

EXCHANGES OF WATER RIGHTS

"CERTAIN WATER RIGHTS MAY QUALIFY FOR TAX DEFERRAL"



Compliments of

The types of real property which can be exchanged under IRC Section 1031 as qualifying "like-kind" property are extremely broad. Any real property held for productive use in a trade or business or for investment – whether improved or unimproved – can be considered "like-kind."

WHAT ABOUT WATER RIGHTS?

It is important to look to the treatment of water rights under the applicable state laws. Often, water rights are treated as real property and may qualify for an exchange of other "like-kind" (including non-water rights) real property for IRC Section 1031 purposes.

TYPES OF WATER RIGHTS

Riparian Right: A) Cannot be lost by non-use; B) Rights in water arise from, and only from, ownership of land which adjoins or underlies a stream; C) Can only be used on the riparian tract.

Prior Appropriation: A) Follow the mining laws concept; B) The first to use the water is protected against later water takers; C) Allows maximum use of water resources; D) Provides more flexible water usage.

Under the "Prior Appropriation" system, a water right gives an individual the right to use a maximum quantity of water from a specific resource, at a specified point of diversion or withdrawal, for a specified use, and a specified time. The right has a particular "priority" in relation to other water rights from the same source and the priority is the order of ranking in which the owner of the right may take their entitlement. The first in time is the first in right. A senior water right has priority over a junior water right.

LEGAL GUIDANCE ON WATER RIGHTS

In *Weichens v. United States*, 228 F. Supp. 1080 (Arizona - 2002) a water right constituted real property under state law, but the court held that the rights were so limited in priority, quantity, and duration as to not be like-kind to a fee simple interest in real property. On the other hand, in Revenue Rulings 68-331 and 55-749, the IRS found that perpetual easements in the form of water rights and an interest in a producing oil lease extending to the exhaustion of the deposit were like-kind to a fee interest in real property. In PLR 200404044, the IRS concluded that a perpetual water right was like-kind despite several actual and potential limitations on the use of the water.

Exchangers should thoroughly review all aspects of a potential exchange of water rights with legal and/or tax advisors familiar with these issues and state laws.

Every Exchanger should consult with their legal and/or tax advisors to review whether the water right in question qualifies for 1031 treatment. A PLR applies to the facts and circumstances of a taxpayer's specific situation. Most Private Letter Rulings have language as follows: "This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be cited as precedent." Contact Asset Preservation toll-free to discuss your particular exchange situation in greater detail.



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