

WATER RIGHT EXCHANGES IN COLORADO

"MOST WATER RIGHTS QUALIFY FOR TAX DEFERRAL"



ARE WATER RIGHTS LIKE-KIND PROPERTY?

Compliments of

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 "like-kind." In other words, to qualify for income tax deferral under IRC §1031, the property relinquished in the exchange must be sufficiently *like* the property received in the 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. If easements and mineral rights are considered like-kind to a fee simple interest in real property, then what about water rights?

Does the sale of water rights qualify for income tax deferral under IRC §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 real property. See, e.g. Revenue Ruling 55-749, 1955-2 CB 295; PLR 2004-04044; PLR 2006-49028; PLR 2008-05012, PLR 2009-01020. On the other hand, water rights that are limited in amount or duration may not be considered sufficiently like 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.

THE 2008 FARM BILL ALLOWS DITCH STOCK IN COLORADO TO BE EXCHANGED

Like-kind issues also arise where water rights are owned indirectly. In some states, water is allocated among land owners 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 an IRC §1031 exchange?

On May 22, 2008, 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 §1031(a)(2)(B) to exclude mutual ditch, reservoir or irrigation company stock from the definition of "stock." Mutual irrigation ditch, reservoir or irrigation company stock as noted in IRC §501(c)(12)(A), may be like-kind to a fee interest in real estate as a result of the Farm Bill. Consequently, in Colorado, mutual ditch, reservoir or irrigation company stock should be eligible in §1031 exchanges. In order to qualify for this treatment, §15342 of the Farm Bill requires that the ditch stock must be recognized as an interest in real property under the law of the state in which the corporation is located. In Colorado, mutual irrigation ditch companies are organized under separate sections of state statutes and ditch stock has been recognized as an interest in real property by the Colorado Courts. Ditch stock in other states may or may not qualify depending upon the circumstances in each state.



ASSET PRESERVATION
INCORPORATED

A National IRC §1031 "Qualified Intermediary"

National Headquarters

800-282-1031

Eastern Region Office

866-394-1031

apiexchange.com

info@apiexchange.com

Template # 39

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