

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Refer Reply To:
CC:ITA:B05 – PLR-144314-03

Date:
October 23, 2003

DO: ■

LEGEND:

Taxpayer =

State =

Aquifer =

Dear :

This responds to your letter, dated July 16, 2003, requesting a ruling on whether water rights are of like-kind with a fee simple interest in farm land under section 1031 of the Internal Revenue Code.

FACTS:

Taxpayer is an individual farmer engaged in the business of farming. Taxpayer owns a right to pump ground water from Aquifer for irrigation purposes and specified tracts of land. Taxpayer's water rights are limited to a maximum diversion rate of 1,100 gallons per minute and a maximum quantity of 195 acre-feet of water per calendar year. The water rights are not limited in duration, but State retains the authority to make reasonable reductions in the diversion rate and the quantity pumped as may be deemed to be in the public interest. Taxpayer proposes to exchange the water rights to a third party for additional farm land. According to Taxpayer, the transaction will be structured to meet all of the section 1031 requirements to achieve a tax-free exchange.

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Taxpayer requests a ruling that the proposed exchange of water rights for farm land constitutes an exchange of like-kind property within the meaning of section 1031 of the Code.

LAW:

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like-kind that is to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) of the Income Tax Regulations defines like-kind as referring to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.

Section 1.1031(a)-1(c)(2) provides that no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate.

In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights that are considered real property rights under the applicable state law. This revenue ruling holds that the exchange of perpetual water rights for a fee interest in land constitutes a nontaxable exchange of like-kind property within the meaning of section 1031.

Rev. Rul. 68-331, 1968-1 C.B. 352, holds that a leasehold interest in a producing oil lease extending until the exhaustion of the deposit is of like-kind to a fee interest in an improved ranch under section 1031 of the Code because both the leasehold interest and the fee interest are continuing interests in real property.

In Wiechens v. United States, 228 F. Supp. 2d 1080 (D. Az. 2002), the taxpayers conveyed water rights for a fee interest in farm land. The taxpayer's water rights were limited in duration to a 50-year period, limited in quantity to a specific percentage of the overall supply of agricultural water, and limited in priority to be secondary to municipal, industrial and Indian uses. The District Court refused to equate the taxpayer's water rights to a 30-year leasehold interest. The Court held that the application of section 1031 "requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are

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substantially alike." Factors to be considered in this analysis include "the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, [and] the duration [of the interests]." Id. at 1085 (citing to Koch v. Commissioner, 71 T.C. 54, 65 (1978)). The Court found that because the taxpayer's water rights were narrowly restricted in priority, quantity, and duration, although the taxpayer's water rights constituted an interest in real property, the water rights were not sufficiently similar to the fee simple interest that it acquired in the farm land to qualify as like-kind property.

Under the regulations cited, the types of real estate interests that are within the same kind or class as fee interests in real estate is broad. Both revenue rulings cited demonstrate that perpetual easements in the form of water rights and an interest in a producing oil lease extending until the exhaustion of the deposit belong to the same kind or class of property as a fee interest in real estate.

In the present case, Taxpayer is exchanging water rights for a fee interest in farm land. Taxpayer's water rights are a perpetual interest in real property under applicable state law. Unlike Wiechens, the water rights are limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water.

Accordingly, based upon the representations submitted and the above analysis, the water rights owned by Taxpayer are of like-kind under section 1031 to the fee simple interest in the replacement farmland, provided that the properties are held for productive use in a trade or business or for investment.

No determination is made by this letter as to whether the described transaction otherwise qualifies under section 1031 as an exchange of property for which Taxpayer will recognize no gain or loss.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed

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by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

Sincerely,

J. Charles Strickland
Senior Technician Reviewer, Branch 5
Office of Income Tax and Accounting
Division

Enclosure (1)

cc: