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Person To Contact:  
 , ID No.

Telephone Number:

Refer Reply To:  
CC:PSI:B09  
PLR-136057-05

Date:  
November 03, 2005

In Re:

**Legend:**

Decedent =  
Spouse =  
Trusts =

Date 1 =

Dear :

This responds to a letter dated June 29, 2005, and subsequent correspondence, requesting a ruling that the conveyance of water rights and the granting of an easement on property specially valued under § 2032A of the Internal Revenue Code, will not constitute a disposition or cessation of the qualified use under § 2032A(c)(1).

The facts submitted and representations made are as follows. Decedent died on Date 1. During their marriage, Decedent and Spouse owned and operated agricultural properties for the production of beef cattle and field crops. Decedent's properties are an integral part of the couples' jointly operated agricultural operations. These operations are represented to meet the tests for qualified use under § 2032A. On the Form 706 filed for Decedent's estate, the value of Decedent's properties was reported based on the qualified use of the properties under § 2032A.

Pursuant to the terms of Decedent's will, Decedent's properties are currently owned by Trusts. Spouse is the trustee of Trusts. It has been represented that the operation of Decedent's properties has not changed since Decedent's death. Spouse's and Decedent's properties have never been irrigated and it is not anticipated that the properties will be irrigated. The majority of the land is used as pastureland for grazing cattle. A small portion of the land has been and will continue to be farmed.

Under Decedent's and Spouse's properties there is a replenishing source of groundwater. The groundwater rights were not part of the property that was specially valued under § 2032A on Decedent's Form 706.

Trusts and certain adjacent landowners want to sell the groundwater located under their land to the local water authority via a lease. The proposed lease with the water authority provides Trusts, as the owner of Decedent's properties, with the right to use the groundwater to the extent necessary to preserve the qualified use under § 2032A of the properties. Under the lease, groundwater is defined as, "all underground water, percolating water, artesian water, and other water from any and all depths and reservoirs, formations, depths and horizons beneath the surface of the Real Estate, excluding underflow or flow in a defined subterranean channel."

In connection with the proposed lease, there is a proposed easement agreement that provides for the development and removal of the groundwater. To facilitate the lease of the water to the water authority, Trusts and the adjacent landowners entered into a limited partnership. The initial capital contribution of each limited partner to the partnership will consist of the grant to the partnership of leasehold water rights and an easement agreement.

Prior to entering into the transaction the trustee of Trusts is seeking a ruling that, except for the property specifically used for removing the groundwater, entering into the proposed lease and easement arrangement will not constitute a disposition or cessation of use of the properties under § 2032A(c)(1).

#### Law and Analysis:

Section 2033 provides that the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2032A(a) provides that, if the decedent at the time of his death was a citizen or resident of the United States and the personal representative makes the election and files the agreement referred to in § 2032A(d)(2), then, for purposes of the estate tax, the value of qualified real property shall be its value for the use under which it qualifies under § 2032A(b) as qualified real property as opposed to its value based on its highest and best use.

Section 2032A(b)(1) defines qualified real property as real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of his family. Section 2032A(b)(2) provides that the term "qualified use" means the use of the property as a farm for farming purposes or in a trade or business other than the trade or business of farming.

Section 20.2032A-3(b)(1) of the Estate Tax Regulations provides that real property valued under § 2032A must pass from the decedent to a qualified heir or be acquired from the decedent by a qualified heir. The real property may be owned directly or it may be owned indirectly through ownership of an interest in a corporation, partnership, or trust. Where the ownership is indirect, the decedent's interest must also qualify under the tests of § 6166(b)(1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other periods of time, combined with periods of direct ownership, to equal at least 5 years of the 8 year period preceding the death of the decedent. Section 6166(b)(1) provides that an interest in a closely-held business includes: (1) an interest in a sole proprietorship, (2) an interest as a partner in a partnership where either 20 percent or more of the total capital interest in the partnership is included in the decedent's gross estate or such partnership has 15 or fewer partners, or (3) an interest in a corporation where 20 percent or more of the value of the voting stock of the corporation is included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Rev. Rul. 88-78, 1988-2 C.B. 330, provides in general that the development of subsurface oil and gas interests in farm property that is subject to a special use valuation election under § 2032A does not trigger the recapture tax provisions of § 2032A(c) because oil and gas interests are not includible as part of the farmland that may be specially valued under § 2032A. To the extent, however, that the specially valued farmland is subsequently used for well drilling and extraction, this constitutes a cessation of use of specially valued farmland for purposes of the recapture provision in § 2032A(c)(1)(B).

The present case is similar to the development of subsurface oil and gas interests addressed in Rev. Rul. 88-78. The property specially valued under § 2032A on Decedent's Form 706 was a separate real estate asset from the subterranean water rights on the property. Accordingly, based upon the facts submitted and the representations made, we conclude that, except for the property specifically used for removing the groundwater, entering into the proposed lease and easement arrangement will not constitute a disposition or cessation of use of the properties under § 2032A(c)(1). With respect to the property specifically used for removing the groundwater, since this property cannot be used for the § 2032A qualified purpose due to the groundwater removal process, entering into the proposed lease and easement agreement will constitute a cessation of use of this property for purposes of the recapture provision in § 2032A(c)(1)(B).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning the value of the subterranean water rights on Decedent's date of death.

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

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

The rulings contained in this letter are based upon information and representations submitted by the taxpayer 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.

Sincerely,

Melissa C. Liquerman

Melissa C. Liquerman  
Branch Chief, Branch 9  
(Passthroughs & Special Industries)

Enclosures: Copy for § 6110 purposes

cc: