (Or. 1943).

92. OR. REV. STAT. § 540.510(2) (2010) (Appurtenancy of water to premises; restrictions on change of use, place of use or point of diversion; application for transfer of primary and supplemental water rights; right to use conserved water).

93. WASH. REV. CODE § 90.03.010 (2010) (Appropriation of water rights - Existing rights preserved).

94. *In re Adjudication of Deadman Creek, Dep't of Ecology v. Abbott*, 694 P.2d 1071 (Wash. 1985) (Fifteen years deemed reasonable notice to put water to reasonable use on riparian lands after adoption of 1917 water code).

95. WASH. REV. CODE § 90.03.380 (2010) (Right to water attaches to land - Transfer or change in point of diversion - Transfer of rights from one district to another - Priority of water rights applications - Exemption for small irrigation impoundments).

96. MONT. CONST. art. IX, § 3(3); MONT. CODE ANN. § 85-2-101(1) (2010) (Declaration of policy and purpose).

97. MONT. CODE ANN. § 85-2-401 (2010) (Priority - recognition and confirmation of changes in appropriations issued after July 1, 1973).

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Real property consists of that which is incidental or appurtenant to land.<sup>98</sup> An appurtenant water right is an interest in the land subject to fair market valuation.<sup>99</sup> One who has appropriated water in Montana acquires a distinct property right, which is a species of property in and of itself, and considered a property of the “highest order.”<sup>100</sup>

Water rights are treated as property rights and, like land, can be freely transferred, such that a landowner can sell his land with the attached water right and the new owner will have the same consumptive use of the entire water right. Water rights may also be expressly exempted from the sale of land by deed and be sold separately or retained, thereby severing the water right from the historic place of use.

**e. Colorado**

The Colorado Constitution declares all the waters of the state are public property subject to appropriation and conditioned on beneficial use.<sup>101</sup> The right to use shall never be denied.<sup>102</sup> Colorado recognized surface water flow rights upon Statehood with the adoption of the prior appropriation doctrine.<sup>104</sup> The three elements of an 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.<sup>105</sup> Riparian rights are not recognized in this pure appropriations state.<sup>106</sup> In 1969, Colorado passed the *Water Right Determination and Administration Act* to adjudicate water rights and priorities.

Water rights are usufructary rights and are considered separate and distinct real property interests.<sup>107</sup> “The right to divert water is an interest in real estate.”<sup>108</sup> “There is absolutely no question that a decreed water right is

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98. MONT. CODE ANN. § 70-1-106(3) (2010); *Dep’t of State Lands v. Pettibone*, 702 P.2d 948, 955 (Mont. 1985).

99. *Pettibone*, 702 P.2d at 955; *Yellowstone Co. v. Assoc. Mortg. Investors*, 290 P. 255 (1930) (spring waters appurtenant to land).

100. *Harrer v. N. Pac. Ry. Co.*, 410 P.2d 713 (Mont. 1966).

101. COLO. CONST. art. XVI, § 5.

102. COLO. CONST. art. XVI, § 6.

104. COLO. CONST. art. XVI, § 6.

105. COLO. CONST. art. XVI, § 6; COLO. REV. STAT. § 37-92-103(3)(a) (2010); § 37-92-103(7) (2010) (Definitions - “Diversion”); § 37-92-103(4) (2010) (Definitions - “Beneficial use”); *Colo. River Water Conservation Dist. v. Rocky Mountain Power Co.*, 406 P.2d 798, 800 (Colo. 1965).

106. *Coffin v. Left Hand Ditch Co.*, 6 Colo. 443, 447 (1882).

107. *Shirola v. Turkey Canon Ranch, LLC*, 937 P.2d 739, 747-48 (Colo. 1997) (“Due to its usufructary nature, the property right is the right to use water.”).

108. *West End Irrigation Co. v. Garvey*, 184 P.2 476, 479 (Colo. 1947); *see also Brighton Ditch Co. v. City of Englewood*, 237 P.2d 116, 120 (Colo. 1951).

valuable property.”<sup>109</sup> Water rights can be conveyed and transferred like real estate, independent from the land where they were used historically.<sup>110</sup>

Colorado requires water rights to be transferred with the same formalities as real estate.<sup>111</sup> “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.”<sup>112</sup>

## **2. Limitations on the Private Real Property Interest in an Appropriative and Riparian Right**

While an appropriative right is a species of real property, in California the right of use is legally constrained by a number of public interest considerations that diminish the certainty and limit the full use of the private right in any given year.<sup>113</sup> California law invokes the following public interest authorities to limit the private use of water.

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109. *Farmers Highline Canal v. Golden*, 272 P.2d 629, 631 (Colo. 1954).

110. COLO. REV. STAT. § 38-30-102 (Water rights conveyed as real estate - well permit transfers - legislative declaration - definitions); *Navajo Dev. Co. v. Sanderson*, 655 P.2d 1374 (Colo. 1982); *Strickler v. Colo. Springs*, 26 P. 313, 316 (Colo. 1891); *Lower Latham Ditch Co. v. Bijou Irr. Co.*, 93 P. 483, 484 (Colo. 1907).

111. COLO. REV. STAT. 38-30-102; *see also Child v. Whitman*, 42 P. 601 (Colo. App. 1896).

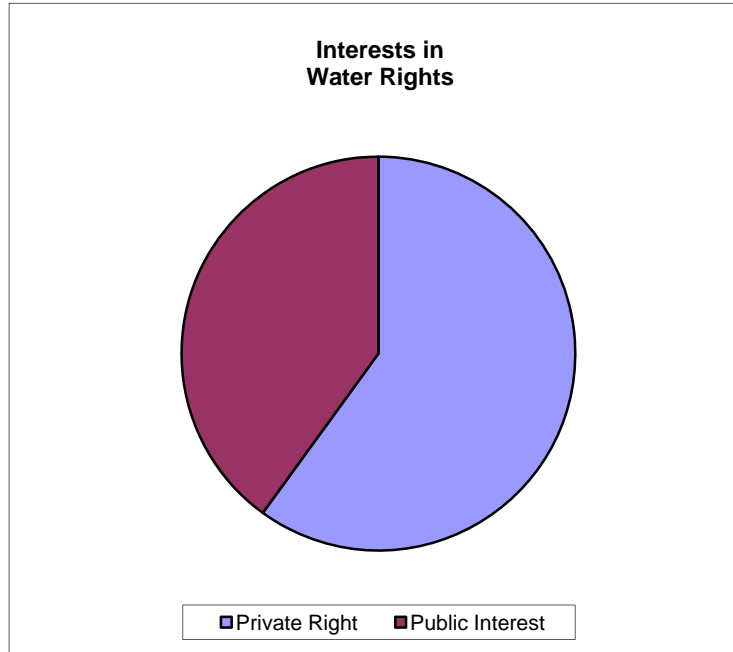
112. *High Plains A&M, LLC v. Se. Colo. Water Conservancy Dist.*, 120 P.3d 710 (Colo. 2005) (citing *Strickler*, 26 P. at 316).

113. *United States v. SWRCB*, 227 Cal. Rptr. 161, 168-69 (Ct. App. 1986) (Distinguishing rights of use from real property rights); *see also State v. Super. Ct. (Underwriters at Lloyd's London)*, 93 Cal. Rptr. 2d 276 (Ct. App. 2000); *Cal. Farm Bureau Fed'n v. SWRCB*, 51 Cal.4th 421 (2011).

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**GRAPH 5:**

Private Rights and Public Interests in a Water Right



**a. Reasonable and Beneficial Use**

All California water rights are conditioned on reasonable and beneficial use, which is embedded in the California Constitution as Article X, Section 2.<sup>114</sup> If a water right holder wastes water, uses water unreasonably, or uses an unreasonable method of use or diversion, the right can be limited or forfeited.<sup>115</sup> There is no property right in an unreasonable

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114. "It is hereby declared that because of the conditions prevailing in this State the general welfare requires that the water resources of the State be put to beneficial use to the fullest extent of which they are capable, and that the waste or unreasonable use or unreasonable method of use of water be prevented, and that the conservation of such waters is to be exercised with a view to the reasonable and beneficial use thereof in the interest of the people and for the public welfare. The right to water or to the use or flow of water in or from any natural stream or water course in this State is and shall be limited to such water as shall be reasonably required for the beneficial use to be served, and such right does not and shall not extend to the waste or unreasonable use or unreasonable method of use or unreasonable method of diversion of water."

115. *Erickson v. Queen Valley Ranch Co.*, 99 Cal. Rptr. 446 (Ct. App. 1971); CAL. WATER CODE § 275 (2010) (Prevention of unreasonable use of water).

use of water.<sup>116</sup> Likewise, what is a beneficial use at one time may, because of changed conditions, become a waste of water at a later time.<sup>117</sup> Each right to use may be regulated by Article X, § 2, which is an expression of the reservation of the police power of the state over water rights to be exercised without payment of “just compensation.”<sup>118</sup> The SWRCB has authority over all rights to limit waste and unreasonable use of water.<sup>119</sup>

### b. Public Trust Doctrine

The Public Trust Doctrine (“PTD”) is the fiduciary obligation of the State to protect inalienable environmental, navigational, recreational, and other public rights inherent in the public commons.<sup>120</sup> A vested appropriative right may be modified and reduced to comply with the public trust requirements without compensation.<sup>121</sup> The PTD “prevents any party from acquiring a vested right to appropriate water in a manner harmful to the interest protected by the public trust” and essentially makes any vested right defeasible (or partially defeasible).<sup>122</sup>

### c. Water Quality

The SWRCB adopts water quality objectives that will protect beneficial

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116. *Joslin v. Marin Mun. Water Dist.*, 429 P.2d 889, 898 (Cal. 1967).

117. *Tulare Irrigation Dist. v. Lindsay-Strathmore Irrigation Dist.*, 45 P.2d 972, 1007 (Cal. 1935) (referring to a once, but no longer, reasonable use of water to flush out and drown gophers on a parcel of property and finding such use to be a “waste” of water); see also *City of Barstow v. Mojave Water Agency*, 5 P.3d 853 (Cal. 2000) (“[w]hat constitutes reasonable water use is dependent upon not only the entire circumstances presented but varies as the current situation changes.”)

118. *Gin S. Chow v. City of Santa Barbara*, 22 P.2d 5, 16-17 (Cal. 1933); see also *Dep’t of Ecology v. Adsit*, 694 P.2d 1065 (Wash. 1985) (the state’s police powers over waters includes the power to limit and even extinguish existing water rights).

119. CAL. WATER CODE § 275 (2010) (Prevention of unreasonable use of water); *In re Water of Hallett Creek Stream System*, 749 P.2d 324, 337 n. 16 (Cal. 1988) (SWRCB authority to apply public trust and reasonableness requirements to riparian rights); SWRCB Order WR 95-4 Big Bear (same, pre-1914 rights); *Imperial Irrigation Dist. v. SWRCB*, 231 Cal. Rptr. 283 (Ct. App. 1986) (confirming SWRCB authority over pre-1914 and contract rights under Water Code § 275).

120. *Ill. Cent. R.R. Co. v. Illinois*, 146 U.S. 387 (1892); *Mont. Coal. for Stream Access v. Curran*, 682 P.2d 163, 171 (Mont. 1984); *State Eng’r v. City of Golden*, 69 P.3d 1027 (Colo. 2003); *Aspen Wilderness Workshop, Inc. v. CWCB*, 901 P.2d 1251 (Colo. 1995); *Orion Corp. v. Washington*, 747 P.2d 1062 (Wash. 1988); *Caminiti v. Boyle*, 732 P.2d 989 (Wash. 1987); *Wilbour v. Gallagher*, 462 P.2d 232 (Wash. 1969); *Rettkowski v. Dep’t of Ecology*, 858 P.2d 232 (Wash. 1993).

121. *Nat’l Audubon Soc’y v. Superior Court*, 658 P.2d 709, 722-23 (Cal. 1983); See also *infra*, note 139 (citing takings cases).

122. *Nat’l Audubon Soc’y*, 658 P.2d at 726-27; see also *SWRCB Cases*, 39 Cal. Rptr. 3d 189 (Cal. App. 2006) (for how SWRCB applies the public trust doctrine).

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uses.<sup>123</sup> The SWRCB has regulatory authority to prevent uses that unreasonably harm water quality and implements water quality objectives through various means, including water right orders, which can amend individual appropriative water right permits and curtail private uses of water.<sup>124</sup> This authority to amend water right permits extends to evaluations of the relative benefit to be derived from competing uses of water, even those senior rights which are beneficial and reasonable, but which become less so when water quality impacts are considered.<sup>125</sup> Senior rights may be required to shoulder some of the burden required to meet water quality objectives.<sup>126</sup>

**d. Area of Origin Protections<sup>127</sup>**

The purpose of the *County of Origin Act* and other similar laws is to “reserve for the areas where water originates some sort of right to such water for future needs which is preferential or paramount to the right of outside areas . . .”<sup>128</sup> These laws protect areas (typically more rural, north and east) from water supply encroachment by faster-growing areas (usually urban/suburban and more south and west) that may otherwise establish senior and priority rights to the exclusion of local future uses in the headwaters of the area of origin.

**e. Fish & Game Code**

Fish & Game Code § 5937 and § 5946 authorize the Department of Fish and Game (“DFG”) to direct the operators of a dam to release enough water to keep fish below the dam in “good condition.”<sup>129</sup> The SWRCB has authority

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123. SWRCB Water Right Decision 1641 (“D-1641”) (Dec. 29, 1999).

124. *United States v. SWRCB*, 227 Cal. Rptr. 161 (Ct. App. 1986); SWRCB Orders WR 95-6 and 98-09.

125. CAL. WATER CODE § 1257 (2010) (Consideration of relative benefit); *United States v. SWRCB*, 227 Cal. Rptr. 161 at 189.

126. *El Dorado Irrigation Dist. v. SWRCB*, 48 Cal. Rptr. 3d 468, 491 at fn. 21 (Ct. App. 2006)

127. CAL. WATER CODE § 10505 (2010) (Restrictions on release or assignment; also County of Origin Protection Act); CAL. WATER CODE § 11460 *et seq.* (2010) (Prior right to watershed water; also Watershed Protection Act); CAL. WATER CODE § 12200 *et seq.* (2010) (Sacramento-San Joaquin Delta; also Delta Protection Act); CAL. WATER CODE § 12230 *et seq.* (2010) (San Joaquin River; also San Joaquin River Protection Act); collectively “Area of Origin Protections”.

128. Opinion No. 53-298, 25 Ops. Cal. Atty. Gen. 8, 10 (1955); *see also* Virginia Cahill, California Attorney General opinion letter to John Kirlin, Delta Vision, (July 2, 2008) (Area of Origin Provisions in California Law).

129. While the definition of good condition is not fixed, Cal. Fish & Game Code section 5937 has been used most recently to show that sixty miles of a completely dewatered San Joaquin River was unable to keep historic runs of spring

to modify permits and licenses to ensure sufficient water flows for downstream fisheries.<sup>130</sup>

#### f. Endangered Species Act

Title to the fish within state waters is held in trust by the state for the people of the state.<sup>131</sup>

Both federal and California law prohibits the “take” or killing of a threatened or endangered species.<sup>132</sup> An endangered species is in danger of extinction in all or a significant part of its range and a threatened species is one that is likely to become endangered in the near future.<sup>133</sup> Agencies such as DFG, National Marine Fisheries Service (“NMFS”), and the U.S. Fish & Wildlife Service (“USFWS”) have the authority to limit the use of an appropriative or contractual water right to protect wildlife and fish.<sup>134</sup> The ESA has been at the center of court-ordered reductions of water for export south through State Water Project and Central Valley Project pumps in the Delta.<sup>135</sup>

However, the Takings Clause of the Fifth Amendment of the U.S. Constitution bars “Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”<sup>136</sup> The public reallocation of any portion of a private right of use to an instream flow purpose for endangered species without compensation is the central issue in “takings” litigation related to the physical or regulatory taking of property by the government.<sup>137</sup> The fair market valuation and appropriate damages compensation for the taking of

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and fall run Chinook salmon in good condition. The river was dry and there were no fish.

130. *Cal. Trout, Inc. v. SWRCB*, 255 Cal. Rptr. 184 (Ct. App. 1989).

131. *People v. Glenn-Colusa Irr. Dist.*, 15 P.2d 549 (Cal. Ct. App. 1932).

132. 16 U.S.C. § 1531 *et seq.* (2010) (“Take” of endangered species); Cal. Fish & Game Code § 2073 *et seq.* (2010).

133. 16 U.S.C. § 1536 (2010).

134. 16 U.S.C. § 1536 (2010).

135. *Natural Res. Def. Counsel v. Kempthorne*, 506 F. Supp. 2d 322 (E.D. Cal. 2007); *see also Delta Smelt Consolidated Cases*, 2010 WL 2520946 (E.D. Cal. 2010).

136. *Armstrong v. U.S.*, 364 U.S. 40, 49 (1960).

137. *Tulare Lake Basin Water Storage Dist. v. U.S.*, 76 Fed. Cl. 100 (2001); *Tulare Lake Basin Water Storage Dist. v. U.S.*, 49 Fed. Cl. 313 (2001); *Tulare Lake Basin Water Storage Dist. v. U.S.*, 59 Fed. Cl. 246 (2003); *Klamath Irrigation Dist. v. U.S.*, 67 Fed. Cl. 504 (2005); *Casitas Mun. Water Dist. v. U.S.*, 72 Fed. Cl. 746 (2006); *Casitas Mun. Water Dist. v. U.S.*, 76 Fed. Cl. 100 (2007); *see also* John D. Echeverria, *Is Regulation of Water a Constitutional Taking?*, 11 *Vt. J. ENVTL. L.* 581 (2010). A full analysis of these cases is beyond the scope of this article. The cases commonly address physical versus regulatory takings of water rights by governmental agencies and the compensable property interest, if any, protected by the Constitution.

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these rights for public benefit is fiercely litigated issue.<sup>138</sup>

**g. Nuisance Law**

California nuisance law also places a restriction on the private use of water rights to the extent that any such nuisance interferes with public property rights such as the right to free passage or use of any navigable river.<sup>139</sup>

**3. Conclusion Regarding Qualified Real Property Interest**

Again, the general rule regarding partial interests prohibits deductions, except for partial interests that are qualified conservation contributions.

The real property interest in an appropriative or riparian water right to the use of the public water resource is determined by state-level property law. State law will define whether appropriative and riparian water rights are real property interests and address related issues of appurtenance, severability, instream transfer, and ownership of conserved water.

Each of the surveyed states recognizes the real property interest in an appropriative and/or riparian water right. Accordingly, a voluntary restriction on the full right of use of an appropriative or riparian right is a partial interest of a qualified real property interest.<sup>140</sup>

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138. Steven Herzog, MAI, *Final Report: Guidelines for the Appraisal of Water Rights in California* 3-12 (Sept. 2006) (Taking plus damages appraisals); hereinafter "*Water Rights Appraisal Guidelines*."

139. CAL. CIV. CODE § 3479 (2010) (Acts constituting nuisance.); *see also People v. Gold Run Ditch & Mining Co.*, 4 P. 1152, 1153-1154 (Cal. 1884) (Court upheld nuisance injunction prohibiting discharge of hydraulic mining gravel into navigable waters. River beds had risen between 6-12 feet preventing navigation.).

140. *Eastern Enterprises v. Apfel*, 524 U.S. 498 (1998).

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**CHART 2:**

## Land &amp; Water Right Conservation Easement Matrix

<b>Land Component</b>	<b>Water Component</b>	<b>Riparian</b>	<b>Appropriative</b>	<b>Restrictions</b>
Yes	No	No	No	Traditional CE should include express language reserving all water rights to donor.
Yes	Yes	Yes	No	Fee interest and riparian right are entire interest. Riparian right is partial interest, which is part and parcel of property and generally non-severable. Permanent instream transfer may be possible per state law without severance.
Yes	Yes	No	Yes	Fee interest and appurtenant appropriative right are two separate entire interests which may need to be appraised independently of one another. Confirm state law regarding restrictions on severance of appurtenance and transfer of appropriative right.
Yes	Yes	Yes	Yes	Hybrid. Analyze each right separately.
No	Yes	Yes	No	Not possible. Riparian right is partial interest, which is part parcel of property and non-severable.
No	Yes	No	Yes	Severed and transferred appropriative right ought to be substantiated wet water and independently appraised.

**B. I.R.C. § 170(h)(3): The Qualified Conservation Contribution Must be Given to a Qualified Organization<sup>141</sup>**

A qualified conservation contribution of the qualified real property interest in a water right must be permanently dedicated to either a government unit or a publicly supported 501(c)(3) charitable organization or both.<sup>142</sup>

The public agency or charitable organization qualified and authorized to hold the donated interest in a right transferred instream must have the commitment and resources to monitor and enforce the easement's restrictions.<sup>143</sup> Even if the interest is donated for "free," the state agency or qualified organization acquires all the liabilities of instream flow stewardship in perpetuity, including a long-term relationship with the water right donor. Qualifications subject to IRS review include: a resolution by public agency or Board of Directors accepting the qualified conservation contribution, an annual report indicating track record and organizational finances, Board biographies and expertise, policies in regard to easement acquisition and enforcement, as well as a backup grantee as necessary.<sup>144</sup> Such easements can only be transferred to other qualified organizations.<sup>145</sup>

Starting with the Oregon Water Trust ("OWT") in 1993, a growing number of public interest, I.R.C. § 501(c)(3) non-profit organizations have been created to focus on the opportunities created by water market reforms.<sup>146</sup> These organizations redirect out-of-stream diversions back to instream flows.<sup>147</sup> Generally, water trusts work to restore instream flows and

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141. Treas. Reg. § 1.170A-14(c) (Qualified organization).

142. I.R.C. § 170(h)(3)(A); I.R.C. § 170(b)(1)(A)(v) (Governmental unit); Treas. Reg. § 1.170A-14(c)(i) (Governmental unit); I.R.C. § 509(a)(2) (Private foundation defined - public support test); I.R.C. § 170(b)(1)(A)(vi) (General rule); Treas. Reg. § 1.170A-14(c)(iii) (A charitable 501(c)(3) organization).

143. Treas. Reg. 1.170A-14(c)(1) (Eligible donee).

144. *Id.*

145. Treas. Reg. §1.170A-14(c)(2) (Transfers by the donee).

146. The Freshwater Trust, <http://www.thefreshwatertrust.org> (last visited Mar. 1, 2011) (The Freshwater Trust is the result of a merger with the Oregon Water Trust and Oregon Trust).

147. Deschutes River Conservancy, <http://www.deschutesriver.org> (last visited Mar. 1, 2011); Washington Water Trust, <http://washingtonwatertrust.org> (last visited Mar. 1, 2011); Washington Rivers Conservancy <http://www.warivers.org> (last visited Mar. 1, 2011); Clark Fork Coalition Missoula Montana, <http://www.montanawatertrust.org> (last visited Mar. 1, 2011); Colorado Water Trust, <http://www.coloradowatertrust.org> (last visited Mar. 1, 2011); Scott River Water Trust, <http://www.scottwatertrust.org> (last visited Mar. 1, 2011). The information relating to water trusts generally and specifically to these organizations to follow is synthesized directly from their respective websites.

water quality to support and enhance fish, wildlife and recreational resources.<sup>148</sup> All or a portion of an agriculturally used water right is re-directed instream to maintain critical aquatic habitat and water temperature, especially during the late months of the summer irrigation season when it is not uncommon for fish migration, spawning, or rearing habitat to overheat due to low flows or to run completely dry.

Similar in concept to land trusts, the fundamental commonality of water trusts is the use of *voluntary, private agreements* with farmers, ranchers, irrigation districts, landowners, and others who hold water rights. Water trusts pay fair market-based financial compensation to willing water right holders in exchange for donated, leased, or purchased water rights, on a temporary or permanent basis, to increase instream flows. In some transactions, water trusts facilitate direct financial investment in physical and structural solutions to enhance agricultural water use efficiency on farms, ranches, or irrigation districts. Importantly, such water conservation efforts promote *continued* agricultural use of water rights alongside instream flow restoration.

Water trusts have emerged as specialized intermediaries conducting transactions, outreach and education between public agencies, land trusts, watershed groups, municipalities, tribal entities, other non-profit organizations, and the agricultural community. Water trusts address technical, economic, and other transactional issues locally and regionally, rather than centrally, and are strategically positioned to cultivate the essential ingredients of trust and relationship with water rights holders. Voluntary agreements greatly reduce or eliminate the need for adversarial, intrusive, and less flexible regulation or enforcement actions by public agencies while accomplishing the same flow objectives.

Existing steelhead, salmon, and trout habitat, such as riparian vegetation, cool water, and clean gravel pools, is identified through surveys conducted by state or tribal fisheries biologists and private groups. Minimum instream flow targets and other habitat improvements are developed and flow-limited stream segments are prioritized by highest concern, often on tributaries where small increments of flow can have the most ecologically significant benefit and most quantifiable impact for native fish populations. Additional physical and biological parameters are measured by: pool volume, increased habitat volume, fish cover, undercut banks, terrestrial vegetation, and woody debris. Potential flows are evaluated and timed for critical periods of the fishery life cycle, such as late summer tributary flows that maintain juvenile rearing habitat or fall

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148. "Water trusts" is used generally to describe all public interest organizations who enter private, voluntary conservation transactions such as temporary leases with water right holders to increase instream flows for fish and wildlife purposes.

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mainstem flows to increase upstream migration access to vital spawning areas or spring downstream passage flows, especially for anadromous species en route to the ocean.

Once critical aquatic habitat is identified, water trusts serve a lead role in bridging private rights and public interests in water. Multiple layers of information are processed to confirm the presence of targeted species, to ensure the availability and reliability of water rights, to gauge the interest of local partners, and to analyze and measure the costs and funding availability to maximize resources and impact. Project development and design involves the water rights holder (individual farmer, rancher or representative stakeholder from irrigation districts), technical consultants (engineers, hydrologists, biologists, attorneys), watershed councils, community groups, and public agencies among others.

Typical transaction costs include due diligence of credible historical water use records of actual and perfected consumptive use of water to “prove up” the amount of the appropriated right. Actual ownership of a particular water right must be confirmed and may include review of deed records for water conveyed with land. Due diligence can extend to property inspection, review of historic aerial or other photos, interviews with the property owner to solicit affidavits of water use, crop records, pump records, seed receipts - any evidence that demonstrates beneficial use of water as claimed. Such review is essential to show “no injury” to other users in anticipation of more formal state review and to protect the instream transfer from potential future challenges.

A potentially significant limiting factor in claiming a deduction for a water right donation is the cost of appraising the value of the deduction. Water trusts arrange for an independent appraisal of the water right, which can cost \$10,000-\$15,000, especially when there is little market information known about a particular area or the deal is of a large enough size to warrant its own appraisal. Other times, the amount of potential water does not merit a full appraisal for each transaction. In some instances, especially for smaller volumes of water, the cost of the appraisal may be a significant percentage of the overall transaction. In essence, the donor must pay to give away their water right asset.

Ultimately, water trusts help shepherd the transfer application to change the point of diversion, place, and purpose of use to an instream beneficial use purpose through the necessary public notices, state agency review and approvals, and local recordation with the county assessor. It may cost as much as \$30,000 to add an instream beneficial use to a permitted or decreed right, enabling enforcement by a local water master.

Water trusts work with their respective public and tribal partners to monitor each project. Preliminary baseline conditions are used to measure progress towards restoration targets and goals. Seasonal site visits and use of manual or installed discharge gauges comprehensively monitor all related

flows in streams, rivers, canals, ponds, and reservoirs to ensure contracted water is accounted for instream. Water quality factors such as temperature, pH (acidity), ORP (oxidation reduction potential), SC (specific conductivity), DO (dissolved oxygen), and TDS (total dissolved solids) are monitored and recorded to assess the physical and biological benefits of increased flows. Biological minimum flows are determined to ensure adequate pool and riffle habitat, and to measure and index benthic macroinvertebrates (insects without backbones that are an indicator of stream health and a food source for fish). Fish-per-mile and general population estimates over time are generated by fish shocking and underwater-snorkeling for census measurement and species identification purposes.

Monitoring and verifying the timing and volume of instream flows has ongoing costs, no matter how cost-effective. To comply with the I.R.C. such monitoring would need to substantiate nondiverted donated flows *in situ* beyond prior points of diversion as water molecules aggregate and mix with downstream waters. Instream flow accounting must be transparent and accurate to properly manage donated flows alongside existing rights between two points. In addition, donated rights would need to be monitored to quantify and measure the impact of conservation benefits attributable to the donated instream transfer.

Given the time and financial costs associated with each transaction, water trusts raise the necessary funds from varied state, federal, and private sources, to provide technical staff and cover hard costs to provide an important incentive for landowner participation.

Lastly, water trusts pursue enforcement actions as appropriate to ensure compliance with the terms of the conservation transaction agreement.

### **C. I.R.C. § 170(h)(4)-(5): The Qualified Conservation Contribution Must be Donated Exclusively for 'Conservation Purposes'**

The qualified conservation contribution of the qualified real property interest in an appropriative or riparian water right permanently dedicated to a qualified organization is donated for *conservation purposes*<sup>149</sup> when it will: (1) preserve land areas for outdoor recreation by, or the education of, the general public;<sup>150</sup> (2) protect a relatively natural habitat of fish, wildlife, or

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149. Treas. Reg. § 1.170A-14(d) (Conservation purposes); Treas. Reg. § 1.170A-14(e) (Exclusively for conservation purposes).

150. I.R.C. § 170(h)(4)(A)(i) (Outdoor recreation by, or the education of, the general public); Treas. Reg. 1.170A-14(d)(1)(i) (Recreation or education); Treas. Reg. 1.170A-14(d)(2) (Recreation or education).

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plants or similar ecosystem;<sup>151</sup> or (3) preserve open space.<sup>152</sup>

The conservation purpose must be protected in perpetuity.<sup>153</sup> Surface mining is not permitted and a mortgage or deed of trust, if any, must be subordinated.<sup>154</sup>

**1. I.R.C. § 170(h)(4)(A)(i): Outdoor Recreation or Education<sup>155</sup>**

The preservation of a *water area* for the use of the public for boating or fishing is a conservation purpose.<sup>156</sup> The preservation of a *land area* will not meet the conservation purposes test unless the recreation or education is for the substantial and regular use of the general public.<sup>157</sup>

This regulation provides important support for the argument that neither the I.R.C. nor Treasury regulations need to be amended in order to accommodate the donation of appropriative or riparian water rights. While the preservation of a water right is clearly not a “land area,” the express “water area” example used in the Treasury regulations unambiguously recognizes the recreational and educational aspects of boating and fishing. Neither can exist without water, so the donation of a water right would reinforce these conservation purposes.

**2. I.R.C. § 170(h)(4)(A)(ii): Relatively Natural Habitat/Protection of Environmental System<sup>158</sup>**

The protection of a relatively natural area of fish habitat is a conservation purpose.<sup>159</sup> Significant habitats or ecosystems include, but are

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151. I.R.C. § 170(h)(4)(A)(ii) (Relatively natural habitat of fish); Treas. Reg. 1.170A-14(d)(1)(ii) (Relatively natural habitat of fish); Treas. Reg. 1.170A-14(d)(3) (Protection of environmental system).

152. I.R.C. § 170(h)(4)(A)(iii) (Preservation of open space); Treas. Reg. 1.170A-14(d)(4) (Preservation of open space).

153. I.R.C. § 170(h)(5)(A) (Exclusively for conservation purposes - conservation purpose must be protected); Treas. Reg. 1.170A-14(e) (Exclusively for conservation purposes).

154. I.R.C. § 170(h)(5)(B) (Exclusively for conservation purposes - conservation purpose must be protected); Treas. Reg. 1.170A-14(e) (Exclusively for conservation purposes).

155. Treas. Reg. § 1.170A-14(d)(1)(i) (Recreation or education); Treas. Reg. § 1.170A-14(d)(2) (Recreation or education).

156. Treas. Reg. § 1.170A-14(d)(2)(i) (Recreation or education - In general).

157. Treas. Reg. § 1.170A-14(d)(2)(ii) (Recreation or education - Access).

158. Treas. Reg. § 1.170A-14(d)(1)(ii) (Relatively natural habitat of fish); Treas. Reg. § 1.170A-14(d)(3) (Protection of environmental system).

159. I.R.C. § 170(h)(4)(A)(ii) (Conservation purpose defined).

not limited to, habitats for rare, endangered, or threatened species of fish.<sup>160</sup> 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.<sup>161</sup> 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.<sup>162</sup>

Again, the express language of both the I.R.C. and Treasury regulations provides additional support for the argument that neither needs to be amended in order to accommodate the donation of an appropriative or riparian water right. Water is aquatic habitat for fish. Rare, threatened, or endangered species of fish are present in virtually all the public waters of the western states. The donation of any part of an appropriative or riparian water right would provide an additional increment of physical “wet” habitat that would benefit fish.

The most prominent example of a partial interest donation of a water right transferred to instream conservation purposes that *received* an IRS deduction (without any private letter or revenue ruling) involved the 1988 donation of an interest in a conditional water right for 300 cubic feet per second on the Upper Gunnison River in Colorado.<sup>163</sup> The IRS challenged the donor’s claimed multi-million dollar deduction.<sup>164</sup> The donor claimed the donated water satisfied the conservation purpose by protecting the “relatively natural habitat” of trout in a 29-mile segment of the river.<sup>165</sup> The IRS countered that the donation must protect a “significant relatively natural habitat” and there were no rare, threatened, or endangered species in the area of the donation.<sup>166</sup> In fact, the IRS maintained, there was already a high-quality trout fishery without the donation and “the maintenance of the fishery appears to have little dependency on the flow donated.”<sup>167</sup>

Ultimately, the donor transferred the water right to an intermediary 501(c)(3) charitable organization who then re-donated it to the Colorado Water Conservation Board (“CWCB”), which adjudicated a change in the decreed water right for a public instream flow use.<sup>168</sup> In 1992, the donor and the IRS reached a settlement for around 30 cents on the dollar, in part, due to the similarity between the CWCB’s legal restriction for acquiring water

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160. Treas. Reg. § 1.170A-14(d)(3)(ii) (Significant habitat or ecosystem).

161. *Id.*

162. Treas. Reg. § 1.170A-14(d)(3)(ii) (Protection of environmental system).

163. Memorandum from Peter Nichols, Colorado attorney-at-law, dated March 2002 (on file with author).

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.*

168. Case No. 92CW107 (Colo. Water Div. 4, 1992).

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rights for minimum instream flows to *preserve* the natural environment to a reasonable degree and the IRS's own definition of conservation purpose.<sup>169</sup>

### **3. I.R.C. § 170(h)(4)(A)(iii): Preservation of Open Space**

The preservation of open space<sup>170</sup> (including farmland or forest land) qualifies where such preservation is (I) for the scenic enjoyment of the general public, or (II) pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit.<sup>171</sup>

Many factors would be evaluated to determine the significance of the public benefit of an open space (water right) donated for scenic enjoyment or pursuant to a government conservation policy.<sup>172</sup> The most relevant characteristics are the uniqueness of the property to the area and the consistency of the proposed open space (water right) use with public programs (whether federal, state or local) for conservation in the region, including programs for outdoor recreation, irrigation or water supply protection, water quality maintenance or enhancement, flood prevention and control, erosion control, shoreline protection, and protection of land areas, included in, or related to, a government approved master plan or land management area.<sup>173</sup>

#### **a. I.R.C. § 170(h)(4)(A)(iii)(I): Scenic Enjoyment**

The preservation of open space (water right) for the scenic enjoyment of the public is a conservation purpose. Preservation may be for scenic enjoyment<sup>174</sup> 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.<sup>175</sup>

Despite the fact that the I.R.C. and Treasury regulations are primarily oriented to land values and the separate fact that there is no IRS interpretive

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169. *Id.*

170. Treas. Reg. § 1.170A-14(d)(1)(iii) (Preservation of certain open space); Treas. Reg. § 1.170A-14(d)(4) (Preservation of certain open space).

171. I.R.C. § 170(h)(4)(A)(iii)(I)-(II) (Scenic enjoyment - clearly delineated governmental policy - significant public benefit).

172. Treas. Reg. § 1.170A-14(d)(4)(iv) (Significant public benefit).

173. Treas. Reg. § 1.170A-14(d)(4)(iv)(1) and (3) (Significant public benefit factors).

174. Treas. Reg. § 1.170A-14(d)(4)(i)(B) (Scenic enjoyment); Treas. Reg. § 1.170A-14(d)(4)(ii) (Scenic enjoyment).

175. Treas. Reg. § 1.170A-14(d)(4)(ii)(1)-(8) (Scenic enjoyment factors).

guidance related to deductions for donated water rights, the consistent inclusion of language such as *waterbody*, e.g., river, reinforces the conclusion that a water right is a considered and intended component of a qualified conservation contribution. The full development of the property interest in all appropriative or riparian water rights would undoubtedly diminish the volume of instream flows and dramatically impact the aesthetic attributes and scenic enjoyment of countless western landscapes. The dedication and transfer of water rights to instream beneficial uses preserves the “scenic panorama” and enjoyment of waterbodies by the general public, whether by road, trail, or boat.

**b. I.R.C. § 170(h)(4)(A)(iii)(II): Pursuant to Governmental Conservation Policy**

The preservation of an open space [river] pursuant to clearly delineated governmental conservation policy<sup>176</sup> that states it is in the public interest to preserve a certain type of property (water right) is a conservation purpose.<sup>177</sup>

Cold water fisheries (e.g. salmon and trout) across the western United States have been in severe decline and imperiled by decades of out-of-stream diversions that have either completely dewatered or critically reduced instream flows. Oregon, Washington, Montana, Colorado, and California have initiated significant legal reforms and state government conservation policies to support preservation of water rights for: (1) instream flows; (2) transfers; and (3) water conservation.

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176. Treas. Reg. § 1.170A-14(d)(4)(i)(A) (Governmental conservation policy); Treas. Reg. § 1.170A-14(d)(4)(iii). (Governmental conservation policy).

177. Treas. Reg. § 1.170A-14(d)(4)(i)(A) (Governmental conservation policy); Treas. Reg. § 1.170A-14(d)(4)(iii). (Governmental conservation policy).

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**CHART 3:**

## Water Law &amp; Conservation Policy Reforms

<b>Reform</b>	<b>California</b>	<b>Oregon</b>	<b>Washington</b>	<b>Montana</b>	<b>Colorado</b>
No diversion required to maintain appropriative right transferred instream	Yes	Yes	Yes	Yes	Yes
New junior instream appropriations by state agency	No	Yes	Yes	No	Yes
Right to conserved water retained by water right holder	Yes	Yes	Yes	Yes	No
Water transfers	Yes	Yes	Yes	Yes	Yes
Public agency can hold and administer transferred right instream	Yes	Yes: OWRD	Yes: Ecology	Yes: MDNRC	Yes: CWCB
Individual or private organization can hold transferred right instream	Yes	No	No	No	No

(continued)

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<b>Reform</b>	<b>California</b>	<b>Oregon</b>	<b>Washington</b>	<b>Montana</b>	<b>Colorado</b>
Individual or private organization can purchase, lease, or acquire donation of entire or partial interest and transfer to agency to hold as instream flow right	Yes	Yes	Yes	Yes	Yes
Seniority of instream transfer preserved	Yes	Yes or 1-minute junior	Yes or 1-minute junior	Yes	Yes
Express state qualification of donated interest in water right as deductible for "federal tax purposes"	No	No	Yes	No	No
Agency standing to enforce instream flow	Yes	Yes	Yes	Yes	Yes
Private party standing to enforce instream flow	Yes	Yes	Yes	Yes*	Yes**
State tax credit	Yes: DFG- WCB	No	N/A***	No	Yes: CWCB

\*Technically, only the lessor, not the lessee can enforce.

\*\*Some donors have the right, by contract with the CWCB, to stand in the shoes of the CWCB to enforce instream flows they have donated to the CWCB.

\*\*\*No state income tax.

**i. California**

Historically, the appropriative water right required an out-of-stream diversion to demonstrate control and dominion over water. On January 1, 1992, an express legislative exception took effect which allowed *any* permitted water right holder to petition the SWRCB for a transfer change of a *preexisting* right for the beneficial purposes of preserving or enhancing wetlands habitat, fish and wildlife resources, or recreation in, or on, the water.<sup>178</sup> Water Code Section 1707 (“Section 1707”) overruled *Cal Trout* and *Fullerton*, expressly providing that the SWRCB may approve the instream change “whether or not the proposed use involves a diversion of water.”<sup>179</sup> The bill was sponsored by the SWRCB to allow for voluntary dedications of appropriative or riparian rights to recognized beneficial instream purposes with flows protected from claims of forfeiture or intentional abandonment.

Separate from appropriations, unappropriated waters can be left instream for recognized fish and wildlife beneficial uses.<sup>180</sup> When an application for an appropriation is filed with the SWRCB, the California Department of Fish & Game (“DFG”) is authorized to recommend amounts of water required to preserve and enhance fish and wildlife resources.<sup>181</sup> The SWRCB uses the DFG recommendations to modify permits or establish the flow requirements in a water quality control plan, e.g., during federal FERC relicensing of hydroelectric projects DFG often recommends minimum instream or bypass flows to for inclusion in the SWRCB’s Clean Water Act (“CWA”) § 401 certification to restore previously dewatered sections of river. However, DFG recommendations are not mandatory conditions.<sup>182</sup>

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178. CAL. WATER CODE § 1707(a) (2010) (Change for purposes of preserving or enhancing wetlands habitat, fish and wildlife resources, or recreation in, or on, the water).

179. CAL. WATER CODE § 1707(b) (2010).

180. CAL. WATER CODE § 1202 (Unappropriated water); *Fullerton v. SWRCB*, 153 Cal. Rptr. 518 (Ct. App. 1979); *see also California Trout v. SWRCB*, 153 Cal. Rptr. 672 (Ct. App. 1979) (Separate appropriative right applications filed by DFG and California Trout for junior instream flows were denied by the SWRCB in the absence of a diversion); CAL. WATER CODE § 1243 (2010) (Recreation; preservation of fish and wildlife resources); Public Resources Code §§ 10001-02 (Streamflow protection standards).

181. CAL. WATER CODE § 1243 (Recreation; preservation of fish and wildlife resources); CAL. WATER CODE § 1243.5 (Preservation of source water; protection of beneficial uses); CAL. WATER CODE § 1257 (Consideration of relative benefit); CAL. WATER CODE § 1257.5 (Consideration of streamflow requirements); CAL. WATER CODE § 1300 *et seq.*

182. The Federal Power Act (“FPA”), which governs FERC projects, authorizes state and federal agencies, such as SWRCB, DFG, U.S. Fish and Wildlife Service (“FWS”) or National Marine Fisheries Service (“NMFS”), to issue instream flows recommendations and/or mandatory licensing conditions. Recommendations

However, the water in most every river system is over-allocated with no remaining unappropriated waters. New applications conferring rights for instream junior appropriations by agencies or private organizations are not permitted.

California encourages conservation of water and preserves appropriative rights where conservation efforts reduce consumptive use.<sup>183</sup> Consumptive use is the water that is actually consumed and not returned to the immediate water environment. It is the portion of water that evaporates, is used in products or crops, or consumed by humans or livestock.

*Water conservation* means the use of less water to accomplish the same purpose.<sup>184</sup> The appropriator must be able to demonstrate an intention to conserve water and to quantify the cessation or reduction of his use of less water to accomplish the same purpose of use entitled under the full appropriated right.<sup>185</sup> Conserved water is not subject to forfeiture for non-use and can be sold, leased, exchanged or otherwise transferred.<sup>186</sup> Transferred conserved water cannot be used as evidence of waste,

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include: FPA § 10(a) (Comprehensive Plans - authorizing a project provided it is “best adapted to a comprehensive plan for improving or developing a waterway or waterways for the use or benefit of interstate or foreign commerce, for the improvement and utilization of water power, for the adequate protection, mitigation, and enhancement of fish and wildlife, and for other beneficial public uses including irrigation, flood control, water supply, and recreational and other purposes”); FPA § 10(j) (Fish and Wildlife Agencies - FERC has to address and then either accept or refute recommendations from these resource agencies relative to the protection, mitigation, and enhancement of fish and wildlife resources impacted by the project; see *American Rivers v. FERC*, 187 F.3d 1007 (9th Cir. 1999)). Mandatory conditions include: FPA § 4(e) (Equal Consideration - FERC must give “equal consideration to the purposes of energy conservation, the protection, mitigation of damage to, and enhancement of, fish and wildlife (including related spawning grounds and habitat), the protection of recreational opportunities, and the preservation of other aspects of environmental quality”; see *Escondido Mutual Water Co. v. La Jolla Band of Mission Indians*, 467 U.S. 1267 (1984)); FPA § 18(j) (Fishway prescriptions, e.g., fish passage ladders; see *American Rivers v. FERC*, 187 F.3d 1007 (9th Cir. 1999)); and Clean Water Act § 401 (Water quality - States have mandatory conditioning authority over minimum instream flows and water discharges; see *PUD #1 of Jefferson Cnty. v. Wash. Dep’t of Ecology*, 511 U.S. 698 (1994); also *S.D. Warren Co. v. Maine Dep’t of Envtl. Prot.*, 547 U.S. 370 (2006)).

183. CAL. WATER CODE § 1011(b) (2010) (Appropriated water rights; cessation or reduction of in use; forfeiture; transfer; reversion of rights).

184. SWRCB Water Right Order 99-012, at 8 (Order approving in part and denying in part petition for temporary water transfer).

185. CAL. WATER CODE § 1011(b) (Appropriated water rights; cessation or reduction of in use; forfeiture; transfer; reversion of rights).

186. SWRCB Water Right Order 99-012, at 2 (Order approving in part and denying in part petition for temporary water transfer).

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unreasonable use or for determination of forfeiture of a water right.<sup>187</sup>

California policies encourage the voluntary transfer of water and water rights.<sup>188</sup> A water transfer is a change in the way water is usually allocated among water users.<sup>189</sup> There are three basic types of water transfer: (1) Temporary Urgency Change (180-days or less);<sup>190</sup> (2) Temporary Change (one year or less);<sup>191</sup> and (3) Long-Term Transfer (one year or more).<sup>192</sup> These transfers are governed by enforceable contracts or leases for water.<sup>193</sup> At the end of the term of the leased or transferred water, the full water right reverts to the holder of the right.<sup>194</sup>

A transfer application/petition must be filed with the SWRCB (also "Board") indicating any proposed changes related to: (1) Point of diversion; (2) Place of use; and (3) Purpose of use.<sup>195</sup> The permittee notifies the Board, which then provides notice and opportunity for a hearing to review

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187. CAL. WATER CODE § 1010 (Use of recycled, desalinated or polluted water as beneficial use; lapse, reduction or loss of rights; extension of permit; periodic reports; transfer of water or water rights); CAL. WATER CODE § 1011 (Appropriated water rights; cessation or reduction of in use; forfeiture; transfer; reversion of rights); CAL. WATER CODE § 1011.5 (Conjunctive use of surface water and groundwater supplies; availability of surface water for other beneficial uses); CAL. WATER CODE § 1012 (Conservation effort Colorado River); CAL. WATER CODE §§ 1014-17 (Transfer of water or offer to transfer; effect on water rights); CAL. WATER CODE § 1024 (Sale of water right or modification of water right or contract; acquisition of rights by use; water conservation); CAL. WATER CODE § 1244 (Evidence of waste or unreasonable use, unreasonable method of use, or unreasonable method of diversion); CAL. WATER CODE § 1440 (Rights acquired under order; expiration of orders); CAL. WATER CODE § 1731 (Reversion of rights); CAL. WATER CODE § 1737 (Reversion of rights); CAL. WATER CODE § 1745.07 (Effect of transfer on water rights; approved transfer deeded beneficial use).

188. CAL. WATER CODE § 109 (2010) (Efficient use of water; encouragement of voluntary transfer of water and water rights); CAL. WATER CODE § 475 (2010) (Legislative findings and declarations); CAL. WATER CODE § 480 (2010) (Establishment of ongoing program to facilitate voluntary exchange or transfer of water). In California, between roughly 1988 and 2003, transfers accounted for 3% of all water used by agricultural, municipal and agricultural purposes. Short-term transfers comprise 80% of the volume in this market. Government transfers represent about 33% of the total volume traded, while transfers among contractors within the same state or federal water projects are approximately 50% of the volume traded. *See* Hanak, *Water Market*, *supra* note 28, at 14.

189. Water Rights Div., SWRCB, *A Guide to Water Transfers 1-1* (2009); *see also* Water Transfer Workgroup, SWRCB, *Water Transfer Issues in California I* (2002).

190. CAL. WATER CODE § 1435 (Conditional, temporary change order; findings; definition; issuance).

191. CAL. WATER CODE §§ 1725-32 (Temporary changes).

192. CAL. WATER CODE §§ 1735-37 (Long-term transfers).

193. CAL. WATER CODE § 1020-31 (Water leases).

194. CAL. WATER CODE § 1731 (Reversion of (temporary transfer) rights); CAL. WATER CODE § 1737 (Reversion of (long-term transfer) rights).

195. CAL. WATER CODE § 1706 (Persons entitled to make changes).

objections by interested parties.

The required Board findings include (as applicable): (1) urgent need; (2) no injury to other legal users of water;<sup>196</sup> (3) no unreasonable effect on fish, wildlife, instream uses;<sup>197</sup> (4) change in public interest; (5) involves only water consumptively used/stored; (6) water must be surplus;<sup>198</sup> (7) no unreasonable effect on economy of area of transfer, e.g., fallowing; (8) water agency in area to which water will be transferred must approve; (9) water is stored or conserved;<sup>199</sup> (10) cannot replace surface water with groundwater unless consistent with plan or approved by supplier; (11) no unreasonable economic impact; (12) will not create/contribute to overdraft.

The short-term transfer is exempt from the California Environmental Quality Act ("CEQA"), while long-term transfers require an Environmental Impact Report ("EIR") to adequately consider impacts and alternatives.<sup>200</sup> There is no Board hearing unless needed to make required findings. Short-term transfers only allow for transfer of water from reduced consumptive use or storage, while long-term transfers also allow for transfer of conveyance losses and applied water return flows.

Changes in use and transfers of water cannot injure other legal users of water, have unreasonable environmental impacts on fish and wildlife, or harm the economy of the area from which water is transferred.<sup>201</sup> Transfers of water that retire or fallow irrigated acreage must consider the impacts of such transfers on: local employment (field workers, aerial sprayers, mechanics and machinists, processing handlers, packers and truckers, livestock handlers and movers, tractor salesmen, local bankers and the food service industries serving working lunches to all), machinery, seed processing and distribution, reduced taxes, as well as added local costs related to increased reliance on social services. Notwithstanding the presence of such third party impacts, transfers may still be authorized by the SWRCB if determined to be in the greater public interest.

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196. CAL. WATER CODE § 1702 (Injury to legal user of water).

197. CAL. WATER CODE § 1028 (Effects of water transfer pursuant to lease on legal users of water and on fish and wildlife; court determination of issues).

198. CAL. WATER CODE § 383 (Surplus water defined).

199. CAL. WATER CODE § 1745.05 (Water eligible for transfer).

200. CAL. WATER CODE § 1729 (Exemption).

201. CAL. WATER CODE § 386 (Findings prior to transfer; fees of petitioner for transfer); CAL. WATER CODE § 1702 (Injury to legal user of water); CAL. WATER CODE § 1706 (Persons entitled to make changes); CAL. WATER CODE § 1707 (Change for purposes of preserving or enhancing wetlands, habitat, fish and wildlife resources, or recreation in, or on, the water); CAL. WATER CODE § 1725 (Changes permitted); CAL. WATER CODE § 1727 (Review of (temporary change) petition); CAL. WATER CODE § 1736 (Approval of (long-term transfer) petitions); CAL. WATER CODE §§ 1810-1814 (transfers via unused water conveyance capacity and associated requirements).

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Numerous state-level environmental, municipal and agricultural policies reinforce the importance of water transfers to support: (1) increased agricultural water use efficiency and technology investments; (2) increased Delta water outflows and timing of releases to benefit beneficial uses for water quality, fisheries and natural systems; (3) new legal and market based mechanisms and incentives; (4) increased water-based recreational and tourism opportunities; and (5) enhanced institutional capacity to gather data, monitor existing flows, and administration of water rights.<sup>202</sup>

New policies are sought to reduce investment barriers for water conservation and efficiency improvements. Such policies will include the development of new legal mechanisms by which public agencies and/or private investors can invest in irrigation water use efficiency systems in exchange for transfer of conserved water and work to develop other state-federal mechanisms that encourage water use efficiency if they achieve broader social or environmental benefits, or both.<sup>203</sup>

In California, existing public-private instream programs and administration must be reexamined and simplified to forge a functional cooperative partnership model that is better positioned to accommodate sale, temporary lease, and donation of appropriative or riparian rights to instream flows which are also I.R.S.-qualified tax deductions. Successful models of local, state, federal, and private partnerships are available.

The Columbia Basin Water Transactions Program ("CBWTP") is an interstate program in the Pacific Northwest started in 2002. Managed by the National Fish and Wildlife Foundation in cooperation with the Bonneville Power Administration and the Northwest Power and Conservation Council, CBWTP funds public-interest *Qualified Local Entities* ("QLEs"), such as water trusts, which in turn provide localized technical assistance and support services in agricultural communities to achieve improved instream flows on local and regional streams. California could tap into and synergize an existing network of local and regional public interest organizations to facilitate hundreds of new water transactions within a decade by maximizing the benefits of QLE-type partnerships.

While there are many uncertainties related to climate change, there is a growing consensus that the warming impacts on cold water aquatic ecosystems will be intense, potentially more so than current models anticipate. In California, anticipated climate change impacts will affect the

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202. In November 2009, five separate bills were signed into law by Governor Schwarzenegger, reflecting many of the recommendations of the final recommendations of the *Delta Vision Strategic Plan* issued by the Blue Ribbon Task Force in October 2008.

203. Heather Cooley, Juliet Christian-Smith, Peter Gleick, *More With Less: Agricultural Water Conservation and Efficiency in California (A Special Focus on the Delta)* (Pacific Institute, September 2008).

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timing, intensity, location, amount and variability of precipitation, potentially reducing the state's average annual snow pack with a loss of up to 5 million acre-feet ("MAF").<sup>204</sup> The traditional curved hydrograph with peak snowmelt runoff in May-June will shift its peak earlier in the year and spike during uncontrolled winter storm events that exceed surface storage capacity and cause downstream flooding. Late summer flows will be reduced and flows that remain will have increased water temperatures. Changes to the physical, biological and chemical integrity of streams will broadly impact and negatively affect listed and endangered species.<sup>205</sup>

## ii. Oregon

No change in use or place of use may be made without state water transfer approvals.<sup>206</sup> All transfer applications are processed by the Oregon Water Resources Department ("OWRD").<sup>207</sup> Both temporary and permanent transfers are permitted, and both types of transfer are subject to notice and the no injury rule.<sup>208</sup> Temporary transfers cannot exceed five years, are exempt from forfeiture, and revert automatically upon expiration of the lease.<sup>209</sup>

In 1955, Oregon created a minimum perennial stream flow program. These minimum flows were structured as administrative rules and not enforceable as water rights.<sup>210</sup>

In 1987, Oregon passed the *Instream Water Rights Act* ("IWRA") to amend its water code and encourage beneficial instream public uses to protect aquatic habitat, improve water quality and provide recreational

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204. Cal. Dep't of Water Res., *Progress on Incorporating Climate Change into Management Of California's Water Resources: July 2006 Technical Memorandum Report*, 2-6 (2006). Hereafter, "DWR Climate Change Report."

205. *Id.*

206. OR. REV. STAT. § 540.510 (2010) (Appurtenancy of water to premises; restrictions on change of use, place of use or point of diversion; application for transfer of primary and supplemental water rights; right to use conserved water); OR. REV. STAT. § 540.530 (2010) (Order authorizing change in use, place of use or point of diversion); *see also* Janet C. Neuman, *The Good, The Bad, and The Ugly: The First Ten Years of the Oregon Water Trust*, 83 NEBRASKA L. REV. 432 (2004).

207. OR. REV. STAT. § 540.520 (2010) (Application for change of use, place of use or point of diversion; public notice; protest; hearings; exemptions).

208. OR. REV. STAT. § 540.523(2) (2010) (Temporary transfer of water right or permit; terms; revocation; status of supplemental water right or permit); OR. REV. STAT. § 540.580(1)(c) (2010) (Permanent transfer of place of use of water within district; requirements; procedure).

209. OR. REV. STAT. § 540.523(1), (3), & (4) (2010) (Temporary transfer of water right or permit; terms; revocation; status of supplemental water right or permit).

210. OR. REV. STAT. § 537.346(1) (2010) (Conversion of minimum perennial streamflows to in-stream water rights).

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opportunities.<sup>211</sup> Before 1987, only out-of-stream, consumptive uses were recognized as beneficial. Today, an instream water right does not require a prior diversion or any other means of physical control over the water.<sup>212</sup>

Distinct from California, Oregon's Department of Fish and Wildlife ("ODFW"), Department of Environmental Quality ("ODEQ") and State Parks and Recreation ("OPRD") can each apply for a *new* appropriation for an instream flow right, which is reviewed by the OWRD.<sup>213</sup> Instream water rights are exclusively held by OWRD in trust for the people of Oregon.<sup>214</sup> Each new, post-1987, instream water right derives from unappropriated flows and has a relatively junior priority date as of the date of the filing of the application.<sup>215</sup> IWRA also converted minimum instream flows established pursuant to the 1955 Act into instream water rights with the same priority date as the original minimum instream flow was created.<sup>216</sup>

In 1987, Oregon also passed the *Allocation of Conserved Waters Program* to create new water conservation and efficiency incentives.<sup>217</sup> *Conservation* is the reduction of the amount of water diverted to satisfy an existing beneficial use through improved technology or method of diverting, transporting, applying or recovering the water.<sup>218</sup> Conservation is the efficient utilization of water without waste.<sup>219</sup> Water users who voluntarily conserve water retain control over 75% of the saved water, which can be used to irrigate additional lands, leased, resold, or dedicated to instream purposes.<sup>220</sup> At least 25% of any conserved water is allocated to instream flows. The priority of the conserved water is either the same or one minute after the underlying right.<sup>221</sup>

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211. OR. REV. STAT. § 537.332-360 (2010) (Instream water rights); OR. REV. STAT. § 537.334 (2010) (Findings).

212. OR. REV. STAT. § 537.332(3) (2010) (Definitions - Instream water right).

213. OR. REV. STAT. § 537.336 (2010) (State agencies authorized to request instream water rights; agreement required when supply is stored water).

214. OR. REV. STAT. § 537.341 (2010) (Certificate for instream water right).

215. OR. REV. STAT. § 537.341 (2010) (Certificate for instream water right); OR. REV. STAT. § 536.235 (2010) (Minimum streamflows); OR. REV. STAT. § 536.310 (2010) (Fishery as economic and recreational asset); OR. REV. STAT. § 536.410 (2010) (Withdrawal of unappropriated waters from appropriation).

216. OR. REV. STAT. § 537.346(1) (2010) (Conversion of minimum perennial streamflows to instream water rights).

217. OR. REV. STAT. § 537.455-500 (2010) (Conservation and use of conserved water).

218. OR. REV. STAT. § 537.455(1) (2010) (Conservation).

219. OR. REV. STAT. § 537.460 (2010) (Legislative findings; policy).

220. OR. REV. STAT. § 537.470 (2010) (Allocation of conserved water by commission; criteria; percentage to state; certificates showing change in original water right).

221. OR. REV. STAT. § 537.485 (2010) (Priority of right to use conserved water; choice of priority).

State agencies are authorized to purchase rights to conserved water or to accept rights (or any portion) as a gift.<sup>222</sup> Separately, private parties can purchase, lease, or accept a donation of an existing appropriative right for conversion to an instream right with the same priority date as the original right.<sup>223</sup> Either way, all acquisitions for instream uses must be transferred to OWRD.

### iii. Washington

Transfer applications require notice and cannot cause injury or detriment to existing rights.<sup>224</sup> A change to add purpose of use or add irrigated acreage may be permitted if the proposed change results in no increase in the annual consumptive quantity of water used under the water right, as measured at the point of diversion reduced by the annual amount of return flows.<sup>225</sup> A change of a surface water right is not subject to review under a public trust analysis.<sup>226</sup>

In 1967, the *Minimum Water Flows and Levels Act* authorized the Washington Department of Ecology ("Ecology") to establish baseline instream flows for fish, game, birds, other wildlife, recreational, or aesthetic values.<sup>227</sup> The achievement of wild salmonid production is a priority and primary goal.<sup>228</sup> Instream flows are established or modified by Ecology only through notice and public hearings.<sup>229</sup> Minimum flows shall not affect

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222. OR. REV. STAT. § 537.495 (2010) (Receipt by state agency or political subdivision of right to use conserved water).

223. OR. REV. STAT. § 537.348 (2010) (Purchase, lease or gift of water right for conversion to instream water right; priority dates).

224. WASH. REV. CODE § 90.03.280 (2010) (Appropriation procedure - Notice); WASH. REV. CODE § 90.03.380 (2010) (Right to water attaches to land - Transfer or change in point of diversion - Transfer of rights from one district to another - Priority of water rights applications - Exemption for small irrigation impoundments).

225. WASH. REV. CODE § 90.03.380 (2010) (Right to water attaches to land - Transfer or change in point of diversion - Transfer of rights from one district to another - Priority of water rights applications - Exemption for small irrigation impoundments); DEP'T OF ECOLOGY, STATE OF WASH., POLICY 1020 (1991) (Consumptive and Non-consumptive Water Use (10/31/1991)); DEP'T OF ECOLOGY, STATE OF WASH., POLICY 1210 (2006) (Evaluation of Changes to Enable Irrigation of Additional Acreage or the Addition of New Purposes of Use to Existing Water Rights Revised (02/08/06)).

226. *Pend Oreille PUD v. Ecology*, 596 P.2d 285 (Wash. 1979).

227. WASH. REV. CODE § 90.22.010 (2010) (Establishment of minimum water flows or levels - authorized purposes).

228. WASH. REV. CODE § 90.22.060 (2010) (Instream flow evaluations - statewide list of priorities - salmon impact).

229. WASH. REV. CODE § 90.22.020 (2010) (Establishment of minimum water flows or levels - hearings - notice rules).

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existing water and storage rights.<sup>230</sup> Minimum instream flows established by administrative rule are water rights and Ecology has enforcement authority to protect instream flows from withdrawal by junior users in a water-short year.<sup>231</sup>

In 1991, Ecology was further authorized to administer the *Trust Water Right Program* (“TWRP”) for both temporary and permanent voluntary transfers of *Trust Waters* derived from state-financed water conservation and/or acquisition, donation, or other appropriate means other than condemnation.<sup>232</sup>

The Trust Waters program was created to promote conservation and allow the saved water to be protected from relinquishment. It continues to be interpreted and implemented through evolving policy and procedural statements from Ecology.<sup>233</sup> An appropriative water right need not be diverted and is a legally recognized beneficial use when used instream for fish, wildlife, recreational, and other purposes through the TWRP.<sup>234</sup> Water rights transferred to the Trust on a temporary and permanent basis are exempt from the five year “use it or lose it” relinquishment statute while in the Trust Waters Program.<sup>235</sup> Conserved water not managed through the TWRP is considered waste and subject to relinquishment.<sup>236</sup> In 2009, the Trust Water statute was amended to clarify that groundwater rights are

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230. WASH. REV. CODE § 90.22.030 (2010) (Existing water and storage rights - right to divert or store water).

231. WASH. REV. CODE § 43.21A.064 (2010) (Powers and duties - water resources); WASH. REV. CODE § 90.03.005 (2010) (State water policy - Cooperation with other agencies - Reduction of wasteful practices); WASH. REV. CODE § 90.03.400 (2010) (Crimes against water code - Unauthorized use of water); WASH. REV. CODE § (2010) 90.38.040(2) (Trust water rights program); WASH. REV. CODE 90.42.040(3) (2010) (Trust water rights program - Water right certificate - Notice of creation or modification).

232. WASH. REV. CODE § 90.42.010 (2010) (Findings - Intent).

233. *Id.*

234. WASH. REV. CODE § 90.54.020(1) (2010) (General declaration of fundamentals for utilization and management of waters of the state).

235. WASH. REV. CODE § 90.14.071 (2010) (Failure to file claim waives and relinquishes right); WASH. REV. CODE § 90.14.130 (2010) (Reversion of rights to state due to nonuse - Notice by order - Relinquishment determinations - Appeal); WASH. REV. CODE § 90.14.160-180 (2010) (Relinquishment of right for abandonment or failure to beneficially use without sufficient cause - Prior rights acquired through appropriation, custom or general adjudication); WASH. REV. CODE § 90.13.170 (2010) (Relinquishment of right for abandonment or failure to beneficially use without sufficient cause - Rights acquired due to ownership of land abutting stream, lake, or watercourse); WASH. REV. CODE § 90.42.040(6) (2010) (Trust water rights program - Water right certificate - Notice of creation or modification).

236. WASH. REV. CODE § 90.14.160 (2010) (Relinquishment of right for abandonment or failure to beneficially use without sufficient cause - Prior rights acquired through appropriation, custom or general adjudication).

eligible to be held in the Trust Water Rights Program.<sup>237</sup>

Any person who intentionally abandons or fails to beneficially use an appropriative right for five consecutive years of nonuse shall relinquish their right, which reverts to the state, unless “sufficient cause” for nonuse is identified.<sup>238</sup> A sufficient cause for nonuse includes leasing to the State Water Trust Program as long as the right is beneficially used under the lease.<sup>239</sup>

Any legal changes in the point of diversion, purpose of use, or place of use of a Trust Water right requires state approval.<sup>240</sup> Trust Water has a new designated place of use (a section of stream or public body of groundwater) and the same designated season-of-use as the original water right. Trust Water retains its priority date, but is considered one minute junior to the original or “parent” water right if it is separated from it, unless otherwise specified by agreement with the water right holder.<sup>241</sup> Trust Waters are quantified by month and distance downstream from the original point of diversion.<sup>242</sup> Trust Water can be kept instream for any amount of time, depending on the time designated for a lease or temporary donation, or if it is a permanent donation or purchase.<sup>243</sup>

Trust Water can be acquired by the state or other third party for the

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237. WASH. REV. CODE § 90.42.080 (2010).

238. WASH. REV. CODE § 90.14.160 (2010) (Relinquishment of right for abandonment or failure to beneficially use without sufficient cause - Prior rights acquired through appropriation, custom or general adjudication).

239. WASH. REV. CODE § 90.14.140 (2010) (“Sufficient cause” for nonuse defined - rights exempted).

240. WASH. REV. CODE § 90.42.040 (2010) (Trust water rights program - Water right certificate - Notice of creation or modification); WASH. REV. CODE § 90.42.080 (2010) (Trust water rights - Acquisition, donation, exercise, and transfer - Appropriation required for expenditure of funds); WASH. REV. CODE § 90.38.040 (2010) (Trust water rights program); Wash. REV. CODE § 90.38.020 (2010) (Acquisition or donation of trust water rights); WASH. REV. CODE § 90.03.280 (2010) (Appropriation procedure - Notice); WASH. REV. CODE § 90.03.380 (2010) (Right to water attaches to land - Transfer or change in point of diversion - Transfer of rights from one district to another - Priority of water rights applications - Exemption for small irrigation impoundments); DEP’T OF ECOLOGY, STATE OF WASH., POLICY 1120 (2004) (Conducting Tentative Determinations of Water Rights (08/30/2004)); DEP’T OF ECOLOGY, STATE OF WASH., POLICY 1200 (1999) (Evaluation of Changes or Transfers to Water Rights (01/08/1999)); DEP’T OF ECOLOGY, STATE OF WASH., POLICY 2010 (2006) (Defining and Delineation of Water Sources (02/15/2007)).

241. WASH. REV. CODE § 90.42.040(3) (2010) (Trust water rights program - Water right certificate - Notice of creation or modification).

242. Malloch, *Liquid Assets*, supra note 33, at 27.

243. WASH. REV. CODE § 90.14.140(2)(a) (2010) (“Sufficient cause” for nonuse defined - Rights exempted).

purpose of instream flow, irrigation, municipal, or other beneficial uses.<sup>244</sup> Ecology exclusively holds and manages Trust Water and has enforcement authority.<sup>245</sup> Ecology is limited in enforcement actions as between water rights unless the priorities have been previously been adjudicated.<sup>246</sup> Neither individuals nor organizations can hold a Trust Water right. Expedited processing is granted to Trust Water changes that result in an environmental benefit.<sup>247</sup> If the lease or donation of Trust Water ends with no renewal or extension, temporary Trust Water transfers revert back to the lessor or donor in the same amount that was beneficially used prior to the lease or donation.<sup>248</sup>

Any water conditionally conveyed to the TWRP for instream flow is managed to ensure that it qualifies as a gift deductible for federal income tax purposes for the donor.<sup>249</sup>

#### iv. Montana

In 1969, the Montana Fish & Game Commission was authorized to appropriate unappropriated waters to maintain instream flows on select rivers and streams.<sup>250</sup> In addition, Montana recognized uses of water for fish, wildlife, and recreation as beneficial uses.<sup>251</sup>

In 1973, the *Water Use Act* instituted a permit system for new appropriation applications to divert water, rather than simply diverting water, putting it to beneficial use and then filing a claim. In addition, all transfer changes to the place and purpose of use and point of diversion required Department of Natural Resources and Conservation (“DNRC”) approval. All transfers are subject to the no injury rule.<sup>252</sup>

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244. WASH. REV. CODE § 90.38.040 (2010) (Trust water rights program); Wash. Rev. Code § 90.42.040 (2010) (Trust water rights program - Water right certificate - Notice of creation or modification).

245. WASH. REV. CODE § 90.42.040 (2010) (Trust water rights program - Water right certificate - Notice of creation or modification).

246. *Rettkowski v Ecology*, 858 P.2d 232 (Wash. 1993).

247. WASH. ADMIN. CODE § 173-152-050 (2b) & (3a) (2010) (Criteria for priority processing of competing applications).

248. WASH. REV. CODE § 90.42.080(9) (2010) (Trust water rights - Acquisition, donation, exercise, and transfer - Appropriation required for expenditure of funds).

249. WASH. REV. CODE § 90.42.080(7) (2010) (Trust water rights - Acquisition, donation, exercise, and transfer - Appropriation required for expenditure of funds).

250. Lawrence J. MacDonnell, *Environmental Flows in the Rocky Mountain West: A Progress Report*, 9 WYO. L. REV. 335, 360 (2009).

251. MONT. CODE ANN. § 85-2-102(4) (2010) (“Beneficial use”).

252. MONT. CODE ANN. § 85-2-402(2)(a) (2010) (Changes in appropriation rights); MONT. CODE ANN. § 85-2-407(4)(a) (2010) (Temporary changes in appropriation right).

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Prior to 1973, Montana did not absolutely require a diversion for a valid appropriation of water for fish, wildlife, and recreation, including instream and inlake uses.<sup>253</sup> The Montana Department of Fish, Wildlife, and Parks ("MDFWP") could claim water for instream flow in a natural river or stream for fish and wildlife. However, because all claims for pre-1973 use of water in Montana had to be filed over twenty years ago, the MDFWP can no longer file a claim for instream flow today.

Since 1973, MDFWP has never been able to apply for an instream appropriation. The only way MDFWP has obtained instream rights after 1973 is to apply to DNRC for a water reservation.<sup>254</sup> Reservations are a different family of water rights, which can only be held by public entities, e.g., irrigation districts and municipalities, for consumptive use. MDFWP can hold reservations for nonconsumptive minimum instream flow uses for fisheries. The Montana Department of Environmental Quality also holds reservations for nonconsumptive instream flow (dilution being the solution to pollution).

In 1979, Montana initiated a comprehensive statewide adjudication of all pre-1973 water rights. Pre-1973 domestic and livestock water uses are exempt from the adjudication process. All pre-1973 water right claimants were required to file a "statement of claim" with the Montana Water Court by 1982 or risk losing their claimed rights through a presumption of abandonment.

In 1989, a pilot water leasing statute authorized MDFWP to lease senior water rights for use instream to protect fisheries.<sup>255</sup> Appropriative uses changed to instream flows to protect, maintain, or enhance fisheries were specifically recognized as beneficial.<sup>256</sup> Water right holders can preserve both the seniority and the quantity of their entire right even if they do not consumptively use their entire right in a given year by leasing a portion of their full right instream. This instream flow is protected against abandonment.<sup>257</sup>

In 1995, the scope of who could lease water rights for instream flows was expanded from solely the MDFWP to private individuals and organizations.<sup>258</sup> Notably, a broad coalition of organizations forged common ground to simultaneously achieve both agricultural and environmental

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253. *In re: Mo. River*, 55 P.3d 396 (Mont. 2002).

254. MONT. CODE ANN. § 85-2-316 (2010) (State reservation of waters).

255. House Bill 707 was codified as MONT. CODE ANN. § 85-2-436 (2010).

256. MONT. CODE ANN. § 85-2-102(4) (2010) (Beneficial use).

257. MONT. CODE ANN. § 85-2-404(4). (2010) (Abandonment of appropriation right).

258. MONT. CODE ANN. § 85-2-408 (2010) (Temporary change authorization for instream flow - additional requirements).

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goals.<sup>259</sup>

Separately, a water right holder can apply to DNRC to convert their consumptive water right to temporary instream use without a lease.<sup>260</sup> DNRC limits leased water to the amount which has been historically consumed and applied to a beneficial use.<sup>261</sup> There has been some disagreement about what the amount “historically consumed” means in relation to an instream lease and how much water is protectible instream below the historic point of diversion. In 2009, a district court decision held that an instream change could protect any water historically lost to a reach below the original point of diversion, even if it was not lost to evapotranspiration, e.g., it returned to the source below the protected reach as seepage or waste water, could be considered as “historically consumed” for purposes of instream protection.<sup>262</sup>

Appropriative rights can be transferred *temporarily* for a period not to exceed ten years, although an unlimited number of renewals are permitted.<sup>263</sup> The water right transferred instream shares the priority date of the original water right and is unavailable for use by junior water users in the protected stream reach.<sup>264</sup> As to temporary transfers, the water right holder retains full title to the leased right. Only the owner, not the lessee, of the water right may seek enforcement of the temporary change authorization.<sup>265</sup>

Generally, Montana does not permit the *permanent* transfer of water rights for instream use. However, in 2007, a legislative exception authorized MDFWP to convert water rights that it holds in fee to permanent instream

259. Trout Unlimited, Montana Stockgrowers Association, Montana Wildlife Federation, Montana Farm Bureau Federation, Montana Association of Conservation Districts, and the Montana Water Resources Association. Trout Unlimited, *Private Water Leasing: A Montana Approach*, 2005, at 8.

260. In 2005, a ten-year sunset provision was removed. MONT. CODE ANN. § 85-2-408 (2010) (Temporary change authorization for instream flow - additional requirements).

261. MONT. CODE ANN. § 85-2-408(7) (Temporary change authorization for instream flow - additional requirements).

262. *Christian C. Hohenlohe et al v. Mont. Dep't of Natural Res. and Conservation*, Case No. BDV-2008-750 (2009) (DNRC appealed the case [which addressed a number of other issues besides “historic consumed amount”] to the Supreme Court, but specifically accepted the district court’s ruling as to the issue of how much water could be protected below the historic diversion.).

263. MONT. CODE ANN. § 85-2-407(2) (2010) (Temporary changes in appropriation right).

264. MONT. CODE ANN. § 85-2-407(5) (2010) (Temporary changes in appropriation right (Priority)).

265. MONT. CODE ANN. § 85-2-408(5) (2010) (Temporary change authorization for instream flow - additional requirements); MONT. CODE ANN. § 85-2-308 (2010) (Objections).

rights on no more than twelve stream reaches.<sup>266</sup>

#### v. Colorado

Reliance by junior appropriators on return flows from all uses, including municipal, industrial, and commercial, (the status of the system at the time of their appropriation) protects them from water transfers that cause injury or harm to their vested water rights. They are entitled to “the continuation of stream conditions as they existed at the time of their respective appropriations.”<sup>267</sup> However, conversion of conserved, non-consumptive water use to instream flow can be noninjurious.

Priority in Colorado is determined both by date of appropriation *and* date of adjudication, with date of adjudication controlling over the date of appropriation. One can have an unadjudicated but appropriated 1892 water right that will be junior to an appropriated, adjudicated 1991 water right.

In 1973, the Colorado Water Conservation Board (“CWCB”) was granted exclusive authority for the *Instream Flow Program* to apply for new instream flow rights through state water courts and to appropriate such minimum flows as are required to “preserve the natural environment to a reasonable degree.”<sup>268</sup> The CWCB is the only entity or qualified conservation organization that can hold instream flows.

These new appropriations for instream water rights do not require a diversion.<sup>269</sup> These junior instream flow rights do not prevent senior diversions nor, in most cases, maintain minimum instream flows during critical drought periods. Nonetheless, even if junior, such instream flow rights are not insignificant. In instances where senior rights are transferred, junior rights are still protected from injury caused by the change. The CWCB has standing in water court to ensure that changes of existing water rights or new plans for augmentation do not alter stream conditions in a way that injures decreed instream flow water rights.

In 2002, the CWCB was further authorized to use existing senior water rights acquired through lease, purchase, or donation beyond *preservation* to

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266. MONT. CODE ANN. § 85-2-436(6)(a) (2010) (Instream flow to protect, maintain, or enhance streamflows to benefit fishery resource - change in appropriation rights by department of fish, wildlife, and parks until June 30, 2019).

267. *Farmers High Line Canal & Reservoir Co. v. City of Golden*, 975 P.2d 189 (Colo. 1999).

268. COLO. REV. STAT. § 37-92-102(3) (2010) (Legislative declaration - basic tenants of Colorado water law); COLO. REV. STAT. § 37-92-103(4) (2010) (Definitions - “Beneficial use”).

269. COLO. REV. STAT. § 37-92-103(4) (2010) (Definitions - “Beneficial use”); *Colo. River Water Conservation Dist. v. Colo. Water Conservation Bd.*, 594 P.2d 570 (Colo. 1979).

improve the natural environment to a reasonable degree.<sup>270</sup> Water rights can be leased, sold, and/or donated to the CWCB, which then obtains a decreed right for instream flow use and monitors and enforces the changed water rights. Private parties cannot lease water for instream flow use, as the CWCB is the only entity allowed to hold such rights.<sup>271</sup> Water rights can also be temporarily loaned to the CWCB without the need for water court approval.<sup>272</sup> Separately, other public entities may hold recreational in-channel diversion water rights, but otherwise, the traditional appropriative right requirements of diversion, capture, possession, or control of water are required.<sup>273</sup>

Notably, in 2003, the *Conservation Easement Statute* defined “Conservation easement in gross” so as to expressly include water rights for the purpose of wildlife habitat, environmental quality or life-sustaining ecological diversity, among other purposes.<sup>274</sup> The statute does not permit an independent easement on the water right separate from its beneficial and appurtenant use upon encumbered land. The statutory clarification recognizes and allows collateral instream or wetland benefits to accrue from return flows from an irrigated parcel.<sup>275</sup> The statute also indirectly protects instream flows from upstream junior appropriators when the downstream senior right is permanently attached to land protected through a conservation easement, thereby ensuring that potential future transfers of the land cannot separate the water right from the irrigated property.<sup>276</sup> Land transfer is unrestricted, while the separation of the water from the land is restricted.

In 2009, the Instream Flow Incentive Tax Credit was passed to authorize CWCB to award tax credit certificates to donors of water rights that protect and enhance instream flows for the benefit of the environment.<sup>277</sup>

## **V. Closing the Transaction: Moving from State Instream Transfer Approval to IRS Review of a Federal Income or**

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270. COLO. REV. STAT. § 37-92-102(3) (2010) (Legislative declaration - basic tenants of Colorado water law).

271. COLO. REV. STAT. § 37-92-102(3) (2010) (Legislative declaration - basic tenants of Colorado water law).

272. COLO. REV. STAT. § 37-83-105(2) (2010) (Owner may loan agricultural water right - loans to Colorado water conservation board for instream flows).

273. COLO. REV. STAT. § 37-92-103(4) (2010) (Legislative declaration - basic tenants of Colorado water law -(Appropriations)); *City of Thornton v. City of Ft. Collins*, 830 P.2d 915 (Colo. 1992).

274. COLO. REV. STAT. § 38-30.5-102 (2010) (Conservation easement in gross).

275. Michael F. Browning, *Private Means to Enhance Public Streams*, THE COLORADO LAWYER, April 2004, Vol. 33, No. 4, at 72.

276. *Id.*

277. H.B. 09-1067, 67th Gen. Assemb., 1st Reg. Sess. (Colo. 2009), codified at COLO. REV. STAT. § 39-22-533.

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## **Estate Tax Charitable Deduction for a Donated Appropriative or Riparian Water Right**

### **A. State Affirmation of the Donation and Transfer of the Property Interest in a Water Right to an Instream Flow**

So far, the steps in the deductibility analysis of a partial interest in a donated water right are to: (1) establish the character of the surface water right - riparian or appropriative; (2) establish whether the donated interest is an entire or partial interest; (3) determine whether the particular combinations of rights and interests conform with state water law regarding donation and instream transfer; and (4) establish whether the partial interest is deductible as a qualified conservation contribution of a qualified real property interest in a water right permanently donated to either a government unit or a publicly supported 501(c)(3) charitable organization (or both) and dedicated exclusively to conservation purposes.<sup>278</sup> Once deductible, then the charitable contribution can be valued.

Before valuation, it is important to distinguish that whether the federal deduction for donation of a partial interest in the qualified real property interest in a water right donated in perpetuity to a qualified organization for instream conservation purposes is legally *possible* is a different question than whether the permanent donative tool is the best fit for a particular conservation transaction.

From a practical perspective, fundamental considerations such as cost and budget will direct whether the instream conservation transaction results in a permanent sale of an entire interest, a temporal lease, a bargain sale, or a permanent donation of an entire or partial interest. In many instances, the instream flow objectives might be best reached through direct acquisition and outright ownership or through split-year or dry-year leases with water rights holders who are willing to enter *any* water right transaction at all.

The potential motivations of a farmer or rancher to enter a voluntary instream flow transaction are numerous and not all are donative. The most basic motivations are cash or to temporarily protect an appropriative right from forfeiture.<sup>279</sup> Cash can be used for: (1) nonfarm uses, such as retirement income and savings; (2) farm investment such as machinery purchases or irrigation efficiency investments; (3) estate settlement; and (4) reduction of farm debt.<sup>280</sup> Other motivations include land preservation

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278. The deductibility analysis for a donation of an entire interest of an appropriative right does not implicate the qualified conservation contribution deductibility analysis for a donation of a partial interest of an appropriative or riparian right.

279. Hanak, *Water Market*, *supra* note 28, at 83-84.

280. *Id.* at viii.

values.<sup>281</sup>

The federal tax benefits of the conservation easement may have more value to the donor for estate planning purposes as an *estate tax deduction* than as an income tax deduction.<sup>282</sup> Income tax deductions are not particularly strong incentives for individuals with limited income who might not be able to take advantage of the full tax deduction benefits. However, a lifetime or generations of family stewardship on a particular farm or ranch often cultivates a strong sense of place and an instinct to protect or preserve irreplaceable land values. The motivation to pass land and a way of life to one's heirs makes the use of the estate tax deduction for a donation of a water right a much more plausible incentive for those who are land rich and cash poor. The protected property will enter into the decedent's estate at its easement-reduced value.

While this article sees the potential for greater use of the partial interest qualified conservation contribution deduction, it cannot answer - at a general level - how or when the partial interest deduction will or should be used as a component of consideration to close certain conservation transactions. Such determinations are highly fact dependent. However, in time, this article contends and anticipates that once established, the donative tool will emerge as a key consideration in any conservation transaction that touches on a water right, even if it is not included in the final conservation transaction.

### **B. Valuation and Appraisal Issues**

The issue of water right appraisal and transfer valuation has been, until now, secondary to the determination that a partial interest donation is a qualified conservation contribution eligible for a deduction.<sup>283</sup>

The charitable contribution of a partial interest in a water right may be an outright donation or it may be a bargain sale. Either way, donated water rights valued in excess of \$5,000 must be substantiated with a qualified appraisal signed by a qualified appraiser, an appraisal summary, and required record keeping.<sup>284</sup>

A qualified appraiser is an individual who performs appraisals on a

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281. Ellen Rilla and Alvin D. Sokolow, *California Farmers and Conservation Easements: Motivations, Experiences, and Perceptions in Three Counties*, UNIVERSITY OF CALIFORNIA AGRICULTURAL ISSUES CENTER, Research Paper #4, December 2000 at vii.

282. I.R.C. § 2031(c) (Definition of gross estate - Estate tax with respect to land subject to a qualified conservation easement).

283. Treas. Reg. § 1.170A-14(h) (Valuation).

284. I.R.C. § 170(f)(11)(d) (Qualified Appraisals for contributions of more than \$5,000); Treas. Reg. § 1.170A-13(c)(1) (Deductions in excess of \$5,000 for certain charitable contributions of property made after Dec. 31, 1984); Treas. Reg. § 1.170A-13(c)(2) (Substantiation requirements).

regular basis of the type of property being valued.<sup>285</sup> The appraiser is not qualified if they are the donor or taxpayer, a party to the transaction, the donee, or any person employed or related to any of the parties.<sup>286</sup> An appraiser may be subject to civil penalties for an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary.<sup>287</sup> In the surveyed states, there were few recognized appraisers with sufficient expertise to accurately appraise water rights.

A qualified appraisal must be made within sixty days of the contribution of the appraised property and include all relevant appraisal information, such as detailed property description, date of contribution, terms of the agreement, etc.<sup>288</sup> This information prominently includes the appraised FMV and method of valuation.

This requirement may pose problems for the multi-year process required to complete some donations. In the example of the partial interest deduction taken on Colorado's Gunnison River, the donation agreement between the Donor and the 501(c)(3) charitable organization was signed in 1987, while the quitclaim deed was signed by Donor in 1988. The subsequent transfer from the non-profit to the CWCB was not adjudicated for instream flow use in 1992, a prerequisite before the IRS would recognize the deduction in 1992.<sup>289</sup>

If a charitable contribution is made in property other than money, the amount of contribution is the FMV of the property at the time of the contribution minus any appropriate reductions.<sup>290</sup>

The *sales comparison method* analyzes similar properties and compares the subject water right with similar water rights that have recently been leased, sold, or listed for sale.<sup>291</sup> A major premise of the sales comparison approach is that the FMV of a property is related to the prices of comparable, competitive properties.<sup>292</sup> When truly comparable water rights are available,

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285. Treas. Reg. § 1.170A-13(c)(5)(i)(A)-(B) (Qualified appraiser - In general).

286. Treas. Reg. § 1.170A-13(c)(5)(iv)(A)-(F) (Qualified appraiser - In general.); *see also* Memorandum from Dan Merriman and Bahman Hatami for CWCB Board Members (Jan. 21, 1998) (on file with author) (emphasizing that "the staff does not get involved in the appraisal of donated water rights").

287. Treas. Reg. § 1.170A-13(c)(5)(i)(D) (Qualified appraiser - In general).

288. Treas. Reg. § 1.170A-13(c)(3)(i)(A) (Qualified appraisal - In general); Treas. Reg. § 1.170A-13(c)(3)(ii)(A)-(K) (Information included in qualified appraisal).

289. Memorandum from Peter Nichols, Colorado attorney-at-law, dated March 2002 (on file with author).

290. Treas. Reg. § 1.170A-1(c)(1) (Value of a contribution of property).

291. Herzog, *Water Rights Appraisal Guidelines*, *supra* note 138, at 2-5.

292. *Id.*

this approach generally results in the most reliable indicator of value.<sup>293</sup>

The *income capitalization method* analyzes a property's capacity to generate benefits and convert these benefits into an indication of present value.<sup>294</sup> This method is generally applied when a property is viewed as an investment vehicle.<sup>295</sup> An investor who purchases income producing real estate is essentially trading present dollars for the expectation of receiving future dollars.<sup>296</sup> From an investor's point of view, *earning power* is the critical element of property value.<sup>297</sup> The income to be capitalized is the market or economic rent of the property.<sup>298</sup> This method estimates the agricultural value of water in its current use by determining the contribution of irrigation water to net income from agriculture production.<sup>299</sup> It calculates foregone net income resulting from production losses due to the reduction of the available water.<sup>300</sup> While an analysis of foregone net income may serve as an indicator of the upper limit on the value of the water, it should not be the primary value indicator.<sup>301</sup>

The *replacement cost approach* for valuing property is derived by adding the estimated value of the land to the current cost of construction of a reproduction or replacement for the improvements and then subtracting the amount of depreciation in the structures from all causes.<sup>302</sup> This approach determines the cost users are willing to pay to develop new water supplies. For instance, if surface water can be replaced with groundwater, the cost of developing the groundwater can be considered a replacement cost for the surface water.<sup>303</sup> The FMV of an easement is the FMV of the property *before and after* the granting of the easement.<sup>305</sup> The *before and after* valuation is the best indicator of the FMV of the part of a water right restricted by a conservation easement. The FMV is the differential between irrigated land with an unrestricted water right and land with a partial restriction on the full use of the water right.<sup>306</sup>

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293. *Id.*

294. *Id.* at 2-9.

295. *Id.* at 2-13.

296. *Id.* at 2-9.

297. *Id.*

298. *Id.* at 2-10.

299. *Id.* at 2-12.

300. *Id.*

301. *Id.*

302. *Id.* at 2-7.

303. *Id.* at 2-8.

305. *Johnston v. Comm'r*, 74 T.C.M. (CCH) 968 (T.C. 1997) (citing *Dorsey v. Comm'r*, 59 T.C.M. (CCH) 592 (T.C. 1990)).

306. Treas. Reg. §1.170A-14(h)(3)(i) (Valuation - Perpetual conservation restriction).

Appraisers shall estimate the value of water rights for their most optimum use.<sup>307</sup> Valuation of the *highest and best use* of a property at the valuation date, including potential development is the “highest and most profitable use for which the property is adapted or needed or likely to be needed in the reasonably near future.”<sup>308</sup> In some instances, conserved water may be most profitably transferred and used for housing developments instead of agricultural use, which potentially escalates the potential value of any conserved water transferred instream. The difference in the range of values represents the highest and best value attributable to the donated part of the water right.

Other factors that influence the price of water include: (1) the reliability of delivery based on the priority date of the water right; (2) whether the basin is fully adjudicated or not; (3) the actual consumptive right of use; (4) the location of the point of diversion and place of use; (5) access and cost of alternative sources of water; (6) source of water (ground or surface); (7) transferability of the water right; and (8) the presence or potential benefit to endangered species. Other important information of the land characteristics includes: size, soils, crops grown, terrain, development potential, and improvements.<sup>309</sup>

Conservation easements in prior appropriation states often include restrictions on water rights, and it is not always appropriate to attempt to make a separate appraisal of the water rights, as the water rights may simply be an asset contributing to the overall value of the associated property, often as irrigated agriculture.<sup>310</sup> However, it is very important to undertake an appraisal of appropriative water rights sought to be excluded by a grantor of a conservation easement on land. A valuation error will occur in the case where a grantor of a conservation easement appraises his property as irrigated agriculture, but seeks to exclude the water rights from the conservation easement and retain the ability to sell the water rights for other purposes.<sup>311</sup>

Highest and best use is determined by economic considerations and market forces, and therefore, non-market values are not accounted for in appraisals.<sup>312</sup> Environmental or government uses of water are generally not used to produce goods that are bought and sold in markets and do not always have prices associated with them. Without market prices a dollar value cannot be attributed to water used for environmental purposes for

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307. Herzog, *Water Rights Appraisal Guidelines*, *supra* note 138, at 2-6.

308. *Strasburg v. Comm’r*, 79 T.C.M. (CCH) 1697 (T.C. 2000) (citing *Stanley Works v. Comm’r*, 87 T.C. 389, 400 (T.C. 1986)); see also *Olson v. U.S.*, 292 U.S. 246, 255 (1934).

309. Herzog, *Water Rights Appraisal Guidelines*, *supra* note 138, at ES-7.

310. Anonymous comment from peer reviewer.

311. *Id.*

312. Herzog, *Water Rights Appraisal Guidelines*, *supra* note 138, at 2-15.

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public benefit.<sup>313</sup>

Nonetheless, as seen on Colorado's Gunnison River, a multi-million dollar partial interest deduction was sought and subsequently settled for approximately 30 cents on the dollar.<sup>314</sup> Again, the specific characteristics of the water right and the highly fact-specific context of the case are unique. Still, what is illustrative is that the partial interest was first deductible as a qualified conservation contribution. Then it was valued and the value was negotiated. The potential difference in water right valuations will almost always fall into a range of low-end valuations to high-end valuations that are not insubstantial.<sup>315</sup>

Proper appraisals reflect the actual FMV of the private property right to use of the public resource and are therefore an important measure of the value the public places on coldwater fisheries and water quality benefits.

The more senior and reliable the annual use of a particular water right, the more valuable the right. In times of increasing demand and diminished supply, the uncertainty of water delivery is carried most heavily by junior appropriators who find the value of their unrealized water right diminished, or at worst, worthless. More specifically, the reliability of a senior water right, plus the ability to move that water to where the demand is, is what makes a water right even more valuable.

For example, a junior water right for storage at times when water is plentiful may be worth more than a senior right for direct diversion at times when even more senior rights can divert all the available water. Also, a riparian right on an ephemeral stream might not be worth much, if there is no water during the irrigation season, but a relatively senior right to divert water to storage on the same stream may be worth more. Also, many senior rights can only divert during the irrigation season, while a more junior right that has a year round diversion season and includes the ability to divert to storage may be worth more because it has the potential to support municipal use.

However valuated, if the donation is contingent upon the occurrence of a condition precedent in order to become effective, e.g., state transfer approval, no deduction is allowed unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.<sup>316</sup> Other final matters to review: (1) time of delivery of donation;<sup>317</sup> (2) inconsistent

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313. *Id.*

314. Memorandum from Peter Nichols, Colorado attorney-at-law, dated March 2002 (on file with author).

315. A number of peer reviewers specifically cited the need for appraisal value guidance for environmental or nonmarket, instream values.

316. Treas. Reg. §1.170A-1(e) (Transfers subject to a condition or power).

317. Treas. Reg. §1.170A-1(b) (Timing of making contribution).

uses;<sup>318</sup> and (3) clearly delineated governmental policies and the significance of the public benefit.<sup>319</sup>

Because of perceived taxpayer-donor abuses in deducting partial interest qualified conservation contributions, close scrutiny by the IRS should be expected. In Notice 2004-41, the IRS raised specific concerns related to: (1) easement overvaluation; (2) actions being taken after the donation which are inconsistent with the conservation purposes; and (3) instances where the benefit to the donor exceeds the value of the easement.<sup>320</sup> Should a potential donor wish to confirm in advance that the requirements for a deduction will be satisfied by the terms of the proposed gift, an IRS *Private Letter Ruling* may be requested.<sup>321</sup>

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318. Treas. Reg. §1.170A-14(e)(2)-(3) (Exclusively for conservation purposes - Inconsistent use).

319. Treas. Reg. §1.170A-14(d)(vi) (Relationship of requirements).

320. *Income Tax Aspects*, *supra* note 41, 521-3rd at A-77.

321. *Income Tax Aspects*, *supra* note 41, 521-3rd at A-77.

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**CHART 4:**  
IRS Tax Treatment Matrix

<b>Conservation Transaction</b>	<b>Permanent</b>	<b>Entire Interest</b>	<b>Partial Interest</b>	<b>Charitable Tax Deduction</b>	<b>Qualified Conservation Contribution</b>
<b>Sale</b>	Yes	Yes	No	No	No
<b>Lease</b>	No	No	Yes	No	No
<b>Outright Donation or Bargain Sale</b>					
<b>Temporary</b>					
<i>Entire Right</i>	No	Yes: April 1- October 15: 100% of water right diversion (e.g. dry year lease)	Yes	No	No
<i>Partial Right</i>	No	No	Yes: (1) April 1-Oct 15: 25% of water right diversion; (2) Aug 1-Oct 15: 100% total water right diversion (e.g. split-season lease); (3) Aug 1-Oct 15: 25% total water right diversion.	No	No

(continued)

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<i>Conservation Transaction</i>	<i>Permanent</i>	<i>Entire Interest</i>	<i>Partial Interest</i>	<i>Charitable Tax Deduction</i>	<i>Qualified Conservation Contribution</i>
<b>Outright Donation or Bargain Sale</b>					
<b>Permanent</b>					
<i>Entire Right</i>	Yes	Yes: April 1- October 15: 100% of total water diversion	No	Yes	No
<i>Partial Right</i>	Yes	No	Yes: (1) April 1-Oct 15: 25% of conserved water transferred instream); (2) Aug 1- Oct 15: 100% total water right diversion; (3) Aug 1- Oct 15: 25% total water right diversion.	Yes	Yes

**VI. Conclusion: Consistent Federal Tax Deductions Will Increase Permanent Instream Flows**

Recent decades of state water law and policy reforms have eliminated traditional barriers and disincentives to conserve agricultural water, which is increasingly available for transfer - temporarily, long-term, or permanently - including instream purposes. These changes demonstrate the shifting of political will towards higher valuation of natural systems and the importance to local economies of the conservation values that instream flows serve. While the surveyed states have made tremendous strides to increase the lease, sale, or donation of water rights for beneficial instream uses, even more can be done to facilitate these transactions. Ideally, the tax

deduction emerges as a new transactional tool that, in the best of circumstances, aligns with the water rightholder's financial interests and stewardship objectives.

While the IRS has issued no formal interpretation regarding the deductibility of a charitable contribution of an entire or partial interest in an appropriative or riparian water right, there is no urgent need for a clarifying amendment of the I.R.C. or Treasury Regulations to accommodate charitable contributions of appropriative or riparian rights.

The I.R.C. already authorizes tax deductions for qualified conservation contributions traditionally applied to conservation transactions measured in acres as opposed to acre-feet. Existing I.R.C. and Treasury Regulations expressly include conservation benefits for fish, aquatic habitat, education, fishing and boating, among others. This statutory and regulatory guidance unambiguously recognizes that water - and therefore a water right - is already a considered component of a qualified conservation contribution and is therefore already eligible for a partial interest exception deduction.

If and when presented with a request for a private letter or revenue ruling, the IRS should affirm the deductibility of a state-defined property interest in a water right and provide appropriate interpretive guidance to lessen existing uncertainties, e.g., the valuation of a qualified real property interest in a right of use dedicated to instream conservation purposes.

Separate from voluntary market mechanisms to transfer water instream stands the general principal that the public should not pay for or buy water for instream Public Trust purposes.<sup>322</sup> Regulatory enforcement and litigation has the potential to reallocate water rights to instream conservation purposes without compensation. Advocates do not see the market as a substitute for regulatory requirements, compliance with minimum instream flows, or as a mechanism to meet a state's Public Trust obligations.

However, this article proposes that the donation of a water right transferred instream and compensated by an IRS tax deduction could stand as an "exception" to the general principal. In essence, the public would be paying for water to help achieve more certain instream flows through foregone tax revenues. Ultimately, this article concludes the permanent donative transaction can and will complement other instream flow tools and strategies. The test will be whether an added increment of instream flow would not be instream at all, *but for* the donation and the tax consideration of the partial interest deduction.

A shared interpretation of the existing I.R.C. and Treasury Regulations regarding the qualified conservation contribution of water rights will

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322. John D. Echeverria, *Regulating Versus Paying Land Owners to Protect the Environment*, 26 J. LAND RESOURCES, & ENVTL. L. 1 (2005); *see also* John D. Echeverria, *Skeptic's Perspective on Voluntary Conservation Easements* (2005) (on file with author).

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generate immediate, tangible, and important increments of instream flow that will generate conservation benefit. In the aggregate, individual donations will cumulatively add up to hundreds, possibly thousands of transactions that will help preserve and enhance cold water fisheries in perpetuity.

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