

## Internal Revenue Service

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Date:

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### Legend

Taxpayer =

Founder =

Ranch =

Ranch Owners =

State A =

License =

Year 1 =

Date A =

X =

Y =

Z =

A =

B =

C =

D =

City =

County =

River =

Diversion Season =

Dear :

This is in response to a request for a Private Letter Ruling dated June 10, 2022, filed on behalf of Taxpayer by its authorized representative. Taxpayer is requesting that the Internal Revenue Service issue a ruling that certain water rights described below are "real property" as that term is used in § 1031 of the Internal Revenue Code ("Code") and the Treasury Regulations issued pursuant to it and are like kind to a fee simple interest in real property for purposes of § 1031, provided that the properties are held for productive use in a trade or business or for investment.

### FACTS

In Year 1, Founder began Ranch and was the original licensee of a License for the diversion and use of water issued by State A, having a priority date of Date A. Taxpayer and the other Ranch Owners own approximately x acres of real property located outside of City in County consisting of the former Ranch. Each of the Ranch Owners owns its respective property in fee simple. Ranch is a diversified farming and cattle operation producing crops adjacent to an additional rangeland. Ranch Owners do not carry on a joint business activity, have never joined in filing a partnership return with respect to their ownership of their respective properties, and engage in their own separate business activities.

Ranch Owners are the successors in interest to Founder's rights in the License. Pursuant to the License, Ranch Owners own the right to divert y cubic feet per second (about z gallons per minute) ("Diversion Rate") of water from River during Diversion Season each year. If diversions were made at the maximum allowed rate for 24 hours a day for the Diversion Season, the maximum allowed annual diversion amount would be A acre-feet. Ranch Owners' rights to use these waters are referred to as the "Water Rights."

The lands where the diverted water is put to beneficial use for irrigation purposes total B acres of the Ranch (such portion, the "Land"). Each of the Ranch Owners owns a specified percentage of the Land. Although the Ranch Owners each own different percentages of the Land, each has full access to and the right to divert water under the License. The Ranch Owners have agreed that if all or a portion of the Water Rights are sold, then the proceeds from such sale shall be allocated in accordance with the Ranch Owners' relative percentages of the Land owned.

Taxpayer plans to sell a portion of Water Rights and reinvest the proceeds in real property in a transaction that will qualify for nonrecognition under § 1031 of the Code. The purpose of such transaction is to diversify the Taxpayer's real estate holdings. The Taxpayer has concluded that its full portion of Water Rights may not be necessary for its current business purposes. Taxpayer plans to sell a portion of Water Rights (also referred to herein as the "Relinquished Property") to an unrelated purchaser ("Buyer") pursuant to a Purchase and Sale Agreement ("Agreement").

The proposed terms of the Agreement are as follows: Taxpayer agrees to permanently sell a portion of the License to Buyer; Taxpayer will retain the right to divert C-acre feet of water; and Buyer agrees to purchase a portion of the License from Taxpayer for \$D per acre foot of water. To determine the total purchase price, the parties will multiply the per acre foot price by the quantity of water sold. To calculate the quantity of water sold, the Diversion Rate sold will be multiplied by the number of days of the Diversion Season sold, which will further be multiplied by (i.e., the quantity of water in acre feet diverted after taking one cubic foot per second for one day).

The Buyer will pay Taxpayer cash in an amount equal to the total purchase price in exchange for the Relinquished Property. The cash sales proceeds will be allocated among the Ranch Owners, including Taxpayer, according to their percentage ownership of the Land. Pursuant to State A administrative procedures, the License will be bifurcated into two separate licenses: one vested in the Taxpayer and one vested in the Buyer.

You have requested a ruling that the Water Rights are "real property" as that term is used in § 1031 of the Code and the regulations thereunder and are like-kind to a fee simple interest in real property for purposes of § 1031 provided that the properties are held for productive use in a trade or business or for investment.

#### LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment if the real property is exchanged solely for real 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 § 1031, 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) of the Income Tax Regulations 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, 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.

Section 1.1031(a)-3(a)(1) of the Income Tax Regulations defines the term "real property" to mean land and improvements to land, unsevered natural products of land, and water and air space superjacent to land. Under paragraph (a)(5) of this section, an intangible interest in real property of a type described in this paragraph (a)(1) is real property for purposes of § 1031 and this section. Property that is real property under

State or local law as provided in paragraph (a)(6) of this section is real property for purposes of § 1031 and this section.

Section 1.1031(a)-3(a)(5)(i) of the Income Tax Regulations provides that intangible assets that are real property for purposes of § 1031 and this section include the following: Fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; certain stock in a cooperative housing corporation; shares in a certain mutual ditch, reservoir, or irrigation companies described in § 501(c)(12)(A) of the Code; and land development rights. Similar interests are real property for purposes of § 1031 and this section if the intangible asset derives its value from the real property or an interest in real property and is inseparable from that real property or interest in real property. Under paragraph (ii), a license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, easement or other similar right, generally is an interest in real property under this section.

Section 1.1031(a)-3(a)(6) of the Income Tax Regulations provides that with certain exceptions, property is real property within the meaning of paragraph (a)(1) of this section under State or local law if, on the date it is transferred in an exchange, the property is real property or an interest in real property under the law of the State or local jurisdiction in which that property is located.

In Rev. Rul. 55-749, 1955-2 C.B. 295, land was exchanged for perpetual water rights that were considered real property rights under the applicable state law. Since the water rights were granted "in perpetuity" and were not merely rights "to a specific total amount of water or to a specific amount of water for a limited period," the Service concluded that the water rights and the land involved were sufficiently similar to constitute property of a like kind within the meaning of § 1031(a). Accordingly, Rev. Rul. 55-749 holds that the exchange of perpetual water rights for a fee interest in land is a nontaxable exchange of like-kind property within the meaning of § 1031.

In *Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Az. 2002), the taxpayers conveyed water rights for a fee interest in farmland. 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 § 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 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, and 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 farmland to qualify as like-kind property.

Here, Taxpayer has cited statutes and case law supporting the characterization of the Water Rights as real property under the law of State A. Further, License grants the Ranch Owners rights to a set volume of water during the Diversion Season each year. The Water Rights are not limited to a maximum total amount of water. They are not dependent on anything other than the physical presence of water in River. There is no sunset date on these rights. They are perpetual, subject only to the right of State A to terminate them based on a finding that they are not being put to beneficial use, a determination subject to judicial review. Accordingly, the Water Rights are real property that is like kind to a fee interest in real property under Rev. Rul. 55-749.

### CONCLUSION

We conclude that the Water Rights are "real property" as that term is used in § 1031 of the Code and the Treasury Regulations issued pursuant to that section and are like kind to a fee simple interest in real property for purposes of § 1031, provided that all properties are held for productive use in a trade or business or for investment.

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

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

John M. Aramburu  
Senior Counsel, Branch 5  
Office of Chief Counsel  
(Income Tax & Accounting)

Enclosure (1)

cc: