

“Tax Incentives to Enhance Stream Flow”

Tom Hicks, *of counsel*
TU Western Water and
Habitat Project

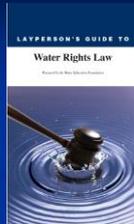


Briefing Agenda

- Introductions
- Jardine Mine, Montana
- Federal tax briefing
- State instream flow review and discussion
- Connecting Policy with Transactional Strategies

Author, Layperson’s Guide to Water Rights Law

- The 28-page, recognized as the most thorough explanation of California water rights law available to non-lawyers, traces the authority for water flowing in a stream or reservoir, from a faucet or into an irrigation ditch through the complex web of California water rights.
- It includes historical information on the development of water rights law, sections on surface water rights and groundwater rights, a description of the different agencies involved in water rights, and a section on the issues not only shaped by water rights decisions but that are also driving changes in water rights. Includes chronology of landmark cases and legislation and an extensive glossary.
- <http://www.watereducation.org/publication/laypersons-guide-water-rights-law>



Who is in the Audience?

- Conservation Professionals?
- Land owners? Ranchers? Farmers?
- Environmental organizations?
- Attorneys?
- State or federal agencies?
- Concerned citizens?
- Others?

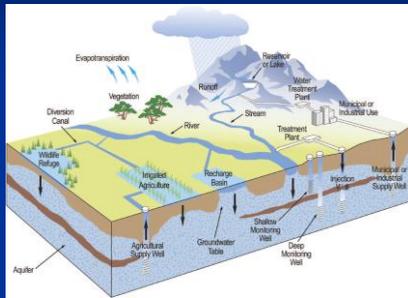
Presentation Goals

1. Educate participants concerning the donation of appropriative water rights, including the deductibility of entire and partial interests for conservation purposes.
2. Discuss the use of donated water rights to further conservation values, including transactional issues and alternatives.
3. Inform participants of efforts to resolve legal questions about the deductibility of donated water rights.
4. Identify common opportunities for conservation professionals to engage with water right issues.

California Water Law

- Many Legal Definitions & Issues:
 - Appropriative water rights
 - Riparian water rights
 - Groundwater rights
 - Beneficial use
 - Public Trust Doctrine
 - Property rights
 - Environmental law
 - Federal water law authorities
 - Hydropower development

Water Law in the Watershed



TU Tax and Water Legal Team

- Tom Hicks, *Of Counsel*, TU Western Water Project
- Laura Ziemer, TU Senior Counsel and Water Policy Advisor
- Bill Silberstein, *Kaplan Kirsch & Rockwell LLP*, Colorado
- Peter Nichols, *Berg, Hill, Greenleaf, Ruscitti LLP*, Colorado
- Bill Hutton, *Coblentz, Patch, Duffy & Bass*, California
- Pat Byorth, TU Western Water Project



Background

- “Can you donate an appropriative water right for a tax deduction?” – Huey Johnson – founder of the Trust for Public Land, former California Resources Agency
- Entire Interest or
- Three partial interest deductions:
 1. Contribution of a *remainder interest* in a personal residence or farm;
 2. Contribution of an *undivided portion of the taxpayer's entire interest in property*; and
 3. A *qualified conservation contribution*.

Entire and Partial Interests

- A partial interest is any interest in property that consists of less than the donor's entire interest in the property.
- 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.
- 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.

Revenue Ruling Focus: Entire Interest

- **Threshold Question #1:** A gift of taxpayer's entire interest in an Appropriative Water Right to an organization described in § 170(c) qualifies for a charitable deduction under § 170(a).
- For example, a taxpayer owns the right to divert two cubic feet per second of water from a stream for taxpayer's use. Taxpayer makes a gift of this water right to an organization described in § 170(c). This qualifies as a charitable deduction under § 170(a).

Donated Entire Interest: National Precedent

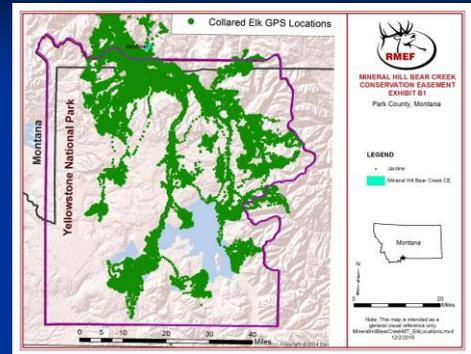
On Thursday, August 17, 2017, a formal ceremony brought Trout Unlimited, Kinross Gold, Inc., and the Rocky Mountain Elk Foundation together to celebrate two conservation transactions that included:

- (1) a donated conservation easement on the fee interest from Kinross to RMEF; and
- (2) an outright donation of the Jardine Mine water right from Kinross to TU.

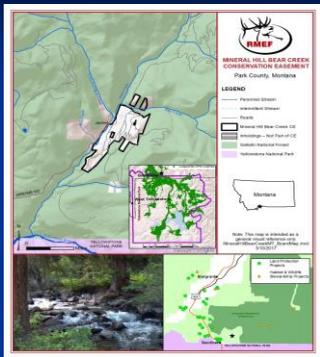
Donated Entire Interest: National Precedent



Donated Entire Interest: National Precedent



Donated Entire Interest: National Precedent



Donated Entire Interest: National Precedent



(from left to right: Chris Wood, President and CEO of Trout Unlimited; David Allen, President and CEO, Rocky Mountain Elk Foundation; U.S. Congressman Greg Gianforte (MT); Dan Wenk, Superintendent Yellowstone National Park; J. Paul Robinson, President and CEO, Kinross Gold; David Bernhard, Deputy Secretary Department of the Interior; U.S. Sen. Jon Tester (MT); Gov. Steve Bullock (MT); U.S. Sen. Steve Daines (MT).

Donated Entire Interest: National Precedent

The conclusions of the Water Rights Due Diligence:

1. **Pine Creek Water Right:** Evidence supported protection of the Pine Creek water right with up to 2.5 cfs of consumptive use from April 1 - August 31, and 1.4 cfs from September 1 – March 31, with a volume of up to 1,345 acre-feet
2. **Bear Creek Water Right #1:** Evidence supported protection of Bear Creek's contribution to 4.0 cfs of consumptive use with a volume of 1,079 acre-feet.
3. **Bear Creek Water Right #2:** Evidence supported protection of up to 10 cfs of non-consumptive use based on historic mine hydropower production, relying on the Bear Creek water right of up to 6,404.0 acre-feet.
4. Valuation of the donation was based on the aggregate total of approximately 8,828 acre-feet of protected volume, or approximately 2.88 billion gallons of water.
5. The proposed protected reach will extend from the upstream-most point of diversion on Bear Creek and Pine Creek to their confluence with the Yellowstone River and beyond.

Donated Entire Interest: National Precedent

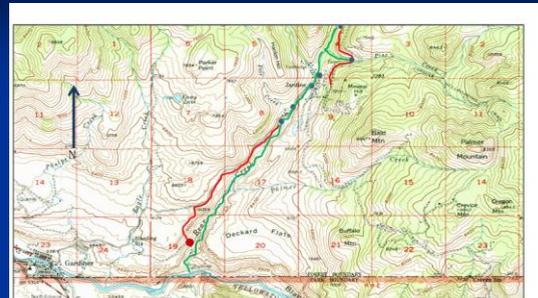


Figure 1. Map of the project area at Jarline, MT at Mineral Hill, T9S R9E, Park County, MT. Blue circles are historic points of diversions, red lines are ditch locations. The Bear Creek Ditch (Biglow Chapman Ditch) is red line west of Bear Creek, and power plant location red circle. Proposed protected reach is green line. Source: USGS Gardiner Quadrangle (1955).

Legal Focus: Narrow Scope

- The Request does not concern a gift of either:
 - a *remainder interest* in an appropriative water right under I.R.C. § 170(f)(3)(B)(i) or
 - a *qualified conservation contribution* of the qualified real property interest in an appropriative water right to a qualified organization given exclusively for conservation purposes in perpetuity under I.R.C. § 170(f)(3)(B)(iii) and I.R.C. § 170(h).
- The Request does not concern gifts of riparian rights or groundwater rights.

Revenue Ruling Focus: Partial Interest

- **Question #2:** A gift of an undivided portion of a taxpayer's entire interest in an Appropriative Water Right to an organization described in § 170(c) qualifies for a charitable deduction under § 170(a).
- For example, a taxpayer owns the right to divert two cubic feet per second of water from a stream for taxpayer's use. Taxpayer makes a gift of a fifty percent undivided interest of this right to an organization described in § 170(c). The taxpayer has conveyed a fraction or percentage of each and every interest or right owned by the taxpayer in such property. The taxpayer has not retained any right, not even an insubstantial right, in the property conveyed. This qualifies as a charitable deduction under § 170(a).

Legal Focus: I.R.C. § 170(f)(3)(B)(ii)

- **Scenario:** Owner owns an entire interest in an appropriative water right. Owner makes a charitable contribution of an undivided 50% interest in his/her appropriative water right to an organization described in I.R.C. § 170(c).
- Donor permanently transfers all his/her interest in the 50% undivided interest in the appropriative right to the donee.
- Owner maintains and retains an unencumbered interest in the remaining 50% interest in his/her appropriative water right.
- **Deductible.**

Temporary: Forbearance Agreement

- Simply a contract between a landowner/water user and a local land trust or water trust (or other entity)
- Water user agrees to forego withdrawals of water pursuant to the terms and conditions set forth in the contract.
- The main advantage of a forbearance agreement is its simplicity and efficiency, as the terms of the agreement can be structured to fit the needs of the parties.
- Often, the key term is *seasonal* (not year-round) forbearance from withdrawing water. That is, the landowners retain the right to withdraw water during the wetter or higher-flow seasons, but give up the right to withdraw water during the dry season when flows are critically low.
- Forbearance Agreements are not permanent. They typically extend for a term of years agreed to by the parties.
- **Non-deductible.**

Permanent: Fractional Use Agreements

- To qualify for a federal tax deduction the water right owner must permanently relinquish a fractional or partial interest in an appropriative water right.
- Fractional Use Agreements can be considered an evolutionary progression of and are *permanent* Forbearance Agreements.
- Bargain sale transactions (that have both cash and donative components) or outright 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.

I.R.C. § 170(h): Qualified Conservation Contribution

The I.R.S. provides income tax and estate tax deductions for a qualified conservation contribution:

- of a qualified real property interest;
- to a qualified organization; and
- donated exclusively for conservation purposes.

I.R.C. § 170(h)(2): Easement must be a Qualified Real Property Interest

A *qualified real property interest* is any of the following interests in real property:

- (1) The entire interest of the donor other than qualified mineral interest;
- (2) A remainder interest; and
- (3) A restriction (granted in perpetuity) on the use which may be made of the real property.

State Defined Property Right

- Conservation easements are negotiated, voluntary agreements to permanently restrict an otherwise full right of *future, potential* uses of the real property interest, e.g. subdivision, commercial development, etc., enforceable under state law.

Limitations on the Real Property Interest in a Water Right

- Reasonable and beneficial use
- Water Quality
- Endangered Species Act (“ESA”)
- Public Trust Doctrine

1983 National Audubon Society v. Superior Court (California)



I.R.C. § 170(h)(3): Easement must be given to a qualified organization

- A qualified conservation contribution of the qualified real property interest in an appropriative water right must be permanently dedicated to either:
 - A government unit or
 - A publicly supported 501(c)(3) charitable organization or
 - Both

I.R.C. § 170(h)(4)-(5): Easement must be donated exclusively for "conservation purposes"

- The qualified conservation contribution of the qualified real property interest in an appropriative water right permanently dedicated to a qualified organization is donated for *conservation purposes* when it will:
 - (1) preserve land areas for outdoor recreation by, or the education of, the general public;
 - (2) protect a relatively natural habitat of fish, wildlife, or plants or similar ecosystem; or
 - (3) preserve open space.

Perpetuity

- The conservation purpose must be protected in perpetuity.

I.R.C. § 170(h)(4)(A)(i): Outdoor Recreation or Education

- The preservation of a *water area* for the use of the public for boating or fishing is a conservation purpose.
- The preservation of a *land area* [or an instream appropriative right, e.g. river] will not meet the conservation purposes test unless the recreation or education is for the substantial and regular use of the general public.



I.R.C. § 170(h)(4)(A)(ii): Relatively Natural Habitat/Protection of Environmental System

- The protection of a relatively natural habitat of fish is a conservation purpose.
- Significant habitats or ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of fish.
- 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.
- 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.



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

- The preservation of open space (including farmland or forest land) qualifies where such preservation is
- (I) for the scenic enjoyment of the enjoyment of the public, or
- (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit.

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

- The preservation of open space for the scenic enjoyment of the public is a conservation purpose.
- Preservation may be for scenic enjoyment 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.

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

- The preservation of open space pursuant to clearly delineated governmental conservation policy that states it is in the public interest to preserve a certain type of property is a conservation purpose.



Distinctions Between Permanent Forbearance Agreements and Conservation Easements

- Exclusive focus on gift of the real property interest pursuant to state law, measured as the fractional reduction of the full right of diversion, at the time of the gift;
- Not contingent upon the secondary state administrative transfer of the water right to an instream fish and wildlife reasonable and beneficial use or other conservation purposes, which can take years;
- The burden of monitoring a non-diversion in perpetuity is an obligation that should not casually be taken on by private, non-profit, or public entities;
- The difficulty of attaching an "exclusively conservation purpose" in perpetuity to a particular right, which may accomplish multiple municipal, environmental or agricultural beneficial uses as water flows downstream.

Drafting Guidance: Permanent Forbearance Agreements

- Separate real property interest.
- Permanent Term.
- Fraction or percentage of each and every substantial interest.
- No Retainer Substantial Interest.
- Right of possession, dominion and control.
- Time of accrual of right of deduction.
- Perpetual Nature of Appropriative Water Right.
- Retained Uses of Water Right.
- **Deductible**

TU Resources #1

- **Model Seasonal Use Agreements:** TU has west wide split season lease examples and continues to refine a multi-state **Model Permanent Forbearance Agreement** for permanent forbearance and non-diversion of a water right for instream use for—typically—just the second half of an irrigation season when low stream flows are most critical. TU can work together to advance the familiarity and use of temporary and permanent seasonal use agreements by conservation professionals.

TU Resources #2

- **Tax Deductible Donative Transactions:** TU can coordinate and provide appropriate assistance to conservation professionals and/or water right donors so as to promote use of federal tax deductions to incentivize water right donations. Together, TU can partner to expand capacity to generate conservation transaction leads - easements, fee simple, temporary lease, donation.

“Tax Incentives to Enhance Stream Flow”

Tom Hicks, *of counsel*
TU Western Water Project

Instream Tax Incentives Project
415.309.2098
tdh@tomhickslaw.com

