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By *Kelly A. Cole*◆

I. Introduction

In the arid American West, water is a scarce commodity. Western water resources have become over-appropriated because of the many competing demands for water, including agricultural, municipal and other traditional out-of-stream consumptive uses. More rights to divert water out of rivers and streams have been issued than there is water in the streams. The situation is especially critical when periods of low flow or drought coincide with over-appropriation; the end result is often dried-up streambeds.

Both rivers and fish require a continuous flow of water. The ecology of the stream system, watershed and basin is affected when natural streamflows are modified by water diversions. If a stream becomes over-appropriated, reduced flow may prove inadequate as habitat for fish and other aquatic species. A lack of instream flow results in rising water temperatures, accumulating sediment and diminishing water quality. The flow may even be reduced to the point where it is impossible for fish to pass through on their way to their spawning and rearing habitats.

The western water rights system has failed to provide for adequate instream flow. Under the current regime, reallocating our scarce water resources away from consumptive uses to instream uses is an overwhelming undertaking. Although there exist some statutory obligations designed to preserve instream flows, in the long run, if our water resources are to be protected, we must create market incentives for water right holders to contribute to instream flow. This article urges Congress to amend section 170 of the Internal Revenue Code ("Code")—which allows landowners who donate a conservation easement on their land to receive a charitable contribution deduction—so that water right holders may receive similar tax benefits from donating their water rights.

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II. State Law Recognition of Gifting Water Rights to Instream Flow

The question of whether a water user's dedication of his or her water rights for instream beneficial uses is consistent with the western water system has plagued the courts and the legislatures of the western states throughout the twentieth century.[1] Colorado, Idaho, Montana, Oregon, Utah and Wyoming allow state agencies to acquire and to manage appropriative rights for the purpose of protecting fish, wildlife, recreational use, aesthetics and aquatic habitat. Arizona law authorizes private individuals, as well as the state, to appropriate water for recreation and wildlife. California, although it has preserved both the riparian and prior appropriation water systems,[2] has been at the forefront of providing for the preservation of instream flow, employing a combination of statutory guarantees, common law protections and regulatory directives that, at a minimum, require the State Water Resources Control Board ("SWRCB" or "Board") to consider the effects on instream uses of the water rights subject to its jurisdiction.[3]

Although California does not recognize new appropriations for instream uses,[4] it does allow an *existing* water user to devote all or a portion of its water rights to instream uses. In 1991, the California legislature enacted section 1707 of the California Water Code, authorizing any water right holder to petition the SWRCB to change its existing water right "for purposes of preserving or enhancing wetlands habitat, fish and wildlife resources, or recreation in, or on, the water."[5] The Board may approve the petition if it decides that it is "in the public interest" and so long as the change will not increase the amount of water the petitioner is entitled to use, and will not "unreasonably affect any legal user of water."[6]

Section 1707 leaves open some important questions. This article explores the possibility of a riparian[7] water right holder creating a conservation easement in his or her water right by giving up the right to use the water, and letting it remain in the stream.[8] Specifically, may a

1. *See, e.g.*, Empire Water & Power Co. v. Cascade Town Co., 205 F. 123 (8th Cir. 1913). Although the court had no difficulty determining that preservation of stream flows was important to the local community, and thus qualified as a beneficial use under Colorado law, it struggled over whether protection of the natural stream flow was reasonable in light of defendant's competing use of water for the generation of hydroelectric power, and whether plaintiff could protect instream flow without an "appropriation" of water for that purpose. *See id.*

2. California has incorporated both the doctrine of riparian rights and the doctrine of prior appropriation into its water rights system. When California became a state in 1850, it adopted the English common law as its own, which included the law of riparian rights. According to the riparian rights doctrine, owners of adjacent land have the right to the water that flows there. *See* Lux v. Haggin, 69 Cal. 255, 10 P. 674 (1886) (officially recognizing the doctrine of riparian rights as California's system of water law). In 1855, the California Supreme Court also recognized the doctrine of prior appropriation. *See* Irwin v. Phillips, 5 Cal. 140, 1855 WL 691 (Cal.) (1855) (in a dispute between two miners, the California Supreme Court defers to the mining custom of water rights—"first in time, first in right"). According to the doctrine of prior appropriation, water is taken away from the riparian area to be used elsewhere and senior appropriators are those that claimed their water rights first.

3. *See* Brian E. Gray, A *Reconsideration of Instream Appropriative Water Rights in California*, 16 ECOLOGY L.Q. 667, 671-84 (1989).

4. *See* California Trout v. State Water Resources Control Board, 90 Cal. App. 3d 816, 153 Cal. Rptr. 672 (1979) (the California Water Code does not authorize the appropriation of water without a diversion or impoundment of the water).

5. CAL. WATER CODE § 1707.

6. *Id.*

7. The current tax code may not bar *appropriators* from receiving a charitable deduction for donating their water rights because it would not be the donation of a partial interest. *See infra* Part III.B.2.

8. Both the state of California and the federal government currently mandate that a specific amount of water remain instream for environmental purposes; therefore, it is possible that any water voluntarily left in the stream by riparian water right holders who donate their water to instream flow would merely take the place of the statutorily mandated water. In effect, any water donated by riparians would mean that that much less would have to be taken from appropriators who are subject to the statutory obligation. This result is contrary to the spirit behind conservation easements in water. It also reduces the incentive to donate water to instream purposes since donations would not increase the amount of instream flow, they would merely shift the burden away from appropriators. However, the California legislature recently passed legislation that addresses this phenomenon. Senate bill 970 amends section 1707 of the Water Code so that water donated for instream flow

> shall be *in addition to water that is required*, if any, to be used for instream purposes to satisfy any applicable federal, state, or local regulatory requirements governing water quantity, water quality, instream flows, fish and wildlife, wetlands, recreation, and other instream beneficial uses. If the request [for a permit to dedicate water to instream flow] is approved by the board, state and local agencies, as well as the courts, *shall not credit the water subject to that petition towards compliance with any of the regulatory requirements* described in this subdivision.

S.B. 970, (Cal. 1999) (emphasis added); CAL. WATER CODE § 1707(c)(1).

water right holder permanently dedicate a portion of his or her rights under section 1707 and claim an income tax deduction for a charitable contribution? If so, the tax benefits associated with conservation easement law would create a powerful incentive for water right holders in California to take advantage of section 1707. The legislature, however, has not explained the relationship between section 1707 of the Water Code and section 170 of the Internal Revenue Code which governs charitable contributions. This article proposes amending the tax code to reflect the donation of conservation easements in water.

III. Why the Current Tax Code Does Not Allow a Deduction for the Donation of Riparian Water Rights to Instream Flow

A. Section 170(h) of the Internal Revenue Code

Section 170 of the Code allows a charitable deduction to the donors of a "qualified conservation contribution."[9] A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.[10] As the current Code is written, the donation of riparian water rights would not qualify as a charitable deduction because such water rights do not meet the requirements of a "qualified real property interest."

B. "Qualified Real Property Interest"

A "qualified real property interest" means any of the following interests in real property: (1) the entire interest of the donor other than a 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.[11]

1. *Real Property*

The first obstacle in meeting the requirements of section 170, pursuant to the donation of water rights, is determining whether water rights qualify as "real property." Black's Law Dictionary defines "real property" as "[l]and and anything growing on, attached to, or erected on it, excluding anything that may be severed without injury to the land."[12] Water, unlike trees and buildings, neither grows on, is attached to, nor erected on, land. Moreover, if water rights are riparian (and thus belong to the adjacent landowner), severing those rights from the land would most likely decrease the value of that land, thus "injuring" it. As such, it would seem that water rights are excluded from the definition of "real property."

Regardless of whether water rights are *real* property, they may not even be considered full-fledged "property" at all. The nature of water rights is fundamentally different from that of other property rights. Unlike most property rights, one cannot have complete dominion over water, only a usufructuary right. Possessing a usufructuary right means that one has the right to use water taken from a river, but one cannot own the river. Blackstone defines *usus fructus* as a "temporary right of using a thing, without having the ultimate property, or the full dominion of the substance."[13] The owner of a usufruct does not have exclusive dominion over it; rather, he or she only has a right to uses that are compatible with the community's dependence on the property as a resource.[14] The concept of usufructuary rights is central to American water law.[15]

One of the hallmarks of a real property interest is the certainty inherent in the landowner's right. Water rights, however, are far from certain. In California, water rights are especially uncertain due to the Reasonable Use Doctrine, codified in the California

9. I.R.C. § 170(f)(3)(A).

10. *See id.* § 170(h)(1).

11. *Id.* § 170(h)(2).

12. BLACK'S LAW DICTIONARY 508 (Pocket Ed. 1996).

13. WILLIAM BLACKSTONE, COMMENTARIES ON THE LAW OF ENGLAND, 262-63 (1867).

14. *See* Joseph L. Sax, *Property Rights and the Economy of Nature: Understanding Lucas v. South Carolina Coastal Council*, 45 STAN. L. REV. 1433, 1452 (1993).

15. *See* SAMUEL C. WEIL, WATER RIGHTS IN THE WESTERN STATES, 14-21 (3d ed. 1911).

Constitution.[16] Under the Reasonable Use Doctrine, water right holders must comply with the "use it or lose it" principle; that is, any unreasonable uses of water will result in the loss of that water right.[17] What is reasonable, however, changes over time, making the underlying water rights fragile and dynamic.[18] As economic conditions, political needs and societal values change and new demands for water arise, the state may adjust existing water rights to accommodate the relatively more valuable uses of the state's scarce water resources.[19] Because the right to water is so uncertain, it may qualify as something less than a full-fledged property right.

2. *Entire Interest*

The second obstacle to meeting the "qualified real property interest" prong of section 170, relative to the donation of water rights, is whether water rights are considered an "entire interest," or only a "partial interest." Section 170 denies a charitable deduction in the case of a contribution of an interest in property that consists of less than the taxpayer's entire interest in such property.[20] A landowner that donates a conservation easement is not donating the land itself, only giving up the development rights to that land. Technically, thus, the donation of a conservation easement is the donation of a partial interest in real property. In order to allow for the charitable donation of conservation easements, however, Congress made an exception for such "partial interests," specifically excluding "qualified conservation contribution[s]" from the entire interest requirement.[21]

Therefore, if a water donor holds appropriative water rights and subsequently gifts those water rights to a qualified organization for conservation purposes, the "entire interest" requirement would most likely be met because the donor gave away all he or she owned. However, if the donor holds riparian water rights (that is, he or she owns both the water rights and the underlying land) and donates only the water and *not* the underlying land, this would be a partial interest donation and, thus, no deduction would be allowed under the current tax code.

IV. Proposal for IRS Recognition of Gifting Water Rights to Instream Flow

A. Amend the Definition of "Qualified Real Property Interest"

In order for the donation of water rights to qualify as a charitable deduction, Congress should expand the definition of "qualified real property interest" as that term is used in section 170. First, in order to avoid confusion as to whether water is in fact considered property, the Code must define the term "real property" to explicitly include water rights. For example, the language might be amended to read: "The term 'real property' as used in this subsection shall include the right to use a quantifiable amount of water."[22]

16. *See* CAL. CONST. art. X, § 2.

17. *See, e.g.*, Joslin v. Marin Mun. Water Dist., 67 Cal. 2d 132, 429 P. 2d 889 (1967) (holding that plaintiff's gravel business worth $250,000 had become unreasonable in light of defendant's dam downstream which stored water for munipal use and which, according to the court, was a more valuable use of the state's water resources).

18. *See generally* Brian E. Gray, *In Search of Bigfoot: The Common Law Origins of Article X, Section 2 of the California Constitution*, 17 HASTINGS CON. L.Q. 225 (1989).

19. *See Joslin*, 67 Cal. 2d at 137, 429 P. 2d at 894 ("What is a reasonable use of water depends on the circumstances of each case, such an inquiry cannot be resolved *in vacuo* isolated from statewide considerations of transcendent importance").

20. *See* I.R.C. § 170(f)(3)(A).

21. *See id.* § 170(f)(3)(B)(iii).

22. The size of the charitable deduction that a donor receives for the donation of a qualified conservation contribution under section 170(h) depends upon the value of the rights he or she gifted to the donee organization. The normal method of appraising conservation easements is to value the property before the donation (with full development rights intact) and after the donation (with less or no development rights); the change in value is the "gift" to the donee and the donor's charitable deduction. Valuing the donation of water rights would function in a similar manner. A substantial portion of a riparian land's value is due to the attached water rights. Thus, severing the landowner's right to divert and use the water that flows through the property from the property itself would significantly reduce the property's value. The resulting reduction in the property's market value would constitute the gift to the donee organization and the donor's charitable deduction. Although it is beyond the scope of this article, it is worth noting that valuing the donation of appropriated (as opposed to riparian) water rights is more complex and raises a host of questions. Many appropriators in California's Central Valley, for example, purchase water from the federal government at highly subsidized rates. Would the donation of these water rights be valued at the market price or the subsidized price?

Second, in order to afford riparian water right holders the same tax benefits as appropriators, the term "qualified real property interest" must make water rights an explicit exception to the "entire interest" requirement. In this way, riparians who donate their water, but not the underlying land, will not be denied a deduction for donating only a partial interest in their property.

There is already precedent for such an exception. Besides excluding "qualified conservation contribution[s]" from the entire interest requirement,[23] Congress also explicitly excluded another type of partial interest—mineral rights.[24] With the qualified conservation contribution exception, the landowner keeps the title to his or her parcel of land but gives up the *development* rights associated with the land. With the mineral rights exception, however, the landowner that donates a qualified conservation contribution on his or her land gives up only the *surface* development rights, but is allowed to retain development rights to the *subsurface* minerals.

In denying a charitable deduction to a landowner who attempted to donate a conservation easement on his land while reserving full ownership over the underlying mineral rights, the IRS held that the taxpayer had "retained a substantial interest or right in the property and [could not] be considered as donating an undivided portion of the taxpayer's entire interest in the property."[25] In reaction to this revenue ruling, Congress amended section 170 to allow for a deduction even when a landowner retains the underlying mineral interests. As a result, the definition of a "qualified real property interest" now explicitly includes a "qualified mineral interest" as an exception to the "entire interest" requirement.[26] Congress should amend section 170 in a similar manner by explicitly including a "qualified water interest" as an exception to the "entire interest" requirement.

B. "Qualified Water Interest"

To satisfy section 170's "entire interest" requirement in the donation of riparian water rights, the Code must be amended to sever the landowner's interest in land from the landowner's interest in water rights, just as Congress did with mineral rights. The "entire interest" requirement under section 170(h) currently reads: "the term 'qualified real property interest' means . . . the entire interest of the donor other than a qualified mineral interest."[27] Section 170(h)(6) defines the term "qualified mineral interest" as "(A) subsurface oil, gas, or other minerals, and (B) the right to access to such minerals."[28] This means that a landowner may sever the surface estate from the subsurface estate. Thus, the donor landowner may qualify for a charitable deduction for donating the development rights to his or her entire *surface* estate while retaining his or her rights to the *subsurface* estate. Because of the explicit exclusion, the donor's deduction is not barred by the "entire interest" requirement.

Similarly, a "qualified water interest" must allow a donor who owns riparian land to sever his or her water rights from the land. As such, the donor may give up his or her right to use the water and, thus, qualify for a charitable deduction for his or her donation. The Code should be amended in order to afford water rights the same treatment as subsurface mineral rights. For example, the Code might read "the term 'qualified real property interest' means . . . the entire interest of the donor other than a qualified mineral interest or a qualified water interest." In defining the term "qualified water interest," the Code might read "the term 'qualified water interest' means (A) the water that naturally flows through or adjacent to riparian land, and (B) the right to divert it and use it." In this way, the water rights will be severed from the land and the riparian owner will own two separate estates—one in land and one in water. Therefore, when a riparian owner gives up the right to use his or her water rights, the owner has donated the entire estate and section 170's "entire interest" requirement will be satisfied.

23. *See* I.R.C. § 170(f)(3)(B)(iii).
24. *See id.* §§ 170(h)(2)(A), (h)(6).
25. Rev. Rul. 76-331, 1976-2 C.B. 52.
26. *See* I.R.C. §170(h)(2)(A).
27. *Id.*
28. *Id.* § 170(h)(6).

C. "Qualified Organization"

In order for a donor to qualify for a deduction under section 170(h), the donation must be made to a "qualified organization."[29] To be considered an eligible donee, an organization must have a commitment to protect the conservation purposes of the donation and have the resources to enforce the restrictions.[30] A conservation group organized or operated primarily or substantially for one of the conservation purposes specified in section 170(h)(4)(A) will be considered to have the commitment required.[31]

With the donation of a parcel of land, or the donation of a restriction in perpetuity on the use of land, the donee "qualified organization" is usually a land trust organization. A land trust is a local, nonprofit organization described in section 501(c)(3) of the Code that oversees the land and the conservation easements that landowners have donated to it. Acting as a steward, the land trust is responsible for the long term conservation of the properties "in perpetuity."

Rather than specializing in land use issues, the "qualified organization" that would accept donations of water rights should be an organization focusing on water allocation and instream flow preservation. Although the concept of a "water trust" is relatively new, the Oregon Water Trust ("OWT") has been operating since 1987 when the state of Oregon amended its water laws to allow water right holders to voluntarily reallocate water resources to instream flow for environmental needs.[32]

OWT facilitates the conversion of existing water rights to instream flow. The process involves negotiating a private agreement with a water right holder, and then applying to the Oregon Water Resources Department for approval to transfer the water right to instream use. OWT creates an instream right by purchasing, leasing or accepting the donation of existing water rights for conversion to instream rights, with the same priority date as the original right. The older the priority date, the better the chance that the water will remain instream when others on the stream begin diverting water for other uses, like irrigation.

Targeting those water basins that have historically supported significant fisheries, OWT's staff scientist identifies those priority streams where streamflow is a limiting factor for fish habitat and water quality, and where there is potential for acquiring water rights to convert to instream use to enhance flows. OWT concentrates its acquisition efforts on small to medium-sized tributaries that provide spawning and rearing habitat for salmonids. In these systems, small amounts of water can provide significant ecological benefits.

This market-based approach provides water right holders in Oregon with a variety of incentives to convert their consumptive water uses to instream flow. These incentives include: income from marginally productive areas, replacement feed for lost production, funding for irrigation efficiency projects, flexibility in managing water rights, and a possible tax break for permanent donations of water rights.

However, receiving a tax deduction for donating riparian water rights to OWT, or organizations like it, is only "theoretical," since the current tax code does not allow for such a tax benefit.[33] Section 170(h) should be amended in order to allow for this important economic incentive. Without such an incentive, water rights may be wasted on over-irrigation, rather than conserved. If water right holders could receive a tax break for dedicating their conserved water to instream flow, more of these private transactions would take place and, in the process, fish populations and water quality would benefit.

29. *Id.* § 170(h)(3).

30. *See* 26 C.F.R. §1.170A-14(c)(1).

31. *See infra* Part IV.D.

32. *See The Oregon Water Trust* (visited Apr. 5, 2000) <www.owt.org>.

33. *See supra* note 7 and accompanying text.

D. "Exclusively for Conservation Purposes"

In order for a donor to qualify for a deduction under section 170(h), the donation must be made "exclusively for conservation purposes."[34] The term "conservation purpose" means (1) the preservation of land areas for outdoor recreation by, or the education of, the general public, (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, (3) the preservation of open space, or (4) the preservation of an historically important land area or a certified historic structure.[35] In order to be "exclusively" for conservation purposes, the conservation purpose must be protected in perpetuity.[36]

In almost all situations where water right holders are donating water rights to instream flow, fish and aquatic plant habitat is benefitting. Therefore, the "conservation purpose" of protecting a natural habitat of fish, wildlife, or plants will be satisfied, as long as the qualified water trust promises to protect that purpose in perpetuity.

V. Conclusion

The arid American West desperately needs water to flow through its streambeds, or else fish and other aquatic species will disappear. The current western water rights systems, however, have failed to protect instream flows. Tax benefits would create a powerful incentive to reallocate our scarce water resources away from consumptive uses to instream flow. In order to accomplish that, the tax code must be amended so that water right holders who donate water to instream flow can benefit from the same type of tax breaks as those landowners who donate conservation easements.

34. I.R.C. § 170(h)(4).

35. *See id.*

36. *Id.* § 170(h)(5)(A).