

# Exchanges of Water Rights

Water Rights May Qualify for Tax Deferral

1031

Knowledge



## ARE WATER RIGHTS LIKE-KIND PROPERTY?

Internal Revenue Code (IRC) Section 1031 provides, in part, that no gain or loss is recognized on the exchange of property for other property of a "like-kind." In other words, to qualify for income tax deferral under Section 1031, the property relinquished in the exchange must be sufficiently *like* the replacement property received in the 1031 exchange. Fortunately, most property rights characterized as real property under state law are considered like-kind to other interests that are also considered real property under local law. Thus, an easement or mineral right, in most cases, will be considered like-kind to a fee simple interest in real property and vice versa. Since easements and mineral rights are considered like-kind to a fee simple interest in real property, then what about water rights?

In recent years, developers have been willing to purchase water rights at a significant premium, and some economists expect the premium to increase in the future. Does a sale of water rights qualify for income tax deferral under Section 1031? In most states, perpetual water rights are recognized as an interest in real property that would qualify as "like-kind" to a fee interest in real property. See, e.g. Revenue Ruling 55-749, 1955-2 CB 295; IRS Letter Ruling 200404044. On the other hand, water rights that are limited in amount or duration may not be considered like-kind to a fee interest in real property. In *Weichens v. United States*, 228 F. Supp. 1080 (Arizona - 2002), for example, the court held that the water rights in question were so limited in priority, quantity, and duration as to not be like-kind to a fee simple interest in real property.

## DOES DITCH STOCK QUALIFY FOR TAX DEFERRAL UNDER SECTION 1031?

Like-kind issues also arise when water rights are owned indirectly. In some states, water is allocated among landowners by means of ditches. Ditches may be individually owned or may be "mutual" incorporated ditches. Water in incorporated ditches is allocated by shares issued by the company. The ditch shares represent proportional amounts of water rights held by the ditch company. In most cases, stock certificates are issued by ditch companies. So, can ditch stock be exchanged for real property in a 1031 exchange?

Section 1031(a)(2)(B) provides that "stocks, bonds or notes" may not be exchanged in a 1031 exchange. Thus, an exchanger cannot sell stock in a corporation that owns real property even if the underlying real property would qualify as like-kind property. In view of this provision, it would seem to follow logically that a sale of ditch stock should not qualify for deferral under Section 1031. On May 22, 2008, however, Congress enacted the Food, Conservation and Energy Act of 2008 which is often referred to as the Farm Bill. Among other things, the Act amends IRC Section 1031(a)(2)(B) to exclude mutual ditch, reservoir or irrigation company stock from the definition of "stock." As a result, mutual ditch, reservoir or irrigation company stock is eligible for 1031 exchange tax deferral. In order to qualify for this treatment, the law requires that ditch stock must be treated as an interest in real property under the law of the state in which the corporation is located.

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