

MEMORANDUM

To: PALO VERDE IRRIGATION DISTRICT  
From: DOWNEY BRAND LLP  
Date: SEPTEMBER 1, 2004  
Re:

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1. **OVERVIEW AND SUMMARY.**

At the District's request, Downey Brand LLP is providing this Memorandum to the Palo Verde Irrigation District (the "**District**") regarding certain federal income tax consequences of the forthcoming 35-year transfers of Colorado River water ("**Water Transfers**") to The Metropolitan Water District of Southern California ("**MWD**"). The Water Transfers involve a complex series of agreements necessary to ensure the ultimate benefit of the Water Transfers to MWD, and this memorandum refers to the entire transaction and its component agreements as the "**Water Transfer Transactions**".

In summary, the Water Transfers will occur pursuant to 35-year agreements ("**Landowner Agreements**") among the District, MWD, and individual participating landowners in the District ("**Participating Landowners**"). The essence of the Water Transfers is that MWD will pay Participating Landowners to fallow<sup>1</sup> ("**Fallow**") farm land and forego their rights to divert water for that land from the Colorado River (the "**Water Entitlements**") during the term of the Fallowing. The water that otherwise would have been diverted will then be available downstream on the Colorado River for diversion by MWD and delivery by MWD to its member agencies, who in turn will deliver the water to the end-user. The amount of farm land each Participating Landowner will be required to Fallow each year will vary according to fallowing calls made periodically by MWD, but each Participating Landowner will be subject to a minimum annual fallowing obligation and to a maximum fallowing obligation ("**Maximum Fallowing Obligation**") which MWD may require in no more than 10 years during the 35-year term of the Landowner Agreements and which may not exceed 35 percent of the Participating Landowner's total land farmland in the District. Participating Landowners will also be required to encumber farmland equal in acreage to their respective Maximum Fallowing Obligation with a fallowing easement in favor of MWD.

The payments by MWD are of two types: (1) an up-front payment for each acre of a Participating Landowner's Maximum Fallowing Obligation, the amount of which, we

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<sup>1</sup> Fallowing in this instance means completely removing all vegetation from the land and refraining from applying any water to it except to the extent required for dust control.

understand, roughly equates to the current market value<sup>2</sup> of the land, and (2) an annual payment for each acre of land to be Fallowed during that year.

This Memorandum provides an overview of the federal income tax law generally applicable to the Water Transfers and to MWD's payments. It is intended to assist any individual District landowner and their personal tax advisors in evaluating the overall federal income tax consequences from participating in the Water Transfer Transaction. This Memorandum is not intended to provide specific federal income tax advice to any specific landowner or Participating Landowner. Each landowner considering becoming a Participating Landowner should consult with the landowner's own tax and legal advisors in evaluating the tax and other legal implications of the Water Transfer Transactions. We note that there is some doubt as to the proper characterization of the Water Transfer Transactions on account of the unique structure and the absence of clear legal authority controlling the outcome. This Memorandum does not address California or local laws (including property tax issues), and does not address the federal income tax consequences to special taxpayers, such as pension plans, individual retirement plans, nonprofit and governmental organizations, non-resident taxpayers and taxpayers subject to the alternative minimum tax.

The essential issue for Participating Landowners under federal income tax law is the extent to which MWD's payments will be eligible for capital gains treatment rather than treated as ordinary income. Briefly, to qualify for capital gain rates, a capital asset (or a section 1231 asset) must be "sold or exchanged." Resolution of the ultimate capital gains issue thus turns on resolution of two pivotal sub-issues: (1) whether the Participating Landowner's Water Entitlements are capital assets, and (2) whether the Water Transfer with MWD will qualify as a "sale or exchange" or instead are tantamount to a "lease" or a "license".

There is no clear or certain answer to the essential issue of capital gains treatment, largely because of the absence of clear tax law authority governing this type of transaction. Although the transaction is not unique in water law, elements of the transaction appear to be unique in reported federal tax law. As discussed below, legal authority suggests that the Water Entitlements of a Participating Landowner should be classified as either a capital asset or a section 1231 asset.

It is less clear, and there is no controlling authority, regarding whether this Water Transfer should be classified as a "sale or exchange" or as a "lease" (for example, it differs in some respects from the total relinquishment of a contract entitlement to Colorado River water by the Harquahala Valley Irrigation District, discussed below).

Based upon the existing legal authority, there is a reasonable basis for making the argument, that the Water Transfer Transactions involve the sale of a capital or section 1231 asset and that MWD's up-front payments qualify for capital gains treatment (it is doubtful the annual payments so qualify). However, there is a reasonable basis for the argument that the Water

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<sup>2</sup> We have not obtained an independent appraisal of the land within the District. This conclusion as to the approximate value as to average land within the District was represented to us to be a fair approximation by the parties to the Water Transfer Transactions.

Transfer Transactions do not constitute a “sale or exchange.” At bottom, whether the Water Transfer Transactions more closely resemble a sale or a lease will be determinative, and the determination of the IRS (subject to judicial review) in this regard controls. If a Landowner concludes that the transaction is a sale or exchange, then the Landowner must then determine how much basis to apply against the “sales” price. With respect to this issue, we recommend that the Landowners and their tax advisors closely review the 9<sup>th</sup> Circuit opinion in *Gladden v. Commissioner*, 262 F.3d 851 (9th Cir. 2001), where the basis allocation issue was addressed.

Classification determinations of this nature are intensively fact-specific, and the IRS has developed a multitude of factors to determine whether a transaction constitutes a sale (or exchange) or a lease. This memorandum discusses the applicable factors in depth. It also assesses, in table form, whether each of the factors suggests a sale (or exchange) or a lease. Some factors exclusively suggest a sale; a fewer number of factors exclusively suggest a lease. But, the majority of factors are sufficiently ambiguous so that they could be interpreted as suggesting either a sale or a lease.

Consequently, each Participating Landowner must evaluate the relevant facts and applicable law before taking a reporting position on a tax return. The degree of certainty or uncertainty will influence such matters as the position taken, the need to disclose the nature of the transaction to the IRS and whether penalties can be assessed if the position taken by the Participating Landowner is ultimately overruled.

## 2. HISTORICAL PERSPECTIVE OF THE DISTRICT WATER RIGHTS.

The District holds two different rights to Colorado River water. First, the District has rights that were initiated and perfected under California water laws<sup>3</sup> and subsequently decreed as a “present perfected right” (“PPR”) by the United States Supreme Court in its 1979 decree in *Arizona v. California*.<sup>4</sup> The Supreme Court quantified these as the lesser of (i) 219,780 acre-feet per year of diversions, or (ii) the quantity of diversions necessary to supply the consumptive use required to irrigate 33,604 acres and satisfaction of related uses, with a priority of 1901. These rights probably extend only to the natural flow of the Colorado River.

Second, the District holds a right under its February 7, 1933 permanent service contract with the United States to the delivery of water “from storage available in [Lake Mead]” (at no charge), the quantity being that required (i) by 104,500 acres located within the District as it existed in 1933 and on lands between the District’s then-boundaries and the Colorado River, and (ii) 16,000 acres in the Lower Palo Verde Mesa.<sup>5</sup> The first of these is a so-called “first priority”

<sup>3</sup> Between 1877 and 1911, at least nine notices of water appropriation for Colorado River water were filed by or on behalf of the District’s predecessor in interest, the Palo Verde Mutual Water Company (or its predecessor in interest) pursuant to California water law. During this period through mid-1914, California had an appropriation system (first in time, first in right) that was self initiating and did provide for administration by a state agency, as has been the situation since mid-1914.

<sup>4</sup> 439 U.S. 419 (1979).

<sup>5</sup> Under section 5 of the Boulder Canyon Project Act, 43 U.S.C §§ 617 et seq., no one is entitled to use Colorado River water stored pursuant to the Act’s terms except pursuant to a contract with the Secretary of the Interior. These contracts are to be for “permanent service.” Article II(B)(5) of the Supreme Court’s basic decree in *Arizona v. California* provides that “mainstream water shall be released or delivered to water users . . . only pursuant to valid

right among the federal Colorado River contractors (i.e., the federal Yuma Project, the Imperial Irrigation District ("IID"), Coachella Valley Water District ("CVWD"), and MWD) and the second is a "third priority" right shared with IID and CVWD. The first priority entitlement is by far the larger of the two, and only it is involved in the Water Transfer Transactions. The point here is that all of the District's entitlements to Colorado River water are of a high priority and are superior to those of MWD, which holds fourth and fifth priority entitlements.<sup>6</sup>

No court decision has considered how the District's PPR and its contract right interrelate. The District's delivery entitlement under its federal contract right includes water to which the District is entitled under its PPR and Boulder Canyon Project water stored by the Bureau of Reclamation in Lake Mead. But the District's PPR also continues to have some at least theoretical significance, inasmuch as the 1964 decree affords PPRs priority over contract rights in times of shortage.<sup>7</sup> As a practical matter, given the District's first priority on the Colorado River water, the 1933 contract defines the District's total right to Colorado River water and any distinction between the District's PPR and its contract right to project water is probably virtually meaningless today.

The landowners within the District have the right to water service from the District to irrigate their land, a right that gives the land its value for agriculture. The right to this water service is appurtenant to, and is a right inherent in, the land, and it is a significant—if not the primary—factor giving the land meaningful economic value. This right is not a separate right that can be transferred independently from the land. In irrigation districts with a finite water supply, the district is required to distribute its water supply among all landowners wishing water service "ratably" based on the most recent district assessments.<sup>8</sup> The District's entitlement, however, is expressed in terms of the amount of water necessary to irrigate the land that has been included within the District. Given the District's first priority, this means that, as a practical matter, within the limits of reasonable use and waste limitations, the extent of each landowner's right is whatever water is necessary to irrigate the specific crops being grown. Inasmuch as the right is inherent in the land, it is not lost by disuse. And, in any event, considerations of California water law that favor transfers would prevent its loss as a result of the following required for the Water Transfer Transactions.<sup>9</sup> It is uncertain, however, whether entitlement to the delivery of water, by itself, constitutes a real property interest under California Law. Further, while the landowner's delivery entitlement is generally discussed in the context of irrigation, the land would still be eligible for the delivery of water if its use were changed from

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contracts therefore made with such users by the Secretary of the Interior, pursuant to section 5 of the Boulder Canyon Project Act or any other applicable federal statute."

<sup>6</sup> The priorities are established by a 1931 California Seven-Party Agreement among, inter alia, the District, the Coachella Valley Water District, the Imperial Irrigation District, and MWD. That agreement gives the District priorities 1, 3(b) and 6(b), and gives MWD users priorities 4, 5(a) and 5(b).

<sup>7</sup> Article II(B)(3) requires the Secretary of the Interior to first satisfy PPRs in order of priority without regard to state lines.

<sup>8</sup> Water Code §22250. While a landowner may assign the right to use water apportioned to the landowner to other landowners within the district (Water Code §22251), this provision is virtually meaningless with the Palo Verde Irrigation District, given its entitlement to whatever water is needed for irrigation. The right to make such an assignment has value only within irrigation districts with a finite, and over-subscribed supply.

<sup>9</sup> See, e.g., Water Code §1011.

irrigation to some other use.<sup>10</sup> At the present time, it is uncertain (if not unlikely) if there is any residential or commercial development potential for the land—apart from agriculture—due to its distance from large population centers.

### 3. THE AGREEMENTS INVOLVED IN THE WATER TRANSFER TRANSACTION.

The Transaction involves the following series of agreements. (1) The Forbearance and Fallowing Program Agreement ("**Program Agreement**") between the District and MWD which establishes the basic terms and conditions of the fallowing and transfer program ("**Program**") and establishes the respective roles of the District and MWD in administering the Program. (2) The Landowner Agreement to be executed by each Participating Landowner, MWD, and the District, which is attached as an exhibit to the Program Agreement. (3) A Fallowing Easement Deed that would encumber landowner-owned program qualified land in favor of the District and MWD ("**Fallowing Easement Deed**"). (4) A Tenant Subordination Agreement by which tenants of Program-encumbered land would subordinate their rights in favor of the District and MWD under the Fallowing Easement Deed ("**Tenant Subordination Agreement**"). (5) A Subordination of Encumbrance Agreement by which holders of liens and other encumbrances on Program-encumbered land would subordinate their interest to the District and Metropolitan under the Fallowing Easement Deed ("**Subordination of Encumbrance Agreement**"). A more complete description of the terms and conditions of the Program is attached to this memorandum.

Under the Landowner Agreements, MWD will pay Participating Landowners approximately \$3,250 for each acre<sup>11</sup> of the Participating Landowner's Maximum Fallowing Obligation (the "**Purchase Price**"). The amount of farm land each Participating Landowner will be required to Fallow each year will vary according to fallowing calls made periodically by MWD, but each Participating Landowner will be subject to a minimum annual fallowing obligation and to a Maximum Fallowing Obligation which MWD may require in no more than 10 years during the 35-year term of the Landowner Agreements and which may not exceed 35 percent of the Participating Landowner's total farmland in the District. Both the Participating Landowner and the District are prohibited from diverting or using the water that is "saved" for MWD by the Fallowing.

Participating Landowners will also be required to encumber farmland equal in acreage to their respective Maximum Fallowing Obligation (the "**Burdened Land**") with a Fallowing Easement in favor of MWD. The Fallowing Easement will be recorded against the Burdened Land and will entitle MWD to enter the Burdened Land to force Fallowing if a Participating Landowner is in breach of its obligations under the Agreement.

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<sup>10</sup> See Palo Verde Irrigation District Act, Water Code App. §33-11.4, providing that "the use of water required for irrigation . . . and for domestic and other incidental and beneficial uses . . . is hereby declared to be a public use." On May 20, 2003 the District established an industrial rate for water, but to date no water has been delivered at this rate.

<sup>11</sup> This is an approximate average amount per acre resulting from the Participating Landowners electing to be paid over a 2, 3 or 4 year period. Some portion of the Purchase Price may represent imputed interest for federal income tax purposes.

The Purchase Price paid by MWD to each Participating Landowner represents a substantial portion of (or may be equal to) the fair market value of the Burdened Land. From MWD's perspective this price, together with the amount to be paid for each acre actually Fallowed, represents the value of the water to be received by MWD. In short, there is congruence between MWD's payments and the value of the water that otherwise would be applied to the land. To put it another way, if the total value of the land were capable of being segregated between (i) the value of the right to received delivery of water from the District that is inherent in the land, and (ii) all other rights associated with property ownership, the Purchase Price would be approximately equal to the value specifically allocated to the water delivery entitlement.

In any year MWD requires a Participating Landowner to Fallow land, MWD will pay the Participating Landowner an additional Six Hundred Four Dollars (\$604.00) (the "**Annual Fallowing Payment**") per acre of Fallowed land. As a practical matter, this payment will more than offset costs that will be incurred by the Participating Landowners, including assessments, taxes, fees and water tolls that are charged by District with respect to the land that is being Fallowed. None of the land will be Fallowed for more than five consecutive years to insure that it is not permanently damaged. MWD will be responsible for all payments made to the USBR for water delivered to MWD, while Participating Landowners will remain responsible for fees, taxes and other payments due to the District (even though these costs are, in effect, reimbursed as a result of the Annual Fallowing Payment).

#### **4. LEGAL PRINCIPLES APPLICABLE TO TRANSACTIONS SIMILAR TO THE AGREEMENT.**

(a) In General. Taxable income of an individual taxpayer is generally subject to either ordinary income tax rates (which can be as high as 35%) or long-term capital gains tax rates (which can be as high as 15%).<sup>12</sup> In many ordinary income situations (e.g., receipt of rent, interest or fees for services), the taxpayer must recognize the full amount received as income. By contrast, in long-term capital gain situations (e.g., the sale of real estate), the taxpayer is able to offset all or some portion of his tax basis in the property sold against the sales price and thereby reduce the amount of gain recognized.

There is generally no tax rate differential for ordinary income and long-term capital gains for so-called "C" corporations. The individual owners of "S" corporations may take advantage of the favorable tax rates applicable to long-term capital gains. Partnerships and entities taxed as partnerships (e.g., limited liability companies) generally pay no federal income tax. Instead, their owners must report their proportionate share of the income and losses of the partnership. As such, individual partners may take advantage of long-term capital gains recognized by their partnership.

(b) Long-Term Capital Gains. Gain is defined as the excess of cash and or the fair value of property received over the basis (i.e., generally the depreciated cost) of property sold or

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<sup>12</sup> California and local taxes are in addition to these Federal taxes.

exchanged.<sup>13</sup> Whether the gain is capital or ordinary depends on (i) the character of the asset (i.e., whether it is a capital asset), and (ii) whether a capital asset has been “sold or exchanged” to another party. Capital gain resulting from the sale or exchange of a capital asset is considered “long-term” if the property has been held for at least one year.

(i) Capital Assets.

(1) Generally. Section 1221(a) of the Code defines all property as a capital asset unless it falls within specifically enumerated exceptions (e.g., inventory, depreciable assets, and real property used in a trade or business).<sup>14</sup> Real property and other depreciable property used in a taxpayer’s trade or business is referred to as Section 1231 Property. Gain recognized on the sale or exchange of Section 1231 real property held for more than one year is generally treated as long-term capital gain.<sup>15</sup> The Supreme Court has stated that the term “capital asset” is to be “construed narrowly in accordance with the purpose of Congress to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time and thus to ameliorate the hardship of taxation of the entire gain in one year.”<sup>16</sup>

(2) Surface Water Entitlements as Capital Assets. In *Gladden v. Commissioner*,<sup>17</sup> the Tax Court concluded that a landowner’s 50-year surface water rights to Colorado River water were a capital asset where such water rights could not be transferred separately from the land.<sup>18</sup> In *Wiechens v. United States*,<sup>19</sup> the District Court concluded that the same water rights at issue in *Gladden* were in fact property rights, but that such water rights were not sufficiently similar to fee title in real estate for purposes of the like-kind exchange rules of Section 1031. In that case, it appears that the court concluded that limited water rights (i.e., of a 50-year duration) were not sufficiently similar to fee title. However, in Rev. Rul. 55-749, 1955-2 C.B. 295, the IRS concluded that **perpetual** water rights could be exchanged for fee title in real property under Section 1031. To qualify as such, the water rights in that ruling must have been considered a capital asset or a Section 1231 asset. In another situation, the IRS ruled that the water rights of a landowner within the jurisdiction of a mutual ditch company were a capital

<sup>13</sup> § 1001(a).

<sup>14</sup> Section 1221(a)(1)-(7) lists the specific types of property that are excluded from the definition of a capital asset.

<sup>15</sup> See Section 1231(a). Some portion of the gain recognized on the sale or exchange of real property qualifying as Section 1231 property or as a capital asset under Section 1221 may, in limited circumstances, be subject to depreciation recapture under Code Section 1245 or 1250, or an increased capital gain rate for “unrecaptured Section 1250 gain” under Code Section 1(h)(D). In addition, in certain circumstances, some portion of the gain from the sale of certain farm land held for less than 10 years may be ordinary income if the landowner previously deducted soil and water conservation expenditures under Code Section 1252.

<sup>16</sup> *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134 (1960).

<sup>17</sup> *Gladden v. Commissioner*, 112 T.C. 209 (1999); reversed and remanded on other grounds by 262 F.3d 851 (9th Cir. 2001); supplemental opinion at 120 T.C. 446 (2003). In *Gladden*, the Court noted that the parties did not argue for Section 1231 characterization—even though the water rights were used in the farming business, apparently because there was an unresolved question of whether the rights were an intangible asset (and therefore a capital asset under Section 1221) or real property used in a trade or business (and therefore a Section 1231 asset).

<sup>18</sup> 112 T.C. 209, 223.

<sup>19</sup> *Wiechens v. United States*, 228 F.Supp. 2d 1080 (2002).

asset where, as a matter of state law, the water rights were considered property rights owned by the landowners.<sup>20</sup>

(ii) Sale or Exchange. To qualify for capital gain rates, a capital asset (or a Section 1231 asset) must be “sold or exchanged.” This requirement is the subject of extensive litigation and IRS pronouncements because the resolution of each case depends upon the particular facts and circumstances of the situation. This factual inquiry requirement is the most difficult factor to analyze. For example, the simple lease of a newly-constructed building for 5 years is a rental arrangement for the use of property, and clearly is not a sale. However, a 50-year lease of the same building with a bargain purchase option more closely resembles a sale (and will be treated as such) and not a rental arrangement. The discussion below focuses on a variety of situations somewhat factually similar to the Water Transfers. It is uncertain which of the legal theories set forth below should govern or be applicable to the Agreement and the Water Transfers due to the highly unique nature of the Water Transfers.

(1) Natural Resources Extraction Cases Extended to Underground Water Entitlements. Prior to the enactment of special rules relating to the extraction of natural resources, taxpayers and the IRS frequently litigated the character of gain realized from the removal of sand, gravel and other minerals from land under the “economic interest” test.<sup>21</sup> Under the economic interest test, if the owner sold a mineral rights interest, the gain was characterized as capital gain, unless the owner retains an “economic interest” in the mineral rights. An economic interest was retained and the gain characterized as ordinary royalty income if the amount paid to the property owner was based upon the quantity of minerals extracted from his land.<sup>22</sup> In contrast, where an owner sold the entire interest he owned in his mineral rights or sold as much as the buyer could extract over a given period of time for a fixed price, then the owner did not retain an economic interest.<sup>23</sup>

A number of cases applied the economic interest test to the “transfer” of underground water rights.<sup>24</sup> In these cases, the taxpayer-landowners recognized ordinary income where the following factors were present: (i) the amount paid by the buyer to the taxpayer-landowner was dependent upon the amount of water the buyer pumped from underground wells, (ii) the underground water resource was naturally recharged (i.e., a renewable resource), and (iii) there was no substantial initial up-front payment. There was no sale or exchange in these cases because the facts more closely resembled a lease of the recharged underground water or a royalty fee paid based upon the amount of water pumped from the underground wells. By contrast, the presence of (i) a large initial up-front payment, coupled with (ii) an underground water resource

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<sup>20</sup> PLR 200307009.

<sup>21</sup> For example, see *Rutledge v. Commissioner* (1970, 5th Cir.) 428 F.2d 347.

<sup>22</sup> *Id.* at 350.

<sup>23</sup> *Rhodes v. U.S.*, (1972 5th Cir.) 464 F.2d 1307.

<sup>24</sup> For example, see *Puckett v. Commissioner*, 23 T.C.M. (CCH) 223, affirmed per curiam at 355 F.2d 551 (5<sup>th</sup> Cir. 1966); *Vest v. Commissioner*, 481 F.2d 238 (5<sup>th</sup> Cir. 1973); *Linebery v. Commissioner*, 64 T.C. 108 (1975); and Rev. Rul. 70-204, 1970-1 C.B. 173.



that was expected to be exhausted and not naturally recharged resulted in a sale or exchange and capital gain.<sup>25</sup>

(2) Sale Versus Lease Cases. Whether a property transaction is a sale (resulting in basis recovery and capital gain) or a lease (resulting in no direct basis recovery and ordinary income) depends upon an analysis of all of the relevant facts and circumstances. An agreement labeled a “lease” may be recharacterized as a sale for tax purposes if the economic terms of the transaction more closely resemble a sale. The IRS has listed the following factors to be evaluated in determining whether a personal property transaction is a lease or a conditional sales agreement:<sup>26</sup>

“[2.01]... Each case must be decided in the light of its particular facts. However, from the decisions cited below, it would appear that in the absence of compelling persuasive factors of contrary implication an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

(a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee. See *Truman Bowen v. Commissioner*, 12 T.C. 446, acquiescence, C.B. 1951-2, 1.

(b) The lessee will acquire title upon the payment of a stated amount of “rentals” which under the contract he is required to make. See *Hervey v. Rhode Island Locomotive Works*, 93 U.S. 664 (1876); *Robert A. Taft v. Commissioner*, 27 B.T.A. 808; *Truman Bowen v. Commissioner*, supra.

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of the title. See *Truman Bowen v. Commissioner*, supra.

(d) The agreed “rental” payments materially exceed the current fair rental value. This may be indicative that the payments include an element other than compensation for the use of property. See *William A. McWaters et al. v. Commissioner*, Tax Court Memorandum Opinion, entered June 15, 1950; *Truman Bowen v. Commissioner*, supra.

(e) The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made. See *Burroughs Adding Machine Co. v. Bogdon*, 9 Fed.(2d) 54; *Holeproof Hosiery Co. v. Commissioner*, 11 B.T.A. 547. Compare *H. T. Benton et al. v. Commissioner*, 197 Fed.(2d) 745.

<sup>25</sup> *Day v. Commissioner*, 54 T.C. 1417 (1970).

<sup>26</sup> Rev. Rul. 55-540, 1955-2 C.B. 39.

(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. See *Judson Mills v. Commissioner*, 11 T.C. 25, acquiescence, C.B. 1949-1, 2.

“[2.02] The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

“[2.03] Conditional sales of personal property are, in general, recordable under the various State recording acts if the vendor wishes to protect its lien against claims of creditors. However, the recording or failure to record such a sales contract is usually discretionary with the vendor and is not controlling insofar as the essential nature of the contract is concerned for Federal tax purposes. See *Hervey v. Rhode Island Locomotive Works*, supra.

“[2.04] Agreements are usually indicative of an intent to rent the equipment if the rental payments are at an hourly, daily, or weekly rate, or are based on production, use, mileage, or a similar measure and are not directly related to the normal purchase price, provided, if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date. Thus, agreements of the type described in section 2.01(a) and (b), above, will usually be considered leases, in the absence of other facts or circumstances which denote a passing of title or an equity interest to the lessee.

“[2.05] In the absence of compelling factors indicating a different intent, *it will be presumed* that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges. [Emphasis added.] Agreements of the type described in section 2.01(c), above, will generally be held to be sales of the equipment.

“[2.06] If the sum of the specified “rentals” over a relatively short part of the expected useful life of the equipment approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract, even though a passage of title is not expressly provided in the agreement. Agreements of the type described in section 2.01(d), and (e), above, in general, will be held to be sales contracts.” [Emphasis added].

In another ruling,<sup>27</sup> the IRS concluded that an agreement was a sale because it constituted an “equitable transfer of title” and not a lease where (i) the lessee was required to pay all taxes, insurance and maintenance costs associated with the property, (ii) the property had to be returned to the lessor/seller at the end of the lease term, (iii) legal title to the property was retained by the lessor/seller, (iv) the lease payments in the first 3 years exceeded 90% of the property’s value, and (v) the lease effectively covered a 13 year term where the useful life of the property was somewhere between 10 and 15 years. In a later technical advice memorandum,<sup>28</sup> the IRS concluded that “[t]he [absence of an] option to acquire legal title to the property at a nominal price is but one factor in determining whether a true lease exists.”

In other situations, courts have considered the intent of the parties when the contract was formed<sup>29</sup> and whether the benefits and burdens of ownership have been transferred.<sup>30</sup> The presence of front-loaded lease payments, cumulative lease payments substantially equal to the value of the underlying asset, and lease terms approximating the useful life of the asset are factors suggesting a sale.<sup>31</sup> If the Agreement is considered to be a “lease,” the rent leveling rules of Code Section 467 may be applicable on account of the Purchase Price being paid in the first 2 to 4 years of the Agreement.

### (3) Easement & Restrictive Covenant Situations.

a. Perpetual Easements. It is clear from the IRS rulings and tax cases that gain realized by a landowner when he grants a perpetual easement or restrictive covenant upon his land in exchange for fixed payments will be characterized as a return of basis and/or capital gain.<sup>32</sup> The IRS has ruled that gain realized on the grant of a perpetual agricultural easement on land restricting the development of the burdened land will be characterized as capital gain.<sup>33</sup> In another situation, gain realized by a landowner on granting a third party the right to build a dam and use a portion of his property was treated as a return of basis with any excess being Section 1231 gain.<sup>34</sup>

b. Limited Duration Easements. One court has ruled that gain realized from the granting of a 3-year easement would be characterized as ordinary income

<sup>27</sup> Rev. Rul. 55-541, 1955-2 C.B. 19.

<sup>28</sup> TAM 843510.

<sup>29</sup> E.g., See *Breece Veneer and Panel Co. v. Commissioner*, 232 F.2d 319 (7<sup>th</sup> Cir. 1956); *Oesterreich v. Commissioner*, 226 F.2d 798 (9<sup>th</sup> Cir. 1955); Rev. Rul. 55-541, 1955-2 C.B. 19; Rev. Rul. 55-540, 1955-2 C.B. 39.

<sup>30</sup> E.g., see TAM 843510.

<sup>31</sup> E.g., see *Oesterreich v. Commissioner*, 226 F.2d 798 (9<sup>th</sup> Cir. 1955); *Breece Veneer and Panel Co. v. Commissioner*, 232 F.2d 319 (7<sup>th</sup> Cir. 1956); *Smith v. Commissioner*, T.C. Memo 1976-114; 1976, 35 T.C.M. 512.

<sup>32</sup> E.g., see *Commissioner v. Ray*, 210 F.2d 390 (5<sup>th</sup> Cir. 1954); *Scales v. Commissioner*, 10 B.T.A. 1024 (1928); Rev. Rul. 72-433, 1972-2 C.B. 470; Rev. Rul. 70-510, 1970-2 C.B. 159; Rev. Rul. 70-203, 1970-1 C.B. 171; Rev. Rul. 68-291, 1968-1 C.B. 351, and Rev. Rul. 59-121, 1959-1 C.B. 212. This authority also suggests that the taxpayer may first reduce its basis in the entire real property prior to recognizing capital gain on the remaining proceeds (as opposed to a basis allocation between the asset “sold” and the asset “retained” as suggested in Treas. Reg. 1.61-6(a)).

<sup>33</sup> Rev. Rul. 77-414, 1977-2 C.B. 299.

<sup>34</sup> Rev. Rul. 59-121, 1959-1 C.B. 212, clarified by Rev. Rul. 68-291, 1968-1 C.B. 351.

(similar to lease payments).<sup>35</sup> In another case, the taxpayer recognized ordinary income (similar to rent) upon receiving a one-time payment in exchange for granting a 10-year road easement on his property.<sup>36</sup>

There does not appear to be any authority addressing the character the character of gain realized from payments received in exchange for a long-term (e.g., 35 years) intrusive easement or restrictive covenant where the payment represented a significant portion of the fair market value of the underlying land. Perhaps long-term easements and restrictive covenants should be evaluated under the sale vs. lease authority. Alternatively, it may be that the amount paid for the long-term easement and the fundamental character of the long-term easement or restrictive covenant should be evaluated as a permanent easement if the “purchase price” and long-term duration economically burden the underlying land in a manner similar to a perpetual easement or restrictive covenant.

(4) The Surface Water Situations. In *Gladden*,<sup>37</sup> the Tax Court concluded that the landowner sold its water rights<sup>38</sup> when it relinquished all of its remaining water rights. In *Wiechens*,<sup>39</sup> the District Court reached a similar conclusion with regard to the sale, but concluded that the 50-year contract water rights were not like-kind to other real property under Code Section 1031. On at least two separate occasions, the IRS has also ruled that the relinquishment of perpetual water rights would constitute a sale or exchange.<sup>40</sup> There does not appear to be any authority addressing the sale or exchange requirement on a temporary transfer (whether long-term or short-term) of surface water rights. The analysis noted above in the last paragraph under the “Easement & Restrictive Covenant Situations” may be equally applicable here.

## 5. ANALYSIS OF POTENTIAL FEDERAL INCOME TAX CONSEQUENCES.

### (a) Initial Up-Front Payment.

From the authority cited above, it is fairly clear that the Water Entitlements are an integral part of the Burdened Land and should be characterized as a capital asset or Section 1231 asset and are not further discussed here. The more difficult issue is whether the grant of the easement by the Participating Landowners and the forbearance of water rights thereunder is (i) a “sale or exchange” transaction resulting in return of basis and capital gain, or (ii) a “lease-type” transaction resulting in ordinary income without the return of basis. The following table compares and contrasts some of the facts underlying the Water Transfer to those found in the authority cited above. Each Landowner should consider these as well as other relevant factual

<sup>35</sup> *Nay v. Commissioner*, 19 T.C. 117 (1952).

<sup>36</sup> *Wineberg v. Commissioner*, 326 F.2d 157 (9th Cir. 1963). Similar conclusions were reached in *Vest*, note 16 supra., with respect to a fixed payment received in exchange for the location of wells, flowlines, and roads.

<sup>37</sup> See Note 10 supra.

<sup>38</sup> In *Gladden*, the landowner was entitled to receive surface water from the Colorado River under a 50-year contract, which, at the time of transfer, had 40 years remaining on its term. In other words, these were not perpetual water rights.

<sup>39</sup> See note 12, supra.

<sup>40</sup> See Rev. Rul. 55-749, 1955-2 C.B. 295; and PLR 200307009.

similarities and differences between the Water Transfer and the facts contained in the above authorities. No one fact or set of factors is determinative. Each must be weighed, and considered in light of all of the pertinent facts and circumstances underlying the Water Transfer.

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<b>Underground Water Entitlements Factors</b>	<b>FACTOR</b>	<b>FACTOR SUGGESTS SALE OR EXCHANGE</b>	<b>FACTOR SUGGESTS ORDINARY INCOME (E.G. LEASE)</b>
	Payment based on quantity of water extracted or fixed price.	The Purchase Price paid by MWD may roughly equate to the value of the land and is fixed and not dependent upon quantity of water diverted during 35 years.	
	Transfer of all or limited portion of Water Entitlements.	Unlike the underground water situations, the value of the Burdened Land is substantially diminished from the Water Transfer.	The forbearance period (35 years) is less than the entire remaining life of the water rights.
	Resource may be diminished or exhausted.		Unlike sand, gravel or underground water rights that are exhausted and not replenished, the Water Entitlements are not diminished and do not waste as a result of MWD's water diversion.
<b>Sale v. Lease Factors</b>	Periodic payments applicable to equity.	Not considered in Water Transfer.	Not considered in Water Transfer.
	Acquisition of title.	The long 35-year term nature of the Landowner Agreements, the uncertainty associated with future events during that term (e.g., demographics, regulation, development, viability of agriculture in the District), and the ability of MWD to "retransfer" the Water Entitlements to its member	MWD will not acquire title to the Water Entitlements; MWD will only have use of them during the 35-year period.

		agencies, may suggest that “equitable title” was economically transferred to MWD.	
	Obligation to make payments.	MWD is obligated to pay the Purchase Price whether or not it makes any diversions over the 35-year period.	
	Timing and relationship between the amount of the payment compared to the fair market value of the asset.	MWD is required to pay the Purchase Price over a 2 to 4 year period, substantially less than the 35-year Landowner Agreement term.  The Purchase Price may roughly represent the total value of the Burdened Land and roughly equates to the value of the Water Entitlements as received by MWD. The Purchase Price is not dependent upon the quantity of water diverted.	
	Rental payments exceeding fair rental value of property.	No appraisal has been obtained for the Burdened Land or the Water Entitlements or what would be fair rental (taking the time value of money into account) of the Water Entitlements.	No appraisal has been obtained for the Burdened Land or the Water Entitlements or what would be fair rental (taking the time value of money into account) of the Water Entitlements.
	Option to purchase asset.		The Landowner Agreements do not provide MWD with any purchase option.
	Designating some portion of the payments as rent or interest.	No portion of the Purchase Price is identified as interest, but the amount paid will depend upon the payment term (i.e., 2, 3, or 4 years)	No portion of the Purchase Price is identified as interest, but the amount paid will depend upon the payment

		<p>implying an interest factor. No portions of the payment is designated as rent.</p>	<p>term (i.e., 2, 3, or 4 years) implying an interest factor.</p>
	<p>Comparison between term of agreement and useful life of asset</p>	<p>There is no way of predicting the impact to the District from real estate development, loss of agriculture, and the relationship between the Water Entitlements and the utility of the land over the next 35 years. Significant changes in demographics and agricultural uses may greatly impact the utility of the Water Entitlements by the end of the 35-year period. It may be impossible to predict the “useful life” of the Water Entitlements.</p>	<p>The Water Entitlements, being perpetual, could exist indefinitely, and the use of them over the next 35 years by MWD will not diminish their utility at the end of that period.</p>
	<p>Transfer of the burdens and benefits of ownership.</p>	<p>During the 35-year term, MWD may “resell” the water rights to its member agencies during the remainder of the term without sharing any profit with the Participating Landowners.</p> <p>MWD is required to make the Annual Fallowing Payment to the Participating Landowners when the right is exercised, which covers the incidental operating costs from Fallowing.</p> <p>MWD is required to pay the USBR costs assessed for the water transferred.</p>	<p>At the end of the 35-year period, the Water Entitlements revert back to the Participating Landowners to be used as they see fit.</p>



<b>Easement &amp; Restrictive Covenants</b>	Perpetual or limited duration grant.	Unlike a road or other access easement, the existence of the Landowner Agreements which will be recorded against the land and the right of MWD to enter and Follow substantially diminishes the value and substantially impacts any alternative economic use of the Burdened Land during the term of the Landowner Agreement.  35 years is a significant period of time, and may, economically, be equivalent to a sale.	The Landowner Agreements will cover a 35 year term, rather than a perpetual grant.
	See sale v. lease factors above.		
<b>Surface Water Situations.</b>	Extent of right transferred.	See sale v. lease factors and easement and restrictive covenants above.	The Water Transfer only covers the next 35 years, with the Water Entitlements reverting back to the Participating Landowners at the end of the Landowner Agreement term.

(b) **The Annual Payments Made During Years of Fallowing.**

The Annual Fallowing Payments made to Participating Landowners are designed to reimburse the Participating Landowners for the costs associated with Fallowing. These costs include taxes, fees, water tolls and costs of weed abatement for the land that is Fallowed that year. As such, it would appear likely that the annual payments in the years of Fallowing will be characterized as ordinary income. However, the Participating Landowners should be able to offset the costs and expenses they incur in Fallowing against this income. Therefore,

Participating Landowners may not recognize substantial net taxable income from the Annual Fallowing Payments.

6. **CONCLUSION.**

Each Participating Landowner must evaluate the merits of its reporting position, considering all of the relevant facts and circumstances, the controlling legal authorities and the impact from taking an incorrect reporting position (including penalties, additions to tax, additional amounts and interest).

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**PVID-MWD FORBEARANCE AND FALLOWING PROGRAM  
TERMS AND CONDITIONS**

- Documents required for the Program: (1) a Forbearance and Fallowing Program Agreement between the District and Metropolitan; (2) a Landowner Agreement between each participating individual District landowner and the District and MWD; (3) a Fallowing Easement Deed that will encumber landowner-owned Program qualified land in favor of the District and MWD; (4) a Tenant Subordination Agreement by which tenants of Program-encumbered land will subordinate their rights in favor of the District and MWD under the Fallowing Easement Deed; and (5) a Subordination of Encumbrance Agreement by which holders of liens and other encumbrances on Program encumbered land will subordinate their interest to the District and MWD under the Fallowing Easement Deed (“Subordination of Encumbrance Agreement”).
- Participation in the Program will be open to all land in the District eligible to receive Priority One water from the District and that has a history of irrigated crop production for two out of the five years (1999-2003) preceding enrollment in the Program.
- The Program will have a duration of thirty-five years, unless terminated earlier under conditions specified in the Program Agreement. The most significant is that MWD may terminate the agreement on five years’ notice given on or after July 31, 2010.
- Total fallowing under the Program will be limited to a maximum of approximately 26,500 acres (full subscription). However, the Program will not be undertaken unless a minimum of 13,250 acres are subscribed as participating acreage.
- Under full subscription, a base load area of approximately 6,000 acres will be fallowed each of the 35 years.
- Under full subscription, up to a maximum of 24,000 acres will be fallowed in any 25 years and up to a maximum of 26,500 acres in any 10 years will be fallowed during the 35-year Program (such years need not be consecutive).
- Within the foregoing limits, the amount of fallowing will be determined by MWD and specified in fallowing calls which, once made, may not be rescinded or diminished. However, MWD will manage its calls such that, at full subscription, the average fallowed land over the 35 years will equal at least 12,000 acres per year (approximately 13 percent of irrigated District lands).
- Fallowing as described above will be allocated proportionately among landowners according to the maximum amount of land each landowner proposes to fallow during any 10 years of the Program (maximum fallowing commitment).

- Landowners will grant PVID and MWD a fallowing easement on owned land equivalent in acreage to the landowner's maximum fallowing commitment. Landowners must subordinate any other encumbrances and tenant leases to the fallowing easement. Rights under the easement may be exercised only on a landowner's default in fallowing, and MWD will have responsibility for enforcing the easement.
- Land actually fallowed by a landowner under the Program may be either owned or leased by the landowner.
- Landowners (or their lessees) will be responsible for payment of all taxes, District water toll payments, vegetation abatement, dust control, and all other costs related to the encumbered lands.
- MWD will make a one-time sign-up payment of \$3,170 per acre times the landowner's maximum fallowing commitment. Landowners may elect to receive this payment over two to five years (subject to additional interest payment). Assuming maximum subscription, the sign-up payment will total \$84 million.
- MWD will make an annual payments of \$602 per acre multiplied by the acreage to be fallowed in that year. Annual payments will be adjusted by 2.5 percent per year during the first 10 years and between 2.5 and 5 percent in subsequent years.
- MWD is eligible to participate in the Program as to its land in the District on same terms as other landowners.