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## Reviewing Basis Allocation —Disposing of Water Rights; Sale or Exchange of Capital Asset

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The Tax Court recently held that the disposition of rights to purchase water ("water rights") by a landowner constituted a sale or exchange of a capital asset. In computing gain from the disposition, however, no allocation of the land cost to the water rights was permitted where the water rights had been received after the purchase of the land. *William T. Gladden v. Commissioner*, 112 T.C. No. 15 (1999).

The court's opinion addresses several issues that tax practitioners dealing with real estate matters have wrestled with for many years, including the definition of a capital asset, the determination of whether a disposition constitutes a sale or exchange, and whether valuable rights acquired after the purchase of real property should be viewed as separate property having a separate basis not computed by reference to the original purchase cost.

### Facts

The pertinent circumstances relating to the ownership interest in land, and the evolution of the water rights that were at issue in *Gladden*, are summarized below.

The water rights at issue were granted under federal legislation enacted in 1928 known as the Boulder Canyon Project Act (the "Act"), relating to the use and allocation of lower Colorado River water.

The U.S. Supreme Court concluded in 1963 that, under the Act and rulings of the U.S. Department of the Interior, Arizona was entitled to 2.8 million acre-feet per year of Colorado River water (*Arizona v. California*, 373 U.S. 546). Within eight years thereafter, federal legislation was enacted, apparently as a result of the *Arizona v. California* decision, to authorize construction of a distribution system for the Colorado River water; a state water conservation district (the "CAP Water District") was formed to operate, maintain, and pay for the construction of the water distribution system; and the Harquahala Valley Irrigation District ("HID") was formed for the purpose of establishing a water distribution system in and about Harquahala Valley, Arizona.

In 1976, William and Nicole Gladden (the petitioners) and other investors formed a partnership that, for approximately \$675,000, acquired an ownership interest in farmland in Harquahala Valley. The partnership engaged in a farming activity.

In 1983, the Interior Department allocated to HID and other water users rights to receive, through the CAP Water District system, specified quantities of Colorado River water. A water service subcontract (the

"Subcontract") was then entered into between the Interior Department, the CAP Water District, and HID, providing for the delivery of water to HID over a period of 50 years.

Under Arizona law and the Subcontract, owners of eligible land in the Harquahala Valley, including the partnership, were entitled to receive water allocated to HID, through an allocation on a per-acre basis; and the landowners were required to pay charges per acre-foot of water linked to payments to be made by HID to the CAP Water District.

HID could sell water not desired by Harquahala Valley landowners to landowners in certain other counties of Arizona. A Harquahala Valley landowner, however, could not sell its beneficial interest in the water rights except as part of a sale of its land.

In 1992, HID proposed to the Harquahala Valley landowners to relinquish the Colorado River water rights under the Subcontract to the Interior Department in exchange for relief from debt obligations relating to the construction of the water system, and for additional consideration. The proposal was subject to approval by an election among the landowners. If any landowner did not agree to the relinquishment of the water rights, HID could not dispose of the water rights relating to the land of the dissenting landowner.

All but one landowner ultimately voted to relinquish the water rights, and HID received \$28.7 million from the Interior Department in exchange for relinquishment of those rights. The relinquished water rights were reallocated to other users of Colorado River water.

Most of the funds received by HID upon relinquishment of the water rights were then distributed to Harquahala Valley landowners, and the partnership received \$1,088,132 in 1993 as part of that distribution. The landowners were required to agree to return the funds to HID if HID incurred a liability necessitating the use of the funds.

The opinion does not discuss the positions taken by the partnership and the petitioners in reporting the disposition of water rights and related receipt of funds on their tax returns.

### **Tax Treatment of Disposition**

The issues relating to the treatment of the disposition were presented to the court in the context of cross-motions for summary judgment by the petitioners and the Commissioner. The petitioners argued that the water rights constituted capital assets under Internal Revenue Code section 1221; that the relinquishment of the water rights by the partnership constituted a sale or exchange, such that any resulting income was capital gain; and that, in computing gain, all of the partnership's \$675,000 tax basis in the land should be applied to offset the funds received for the water rights.

The Commissioner asserted, conversely, that the partnership's rights were not capital assets; that there was no sale or exchange by the partnership; and that (if the court rejected the Commissioner's position on these issues) summary judgment would not be appropriate on the basis allocation issue because facts material to an appropriate allocation remained in dispute.

### **Capital Asset**

It was undisputed that contractual rights similar to the water rights at issue may constitute capital assets.

The opinion makes reference to cases, such as *Commissioner v. P.G. Lake*, which conclude that a right to receive future income (e.g., an oil production royalty sold by a landowner) does not constitute a capital asset. The court in *Gladden* readily concluded, however, that the rights at issue were not rights to ordinary income in any direct sense, and constituted capital assets.

The opinion notes that no argument was made that the rights were within the scope of one of the specific exclusions from classification as capital assets, referring specifically to the exclusion for real property used in a trade or business. That classification might in any event have led to an equivalent result under Internal Revenue Code section 1231; but the court noted that the water rights in this case were surface water rights, not "in situ" water rights, which might make it difficult to view the relinquished water rights as real property covered by section 1231.

Also, the Commissioner acknowledged that the water rights of HID constituted capital assets. The court did not perceive any significant difference pertinent to this issue between HID's rights and the rights of the partnership through HID.

## **Sale or Exchange**

The Commissioner argued that the partnership received the payment from HID (i) in exchange for the partnership's agreement to indemnify HID for unexpected future liabilities, or (ii) as a mere windfall distribution of surplus funds by HID. The court concluded, however, that these characterizations ignored the form and the substance of the transaction: the funds were described in contemporaneous documents as relinquishment funds, and were received by the partnership as a result of its relinquishment of water rights.

A footnote to the opinion notes that neither party referred to cases involving "disappearing assets," such as the compromise or collection of a claim. In such cases (the continued relevance of which has been limited by Code section 1234A), courts have concluded that there is no sale or exchange where the property in question ceases to exist as a result of the transaction. The footnote states that those cases "would appear inapplicable" in this context because the water rights that were relinquished "reverted to the Interior Department, survived, and were reallocated to other users."

It could be argued, however, that the property disposed of in *Gladden* was not a generic water right but rather the right of the partnership to buy Colorado River water, through HID, at a specified price. That right was terminated in exchange for a payment and ceased to exist—which would suggest that a sale or exchange did not occur. The water rights reallocated to other users were, it could be argued, simply new contracts executed by the Interior Department.

The proper resolution of these questions might turn on information not stated in the opinion regarding the nature of the water rights and the reallocation process. The court may have concluded that it did not need to explore such issues further in light of the Commissioner's failure to raise the "disappearing asset" issue.

## **Allocation of Basis**

The petitioners argued that, when the partnership acquired an ownership interest in land in 1976, it also acquired an expectation of water rights, such that the consideration paid in 1976 should be viewed as having been paid for the water rights as well as for the interest in land.

The opinion concludes, however, that the partnership had no vested interest in Colorado River water before 1983, and that after the relinquishment of the water rights in 1992, the partnership had the same interest in land as that which it acquired in 1976. Thus, the acquisition and ultimate relinquishment of the water rights were separate from the acquisition of the land.

Based on these conclusions, the court ultimately agreed with the Commissioner that no portion of the partnership's basis in the land should be allocated to the water rights, or otherwise taken into account in connection with the relinquishment of those rights.

## **Observations**

The limited discussion in the opinion of the evolution of the water rights does not provide adequate grounds to question the court's conclusion that the partnership lacked an interest in the water rights in 1976 sufficiently substantial to support an allocation of a portion of the land cost to those rights.

Even assuming that the court was correct that the partnership had no relevant interest in water rights when it purchased the land, however, it does not necessarily follow that no allocation of basis to the rights is appropriate. One can imagine situations in which rights acquired subsequent to a purchase of land are so intertwined with the land that, if such rights were subsequently disposed of, the disposition could only be viewed as a disposition of a portion of the owner's bundle of rights with respect to the land, even where such disposition merely returned the landowner to the ownership position it acquired upon purchase of the land. It appears, however, that the court concluded this was not such a case.

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