Internal Revenue Service

Number: **200307051**
Release Date: 2/14/2003
Index Number: 1001.00-00
301.00-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:CORP:06 -PLR 137383-02

Date:

October 31, 2002

Legend

Company =

District =

Selling Shareholders =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

State C =

xxx =

PPP =

Project B =

ddd percent =

Purchaser 1 =

Purchaser 2 =

Purchaser 3 =

ccc =

hhh =

$fff =

$ggg =

$iii =

Case J =

Dear :

This letter responds to the June 27, 2002 request for rulings submitted by your representative on behalf of Company and the Selling Shareholders listed on the attached Schedule A, with respect to the transfer of certain water rights. You have requested a ruling that for Federal Income Tax purposes, Company's participation in the procedures by which the transfer of the water is accomplished, in conjunction with the sales by the Selling Shareholders of their rights to the water will not constitute a sale or other disposition of property by Company, nor a distribution of property by the Company to the Selling Shareholders with respect to their stock. Additionally, you have requested rulings on whether the water rights will constitute capital assets “in the hands” of the Selling Shareholders and whether certain sales of these water rights will constitute sales or exchanges of capital assets. The information submitted in the request and in a later submission is summarized below.

Facts

Company was organized on Date 1 as a ditch and reservoir company and is subject to State C's statutory requirements for mutual ditch companies. Company uses the cash method of accounting and its fiscal year ends on Date 2. Approximately xxx of the Company's shareholders are Selling Shareholders. The other shareholders are not transferring any of their water rights and are not involved in the transactions, described herein.

State C mutual ditch companies generally were created when a group of farmers banded together and formed the cooperative company for the express purpose of storing and conducting water for irrigation purposes. Company's primary function has been to deliver to and store the water of its shareholders. The Company's assets are limited to those necessary to deliver and store the water. These assets include weirs, canals, dams, water control devices, and a storage reservoir. The shareholders used the bylaws and shares to quantify each of their beneficial use rights in the water transported by the Company. The Company owns no land on which to make use of the water it transports and stores. Although water is derived from two sources, only the water from Project B (the “Project B Water”), as described below, is the subject of this ruling request.

On Date 3, District, a quasi-governmental corporation subject to State C's statutory requirements for such entities, entered into an agreement (the “Repayment Contract”) with the United States Bureau of Reclamation (the “Bureau”) for the development of Project B. Project B emanates from the Reclamation Act of 1902, as amended. The Repayment Contract grants District the right to allocate the Project B Water. The District does so through allotment contracts that require the water users to pay their proportionate share of the District's costs to operate and maintain Project B and to repay the federal government for its construction costs (the “Operating & Reimbursements Costs”).

On Date 4, District entered into an allotment contract with Company which provided that Company would be entitled to receive an allocation of water for the beneficial use of its shareholders. The Project B Water was then allocated pro rata among the shareholders based on their shares. In addition to paying on a pro rata basis Company's annual operating expenses, based on their respective allocation of Project B Water, each shareholder pays his proportionate share of the Operating & Reimbursements Costs under the allotment contract.

Conditions in State C are such that water is in great demand. As such, the Selling Shareholders intend to relinquish their beneficial ownership of ddd percent of the Project B Water through three sales agreements (the “Master Sales Agreements”) with Purchaser 1, Purchaser 2, and Purchaser 3. The Master Sales Agreements with Purchaser 2 and Purchaser 3 provide they will acquire an aggregate of ccc units of Project B Water at $fff per unit and $ggg per unit, respectively. The Master Sales Agreement with Purchaser 1 provides for an allocation of hhh units of Project B Water at $iii per unit. In order to satisfy certain transfer requirements of the District, the Master Sales Agreement with Purchaser 1 includes an option for Purchaser 1 to take all or some of the units through a twenty-five year interruptible supply contract (the “Interruptible Supply Contract”). Under the Interruptible Supply Contract the price for the units is the same as in the Master Sales Agreement and it includes an option to purchase the units for a nominal fee. By its terms, the Interruptible Supply Contract will remove beneficial ownership of the units from the Selling Shareholders. You have indicated that Purchaser 1 has elected to take all the units pursuant to the Interruptible Supply Contract. The Selling Shareholders will be paid in full for all units upon the closing of all three transactions, including the transaction subject to the Interruptible Supply Contract.

To facilitate the negotiation of the Master Sales Agreements and the Interruptible Supply Contract, the Selling Shareholders created PPP to act as their agent. The only members of PPP are the Selling Shareholders. The Selling Shareholders are not selling their shares in Company, but their shares will bear a legend to reflect that they are no longer entitled to their full allocation of the Project B Water.

You have indicated that Company is not materially participating in the transactions described above. Company as a party to the Allotment Contract, however, will agree to the amendment of the Allotment Contract to reflect the reduced allotment of Project B Water.

The Master Sales Agreements and the Interruptible Supply Contract are conditioned on our rulings herein, however, the Selling Shareholders, due to the crisis situation in State C, have already transferred some of the Project B Water to the purchasers (the “Emergency Sales”). The consideration received by the Selling Shareholders from these Emergency Sales is being held in escrow pending our rulings herein.

According to the courts of State C, mutual ditch companies are unique entities which are formed not under State C' s general corporation statutes, but under special legislation reserved for ditch and reservoir companies. In analyzing the relationship between the shareholders and mutual ditch companies in regards to water rights, the Supreme Court of State C in Case J has stated that a mutual ditch company is merely engaged in the business of transporting and storing the water for its shareholders benefit and “the law [of State C] uniformly holds that the actual ownership of the water rights is in the shareholder.” The Supreme Court's analysis noted that a longstanding tenet of State C law is that ownership of a water right can be acquired only by the actual beneficial use of the water, mere diversion is not sufficient to meet the requirements of State C's constitution. Finally the Supreme Court noted that it is well established that the water rights owned by the shareholders are property rights. Accordingly, based on this Supreme Court's decision and other decisions by this Court, it is clear that under State C law, Company is not the beneficial owner of any of the water it transports for the benefit of its shareholders, including the Project B Water.

Representations

Company has represented that it is not a party to the Master Sales Agreements or the Interruptible Supply Contract and shall not receive any proceeds or other consideration arising or resulting from the transactions, described herein.

Based on the information and representations submitted we rule as follows:

1. The Selling Shareholders, for federal income tax purposes, are the beneficial owners of the Project B Water rights, and the sale of such rights, including the short-term Emergency Sales, described above, will not be deemed to be a sale or other disposition of property by the Company or a distribution of property by the Company to the Selling Shareholders with respect to their stock. Accordingly, the Company will not realize gain or loss as a result of the Selling Shareholders' transactions. (Sections 1001, 301(a), 311(b)).

2. The beneficial rights in the Project B Water constitutes a capital asset in the hands of the Selling Shareholders. (Section 1221).

3. The transfer of the beneficial rights in the Project B Water under the Master Sales Agreements and the Interruptible Supply Contract constitute sales of capital assets by the Selling Shareholders. (Section 1222).

Caveat

No opinion is expressed about the tax treatment of the transactions under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling. For example no opinion is expressed about whether the short-term Emergency Sales constitute sales or exchanges of capital assets, nor are we opining on the Selling Shareholders' bases in these water rights.

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

Procedural Statements

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

A copy of this letter must be attached to any income tax return to which it is relevant.

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

Sincerely,

Steven Hankin
Senior Technical Reviewer, Branch 6
Office of Associate Chief Counsel (Corporate)