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TAX TREATMENT OF CONDEMNATION PROCEEDS: AN ANALYSIS AND SOME PROPOSALS FOR REFORM

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I. INTRODUCTION

Vast urban renewal and highway construction projects have become a commonplace part of the American scene. A necessary concomitant of this development has been the more frequent use of eminent domain, the power of the sovereign to take land for public use after payment of just compensation. The use of this power often disrupts expectations and established patterns of life. As more people are being affected, more attention is being directed toward determining whether they are being treated fairly. Work in this area has, however, been directed primarily toward defining the appropriate standards and elements of a condemnation award. It appears that no explicit consideration has been given to the impact of the federal tax laws on the fairness of an otherwise fair award. This paper will analyze this impact and offer suggestions for making the federal tax law more equitable.

At the outset it is important to note that the impact of federal taxation may raise questions of constitutionality as well as questions of abstract fairness. Consideration of the tax treatment may therefore involve challenging the legality of governmental action in addition to raising debatable issues of policy. The standards of the fifth amendment's "just compensation" clause must be satisfied. Thus, before proposing methods of taxation, we identify the constitutional limitations imposed by these clauses.

The fifth amendment provides in part that private property shall not "be taken for public use without just compensation."[1] It is arguable that this clause requires the justness of an award to be evaluated after the imposition of any gains tax, on the theory that, since the payment of the condemnation award triggers the

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1. U.S. CONST. amend. V.

imposition of any tax, the condemnee has received "just compensation" only if the amount finally held by him constitutes a just payment.

The fifth amendment is silent on the question of whether the impact of taxation is to be considered in assessing the constitutionality of an award under the "just compensation" clause. Moreover, any attempt to ascertain legislative intent must contend with the fact that no federal income tax existed at the time the amendment was passed. There are apparently no decisions which specifically raise this question, but cases under the "just compensation" clause seem to have implicitly resolved it by never mentioning the impact of taxation in evaluating the fairness of an award. Since these cases are quite detailed in defining the losses for which compensation must be paid[2] and the methods of valuing those losses,[3] one apparently must conclude that the impact of taxation is not now felt to be a factor in determining "just compensation."

This conclusion is further buttressed by the fact that the determination of the condemnation award and the taxation, if any, of that award are two entirely different transactions. Under a system which taxes income regardless of source, the rate of taxation depends not on the fact that the income comes from a condemnation proceeding but on the total amount of income earned by the taxpayer. Thus the impact of taxation should be judged under the constitutional standards for taxation rather than under the constitutional standards for eminent domain.

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2. *E.g.,* International Paper Co. v. United States, 282 U.S. 399 (1931) (where the government requisitioned from a power company all of the electric power which could be produced by use of the water diverted through its intake canal, thereby eliminating the source of supply of a lessee whose right to draw a portion of that water had the status of a corporeal hereditament under state law, the lessee was awarded compensation for the rights taken); Monongahela Nav. Co. v. United States, 148 U.S. 312 (1893) (upon condemnation of a lock and dam belonging to a navigation company, compensation was required for the franchise to take tolls as well as for the tangible property); United States v. Miller, 317 U.S. 369 (1943) (government was not required to compensate a condemnee for any increment in value added to his property by the action of the public authority in previously condemning adjacent lands where the public project from the beginning included the taking of the condemnee's property as well as that of his neighbors or the possibility of such a taking); Old Dominion Co. v. United States, 269 U.S. 55 (1925) (government was not required to compensate for the value of improvement made by it when it had held the condemned property under a lease).

3. *E.g.,* United States *ex. rel.* T.V.A. v. Powelson, 319 U.S. 266 (1943) (market value is the normal measure of recovery); United States v. Miller, 317 U.S. 369 (1943) (the owner's loss, not the taker's gain, is the measure of just compensation); McCandless v. United States, 298 U.S. 342 (1936) (market value may reflect not only the use to which the property is presently devoted but also that to which it may readily be converted).

To be constitutional, a federal tax must satisfy the due process clause of the fifth amendment.[4] The cases under this standard have made it clear that it is met whenever a tax is imposed to effectuate a reasonable policy.[5] Numerous taxes have been upheld even though they appear to impose discriminatory burdens; examples are the graduated income tax,[6] a tax on oleomargarine greater than the tax on butter,[7] and a tax on employers of eight or more employees.[8] Because of this liberal constitutional standard, the present system of taxation appears to satisfy the due process clause.[9]

Although the constitutional limitations on the tax treatment of a condemnation award are not likely to be violated by a given statute, they should be kept in mind. First, situations may arise in which a constitutional claim will have merit.[10] Second, and more significantly, the notions of fairness which this analysis attempts to refine proceed directly from the fifth amendment's broadly stated requirement of just compensation.

A second important introductory point relates the tax treatment of condemnation awards to the overall policy of present law regarding gains from the "sale or exchange" of property. (See Appendix A for an outline of tax treatment of a sale or exchange.) Basically, the whole problem of deciding how to tax a condemnation award stems from the policy of the current tax structure, which, by taxing appreciation only when property is sold or exchanged, normally permits the taxpayer to decide whether, and when, to incur a tax. It is often forgotten that this system is not the only reasonable way to tax appreciation.

A strong argument can be made that appreciation should be taxed in the year it occurs, regardless of whether the appreciated

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4. *E.g.,* Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916) (progressive rate structure not a violation of fifth amendment due process).

5. *E.g.,* Steward Mach. Co. v. Davis, 301 U.S. 548 (1937); Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916); McCray v. United States, 195 U.S. 27 (1904).

6. Brushaber v. Union Pac. R.R., 240 U.S. 1 (1916).

7. McCray v. United States, 195 U.S. 27 (1904).

8. Steward Mach. Co. v. Davis, 301 U.S. 548 (1937).

9. A claim on "equal protection" grounds cannot be made under the due process clause of the fifth amendment. "Unlike the fourteenth amendment, the fifth contains no equal protection clause and it provides no guaranty against discriminatory legislation by Congress." Detroit Bank v. United States, 317 U.S. 329, 337 (1943); Helvering v. Lerner Stores Co., 314 U.S. 463 (1941).

10. A state law which might well be found to be unconstitutional is MASS. GEN. LAWS ANN. ch. 62, § 7A (Supp. 1966), which taxes at a rate of 50% gains accruing to one who purchased land within one year of its being taken by eminent domain or purchased by a body authorized to take by eminent domain.

property is sold or exchanged.[11] In support of the argument, it is contended that the taxpayer who retains appreciated property is in substantially the same position as if he had sold the property. The existence of any appreciation will be determined by current market value, which, by definition, means that the property can be sold at that value. Thus the taxpayer who retains appreciated property possesses the gain as if he had converted it to cash by a sale and therefore should be taxed on it.

An additional argument against the current tax policy of taxing gain only at the time of sale or exchange is that it distorts the free flow of capital by rewarding those property owners who do not change the form of their investments. This reward occurs in two ways. First, no tax is payable until the investment is sold or exchanged;[12] and, second, the taxpayer can escape the tax permanently by holding the property until his death.[13] As a result of these incentives, capital tends to remain where it is rather than to move freely to more favorable investment opportunities. Thus the vaunted "proper" allocation of resources by a free market is hindered because a more favorable investment opportunity may not be sufficiently advantageous for the taxpayer to incur a gains tax. If the taxpayer had to incur the tax on appreciation even if he retained his investment, then he would move his capital into any slightly more favorable investment.

This alternative to our present system of taxing appreciation of property is relevant for this paper because its adoption would obviate the basic problem of the current Internal Revenue Code regarding the proceeds of a condemnation. The problem is that of harmonizing the treatment of such proceeds with the treatment of other gains. It arises because condemnation, by its nature, forces the taxpayer to change his investment, thereby depriving him of the opportunity to delay taxation by retaining his property. If taxation could never be postponed, it would not be necessary to define the circumstances under which postponement would be permitted.

This paper is not, however, an assessment of the present structure for taxing appreciation of property; this structure is accepted. The focus is on assuring that the condemnee is treated fairly within this structure. Thus the analysis is predicated on

11. Under Eisner v. Macomber, 252 U.S. 189 (1920), gain can constitutionally be taxed only when it is realized. Any change in the law which would tax appreciation prior to a realization by sale or exchange would thus have to contend with the holding of this case.

12. INT. REV. CODE OF 1954, § 1002 [hereinafter cited as IRC].

13. IRC § 1014.

an acceptance of two basic policies of the present law. The first is that the taxpayer is generally free to decide when to incur a gains tax by selling his property; therefore, the tax treatment of a condemnation award can be considered unfair when it accelerates the incidence of taxation so that it occurs before it would have occurred in the absence of condemnation. The second is that the gain is taxable when the taxpayer substantially changes the nature of his investment; therefore, the condemnee should not be able to utilize the fortuity of condemnation to avoid a tax he would have paid absent a condemnation.

II. THEORY

Given a system in which the taxpayer can postpone tax by retaining his property, the basic problem in the condemnation situation is that of deciding whether any property acquired with the condemnation proceeds is sufficiently similar to the condemned property to merit postponing taxation of gain on the condemned property. If the replacement property satisfies the standard of similarity which is adopted, the condemnee is deemd to have restored himself to his pre-condemnation position. He is then treated as if he had retained the condemned land, with the consequence that he is not taxable on any gain represented by the condemnation award.[14]

If the condemnee does not use his award to purchase property which meets the adopted standard of similarity, he is treated in accordance with the policy of the present law which taxes any gain at the time the taxpayer substantially changes the form of his investment. Since an ordinary taxpayer cannot sell property without being taxed on any gain, the condemnee cannot take advantage of the condemnation to make a tax-free change in the nature of his property. Therefore, he must pay a tax on any gain if he chooses to retain the proceeds of the condemnation award or invest them in property which, under the standard of similarity, is dissimilar to the condemned property.

The success with which any method of taxation harmonizes these two policies of not denying the condemnee's right to postpone tax and of not permitting him to receive a tax benefit as a result of the condemnation must depend on one's view of the equities involved in the condemnation situation. It is thus appropriate to analyze the event of condemnation to determine the

14. Under § 1033(a)(3) the taxpayer can, if he wishes, recognize the gain even though he has purchased qualifying replacement property.

relative merits of the equities concerned. Consideration can then be given to whether the standards of present law for determining how the condemnee should be taxed are in accord with the analysis.

The basic premise of this paper is that the government should act to make the condemnee whole. The award should be large enough to cover the economic cost of restoring the condemnee to his pre-condemnation position. He should be no worse off than he was, but he should not benefit from the condemnation.[15] The tax treatment of the condemnation award should be in accord with this purpose.

In seeking to carry out this purpose of restoring the condemnee's *status quo ante* it should be remembered that he is deserving of sympathy because he suffers the loss of his land involuntarily and, presumably, for the public benefit. This sympathetic viewpoint is relevant in formulating the statute intended to promote the goal of enabling him to restore himself to his former position. It is relevant because the case by case application of any statute will yield decisions which will achieve with varying degrees of success the objective of the statute. As our purpose is to do justice by making it possible for the condemnee to restore himself to his pre-condemnation status, the cases arising under a statute aimed directly at this goal of a just result are likely to range along a continuum from undercompensation to overcompensation. Under such a statute, certain condemnees would almost inevitably receive tax treatment that is less than just.

Because the land is taken involuntarily and because it is taken by deliberate government action to produce a public benefit, a statute which produces a less than just result by undercompensating is intolerable. Therefore, the appropriate statute is one under which the least favorable result is nonetheless just, in which, that is, the other decisions reached under the statute would, to varying degrees, leave the condemnee with an improved economic situation. While this latter consequence is not desirable, it should be tolerated because, in the condemnation situation, it is more

15. This view that the award should enable the condemnee to restore himself to his pre-condemnation position goes beyond the constitutional requirements delineated in the cases. The cases require only that the condemnee "be put in as good a position pecuniarily as he would have occupied if his property had not been taken." United States v. Miller, 317 U.S. 369, 373 (1943); Seaboard Air Line Ry. v. United States, 261 U.S. 299 (1923). This means that he must be paid the full value of the property taken. Under our view, however, the condemnee should be compensated, not only for the land taken, but also for expenses incident to restoring him to his pre-condemnation status.

important to assure that everyone is justly compensated for economic losses than to prevent some from reaping an economic gain.

If the above rationale seems to provide an inadequate basis for permitting certain condemnees to improve their economic positions in order to assure that no condemnee's position is worsened, then an additional point should be made. Under present treatment, the condemnee is compensated only for economic losses. Non-economic losses are, however, often incurred as a result of the disruption caused by having to give up the condemned land. Grief at the loss of the family home is one of the more dramatic examples of a non-economic loss.

Since these non-economic losses are very likely to exist, it is possible to view any improvement in the condemnee's economic position as merely offsetting his non-economic losses. As the policy is to make the condemnee whole, the existence of an economic gain to offset non-economic losses can be seen as promoting this policy, rather than obstructing it.

In working to bring about tax treatment that is in accord with this sympatheic view of the condemnee's plight, one can proceed in two ways. The first is to set up standards solely in terms of this view, ignoring the treatment given by the Internal Revenue Code to transactions related to condemnation.[16] The second is to construct standards with reference to the standards for these related transactions, making sure that the relative treatment of condemnation proceeds is appropriate. We work mostly from the first approach; however, we also give attention to related sections of the Code because they offer guides to the political feasibility of our proposals.

Having stated our views as to the appropriate manner of taxing condemnation awards so as to assure the condemnee fair treatment, we turn to the manner of taxation provided by present law.

III. PRESENT LAW

Section 1033 states the basic rules for permitting postponement of tax in the condemnation situation.[17] When they are satisfied,

16. These transactions are covered in IRC §§ 1031-1038. *See also* IRC §§ 351, 721.

17. Section 1033 applies to property compulsorily or involuntarily converted "as a result of its destruction in whole or part, theft, seizure, or requisition or condemnation or threat or imminence thereof". IRC § 1033(a). We focus our attention on conversion by "condemnation or threat or imminence thereof."

the condemnee pays no tax and, in effect, transfers the unrecognized gain to the replacement property by reducing its "cost" basis by the amount of unrecognized gain. The basic rule is that no gain is recognized (1) where property used in a trade or business or held for investment is replaced with property of a "like kind"[18] or (2) where a residence or property held for sale to customers is replaced with property "similar or related in service or use."[19] These two standards are of great importance to the condemnee who must decide rather rapidly[20] what replacement property, if any, he will acquire.

Similar or related in service or use. Residences and property held for sale to customers by a real estate dealer must be replaced by property "similar or related in service or use" to the property condemned.

The Regulations, not too helpfully, provide three examples of when the "similar or related in service or use" test is *not* met: (1) when proceeds of condemned unimproved real estate are invested in improved real estate; (2) when proceeds of a condemnation are applied in reduction of indebtedness previously incurred in the purchase of a leasehold; and (3) when the owner of a requisitioned tug uses the proceeds to buy barges.[21] As a result, the burden of laying down a test to administer this standard has fallen mainly to the courts which have developed at least four different approaches.

The Tax Court developed the so-called "functional" test which examines the actual physical use to which the two properties, original and replacement, are put.[22] While the test emerged when the courts were dealing with situations where the taxpayer himself was the actual user of the properties, it was not confined to such situations but was applied where the taxpayer was leasing property to some other end-user.[23] The Tax Court rejected the proposition that it should be enough to replace one investment property with another.[24] The "functional" approach,

18. IRC § 1033(g).
19. IRC § 1033(a)(2)(A).
20. Under § 1033(a)(2)(B)(i) the taxpayer has until one year after the close of the first taxable year in which any part of the gain upon the conversion is realized to acquire qualifying replacement property. This period may be extended after application to the District Director. *See* Part V. A. 1(b) *infra*.
21. Treas. Regs. § 1.1033(a)-2(c)(9).
22. *See, e.g.,* Steuart Bros., Inc. 29 T.C. 372 (1957), *rev'd,* 261 F.2d 580 (4th Cir. 1958).
23. *Id.*
24. Thomas McCafferty, 31 T.C. 505 (1958), *aff'd,* 275 F.2d 27 (3d Cir. 1960).

which has been picked up by courts other than the Tax Court,[25] gives taxpayers little leeway as to reinvestment which will qualify for non-recognition; not surprisingly, the Tax Court has sometimes been reversed on appeal, with the appellate courts laying down tests of their own.[26]

A second approach was exhibited by the Fourth Circuit in *Steuart Brothers, Inc. v. Commissioner*.[27] The taxpayer owned vacant land on which it had contracted to erect a one-story building to be leased for use as a retail grocery store and a one-story warehouse which was also to be leased. Building permits were denied because the government intended to condemn the land. After the condemnation, the taxpayer bought two replacement properties: one improved with two one-story buildings used as automobile showrooms, repair shop, and service station; the other improved by a two-story building to be used as a service station. The court emphasized the investment character of the original and replacement properties with respect to the taxpayer and held that no gain need be recognized. The court intimated that it would distinguish the case where the taxpayer was the actual user of the condemned property. Allowing the taxpayer to replace investment property with investment property without regard to the use to which it would be put is the most liberal court-developed test from the standpoint of the taxpayer.

In *Filippini v. United States*,[28] the court took a third approach. The condemned property consisted of property leased for farming and for a drive-in theatre; the replacement property consisted of a commercial office building leased to various tenants. The court looked to see if the replacement property was of the "same general class," a test that attempts to reconcile the "functional" approach with the *Steuart* approach. The decision was against allowing non-recognition on the facts presented to the court.

In *Liant Record, Inc. v. Commissioner*,[29] the Second Circuit stressed that the service or use to the taxpayer and not the end use by the lessee was vital. It held that in applying the "related in service or use" test the court must compare, among other things, (1) the extent and type of the lessor's management ac-

25. United Dev. Co. v. United States, 212 F. Supp. 664 (E.D. Mo. 1962).

26. *See, e.g.*, Loco Realty Co. v. Commissioner, 306 F.2d 207 (8th Cir. 1962), *rev'g* 35 T.C. 1059; Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962), *rev'g* 36 T.C. 224; Steuart Bros., Inc. v. Commissioner, 261 F.2d 580 (4th Cir. 1958), *rev'g* 29 T.C. 372.

27. 261 F.2d 580 (4th Cir. 1958), *rev'g* 36 T.C. 372.

28. 200 F. Supp. 286 (N.D. Cal. 1961).

29. 303 F.2d 326 (2d Cir. 1962), *rev'g* 36 T.C. 224.

tivity, (2) the amount and kind of services rendered by him to the tenants, and (3) the nature of the business risks connected with the properties. The court went on to allow non-recognition of gain where proceeds from the condemnation of an office building were reinvested in apartment buildings. The Internal Revenue Service appears to have picked up this approach; a 1964 Revenue Ruling states that the primary factor in comparing the original and replacement properties is the similarity in use to the taxpayer and that, in applying this test, the nature of the business risks, management services, and relations to the tenants should be determined.[30]

Subsequent decisions have not clarified the definition of "similar or related in service or use." Witness, for example, the Eighth Circuit's "reasonable similarity" test, which it arrived at after surveying the four approaches noted above.[31] The resulting situation for the condemnee is not one conducive to sensible investment choices or to tax planning. Given no helpful guidance by the Regulations and faced with a maze of different court-established tests and decisions, he must rapidly make a reinvestment decision, knowing that to overstep the ill-defined line means paying a possibly substantial gains tax. Forced to sell by a government or public authority, he is pushed toward a rather hasty decision at risk of immediate loss of part of his capital. About all the condemnee can be sure of is that he can safely reinvest in property almost identical to that condemned and that in no event can he reinvest in non-real property such as municipal bonds,[32] mortgages,[33] a savings account,[34] or reduction of an indebtedness.[35]

Like kind property. Until 1958, a tax free replacement of any type of condemned property was limited to that "similar or related in service or use;"[36] in that year Congress acted to broaden the scope of possible reinvestments.[37] Now when property held for use in a trade or business or held for investment is disposed of under threat or imminence of condemnation, the con-

30. Rev. Rul. 64-237, 1964-2 CUM. BULL. 319.

31. Loco Realty Co. v. Commissioner, 306 F.2d 207 (8th Cir. 1962), *rev'g* 35 T.C. 1059. *See also* Pohn v. Commissioner, 309 F.2d 427 (7th Cir. 1962) ("continuity of interest" test).

32. I.T. 1617, II-1 CUM. BULL. 119.

33. Winter Realty & Constr. Co. v. Commissioner, 149 F.2d 567 (2d Cir. 1945) *cert. denied,* 326 U.S. 754.

34. G.C.M. 14693, XIV-1 CUM. BULL. 197.

35. J. S. Murray, 24 T.C.M. 762 (1965).

36. All replacements were governed by §§ 1033(a)(2) and (a)(3).

37. Section 1033(g), *added by* Pub. L. No. 85-866, § 46(a) (Sept. 2, 1958).

demnee qualifies for non-recognition of gain to the extent the proceeds are invested in property of a "like kind." The "like kind" standard is defined in the Regulations as follows:

> [T]he words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind of class of property may not . . . be exchanged for property of a different kind or class. The fact that any real estate involved is improved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class.[38]

While the Regulations do provide that an exchange of a ranch or farm for city real estate, or a leasehold with thirty or more years to run for a fee, or unimproved real estate for improved real estate would be "like kind" transactions,[39] they do not give the condemnee a comprehensive statement as to what sort of property he can safely reinvest in.

The "like kind" standard has been read by the few courts which have passed on the question to mean that condemned real estate need only be replaced by other real estate in order to qualify for non-recognition of gain.[40] The court in *Commissioner v. Crichton*[41] stated that:

> [T]he distinction intended and made by the statute is one beween classes and characters of property, for instance, between real and personal property. It was not intended to draw any distinction between parcels of real property, however dissimilar they may be in location, in attributes and in capacities for profitable use.[42]

In holding that the exchange of a mineral interest in unimproved country land for improved city land was a "like kind" exchange, the court indicated it thought the scope of "like kind" was well settled and found it necessary to rebuff the Commissioner, saying:

> [It] will not do for him to now marshall or parade the supposed dissimilarities in grade or quality, the unlikeness, in attributes

38. Treas. Regs. § 1.1031(a)-1(b). At present there are no "like kind" regulations under § 1033, but Treas. Regs. § 1.1033(g)-1(a) contains a reference to the "like kind" regulations of § 1031. Likewise, virtually all "like kind" case law arose under § 1031, since § 1033(g) is so new to the Internal Revenue Code.

39. Treas. Regs. § 1.1031(a)-1(c).

40. Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953); Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941). *See also* Alabama By-Products Corp. v. Patterson, 258 F.2d 892 (5th Cir. 1958).

41. 122 F.2d 181 (5th Cir. 1941).

42. *Id.* at 182.

> appearance and capacities, between undivided real estate interests in a respectively [*sic*] small town hotel and mineral properties.[43]

Courts have found the "like kind" standard to be satisfied where brick and stone office buildings were exchanged for fifteen three story apartment buildings,[44] where city lots containing frame houses and an office building were exchanged for a ranch containing a house,[45] and where a lease was exchanged for some lots.[46] A court drew the line and held that there was no "like kind" exchange where the taxpayer exchanged land for the right to cut and remove standing timber.[47] The decision was partially based on the principle that trees which are to be immediately separated from the land constitute personalty and possibly on a finding that only a license to enter and cut was involved — thus there was either a difference in class or in quantum of interest.

Some early cases suggested that a substantial difference in the rights attaching to the original and exchanged property meant the "like kind" standard was not met.[48] However, a later case appears to have put this distinction to rest: the exchange of a fee interest for limited mineral rights or payments was held to be a "like kind" exchange.[49] And the Internal Revenue Service has indicated that the exchange of perpetual water rights for a fee interest qualified as a "like kind" exchange since the water rights were considered to be real property rights under state law.[50] There still remains an anomaly. A leasehold of thirty years or more is considered to be "like kind" to a fee;[51] a leasehold of less than thirty years apparently is not.

Related Transaction. A second aspect of present law relevant for our analysis is the relation of the tax treatment in the condemnation situation to the tax treatment of similar transactions.[52] The intent of Congress regarding all these transactions is that they should be tax-free if they do not substantially change the taxpayer's position. Different tests of substantial change are applied to the different transactions in this group. The difference in these tests is not, however, related to the difference in the

43. *Id.*
44. Arthur P. Pearce, 13 B.T.A. 150 (1928).
45. E. R. Bradley, 14 B.T.A. 1153 (1929).
46. Biscayne Trust Co., 18 B.T.A. 1015 (1930).
47. Oregon Lumber Co., 20 T.C. 192 (1953).
48. Bandini Petroleum Co., 10 T.C.M. 999 (1951); Kay Kimball, 41 B.T.A. 940 (1940); Midfield Oil Co., 39 B.T.A. 1154 (1939).
49. Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957).
50. Rev. Rul. 55-749, 1955-2 CUM. BULL. 295.
51. Treas. Regs. § 1.1031(a)-1(c)(2).
52. IRC §§ 1031, 1033.

equities inherent in these transactions. Consequently, the relative treatment of these transactions is not in accord with their relative equities.

These transactions fall into three groups. The first consists of exchanges that are voluntary and are not intended to produce a public benefit. An example would be an exchange by a Boston resident of his Cambridge delicatessen for a similar delicatessen in Boston. Here the taxpayer is deemed not to have substantially changed his position if the two properties are of a "like kind."[53]

The second group involves exchanges that are involuntary and that produce no public benefit. Examples from this group include loss of property by natural disaster or by theft and the use of any insurance proceeds to replace the lost property. The significant difference between these transactions and those of the first group is that here the taxpayer has entered the "exchange" against his will. He has been denied the right afforded to taxpayers of the first group to choose whether and when to make an exchange.

The test of substantial change applied here is, however, narrower than that applied to the voluntary exchange. Thus the Internal Revenue Code, by applying the "similar or related in service or use" test to these exchanges rather than the broader "like kind" test, gives the voluntary exchange more favorable treatment than the involuntary exchange.[54]

The third group concerns condemnation proceedings which are both involuntary and intended to produce a public benefit.[55] Here the "exchange" is consummated by using the condemnation award to purchase replacement property. What distinguishes this form of involuntary exchange from those of the second group is that it is brought about, not by the forces of nature or by an anti-social act made illegal by the government, but by the government itself. The taxpayer is told that he must give up his property so that it can be used to benefit his fellow citizens. Despite these elements —— involuntariness and deliberate government action to bring about a public benefit —— that are absent from transactions of the first group, the Internal Revenue Code uses the "like kind" or the "similar or related in service or use standard" to determine taxability in the condemnation situation. Thus condemnation, which merits the most favorable treatment, is treated no better than the voluntary exchange when replacement of the condemned property is tested under the "like kind" standard. When the

53. IRC § 1031.
54. IRC § 1033.
55. *Id.*

"similar or related in service or use" test applies, the condemnee is treated worse than the taxpayer who makes a voluntary exchange.[56]

A search through the legislative history of the provisions covering these transactions disclosed no indications that consideration has been given to taxing them in accordance with this analysis of their relative equities. One cause of the present inequities in the taxation of condemnation proceeds thus stems from this failure to recognize that condemnation involves considerations totally absent from the voluntary exchange situation.

IV. ANALYSIS AND PROPOSALS

Having outlined the treatment afforded under present law, we turn now to an analysis of it and to proposals for making it fairer to the condemnee. We recognize that under these proposals the condemnee may be able to improve his economic position. This possibility must, however, be tolerated to assure that the condemnee's economic position will not be made worse by reason of the condemnation. As already noted, the alternative of assuring that no condemnee reap an economic gain at the risk that some condemnees will suffer economic losses is unacceptable.

A. Analysis and Primary Proposals.[57]

1. *Property held for use in a trade or business.* The present requirement of section 1033 that property used in a trade or business be replaced by "like kind" property in order to qualify for non-recognition of gain is subject to two primary objections. First, it makes inadequate provision for renting as a means of replacing the condemned property. Second, it is at times too broad.

56. Of course, the "similar or related in service or use" test now applies only to property held for sale to customers and residences of the taxpayer, neither of which is within § 1031's voluntary exchange provisions.

57. For purposes of simplicity, proposals made in the body of the paper are discussed on the assumption that the full amount of the price paid for the condemned land, which will be subject to taxation if not reinvested in qualifying property, has been reinvested. Any amount not so reinvested will be subject to tax to the extent of gain realized on the condemnation. If property having a basis of $10 is condemned at a price of $100 and $80 is invested in qualifying property, the taxpayer is taxable on $20 of the $90 gain. If more than the amount of the condemnation payment which must be invested in qualifying property to avoid tax is invested in qualifying property, then the basis of the replacement property, in effect, is the carry-over basis of the condemned property plus the additional amount invested.

The rental problem arises because the sites most comparable to the condemned property in terms of business potential may be in buildings, such as in a shopping center, that are only available for rent. Under present law a lease apparently must be for thirty years or more in order to qualify as replacement property for a fee interest.[58] Thus where the most suitable replacement property is available only for a twenty, ten, or even a one year lease, the condemnee would be denied non-recognition treatment, a result opposed to our goal of putting the condemnee back in his pre-condemnation position.

We would alleviate this problem by defining replacement property to be "any interest in real property"[59] and by making it clear in the statute that this definition includes leaseholds of any duration. This provision is necessary because the laws of some states treat a lease as personal property[60] and a court might be tempted to look to state law to determine what is "an interest in real property."[61]

The objection might be raised that if it is necessary to have a more inclusive limit than that imposed by the "like kind" standard, it is arbitrary to set this limit at "any interest in real property." One could go on to suggest that replacement in any

58. Treas. Regs. § 1.1031(a)-1(c). Under present law, more limited interests, such as short-term interests in mineral rights, are, however, considered to qualify for tax-free treatment if exchanged for a fee. *See, e.g.*, Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957). Thus present law can be criticized as being both inconsistent and as making inadequate allowance for renting as a means of acquiring qualified replacement property.

59. *Cf.* H.R. 3421, § 201, 89th Cong., 1st Sess. (1965) [hereinafter cited as H.R. 3421], which would permit tax-free replacement with "any interest in real property, and property used in the trade or business of the taxpayer (as defined in § 1231(b)(1), but without regard to any holding period) and any property to be held by the taxpayer for investment." We rejected the idea of permitting replacement with "any property used in the trade or business of the taxpayer" or with "any property to be held by the taxpayer for investment" on the ground that the options proposed in this paper more effectively harmonize the policy of assuring fair treatment for all condemnees with the policy against tax-free changes of investment. Permitting tax-free replacement with these kinds of property is necessary to assure fairness to the condemnee only when real property suited to his trade or business is unavailable. In this case, we permit it. In any other case, permitting it effectuates no policy of fairness to the condemnee while contravening the policy against tax-free changes in investment. H.R 3241 died in committee in the 89th Congress and had not been resubmitted to the 90th Congress as of March 8, 1967. The office of Mr. Johnson of California, the bill's sponsor, indicated that the condemnation bill he plans to introduce in the 90th Congress would make no proposals for amending the Internal Revenue Code regarding condemnation.

60. *See* 1 AMERICAN LAW OF PROPERTY § 3.12 (A. J. Casner ed. 1952).

61. *See* Rev. Rul. 55-749, 1955-2 CUM. BULL. 295, for an example of looking to state law to determine whether a particular kind of property is "real property" (water rights).

property, real estate or non-real estate, should be acceptable. This contention is not without some merit, and consideration was given to proposing so broad a standard.[62] However, on balance, there would seem to be more support for drawing the line at "any interest in real property." First it marks less of a departure from the general tax policy of not taxing when there is no substantial change in the character of the investment. Second, the law has often recognized distinctions between real property and other types of property.[63] Finally, since it involves only a small shift from the present "like kind" standard and reflects a long-recognized legal category, the "any interest in real property" standard would appear to be much more feasible politically than a standard embracing non-real estate.

Once the basic definition of replacement property is broadened to include all leases, provision must be made for determining the value of the replacement property considered to have been acquired by signing a given lease and for eventually recognizing the postponed gain. Two methods for determining the value of the acquired rental property suggest themselves.[64] The first would be to compute the present value of the lease obligations and consider that amount to be the amount of replacement property acquired. The primary difficulty with using such a method is that the condemnee might be unable, or unwilling, to acquire a long-term lease with a present value such that investment in it would enable him to avoid tax. For example, if the award was $50,000 for property having a basis of $10,000 and if the longest lease available was for three years with a present value of $15,000, the condemnee would have to recognize $35,000 of the $40,000 gain. If the condemnee has gone into rental quarters of a value comparable to or greater than that of the condemned property, he should not have to recognize gain, because he has essentially put himself back in his pre-condemnation situation.

This suggests a second, and more acceptable, method of determining the amount of replacement property considered to have been acquired. It is to use the fair market value that the leased premises would have if they were to be sold rather than leased.

62. *Cf.* H.R. 3421, *discussed* note 59 *supra.*

63. *See, e.g.,* IRC §§ 1245, 1250.

64. We rejected the possibility that the condemnee be required to prepay the lease in order to qualify for non-recognition of gain because, under present law as to purchase of property, there is no requirement that the entire purchase price of the replacement property be paid within the time limits set by § 1033 and there appears to be no strong reason for treating the acquisition of a lease any differently.

Thus, if the condemnee signed a three-year lease on property with a fair market value of $30,000, he would be considered to have invested in $30,000 of replacement property. While it might be argued that this method would be difficult to administer (for example, in trying to determine the fair market value of a suite of offices in a multi-story building) and might allow the condemnee to escape taxation, these contentions can be rejected on several grounds. First, fair market value determinations are rather common to the Internal Revenue Code.[65] Second, the fact that the fair market value is not as precise an amount as an actual purchase price paid for a piece of real estate does not form the basis for a persuasive objection that the condemnee might use this fair market value determination to escape taxation. The nonrecognition sections by their very nature only postpone recognition of gain until a later time when it is deemed more appropriate for the tax to be imposed. The same concept applies in the condemnation situation under our proposal: that gain which the condemnee does not have to recognize at the present time because he is deemed to have invested in "x" dollars of replacement remains to be taxed at a later time.

The next problem is to determine when the postponed gain should be recognized where the taxpayer has rented as a means of acquiring replacement property. To preserve the pre-condemnation situation of the condemnee, whereby he would not have to recognize gain until he changed investments or not at all if he died, we would postpone recognition until the condemnee terminated his interest in the replacement rental property. We would allow him to exercise options to renew the lease on that property, to sign a new lease on it, or to purchase it. But at the time he ceased to rent it, or to own it if he had purchased it, the entire postponed gain would be taxable to him. A concomitant feature of this method would be that his death would erase the unrecognized gain, just as section 1014 erases gain on property owned by him at his death.

We considered, and rejected, two other possible methods of recognizing the gain. The first would be to treat it by analogy to the treatment given to a premium paid for a lease. When a premium is paid for the acquisition of a lease, the taxpayer is allowed to deduct an alliquot part of the premium over the term of the lease.[66] Here we have not a premium, but rather unrecognized gain, which is a kind of negative basis. By applying the

65. *E.g.*, IRC § 1014.
66. Treas. Regs. § 1.162-11(a). *See also* IRC § 178.

treatment of premium by analogy, gain could be recognized over the period of the lease by reducing the normal rental deduction by an alliquot part of the unrecognized gain. For example, if the condemnee with $10,000 in unrecognized gain signed a ten-year lease at $3,000 a year rental, he would be allowed to deduct only $2,000 a year in rental expense ($3,000 minus 1/10 of $10,000). This approach is objectionable on the ground that it might turn capital gain into ordinary gain, a tax disaster from the condemnee's standpoint. Furthermore, it would be quite unsatisfactory where the condemnee is not entitled to any deduction for rental expense, as, for example, where he is using the leased property as his personal residence.[67]

Under the second possibility, the condemnee might recognize the postponed gain over the term of the lease in a manner somewhat analogous to an installment sale under section 453. Thus, if the condemnee had $50,000 of unrecognized long-term capital gain and a ten-year lease, he would recognize $5,000 of long-term capital gain each year for ten years. This method would maintain the same character (capital or ordinary, short-term or long-term) of the original gain and would allow for some postponement of the tax. However, it is not entirely true to the condemnee's pre-condemnation situation of not having to recognize gain until he changed investments or not at all if he died, in which event his heirs would get a new basis.[68]

We chose the termination of interest in the replacement property as the appropriate moment for recognizing the postponed gain not only because of the weaknesses of the other possibilities discussed above, but also on the theory that had the condemnee owned the property and terminated his interest in it, he would have incurred a gains tax at that time. However, in those situations under sections 1031 and 1033 in which a taxpayer is not taxed upon termination of interest in his property, we would permit continued non-recognition of gain. Thus there would be continued non-recognition of the gain where the condemnee exchanges his lease for another lease or other qualified property within section 1031 or acquires another lease or other qualified replacement property under section 1033 following the condemnation or destruction of his original replacement leased property.

The proposal to allow replacement with a lease would, there-

67. Section 262 specifically denies deduction of any personal, living, or family expenses unless expressly allowed by the Internal Revenue Code, and there is no provision allowing deduction for rental of personal living quarters.

68. IRC § 1014.

fore, be more effective than present law in achieving the goal of restoring the condemnee to his pre-condemnation position. It allows him to acquire the most suitable replacement property and, once it is acquired, treats him as if he owned it.

A second objection to the "like kind" standard is that it might impose unfair burdens on the condemnee by being too broad. Suppose, for example, that the condemnee owns a mill and that there is no property available in the same geographic area which is suitable for a mill. Under present law the condemnee must purchase "like kind" property to avoid tax; and, since the "like kind" standard is a broad one, it is possible that the new business he is forced into would bear little relation to the mill business. In other words, he may have to get involved in a new business in which neither his expertise nor his goodwill from the condemned business would be of benefit to him. Of course, in some ways this permission to go outside the mill business while qualifying for tax free treatment is a liberal measure. However, from our perspective of sympathy for the condemnee's plight, the broad standard is harsh in the sense that it requires the taxpayer to start a new business to avoid tax in those situations in which a site for his pre-condemnation business is not available. The use solely of the "any interest in real property" standard would be subject to this same broadness objection.

Our second proposal would deal with the broadness problem by permitting the condemnee to replace tax-free with any interest in any kind of property if he could show that no property was available which was suitable for carrying on the same business he was engaged in at the time of the condemnation. His basis in the condemned property would become his basis in the replacement property. Thus if the mill owner could not find an appropriate site for a new mill, he could, upon a showing of unavailability of a mill site, invest the condemnation award tax free in stocks.[69] We think that fairness to the condemnee requires per-

69. Alternatively, he could simply keep the money in a bank account and treat the bank account as his replacement property. Until the time for replacement had expired, the condemned would have the option of removing the money from the account and using it to purchase replacement property. If, when the replacement period expired, the money was still in the account, the account would become his replacement property. Once he had withdrawn an amount equal to his basis in the condemned property, he would be taxed on any subsequent withdrawal at the appropriate gains rate. To avoid problems of tracing, he would be required to keep the award in identifiable form, such as in a separate bank account. After the time for replacement expired, so that the bank account would become his replacement property, he would be subject to the requirement that the Commissioner be notified of the nature of the replacement property. If he died after expiration of the time for replacement, the bank account would take

mitting this tax free change of investment in these few situations in which unavailability can be shown.

The test of availability of property suited for a particular business does, however, raise certain problems. Before discussing them is is important to note that this provision will more likely be utilized only by condemnees, such as a mill owner, engaged in businesses that are somehow related to very specialized conditions; it is much more likely that specialized property, such as a mill site, will be unavailable than that there will be no sites suitable for a business such as a drug store. Consequently the problems of proving unavailability of a suitable site will not arise often and when it does proof will probably not be difficult because it will be necessary to show only the unavailability of sites at those places, such as riverbanks in our mill example, where the special conditions needed for carrying on the business exist.

The first problem of the unavailability of suitable property standard lies in defining the geographic area in which unavailability must be shown. We limit this area to a reasonable commuting distance from the condemnee's home where the condemned property is within such an area. This limitation will make meaningful the rule that investment in non-real property will be permitted when property suitable for the condemnee's particular business is unavailable. Requiring a showing of unavailability in a broader area would defeat the purpose of the rule which is to prevent undue burdens on the condemnee. One

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as its basis its value at the date of death. IRC § 1014. If he died before the period for replacement had expired, his estate could replace tax-free with qualifying property which would get a basis equal to the value at date of death of the award; or his estate could instead treat the bank account as the replacement property, in which case its basis would be its date-of-death value. This alternative must be spelled out in the new Code section and accompanying regulations as it is unclear under present law that the estate can reinvest and qualify under § 1033. *Compare* Estate of Goodman v. Commissioner, 199 F.2d 895 (3rd Cir. 1952), *with* Estate of Joseph Resler, 17 T.C. 1085 (1952), *and* Rev. Rul. 64-161, 1964-1 (Part 1) CUM. BULL. 298.

It may be objected that that part of the proposal making a bank account replacement property is too liberal because it changes the basic rule that a failure to replace is a taxable event. The answer to this objection is that this provision treating the failure to replace as replacement applies only when the regular replacement rules do not apply because of the unavailability of appropriate replacement property. We have decided that in this situation the condemnee should not be taxed. Thus it is inconsistent with this provision to tax him for obtaining property in a savings account, thereby putting pressure on him to buy other property, when we would not tax him for obtaining any other kind of property. Moreover, treating a savings account as replacement property spares us from the hair-splitting task of deciding when the form in which the award is held is substantially equivalent to a bank account. We would not want to have to defend the position that a two-month saving certificate is substantially equivalent but that a three-month certificate is not.

of these burdens is forcing the condemnee to enter a new business to avoid tax. Another is requiring him to move his home to stay in his pre-condemnation business. Thus a standard embracing an area beyond a reasonable commuting distance from his home would force him to choose between these burdens when the only available property suited to his business was beyond the radius of a reasonable commute. If, however, this area is circumscribed by commuting distance, then he could invest in non-real property whenever he could show that he was faced with the choice of changing businesses or moving his family. This geographic limitation would impose neither of these burdens on him and is thus in keeping with our sympathetic view of his situation.

In the case where the condemned property is outside a reasonable commuting distance from the condemnee's residence, the condemnee has already shown that the operation of his business does not depend on his living within a reasonable commuting distance from it. However, a different consideration points to the need for limiting the area in which replacement property must be sought. A standard comprising an excessively large geographical area might require the condemnee to re-establish his business in an area which is so far from the condemned business that he would be unable to reacquire the services of his former employees. The standard which best accommodates this consideration appears to be one which would require the condemnee to show unavailability only within a reasonable commuting distance from the condemned property.

The second problem posed by the unavailability of suitable property standard is that of defining when property is "suitable" for carrying on the same business the condemnee was engaged in prior to condemnation. This definitional problem involves two aspects, the price of the property and its potential as a site for the specific business involved.

Suppose that a mill owner received a condemnation award of $100,000. If there was only one other site available for a mill in the appropriate geographic area and buying this site and constructing a mill there would cost $200,000, the condemnee should not be denied the right to invest in any property. Replacement property which is otherwise "suitable" should not be held "suitable" if the cost of reestablishing his business on it would appreciably exceed the amount of the award. Thus if it would cost $10,000 to move to the new site, the available replacement property can be "suitable" only if buying it and preparing it for use as a mill would not cost more than approximately $90,000.

As we have noted, there are few situations in which a condemnee will attempt to show unavailability of replacement property; consequently, any problems of proof raised by our proposed standard regarding price of the property will not arise often. It seems that they could be solved by deeming affidavits from real estate brokers in the area to be sufficient evidence of price. Any broker having knowledge of available sites would also know the approximate price of the land and any building involved. If replacement on a site would require the condemnee to build his own structures, he could testify himself concerning construction costs or submit estimates from appropriate builders.

Defining when a site is a "suitable" location for conducting a given business may be considerably more difficult than stating whether the site's price is "suitable." The difficulty is more likely to arise when the question of suitability relates to a site's economic potential for use in a particular business rather than to its geographic attributes. It is not clear that the test suggested above, evaluation by real estate brokers, is satisfactory. Moreover, certain tests, such as a consulting firm's evaluation of the profit potential of a site or of its geographic attributes, might prove too costly. It seems best to apply a test of reasonableness to properties indicated by the real estate broker to be available. Although this test appears vague when offered in the abstract, it seems likely that it would pose few problems when applied to a specific fact situation. This is so because only condemnees whose businesses require special geographic conditions, such as mill owners, are likely to seek the relief offered by our unavailability proposal. For them suitability of a site is not likely to be a disputed question. For the few remaining cases, it seems that an analysis of the area in which a site was located would determine without undue difficulty whether it was "suitable." For example, if a building was physically suited to housing a supermarket, it would not be considered "suitable" replacement property unless its location was such that a supermarket on it could successfully serve a residential area.

2. *Property held for investment.* The "like kind" standard for replacement of property held for investment poses problems similar to those posed by it with respect to property held for use in a trade or business: it makes inadequate provisions for renting, and it is too broad. Prior to the condemnation the investor could have leased his property to someone else or used it himself without incurring a gains tax; if after the condemnation the most comparable property is available only for lease, then the investor

should be able to acquire it, whether he intends to sublease it or use it himself. We would deal with the rental problem by employing the same proposals outlined with respect to renting property for use in a trade or business. Thus we would permit replacement to be tax-free when the replacement property was "any interest in real property."

The broadness problem would be met by permitting the taxpayer to invest the condemnation proceeds tax-free in any property when he could show that no property similar to his condemned property was available. The appropriate standard of similarity is a test comparing risks, management functions, and profit potential, namely whether the investment risks and management functions of the condemnee regarding available property would be substantially the same as or less than the risks and management functions with respect to the condemned property and whether the profit potential would be at least as great as that of the condemned property.[70] Thus when the condemnee could show that all of the real property available was such that investment in it would change his position adversely under one of these tests, he would not be forced to invest in real property to avoid tax but could invest in any property. It should be noted that utilization of this second proposal by the condemnee will probably be limited, since there will be few situations in which he will be able to show that investment property satisfying these tests is unavailable. The tests of unavailability regarding price and geographic area would be the same as those applied in showing unavailability of property suited for use in a particular trade or business.

3. *Property held for sale to customers.* Unlike the investor, who generally holds property for production of income or for long-term appreciation, and unlike the businessman, who generally holds property for use in his business with no present intent to sell, the dealer in property normally has in mind a sale within the foreseeable future. Since he intends to reduce the property to cash, then purchase property which he likewise will sell, there is less reason for allowing him to postpone recognition of gain in the condemnation situation than there is for permitting postponement by the investor or businessman who is likely to retain his property indefinitely. However, the condemnation may well have

70. *Cf.* Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962), which used a test comparing management activity and business risks to determine whether replacement property was "similar or related in service or use" to the condemned property.

upset the expectations of the dealer in property. For example, some vacant land he was holding for development as a residential area may have been condemned. Assuming that the condemnation resulted in a profit of "x" dollars to him, he might have been able to reap a profit of "10x" dollars if he had been able to complete the development. Because of the disruption of his expectations caused by the condemnation, he should be allowed to postpone recognition of gain.

The present Internal Revenue Code permits him to do so if the replacement property is "similar or related in service or use" to the condemned property.[71] This test poses two distinct problems for him. The first is that it is ambiguous. Unlike the "like kind" test, it has not been interpreted as permitting tax-free reinvestment in any kind of real property.[72] The extent to which it is narrower than the "like kind" test is not, however, clear. Consequently, the condemnee must face the risk that the replacement property which he believed met the "similar or related in service or use" test will be found by the Commissioner and the courts not to have met it.[73] If he is mistaken in his judgment, he will probably not be able to cure his error by selling the non-qualifying property and investing in qualifying property.[74]

The ambiguity of this test also creates problems of administration. The Commissioner must make careful inquiries about the condemned property and the replacement property to determine whether, in his view, the replacement property qualifies for tax-free treatment. Also, there is likely to be litigation concerning the application of this test to the facts of particular cases.

The second problem of the "similar or related in service or use" test is that it is too narrow. It seems that it limits the condemnee to replacing with land having the same status as the condemned land. A commentator has suggested, for example, that a dealer must replace raw acreage with other raw acreage.[75] Thus a dealer whose undeveloped land was condemned could not

71. IRC § 1033(a).

72. No case could be found which construed this test with respect to a real estate dealer. However, the court in Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962), noted specifically that "'like kind' has been interpreted as being broader than 'similar or related in service or use.'"

73. It is not entirely clear that the taxpayer can get a ruling from the Internal Revenue Service as to whether the property the taxpayer proposes to purchase will qualify. *See* Rev. Rul. 55-14, 1955-2 CUM. BULL. 918.

74. He can cure his error only by selling the non-qualifying property and investing in qualifying property within the time limits set by IRC § 1033(a). Since he will probably be informed of his error by the Commissioner only after the time limit has passed, he will be unable to qualify for tax-free treatment.

75. Founts, N.Y.U. 19th INST. ON FED. TAX. 993, 996 (1961).

replace it with land on which a residence or a factory had been built. In view of the apparently limited scope of this standard, it is quite possible that the opportunities presented by the available property satisfying it would not fully restore him to his pre-condemnation position. This could occur, for example, where his property was on a site of great business potential and where all available qualifying property was in relatively less favorable locations. The dealer in real estate should therefore be able to replace tax-free with property beyond the scope of this standard.

To remedy these two problems of ambiguity and narrowness of the "similar or related in service or use" test, the Internal Revenue Code should be amended to permit the dealer whose property is condemned to invest the award tax-free in "any interest in real property." The standard of "any interest in real property" is generally unambiguous. It also greatly reduces the risk under the present standard that no qualifying replacement property of comparable profit potential will be available. If residential property is condemned and the condemnee wishes to purchase raw acreage or wants to acquire less than fee interests in real property, he can do so tax-free.

4. *Residence of the taxpayer.* When a residence is condemned, the replacement property must satisfy the "similar or related in service or use" test to qualify for tax-free treatment.[76] Since this test generally focuses on the use to which the property is put,[77] residential property probably must be replaced with residential property. As there is little likelihood that comparable residential property will not be available, the test is not open to the objection of narrowness that exists when it is applied to dealers in real estate. However, there is a possibility that the test could be interpreted to permit reinvestment in a category of real property broader than residences. Since no problems of unavailability make a broader category necessary, we would change the "similar or related in service or use" test to one of "any interest in resi-

76. IRC § 1033(a).

The taxpayer whose principal residence is condemned or sold under threat or imminence of condemnation can elect non-recognition of gain by complying with either § 1033 or § 1034. Should he select the § 1034 route, he must invest the proceeds in a new residence within one year before or after the condemnation or sale. If he chooses to build a new principal residence, the time is extended to eighteen months after the sale of the old residence. We propose no change in this option.

77. *E.g.*, Liant Record, Inc. v. Commissioner, 303 F.2d 326 (2d Cir. 1962). In this case the court said that the "similar or related in service or use" test requires "a comparison of the services or uses of the original and replacement properties *to the taxpayer-owner.*" *Id.* at 329 (italics in original).

dential property" to eliminate any ambiguity on this point.

This test of "any interest in residential property" would also solve a second problem of the present law,[78] namely its inadequate provision for renting as a means of acquiring replacement property. Because of the vast increase in the number of apartments, even in areas that formerly had almost exclusively single-family dwellings, it is quite possible that the most suitable replacement property in the eyes of the condemnee is an apartment rather than another house. The "any interest in residential property" test would solve this problem by qualifying short-term leases for non-recognition treatment.[79]

As indicated in the discussion of property used in a trade or business, the soundest test for valuing the replacement property considered to have been acquired is not the present value of the lease obligation but rather the fair market value that the leased premises would have if they were to be sold. Again, the postponed gain would be recognized, with certain exceptions, at the termination of interest in the leased residential replacement property. Section 1033 involuntary conversions would be accommodated by allowing the condemnee whose leased replacement property was involuntarily converted to replace it with qualified replacement property and thus escape non-recognition at that point.[80] And since section 1034 allows a taxpayer to postpone recognition of gain from the sale of his principal residence if within one year he purchases another principal residence, or if within eighteen months he builds another principal residence, we would allow the condemnee to move tax-free from the leased replacement residence to the residence he had purchased or built if he met all the other requirements of section 1034.

B. An Alternative Proposal.

An objection that might be raised against our proposals is that they are not fully consistent with the policy of present law against a tax-free change to a dissimilar investment. They may therefore be of questionable political feasibility. In view of this problem

78. The status of a lease under the "similar or related in service or use" test is unknown, since Treas. Regs. § 1.1031(a)-1(c) only refers to "like kind" and no cases were found on the question.

79. Again, it would be necessary to provide in the statute that this definition includes leaseholds in order to avoid the possible problem that state law would consider a lease to be personal property. *See* 1 American Law of Property § 3.12 (A. J. Casner ed. 1952).

80. Section 1031 exchanges need not be provided for, as § 1031 covers only property used in a trade or business or held for investment.

we nave prepared an alternative plan which, though less certain to assure the condemnee of fair treatment, might prove politically more palatable. The plan retains the present treatment of condemnees under section 1033, thereby maintaining present limitations on tax-free changes of investment. Unlike present law, however, it offers an alternative to section 1033. Under the alternative, if the condemnee does not comply with section 1033, he is taxed on any appreciation over his basis in the condemned property at one half the capital gains rate the property would have been subjected to had it been sold in an ordinary sale and qualified for capital gains treatment.

The basis for this alternative is the belief that since replacing with property qualifying under section 1033 is a burden on the condemnee, he should have an alternative route which, like section 1033, will not subject him to the tax burden of an ordinary sale producing capital gain. The tax at one half the appropriate capital gains rate is imposed to accommodate two policies of present law. The first requires that changes of investment be taxed at the appropriate capital gains rate. The second permits the taxpayer to avoid a gains tax altogether by retaining the property until his death.

Since the condemnation has made it impossible to determine whether the condemnee would have sold the property or retained it until death, we must decide when and how to tax him. Section 1033 deals with this problem by treating the replacement property as if it were the condemned property and no condemnation had taken place; it assumes that any sale of the replacement property takes place when the condemned property would have been sold in the absence of condemnation. Our alternative to section 1033 treats the condemnee as if he had sold one half of the property at capital gains rates at the time of condemnation and had retained the other half until death. It thus stands at the midpoint of the two extremes of taxation to which he might have been subjected had he retained the condemned property for at least long enough for a sale of it to qualify for capital gains treatment.[81]

An advantage of this alternative to section 1033 is that it would be easy to administer. It would be necessary only to com-

81. Inquiries made through the office of Congressman Kupferman of New York indicated that no statistics are kept concerning the amount of taxes collected because of the failure of condemnees to replace under § 1033. Thus the cost of our proposal to the Treasury cannot be estimated. If this proposal were enacted, there is the possibility that some who would replace under present law rather than pay the full capital gains tax would elect to pay half the capital gains tax.

pute the capital gains tax on the gain produced by the award and then divide it in half. This plan is, however, subject to two limitations. First, in retaining the "like kind" and "similar or related in service or use" tests, it leaves unsolved the problems already indicated to be inherent in them. Second, the plan leaves unsolved the objection to section 1033 that a condemnee must invest in qualifying property or incur a gains tax, even though all available qualifying property lacks the economic potential of the condemned property. The fact that the tax imposed is less than the tax for a voluntary conversion will give the taxpayer some solace. Nonetheless, the forced imposition of any tax as a result of condemnation violates the general policy of present law that a tax is imposed when the taxpayer acts voluntarily to dispose of his property.

A variation of this proposal for taxing at half the capital gains rate is that the capital gains tax should be forgiven and that the amount of the tax forgiveness be included in the taxpayer's income to be taxed at ordinary rates. For taxpayers whose ordinary income rate is 50% or less, this proposal will produce the same result as taxing at one half the capital gains rate. However, for those in higher brackets the tax savings will be less. For example, the capital gains tax on a gain of $100,000 for a taxpayer in the 70% bracket would be $25,000, one half of which is $12,500. If, however, the $25,000 is taxed at the rate of 70%, the tax payable will be $17,500. Taxing the capital gains tax "saving" at ordinary rates thus imposes greater progressivity than the capital gains rates. Whether this greater progressivity should be imposed depends on whether one feels that it is the tax "saving" that is being taxed, in which case ordinary rates should apply on the analogy of forgiveness of a debt,[82] or that it is the gain on the property which is being taxed, in which case rates geared to the capital gains system of limited progressivity are appropriate. Since we feel that the standards of section 1033 do not permit the condemnee to reinvest tax-free in a broad enough range of property, we feel that, in any system which retains them, the condemnee should not be subjected to regular capital gains rates when he does not meet them. Thus, we feel, the concept of a tax "saving" for any difference between ordinary capital gains rates and the rates actually imposed is inappropriate. Instead, whatever tax is imposed should be viewed as a tax on gain realized on the disposition of property and should thus be con-

82. IRC § 61(a)(12).

sistent with the policies of limited progressivity applied to the taxation of capital gains.

V. TECHNICAL PROBLEMS

Once the proposed general scheme of taxation of condemnation proceeds has been decided on, a number of technical problems remain to be noted, analyzed, and provided for. Some arise out of present statutory and case law; others arise out of elements, such as compensation for moving expenses and loss of goodwill, which are found increasingly in condemnation awards. To facilitate discussion, these problems have been divided into three categories: (1) general problems of non-recognition of gain; (2) problems unique to partial takings; and (3) problems of compensation not attributable to the physical property.

A. General Problems of Non-Recognition of Gain.

1. *Time factors.* (a) Time at which "threat or imminence" of condemnation begins. Under the present law the term "threat or imminence" of condemnation has two meanings. It determines the time after which a sale must take place for it to qualify for treatment under the non-recognition of gain provisions. It also sets the time at which replacement property qualifying under these provisions can first be purchased.

To show "threat or imminence" of condemnation, the taxpayer must show: (1) that the threat came from an authority which possesses the power of eminent domain; (2) that the authority intends to acquire the property and would institute condemnation proceedings if it was unsuccessful in negotiating a purchase; and (3) that it is reasonable for the taxpayer to assume that the threats of the authority's representatives were authorized and would carry out.[83] For example, if the taxpayer learns of the intent to condemn his property through the news media, he must obtain confirmation of the correctness of the report from the public body in order to be in a position to claim the property was sold under "threat or imminence" of condemnation or that the replacement property was acquired after that time.[84]

83. Dominguez Estates Co., 22 T.C.M. 521 (1963); Carson Estate Co., 22 T.C.M. 425 (1963); Louis J. Hexter, 11 T.C.M. 337 (1952). No "threat or imminence" exists when the public agency only "designates" sites to be used for urban renewal. J.S. Murray, 24 T.C.M. 762 (1965).

84. Rev. Rul. 63-221, 1963-2 Cum. Bull. 332, *modifying* Rev. Rul. 58-557, 1957-2 Cum. Bull. 402.

It is arguable that the date a "threat or imminence" is considered to exist should be pushed back in time. The argument is most persuasive with respect to testing the time at which a taxpayer can first sell and still qualify for the non-recognition of gain provisions. While a taxpayer who sells to a public body which possesses the power of eminent domain would presumably have little trouble showing the sale was under "threat or imminence," the taxpayer who sells to a third person[85] when the unconfirmed rumors of a forthcoming condemnation of his property begin to circulate presents a more difficult case. On the one hand, the taxpayer's desire to avoid a possible loss or to re-establish a business in an area where there is no such suggestion of a present taking is deserving of protection. On the other hand, pushing the point of "threat or imminence" back in time to a point where there may be no actual intent of the authority to take the property makes proof more difficult and opens the door somewhat to collusive "threats" created to allow a taxpayer to take advantage of the non-recognition of gain provisions designed to help out the actual condemnee.[86] On balance, it seems that the broad replacement standards proposed provide too great a temptation for collusion to move back to an earlier date the time at which "threat or imminence" of condemnation is deemed to exist. The present rules for determining this time should therefore be preserved.

(b) Time within which replacement must be made. The last day for reinvestment in qualified property so as to obtain non-recognition is one year after the last day of the taxable year in which any part of the gain was first recognized.[87] However, the District Director may extend the time after timely application by the taxpayer showing a reasonable time for delay.[88] The high market value or scarcity of replacement property has not been considered sufficient ground for granting an extension;[89] but an

85. The taxpayer can make such a sale to a third person under "threat or imminence" of condemnation and still qualify for § 1033. Creative Solutions, Inc. v. United States, 320 F.2d 809 (5th Cir. 1963); S.H. Kress, 40 T.C. 142 (1963).

86. Even under present law a court may well look to see if there is any evidence of collusion between the taxpayer and officials to create an artificial threat. *See* Dominguez Estate Co., 22 T.C.M. 521 (1963).

87. IRC § 1033 (a) (3) (B) (i).

88. IRC § 1033 (a) (3) (B) (i); Treas. Regs. § 1.1033(a)-2(c)(3). Even a delinquent application for extension of time to replace condemned property may be granted if it shows reasonable cause for the late filing and is made within a reasonable time after the expiration of the required period of time. T.D. 6679, 1963-2 CUM. BULL. 335.

89. Rev. Rul. 60-69, 1960-1 CUM. BULL. 294; W. J. Fullilove v. United States,

extension was permissible where the taxpayer demonstrated the *impossibility* of replacing or restoring his remaining property within the statutory period.[90]

We see little need for changing the one-year limit in favor of a longer period *if* the District Director does not take an overly strict view of what would constitute sufficient grounds for an extension. In addition, by broadening the permissible scope of qualified replacement property, we minimize the chance that such impossibility will exist.

2. *Replacement through corporate control.* Under the present law, the condemnee may qualify for non-recognition of gain by purchasing control of a corporation which owns property "similar or related in service or use" to the condemned property.[91] To do so he must obtain eighty percent of the combined voting power of all classes of voting stock and at least eighty percent of all other classes of stock in the corporation.[92] This can be done by buying the stock of an existing corporation[93] or by starting a new corporation.[94] Our proposed revision would continue the provision for replacement through purchase of corporate control but would extend the qualified property which must be held by the corporation to "any interest in real property."

One commentator has raised an important, but as yet unanswered question about present law, namely the bearing of the amount of the requisite property held by the acquired corporation on whether the condemned property has been adequately replaced.[95] For example, if the proceeds of the condemnation were $100,000 (potential gain of $90,000) and were used to purchase 100% control of a corporation owning $60,000 of property

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71 F.2d 852 (5th Cir.), *cert. denied,* 293 U.S. 586 (1934); D.L. Collins, 29 T.C. 670 (1958).

90. Rev. Rul. 60-69, 1960-1 CUM. BULL. 294.

91. IRC § 1033(a)(3)(A). IRC § 1033(g)(2) specifically provides that the "like kind" test does not apply to the purchase of stock in the acquisition of control of a corporation. *See also* Treas. Regs. § 1.1033(g)-1(b) providing for this same effect.

92. Treas. Regs. § 1.1033(a)-2(c).

93. Gaynor News Co., 22 T.C. 1172 (1954); Washington Mkt. Co., 25 B.T.A. 576 (1932).

94. John Richard Corp., 46 T.C.____ (1966). The taxpayer cannot, however, qualify for non-recognition of gain under § 1033 merely by making loans to a corporation owned by him. Joseph Sacks, 22 T.C.M. 475 (1963). Nor is it enough to purchase stock in a holding company which owns stock in a company having the property "similar or related in service or use." Rev. Rul. 66-33, 1966-6 INT. REV. BULL. 11.

95. Miller, *Land of Condemnation — Federal Income Tax Consequences,* 38 NEB. L. REV. 509, 519 (1959).

"similar or related in service or use," has the condemnee fully satisfied the section 1033 requirement, or is $40,000 of the potential gain to be taxed now? The latter would seem to be more in keeping with the purpose of the present sction 1033; the law should be clarified to remove this possible loophole by providing that it is the amount of such qualifying real property held by the corporation that determines whether a sufficient amount of replacement property has been obtained.

3. *Basis and holding period of replacement property.* When the condemnee invests the condemnation proceeds in qualified replacement property, the basis of the replacement property is its cost, decreased by the amount of gain realized but not recognized on the condemned property.[96] The holding period is determined by reference to section 1223 which, in pertinent part, provides:

> (1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if . . . the property has . . . the same basis in whole or in part in his hands as the property exchanged, and . . . property exchanged . . . was a capital asset . . . or property described in section 1231. For purposes of this paragraph —
>
> (A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired . . .
>
> (7) In determining the period for which the taxpayer has held a residence, the acquisition of which resulted under section 1034 in the nonrecognition of gain realized on the sale or exchange of another residence, there shall be included the period for which such other residence has been held as of the date of such sale or exchange.

Thus the intent of Congress would clearly seem to be that a condemnee be able to tack the holding period of the replacement property onto that of the condemned property. This result is clearly reached as to section 1034 replacement property. However, it takes some stretching of the statutory language to reach

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96. IRC § 1033(c). A minor exception should be noted. If the condemnee's property is directly converted into replacement property, as where the condemning authority gives him a lot across the street in payment for the condemned property, the basis of the replacement property will be the same as the converted property and adjusted according to the provisions of § 1033(c).

this same result as to section 1033 property; the basis of most section 1033 replacement property will be "the cost of such property decreased in the amount of the gain not so recognized," and to come within the "same basis in whole or in part" language of section 1223 it is necessary to accept the proposition that the reduction of the replacement property's basis by the amount of unrecognized gain means the replacement property has the same basis "in part" as the condemned property. While a court would probably reach the conclusion that the holding periods could be tacked, the statutory language could easily be modified to remove any doubt.

B. Problems Unique to Partial Takings.

A partial taking may occur in different ways: (1) the condemning authority may take less than a fee interest, such as an easement or mineral or air rights,[97] or (2) the authority may take the fee interest in a portion of the condemnee's tract of land.[98] Where the authority takes easements or rights, the proceeds are treated as follow: If they are expended on section 1033 replacement property, no gain is recognized; to the extent they are not so expended, they reduce the basis of the affected land, and any excess over the basis is taxable gain.[99]

Where a fee interest in a portion of the condemnee's land is taken, only that part of the proceeds which constitutes consideration for the land taken is used to determine the amount of gain or loss on the condemned land. Any portion of this amount not reinvested under section 1033 is taxable. The award may also include an amount as severance or consequential damages paid because of diminution in value of the abutting real estate owned by the condemnee. Severance damages qualify for non-recognition under section 1033 if they are expended for qualifying replacement property. To the extent they are not so expended, they reduce the basis of the abutting land to which they are attributed, and any excess over the basis is taxable gain.[100]

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97. *See, e.g.,* Rev. Rul. 60-69, 1960-1 Cum. Bull. 294 (easements, privileges, and rights).

98. *See, e.g.,* L. A. Beeghly, 36 T.C. 154 (1961).

99. *Cf.* Rev. Rul. 53-271, 1953-2 Cum. Bull. 36.

100. Rev. Rul. 53-271, 1953-2 Cum. Bull. 36; Pioneer Real Estate Co., 47 B.T.A. 886 (1942).

Expenses connected with the condemnation award should be allocated, or apportioned if no allocation is possible, between the amount for land taken and the amount for severance damages. Miller, *supra* note 95, at 511.

1. *Severance damages.* There may be some difficulty in determining what amount represents damages for the property taken and what, if any, is for severance damages. In the absence of evidence of collusion, a bill of sale from the condemning authority, as well as a court decree, which breaks down the award into amounts for land taken and for severance damages, is likely to be accepted by the Commissioner and the courts.[101] The Internal Revenue Service considers severance damages to have been stipulated, even though the bill of sale does not refer to them, where the taxpayer is furnished an itemized statement or closing sheet at the time of settlement and payment by the authority which indicates an amount paid as severance damages.[102] Where no such allocation is made, the authorities are divided as to whether the taxpayer may make the allocation after the fact.

In 1950, the Second Circuit[103] decreed that no such allocation could be made by the taxpayer despite evidence that the State of Connecticut, without informing the taxpayer, had taken into account a fixed sum attributable to such damages in deciding what price it was willing to pay for his land. Judge Augustus Hand based his decision not on the difficulty of making such an allocation but rather on the ground that "what the seller actually received is what he realized on the disposal of it by sale."[104] In his view:

> [W]hat appellant would consider to be "severance damages" to the land retained may just as well be treated as an attribute of the land sold, *i.e.*, what might well be called its "protection value" to the remaining land.[105]

The Hand view might mean that an apportionment is never allowable or is allowable only when set out in a court decree.[106]

The Tax Court has been more inclined to accept allocation where it is supported by reasonable evidence.[107] In *L.A. Beeghly*,[108] the taxpayer had sold a diagonal right of way across his farm to the Ohio Turnpike Commission under threat

101. Rev. Rul. 59-173, 1959-1 CUM. BULL. 201.
102. Rev. Rul. 64-183, 1964-1 (Part 1) CUM. BULL. 297.
103. Lapham v. United States, 178 F.2d 994 (2d Cir. 1950). For a Tax Court opinion coming to the same conclusion, *see* O. N. Bymaster, 20 T.C. 649 (1953).
104. 178 F.2d at 996.
105. *Id.*
106. Greene v. United States, 173 F. Supp. 868 (N.D. Ill. 1959).
107. *See, e.g.*, Arch B. Johnson, 42 T.C. 880 (1964); L.A. Beeghly, 36 T.C. 154 (1961).
108. 36 T.C. 154 (1961).

of condemnation. The Commission representatives had told the taxpayer that the $20,350 purchase price included $16,000 in severance damages, but the final agreement contained no such denomination. The Tax Court, in holding that $16,000 was a reasonable figure for severance damages, noted that "it seems obvious that a large portion of the amount received was for damage to the larger amount of land not taken rather than the small amount taken."[109]

Any adjustment of the present federal tax law of condemnation should reflect the *Beeghly* approach. The taxpayer should be allowed to introduce any normally admissible evidence to show that a portion of an award is for severance damages.[110] This rule would eliminate the trap of having the condemnee's future tax treatment depend on his obtaining an apportionment at the time a bill of sale is written.

It is arguable that severance damages should not be taxed at all, even though they exceed the basis of the land to which they are attributable; instead the land would get a "negative basis." There are several difficulties with such a proposal. First, there has been a "realization" of gain from the property — the condemnee has cash in hand which exceeds his basis in the property. Second, there is the problem of collectibility of taxes — the government might find itself unable to collect the tax due at the time the property with a negative basis was sold. For example: severance damages of $21,000 are received on land with a basis of $1,000, giving the property a basis of -$20,000; later the property is sold for $1,000; the taxpayer faces a tax of $5,000, yet has only $1,000 in hand to meet it. For these reasons it seems unwise to codify the concept of negative basis. Moreover it is doubtful that such a proposal would be politically feasible.

2. *Special assessments.* The taxpayer who has only part of his land taken may find that an assessment has been levied against his remaining land on account of the improvement for which the land was taken. He can set off the assessment first against any severance damages awarded, and, to the extent it exceeds severance damages, it reduces consideration for the land taken.[111] For example, suppose that a narrow strip of the taxpayer's land is taken for a street widening project, that he received a net award for land taken of $5,000 plus severance damages of $1,000, and

109. *Id.* at 156.

110. H.R. 3241 would also have provided such a provision. *See* note 59 *supra.*

111. *See* Treas. Regs. § 1.1033(a)-2(c)(10); Christian Ganahl Co. v. Commissioner, 91 F.2d 343 (9th Cir.), *cert. denied,* 302 U.S. 748 (1937); Langley Collyer, 38 B.T.A. 106 (1938).

that at the same time a $2,000 assessment was levied on his remaining property as his share of the cost of the improvement. The assessment would reduce the severance damages to zero, thereby removing them from consideration for tax purposes, and would reduce the award for land taken to $4,000 for tax purposes. If the assessment was larger than the total of severance damages and the award for land taken, then the taxpayer would have to pay the excess out of his own pocket; he then would be entitled to add that amount to the basis of his remaining land.[112]

This applies only to assessments attributable to the improvement for which the partial taking occurred;[113] assessments attributable to other improvements are to be added in their entirety to the basis of the remaining land when they are actually paid.[114] This treatment seems eminently fair to the taxpayer and no change is suggested.

3. *Partial takings which destroy an economic unit.* When only part of the condemnee's land is taken, he may find himself in the position of being unable to continue operating a trade or business at his pre-condemnation location. If he desires to continue in that same business, the proceeds of the condemnation may not be sufficient to purchase another comparable business; yet if he sells his remaining property, he faces a capital gains tax which may take up to twenty-five percent of the proceeds of the sale. The Internal Revenue Service has taken different positions toward the argument that the taxpayer should be able to treat the proceeds of the sale of the remaining land as condemnation proceeds and therefore be able to benefit from the nonrecognition provisions.

A 1957 Revenue Ruling stated that the sale of property which had lost its value as a golf course when it was bisected by a state highway and the use of the proceeds from the sale to purchase property on which to construct a course comparable to the one originally taken did not qualify for treatment under section 1033.[115] The Service saw no destruction of the remaining land and noted the absence of severance damages as well as the fact that the remainder had been sold for residential development at a substantial gain. Thus the equities were not as strong for the taxpayer as they might have been, but the result as well as the validity of these "equities" can still be questioned.

A different result was reached by the Tax Court in *Harry G.*

112. IRC § 1016.
113. Langley Collyer, 38 B.T.A. 106 (1938).
114. *Id.*
115. Rev. Rul. 57-117, 1957-1 CUM. BULL. 261.

Masser.[116] The taxpayer owned a freight terminal and eight vacant lots across the street where he stored or kept temporarily his semi-trailers. The city condemned the parking lots. When the taxpayer could not find adequate replacement lots in the immediate vicinity, the terminal was sold to a laundry and all the proceeds were expended for a suitable terminal and parking facility. The Tax Court allowed the non-recognition of gain provisions to be applied, noting that the lots were practically adjacent to the terminal and that the properties were intended to be used as an economic unit. In 1959, the Internal Revenue Service approved the economic unit concept of the *Masser* case and at the same time revoked the earlier golf course ruling.[117] Thus at present the Service appears willing to provide relief to the taxpayer who lost only part of his property by allowing the non-recognition provisions to be applied to proceeds of sale of the remaining property.

It would seem advisable to codify the *Masser* rule so as to leave no doubt that a taxpayer who has the integrated nature of his property disrupted by a partial taking may sell the remainder of it and obtain non-recognition treatment for those proceeds if he reinvests them in the statutorily designated property.

C. Compensation Not Attributable to the Physical Property.

1. *Goodwill.* A portion of the award may represent payment for loss of goodwill, in effect a payment for an anticipated loss of future earnings.[118] Because goodwill is a non-capital asset, the excess of proceeds over any basis in that goodwill is taxable as ordinary income.[119] Thus it is the Commissioner who is likely to be arguing for an apportionment of goodwill.[120] Restricting the evidence admissible to show payment for goodwill is as inappropriate when applied to the Commissioner as is a restriction on the evidence the condemnee can use to show a payment for severance damages. Therefore, to be consistent with the proposed rules for proof of payment for severance damages, the Commissioner should not be restricted to use of the court decree or bill of sale to show a payment for goodwill.

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116. 30 T.C. 741 (1958).

117. Rev. Rul. 57-117, 1957-1 Cum. Bull. 261.

118. *See, e.g.*, Draft, *Act to Provide Compensation for Loss of Goodwill Resulting from Eminent Domain Proceedings*, 3 Harv. J. Legis. 445 (1966).

119. Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944).

120. See the Commissioner's argument in Claude B. Kendall, 31 T.C. 549 (1958) (held to have been no such apportionment to anticipated loss of business).

2. *Moving expenses.* A portion of the condemnation award may represent compensation for anticipated expenses of relocating.[121] Such compensation would be taxable as ordinary income.[122] However, some condemnees are able to deduct the actual relocation expenses as "ordinary and necessary" expenses under section 162 or section 212;[123] thus, only the compensation for relocation not so expended would actually be taxed. On the other hand, the condemnee whose residence was taken would apparently be taxed on the entire relocation award, since no provision is made for him to deduct his actual relocation expenses. To avoid leaving him with too few after-tax dollars to actually move to his replacement residence, the relocation award should not constitute income to him to the extent it is so expended.[124] Section 217, allowing a taxpayer who changes jobs to deduct his moving expenses, suggests that Congress might well be willing to create a similar provision for condemnees.

3. *Interest.* The condemnee must report any interest on the condemnation award as ordinary income;[125] it is treated no differently from interest paid on a savings account. The rationale for this treatment is that the interest represents the income that would have been earned if the principal amount had been available to the taxpayer. Interest, however, has not always been treated apart from the award. A number of cases in the 1930s and 1940s considered interest to be part of the condemnation award and taxed it as part of the proceeds from the sale of the property.[126]

An argument can be made that the interest is only compensating

121. *See, e.g.,* H.R. 3421, *discussed* note 59 *supra.*

122. IRC § 61. See the Commissioner's contention in National Pub. Co., 24 T.C.M. 1470 (1965).

123. *See, e.g.,* Electric Tachometer Corp., 37 T.C. 158 (1961), which held that moving expenses were deductible where there was no fixed right or agreement to be reimbursed for such expenses by the condemning authority. A distinction would be made between moving expenses and the cost of moving a building to a new site, the latter being a capital expenditure. Clarence E. Baldwin, 14 T.C.M. 794 (1955). However, the cost of moving a building might well qualify as replacement property under § 1033. *See* Rev. Rul. 58-396, 1958-2 CUM. BULL. 403.

124. *See* H.R. 3421, which also would have excluded relocation payments from taxable income.

125. IRC § 61; Issac G. Johnson & Co. v. United States, 149 F.2d 851 (2d Cir. 1945); Commissioner v. Kieselbach, 127 F.2d 359 (3rd Cir. 1942), *aff'd,* 317 U.S. 399 (1943).

126. Seaside Improvement Co. v. Commissioner, 105 F.2d 990 (2d Cir.), *cert. denied,* 308 U.S. 618 (1939); Pioneer Real Estate Co., 47 B.T.A. 886 (1942). *See also* John J. Bliss, 27 B.T.A. 803 (1933), holding that interest on a condemnation award is not interest upon the obligation of a political subdivision within the meaning of the Internal Revenue Code.

the condemnee for a decline in the buying power of the dollars he received — that it only puts him in the same position as if he had been paid on the day the property was physically taken — and that it should be treated for tax purposes as part of the award. This loss of buying power argument can be objected to on three grounds: First, it is only descriptive of what may be happening in times of inflation and, of course, does not account for changing rates of inflation or for deflation; second, in no other place does the Internal Revenue Code take account of changes in the value of the dollar; and third, if the interest payment is to compensate for loss caused by inflation, the taxpayer has not been compensated for the loss of income between the time of the taking and the time of the award. For these three reasons we reject any change in the present treatment of interest.

APPENDIX A

The taxpayer generally must account for increases or decreases in the value of his property at the time of a "sale or exchange."[127] Condemnation or a sale made under "threat or imminence" of condemnation is a "sale or exchange" within the meaning of the Internal Revenue Code.[128] Thus, unless the condemnee deal with the condemnation award or the proceeds of a sale made under "threat or imminence" of condemnation so as to obtain tax-free treatment, he must account for gain or loss in the same manner as if he had made a voluntary sale.[129]

The initial step in determining the tax consequences of the condemnation is to compute the gain or loss, if any, to the taxpayer. Where the entire parcel of land owned is taken, the amount of gain or loss is measured by the difference between the net consideration received and the adjusted basis of the land condemned.[130] The net consideration is determined by deducting from the total award, which includes amounts retained by the condemning authority to satisfy liens and mortgages against the property,[131] the reasonable and necessary expenses incurred in connection with the condemnation.[132] Such expenses include fees

127. IRC § 1002.

128. Commissioner v. Kieselbach, 127 F.2d 359 (3d Cir. 1942), *aff'd*, 317 U.S. 399 (1943).

129. *Cf.* IRC §§ 1002, 1033.

130. IRC § 1001.

131. Treas. Regs. § 1.1033(a)-2(c)(11) (must be included regardless of whether the taxpayer was personally liable); Washington Mkt. Co., 25 B.T.A. 576 (1932).

132. *See, e.g.*, Washington Mkt. Co., 25 B.T.A. 576 (1932).

to engineers[133] and lawyers[134] as well as costs of surveys[135] and of litigation.[136]

The next step is to place the condemned property into one of the four major categories of real property recognized by the Internal Revenue Code. They are: (1) real estate held for productive use in trade or business; (2) real estate held for investment; (3) real estate held for sale by a real estate dealer; and (4) real estate used as a residence of the taxpayer. With regard to property held for use in trade or business, investment property, and residential property, the Internal Revenue Code makes a distinction between property held by the taxpayer for six months or less and that held for more than six months. In general, this line determines whether the gain or loss on the sale or exchange of these kinds of property will qualify for the rather favorable tax treatment accorded to "long-term" "capital" gains or will be taxed under ordinary income rules. The gain on the sale of property held for sale by a real estate dealer is always subject to ordinary income rates regardless of the length of time the property was held.[137]

Losses. Losses on real estate held by a real estate dealer primarily for sale in the ordinary course of his business are deductible from ordinary income, as are losses on real estate used in trade or business and held six months or less.[138] Losses on real estate held as an investment for six months or less are deductible only as short-term capital losses, subject to section 1211 which limits the deductibility of such losses.[139]

When real estate held for investment which has been held for more than six months is sold at a loss, the loss is ordinarily a long-term capital loss.[140] It is set off against capital gains with any excess of loss over gain being deductible, subject to the limitations of section 1211. However, when losses on investment property are realized because of condemnation, they are taxed

133. *Id.*

134. Mary W.T. Connally, 32 B.T.A. 920 (1935); Washington Mkt. Co., 25 B.T.A. 576 (1932).

135. Washington Mkt. Co., 25 B.T.A. 920 (1932).

136. Mary W.T. Connally, 32 B.T.A. 920 (1935); Washington Mkt. Co., 25 B.T.A. 576 (1932).

137. IRC § 61(a)(3).

138. IRC § 165.

139. Under § 1211, a corporation is allowed to deduct capital losses only to the extent of capital gains; however, § 1212 provides for the carryover of capital losses not deductible because of the limits of § 1211. A taxpayer, other than a corporation, is allowed capital losses only to the extent of capital gains plus the taxable income of the taxpayer or $1,000, whichever is smaller.

140. *See* IRC §§ 1221-23.

under section 1231. All property used in a trade or business which is sold at a loss receives section 1231 treatment.

Section 1231 deals with certain kinds of property deemed by Congress to warrant special tax treatment. Sales of section 1231 property at a gain produce capital gains which are taxed at capital gains rates; sales of section 1231 property at a loss become ordinary losses and are deductible from ordinary income, thereby reducing the amount of tax that will be imposed at the higher ordinary income tax rates. Thus the taxpayer who sells section 1231 property gets the best of all possible worlds. However, if the taxpayer engages in more than one section 1231 transaction during a given tax year, he must aggregate all the gains and losses subject to section 1231.[141] It is the net gain or loss that is considered to be capital gain or ordinary loss. To make maximum use of this rather attractive provision, the condemnee must have his condemnation loss fall in a tax year when he has no offsetting section 1231 gains.

When the condemnation of a residence results in a loss to the condemnee, the loss is not deductible by him.[142] Thus the homeowner who loses his home to the public bulldozer enjoys no tax advantage over his neighbor who voluntarily sells his home at a loss.

Gains. If the condemnee realizes a gain on the condemnation, it is taxable as if the property had been sold to a purchaser other than a condemning authority[143] except that (1) long-term gains from property held by others than real estate dealers for more than six months become section 1231 gains and (2) the condemnee has an election as to nonrecognition of all or part of the gain if he reinvests in property qualifying under section 1033. The section 1231 treatment of gains can be to the condemnee's detriment if he had section 1231 losses during the year which will be offset by the gains, thereby losing the opportunity to deduct the losses from ordinary income. This leads to a strong temptation to engage in tax planning so as to realize the gains in a year when there are no such section 1231 losses. Thus, in

141. Hence the term "hotchpot" is often applied to § 1232. *See* B. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 553 (3d ed. 1964).

142. IRC § 165, specifically limiting losses of individuals, would not allow a loss on the sale under threat or imminence of condemnation of a personal residence to be deducted. Since it does, however, allow casualty losses to be deducted, it operates somewhat unfairly against the condemnee—who is more deserving of favorable treatment than the person who lost his property through an event not involving governmental action directed toward producing a public benefit.

143. Commissioner v. Kieselbach, 127 F.2d 359 (3rd Cir. 1942), *aff'd*, 317 U.S. 399 (1943).

the condemnation situation, a taxpayer might want to sell the threatened property to a private third party at a time before the condemning authority was to act in order to take the gain in a year when there would be no offsetting section 1231 losses.[144]

144. Such a sale to a third party under "threat of condemnation" qualifies for non-recognition treatment under § 1033. Creative Solutions, Inc. v. United States, 320 F.2d 809 (5th Cir. 1963); S. H. Kress Co., 40 T.C. 142 (1963).

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A MODEL INTERSTATE COMPACT FOR THE CONTROL OF AIR POLLUTION

I. INTRODUCTION

Although the Constitution of the United States authorizes compacts between states,[1] prior to 1925 little use of compacts was made beyond the determination of boundary matters.[2] However, an article by Frankfurter and Landis in 1925[3] led to a considerable proliferation of interstate compacts, stimulated in part by the problems created by multistate metropolitan populations and in part by the successes in recent years of compacts such as the New York Port Authority.[4]

Compacts usually create multistate agencies dealing with problems that one state alone cannot or will not solve. Air pollution is an excellent example of a problem that is not confined to one state, since airsheds are natural geographic features which do not correspond to political boundaries. Most compacts have been in areas where the federal government cannot act, either because the problem is thought to affect only a local area and therefore not to come within the federal government's commerce powers, or else because the problem is not considered serious enough to merit national attention.[5]

Although compacts may or may not concern matters within the federal jurisdiction, the Constitution requires Congressional consent to all "compacts and agreements."[6] Whether this consent must be expressed or implied, and when it must be given, are discussed in *Virginia v. Tennessee*.[7] The conclusion is that consent is required when the compact might affect the political balance of the federal system or an area of possible federal jurisdiction. The Constitution thus creates a mechanism of legal control over affairs that are projected beyond state lines and yet may not call for, nor be capable of, national treatment.[8]

The Clean Air Act of 1963 gives Congressional consent to

1. Art. 1, § 10.
2. *E.g.*, 3 Stat. 609 (1820) (Kentucky and Tennessee).
3. Frankfurter & Landis, *The Compact Clause of the Constitution*, 34 YALE L.J. 685 (1925).
4. 42 Stat. 174 (1921).
5. F. ZIMMERMAN & M. WENDELL, THE LAW AND USE OF INTERSTATE COMPACTS 40-54 (1961).
6. Art. 1, § 10.
7. 148 U.S. 503 (1893).
8. Frankfurter & Landis, *supra* note 3, at 695.

compacts for the prevention and control of air pollution, and to the establishment of enforcement agencies.[9] However, the statute then seems to remove that apparent consent in advance by providing that no such compact shall be "binding and obligatory" on the parties until it has been approved by Congress. Perhaps the statute means only that states may enter into such air pollution control agreements, but that there is no way for one state to enforce it against the other unless Congressional approval has been obtained.

Compacts are generally classified as (1) technical, *e.g.*, water allocation, (2) study and recommendatory, *e.g.*, marine fisheries, or (3) operating, *e.g.*, port authorities.[10] The proposed model compact does not fit neatly into any of these categories but comes closest to the first. It was originally drafted for areas common to Missouri and Illinois, and Ohio and Kentucky. It is derived from the Indiana-Illinois Compact, which was enacted by those states in 1965[11] and is now awaiting approval by Congress. Most prior compacts either recommended that the party states take action on regulated subjects that were of little interest or affected few people. For instance, the Commission provided for in the Indiana-Illinois Compact must first make extensive studies and submit a report recommending state action concerning the air pollution.[12] Then, six months after the submission of the report, the Commission is empowered to issue an order against the sources of the pollution.[13] This order is subject to review, which creates an additional delay in enforcement.[14] Thus, although it is given powers, the limitation on the exercise of those powers effectively emasculates the Commission. Even with the restrictions, it has been said that the Indiana-Illinois Compact represents "the first interstate agreement setting up an agency with enforcement powers of its own."[15] However the proposed model compact goes substantially further than the Indiana-Illinois Compact and gives power not merely to recommend, but also to take

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9. 42 U.S.C.A. § 1857a(c) (1964).
10. *E.g.*, R. LEACH & R. SUGG, THE ADMINISTRATION OF INTERSTATE COMPACTS (1959).
11. ILL. REV. STAT. ch. 111 1/2, § 240.31 (1965); IND. ANN. STAT. § 35-4621 (1965) [hereinafter cited as INDIANA-ILLINOIS COMPACT].
12. Art. IV(a).
13. Art. IV(d).
14. Art. IV(e).
15. THE COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES 1966-1967 at 238 (1966).

immediate action, to initiate regulatory action, and to require compliance with its rules, regulations, and orders.[16]

Since this compact explores new areas, few guidelines are available either from prior compacts or analogous government agencies. However, it is hoped that the persons administering the agency created will not represent parochial interests alone but will be concerned with the interstate area as a whole. They should be imbued with a desire to control air pollution but at the same time be aware of competing interests such as the economic impact of regulation upon industry. Although financial and judicial checks on the agency exist,[17] such as cessation of funds and court review of orders for enforcement, it is felt that reasonable cooperation and the good faith of the party states and their administrators will preclude the use of such checks.[18]

The interstate compact as presented consists of a state enabling statute which includes the text of the compact itself and a state law. It is assumed that the method employed by each state will vary with the requirements of the legislature involved, which may dictate variations in form or wording.

It may be noted that the title of the statute is similiar to that of the Indiana-Illinois Compact. There are, however, two changes of substance that reflect the basic difference in the regulatory philosophies of the two compacts. The authority exercised under this compact is not limited to air pollution that presently affects the health and property of the residents. Rather, the phrase "or tends to affect" indicates that the regulation is intended to control the sources of air pollution before the danger point of a detrimental effect is reached. An even more crucial change lies in the description of the nature of the pollution with which the compact is concerned. The Indiana-Illinois Compact is concerned only with pollution that originates in one state and affects persons in the other state. Thus, pollution which is wholly intrastate in nature and effect escapes regulation by the compact authority, and is subject only to the jurisdiction of whatever state authority exists. Because of the difficulty in isolating results of any particular quantity of air pollution, and because the state boundaries should not hamper administration of the whole interstate area, this limitation is eliminated. Therefore, the agency administering the compact may act in either state, even if the

16. Art. IV(b).
17. Arts. VII, X.
18. Other checks and enforcement procedures are outlined in F. ZIMMERMAN & M. WENDELL, INTERSTATE COMPACTS SINCE 1925 c. 3 (1951).

pollutants involved seem to affect only one party state.

II. THE STATUTE FOR A MISSOURI-ILLINOIS AIR QUALITY COMPACT

Section One. The following Missouri-Illinois Air Quality Compact, which has been negotiated by the representatives of the States of Missouri and Illinois, is hereby approved, ratified, adopted, enacted into law, and entered into by the State of Missouri as a party thereto and signatory state, substantially as follows:

COMMENT: Constituting the enacting provision of the state act, the section is similar in form to the Indiana law. However, an additional phrase is added which states that the Compact need be enacted only "substantially as follows." Minor differences in the enactment of the compact need not make the agreement invalid. This result could be reached by judicial or administrative interpretation, but the added clause makes it clear that absolute identity is not required, as long as the substance of the acts are the same.[19]

It should be noted that the federal government, although allowed a representative on the Air Quality Commission[20] and presumably heavily involved in the financing of any air pollution compact, is not technically a party.[21] If the government could be convinced to surrender some of its freedom to act in the area of air pollution, through the device of a binding contract with the states, the added federal expertise, prestige, and power might be desirable. It has been suggested that such participation raises a constitutional question due to the lack of any mention in the Compact Clause of state agreements or compacts with the federal government. However, contracts between the states and the United States government are hardly unprecedented. Therefore, little reason in policy is perceived for excluding federal participation on this ground.[22]

ARTICLE I. *Definitions.*

As used in this Compact:

(a) "Air contaminant" means dust, fumes, mist, smoke, vapor, or other particulate matter, gas, or odor-causing substance, or any combination thereof.

19. F. ZIMMERMAN & M. WENDELL, *supra* note 5, at 35-36. *Cf.* F. ZIMMERMAN & M. WENDELL, *supra* note 18, at 89.

20. Art. III(b).

21. The United States is a party to the Delaware River Basin Compact, 75 Stat. 688 (1961).

22. THE COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES 1964-1965 at 269-71.

(b) "Air pollution" means the presence in the outdoor atmosphere of one or more air contaminants in a quantity and of a duration which is or may tend to be injurious to public health or welfare, animal or plant life, or property, or which might unreasonably interfere with the enjoyment of life or property.

(c) "Emission" means the release into the outdoor atmosphere of any air contaminant.

(d) "Air quality goal" means a specification of the maximum desirable concentrations of air contaminants in or precipitating from the outdoor atmosphere in a particular geographic area.

(e) "Person" means any individual, partnership, firm, association, municipality, public or private corporation, subdivision or agency of a state, trust, estate, or any other legal entity.

(f) "County" means any county of either party state or the City of St. Louis.

(g) "Commission" means the Interstate Air Quality Commission created in Article III(a).

(h) "Compact Area" means the area within the jurisdiction of the Commission as provided in Article IV(a) of this Compact.

COMMENT: While the number of definitions in this Compact is greater than the number in the Indiana-Illinois Compact, an attempt was made to minimize them to prevent unnecessary complexity. Most of those provided are of substantive importance to the Compact.

The definition of "air contaminant" in (a) is adapted from a similar definition in the New York Air Pollution Control Act.[23] The general terms "particulate matter, gas, or odor-causing substance" should include any conceivable type of air contaminant.

The definition of "air pollution" in (b) is taken from the Indiana-Illinois Compact,[24] but is modified to take advantage of the definition of air contaminant in this draft. Air pollution is defined for the outdoor atmosphere because any pollution which affects persons or things not on the property of the polluter must pass through the outdoor atmosphere, and the Compact should not attempt to regulate cleanliness of air within the polluter's buildings. The words "may tend to be injurious" obviate the necessity for proving that contaminants have actually harmed someone or something before they can be declared to constitute pollution. The last phrase, "interfere with the enjoyment of life or property," recognizes that pollution may be a problem for reasons of comfort or aesthetics even when it does not constitute a health menace or cause economic harm, and that unpleasant concentrations of contaminants can constitute pollution.

23. N.Y. PUB. HEALTH LAW § 1267(3) (McKinney Supp. 1966).
24. INDIANA-ILLINOIS COMPACT Art. II.

"Air quality goal" in section (d) defines one step in a comprehensive air pollution control program. For the most efficient management of the air supply as a resource, desired air quality goals should be set and then emission standards promulgated as necessary to achieve the air quality goals.

The definition of "person" in section (e) is condensed from the New York Air Pollution Control Act.[25]

ARTICLE II. *Findings, Purposes, and Policy.*

(a) The party states find that there are actual and potential hazards to the health, welfare, property, and comfort of the people resulting from pollutants discharged into the atmosphere in each state. The party states recognize that, due to such variables as population densities, topographic and climatic characteristics, and existing or projected land use and economic development, no single standard for outdoor atmosphere is applicable to all areas within the party states.

(b) It is the purpose of the party states to cooperate faithfully in the prevention, abatement, and control of existing and future air pollution in order to create air quality conditions that will be consistent with protection of the health, welfare, property, and comfort of the people and the maximum economic development in the Compact Area. Each party state shall seek the accomplishment of these objectives through the control of air pollution by all practicable methods and by full and continuing cooperation with any agencies created under the authority of this Compact. It is also the purpose of the party states, which recognize the necessity for particularized knowledge and treatment of the atmospheric and economic conditions of individual airsheds, to provide for and encourage the administration of this Compact on the local level.

(c) The policy of this Compact is that air pollution originating within the Compact Area shall not injuriously affect or tend to affect humans, plants, animal life, or property or unreasonably interfere with enjoyment of life and property in the Compact Area.

COMMENT: Article II is an extensive revision of the corresponding provisions of the Illinois-Indiana Compact. That compact, for example, referred only to "potential" hazards of pollutants. To remedy this ap-

25. N.Y. PUB. HEALTH LAW § 1267(2) (McKinney Supp. 1966).

parent oversight, a reference to "actual" hazards is added to acknowledge the present existence of dangerous levels of pollutants in many areas. The extension of the compact jurisdiction over pollution that is wholly intrastate also requires the omission of some language that limits the scope of the Indiana-Illinois scheme.[26]

Article II(a) includes a statement of the current philosophy of air pollution control, which is derived from a recognition that each airshed has peculiar problems of air pollution that should be dealt with individually for maximum control and abatement. This concept is the basis for the scheme of local administration that may be established pursuant to Article IV(c).

Article II(b) omits the elaborate references in the Indiana-Illinois Compact to legislation to be enacted by the party states. Because the primary enforcement power in the draft lies in the agencies administering the Compact, rather than in initial dependence upon action by the states (Art. IV(b)), state legislation is less significant. Article II(b) thereby becomes a general pledge of cooperation with the Air Quality Commission and with the other state. Other changes in section (b) have been made consistent with the broader jurisdiction of the Compact's agencies. In particular, the pledge of interest and cooperation extends to the whole area, rather than only to those sources of pollution which affect the other state. Because Article IV(c) provides for local administration subject to the supervision of the Commission, a sentence is added to describe the states' commitment to this method of management.

Article II(c) is expanded to correspond with the broader responsibilities of the agencies established under the Compact. The guiding principle is no longer that pollution originating in one state shall not affect the other, but rather that there shall be no pollutants in the entire area which deleteriously affect any person or property anywhere in that area.

ARTICLE III. *The Interstate Air Quality Commission.*

(a) The party states hereby create the Missouri-Illinois Interstate Air Quality Commission to exercise the powers and duties provided in this Compact and any additional powers that may be conferred on it by subsequent action of the legislatures of both party states.

(b) The Commission shall consist of three commissioners representing each party state and one commissioner representing the United States Public Health Service. The commissioners from each party state shall be chosen by the Governor of the state which they represent and shall be removable only for cause in accordance with the laws of that state. The commissioner

26. INDIANA-ILLINOIS COMPACT Art. I(a).

representing the United States Public Health Service shall be chosen by [the President of the United States]. Each Governor shall initially appoint one commissioner for one year, one commissioner for two years, and one commissioner for three years. The terms of all commissioners thereafter appointed, and the term of the commissioner representing the United States Public Health Service, shall be for three years. A vacancy on the Commission shall be filled for the unexpired term in the same manner as an appointment for a full term.

(c) Each commissioner of the party states shall be entitled to one vote in the Commission. No action of the Commission shall be binding unless taken at a meeting at which a majority of all the commissioners are present and unless a majority of those present vote in favor thereof. The commissioner representing the United States Public Health Service may vote only in the event of a tie vote among the other commissioners present.

(d) The Commission may sue and be sued.

(e) The Commission shall elect annually, from among its members, a chairman and vice-chairman. The Commission shall appoint an executive director who shall act as secretary, and in other capacities as provided in this Compact, and who, together with other Commission personnel as the Commission may determine, shall be bonded in the amount or amounts as the Commission may require.

(f) Irrespective of any civil service, personnel, or merit-system laws of either of the party states, the Commission may appoint, remove, discharge, and fix the compensation of the personnel which may be necessary for the performance of the Commission's functions. To the extent practicable, terms and conditions of employment for members of the staff of the Commission shall be similar to those pertaining to comparable employees of the individual party states.

(g) The Commission may establish and maintain, independently or in conjunction with either one or both of the party states, a suitable retirement system for its employees. Employees of the Commission shall be eligible for social security coverage in respect to old-age and survivors insurance, provided that the Commission takes any steps which may be necessary pursuant to federal law to participate in these programs of insurance as a governmental

agency or unit. The Commission may establish and maintain or participate in any additional programs of employee benefits which may be appropriate to afford employees of the Commission terms and conditions of employment similar to those enjoyed by employees of the party states generally.

(h) The Commission may borrow, accept, or contract for services of personnel or other services from any state or the United States, or any subdivision or agency of either, from any interstate agency, or from any other person. The Commission may establish and maintain the facilities necessary for the transacting of its business and may acquire, hold, and convey any interest in real or personal property.

(i) The Commission may accept, for any of its purposes and functions under this Compact, donations and grants of money, equipment, supplies, materials, and services from any state or the United States, or any subdivision or agency of either, from any interstate agency, or from any other person. The annual report of the Commission shall set forth the identity of any donor, the amount and character of any assistance, and the conditions, if any, attached.

(j) The Commission may adopt, amend, and rescind bylaws and procedural rules for the conduct of its business.

(k) Within ten days after issuance of any rule, regulation, or order pursuant to Article IV, the Commission shall publish its text in a newspaper of general circulation. The Commission annually shall make to the Governor and legislature of each party state a report covering the activities of the Commission, stating the rules and regulations adopted by the Commission, and summarizing all actions taken to achieve air quality goals for the Compact Area in the preceding year. The Commission may issue additional reports. These reports shall be available for public examination.

(l) All actions of the Commission shall be taken at public meetings at which the vote of each commissioner present shall be recorded. The minutes of the Commission shall be a public record open to inspection at its offices during regular hours. This section shall not apply insofar as is necessary to prevent disclosure of information relating to secret processes or methods of manufacture and production.

COMMENT: The Indiana-Illinois Compact, in creating the Interstate Commission to administer the Compact and setting forth its powers, does not make clear the manner in which additional powers may be conferred.[27] Certainly the action of one legislature should not be sufficient to add powers which the Commission may exercise over one state without its consent. On the other hand, because the financing of the Compact is obtained from both states, it could be considered inequitable for one state to burden the Commission with more duties than it has in the area as a whole. This seems especially true because of the potential ability of one state to bind the other in taking individual actions within the framework of the Compact as originally enacted. To avoid this, the addition of powers and duties of the Commission will require action by the legislatures of both states.[28] The question arises whether or not additional Congressional consent is required for such an amendment. It is felt that an amendment that does not materially alter the purposes of the Compact would not require consent, since the amendment would not further affect the political balance of the federal system or make further inroads on the federal jurisdiction.

Article III(b) eliminates the professional qualifications provided for commissioners in the Indiana-Illinois scheme.[29] There is no reason for limiting the discretion of the Governor in selecting the persons whom he feels are best qualified, through experience that is not necessarily professional in nature, to assist in the control of air pollution. The remainder of the section, providing for staggered terms and the filling of vacancies, utilizes the same technique as is employed in the Indiana-Illinois Compact.

Article III(c) is a complete departure from the approach taken in the Indiana-Illinois Compact.[30] Under that scheme a majority of the members of each state's delegation must be present for the Commission to have a quorum. A majority of each state's members must also vote on any action for it to be carried. This method gives either state a veto over any action. In order to avoid obstruction by a state which objects to a particular proposal, a simple majority of all the commissioners is a quorum, and a simple majority of those present will carry the vote. Because the federal representative is a commissioner counting towards a quorum, a total boycott by one state will not prevent action being taken. In the event of a tie among those present, the federal representative may vote, thus allowing the Commission to act over the opposition of all the Commissioners of one state. This solution, when combined with the broad rule-making powers of Article IV, creates an extremely powerful commission that is a departure from previous compacts.

Sections (d) through (l) of Article III are drawn from the Indiana-Illinois Compact,[31] which in turn parallel the provisions of the Southern

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27. INDIANA-ILLINOIS COMPACT, Art. III(a).
28. *See* F. ZIMMERMAN & M. WENDELL, *supra* note 18, at 85-86.
29. INDIANA-ILLINOIS COMPACT Art. III(a).
30. *Cf. id.* Art. III(c).
31. *Id.* Art. III(d)-(m).

Interstate Nuclear Compact.[32] Several changes of substance have been made. In section (e) a reference is added regarding the executive director's "other capacities as provided in this Compact." This is required by the addition of the power to issue orders in Article V.[33]

Section (h) incorporates the definition of "person" provided in Article II, and thereby eliminates a cumbersome reference to "any other institution, person, firm, or corporation." After considerable debate, it was determined that the provisions regarding disclosure of the sources of funds should be retained. It was argued that the provision might discourage contributions of funds or information by persons who wished to avoid publicity and identification with the cause of air pollution control for personal or professional reasons. It was also contended that the operations of the Commission are protected by the provisions regarding annual financial reports and statutory prohibitions of bribery. However, these considerations are outweighed by a fear of more subtle financial pressures that might induce the Commissioners to divert their efforts from the areas most needing attention. The prevention of the possibility of the Commission becoming the captive of the industries it is intended to regulate is more important than the possible deterrence of a few contributions from persons with altogether innocent motivation.

Section (k) adds the requirement that the Commission publish its rules, regulations, and orders shortly after they are promulgated. The provision is intended to serve the same function as the Federal Register, so that persons potentially interested in the Commission's regulatory activities may be aware of their rights and obligations. The section also adds the requirement that the annual report disclose "all actions taken to achieve air quality goals for the Compact Area." This requirement will presumably assure that the Commission not only establishes adequate regulations, but also that it undertakes policing activities sufficient to ensure an active program of pollution abatement.

The Indiana-Illinois statue provided the authority to collect and disseminate information. This power is adequately provided by the last two sentences of section (k), and is therefore not separately repeated. Article III(1) of the present draft requires that the actions of the Commission be public. To the extent consistent with the protection of secret industrial processes, the provision is intended to place the operations of the Commission in the public view and prevent any feeling of a lack of accountability to the citizens of the area involved.

ARTICLE IV. *Functions.*

(a) The area of the Commission's jurisdiction shall include:
(1) (name counties along the adjoining borders of Mis-

32. 76 Stat. 249, Art. II (1962).
33. F. ZIMMERMAN & M. WENDELL, *supra* note 5, at 12, 34.

souri and Illinois); and

(2) any other county in the party states which, after due notice and hearing, the Commission determines is affected by, or contains air contaminant sources which contribute to, air pollution in the counties named in subparagraph (1).

(b) In addition to any other powers vested in it by law the Commission shall have the power to:

(1) Encourage and conduct studies, investigations, and research relating to air pollution and its causes, effects, prevention, abatement, and control;

(2) Develop a comprehensive plan or plans for the prevention, abatement, and control of air pollution, including establishment of air quality goals and emission standards, having due regard to the varying needs and conditions of the areas within its jurisdiction;

(3) Issue orders and promulgate rules and regulations necessary to effectuate the purposes of this Compact, and enforce them by all appropriate administrative and judicial proceedings;

(4) Grant individual variances from rules or regulations upon finding that the emissions occurring or expected to occur will not endanger human health or safety and that compliance with the rules and regulations from which a variance is sought would produce serious hardship without equal or greater benefits to the public;

(5) Promulgate rules and regulations authorizing the executive director to order persons causing or contributing to air pollution to reduce or discontinue immediately the emission of air contaminants when he finds that the air pollution creates an emergency requiring immediate action to protect human health or safety or to avoid serious or irreparable damage to property;

(6) Require access to records relating to emissions which cause or contribute to air contamination;

(7) Hold hearings relating to any matter in the administration of this Compact and, in connection therewith, compel the attendance of witnesses and the production of evidence;

(8) Secure necessary scientific and technical services, including laboratory facilities, by contract or otherwise;

(9) Advise, consult, and cooperate with local governmental

units, agencies of the states, industries, interlocal or other interstate agencies, the federal government, and other interested persons or groups;

(10) Encourage voluntary cooperation by persons or groups to achieve the purposes of this Compact;

(11) Consult, upon request, with any person proposing to construct, install, or otherwise acquire an air contaminant source or device or system for the control thereof concerning the efficacy of the device or system or the air pollution problem which may be related to the source, device, or system. Nothing in any consultation shall be construed to relieve any person from the obligation of compliance with this Compact, rules and regulations in force pursuant thereto, or any other provision of law;

(12) Require, by rule or regulation, the registration of sources of air contaminants and permits for new construction of those sources; and

(13) Do any and all acts which may be necessary for the successful achievement of the policy of this Compact, and any other acts which may be specifically enumerated in this Compact.

(c) Creation of Local Air Quality Authorities.

(1) Initiation.

(A) The Commission may propose to local governments within a particular area that a Local Air Quality Authority be established for the area. The local governments may accept or reject the proposal.

(B) The Commission may consider the proposal of any person or group of persons that a Local Air Quality Authority be established within a particular area. The Commission may, after hearing as provided in Article VI(c), accept or reject the proposal.

The Commission may approve a proposed Local Air Quality Authority if it determines that the location, character, or extent of concentrations of population or air contaminant sources, the geographic, topographic, or meteorological conditions, or the convenience in administration of this Compact, justifies the Authority and that the Authority will otherwise further the policies of this Compact. Upon approval by the Commission,

the Commission shall issue a regulation establishing the Authority and setting forth its membership, jurisdiction, powers, and functions, which shall be consistent with the purposes and policy of this Compact.

(2) Jurisdiction and powers. A Local Air Quality Authority may include within its jurisdiction any area in the Compact Area, whether wholly within one state or in both party states. An Authority shall have, within the area of its jurisdiction, any powers that are granted to it by the Commission which are consistent with the powers of the Commission under this Compact. The Commission shall retain the power to

(A) review all activities of the Authority,

(B) suggest standards for the exercise of the Authority's powers consistent with the policies of this Compact,

(C) modify or revoke all or part of the Authority's powers, and

(D) exercise concurrent jurisdiction with the Authority at any time.

(3) Membership.

(A) Upon acceptance of a proposal made by the Commission pursuant to Article IV(c)(1)(A), the local governments to which the proposal was made may select the members of the Local Air Quality Authority, subject to the approval of the Commission.

(B) Any proposal made pursuant to Article IV(c)(1)(B) may include selections of members of the Authority. These selections shall be subject to the approval of the Commission.

The person selected to be Chairman of the Authority shall be an elected official of a political subdivision within the jurisdiction of the Authority. After its establishment, the Authority may, with the approval of the Commission, add additional members.

COMMENT. Article IV is an altogether new section in this Compact, containing three provisions that depart radically from the Indiana-Illinois Compact. Section (a) provides a definition of the jurisdiction of the Commission, in which it will exercise the functions provided in section (b) and establish Local Air Quality Authorities under section (c). The original jurisdiction of the Commission is defined geographically rather than functionally. However, the Commission is given the power to extend the area

of its jurisdiction, based upon a standard which assures that all areas sharing common problems of air pollution control may be included in the scope of the Commission's regulations and orders.

Section (b) gives more power to the interstate agency than most similar compacts. The Indiana-Illinois Compact, as mentioned above, relies upon the states for primary control of pollution and promulgation and enforcement of rules and regulations. Here, the Commission has the complete power to administer an air pollution program, including setting standards and prosecuting violators. Because the powers to be exercised are broader than those previously granted in similar compacts, they are enumerated rather specifically and in detail in Article IV(b).[34]

It should be noted that Article III, in defining the Commission, also grants powers to it, and thus in form overlaps somewhat with Article IV(b). The distinction between the two Articles is that Article III grants primarily administrative powers enabling the Commission to conduct its business efficiently, while Article IV(b) grants substantive powers defining the permissible range of the Commission's activities in studying and regulating air pollution.

It is in the nature of air pollution that its causes, sources and effects vary from one area to another, and thus that the situation in a given area must be carefully studied before an equitable and effective abatement plan can be devised. Thus subsections (1) and (2) of section (b) provide that studies are to be made and then followed by development of a comprehensive plan for abatement, including a setting of emission standards.

Section (b) (3) is perhaps the most important compact provision, because it makes it clear that the Commission has the power to promulgate substantive rules and regulations, to issue orders to obtain compliance with these rules and regulations and other requirements, and to enforce these orders. The Commission does not merely recommend, it promulgates, orders, and enforces. The Compact does not specify air quality goals or maximum emission standards, but provides flexibility through administrative action on these matters after sufficient study.

Section (b) (4) specifically provides the power to grant variances from rules and regulations, subject to a rather strict standard which should ensure that variances are not granted so easily that pollution control is seriously weakened.[35] Section (b) (5) allows the director to order polluters to reduce or cease emissions of pollutants if the specified emergency exists. Because this provision could result in some factories being shut down for the duration of the emergency, which could arouse substantial opposition from both labor and industry, this provision, with its limiting standard,

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34. Generally, these powers are adapted from the INDIANA-ILLINOIS COMPACT, the *Model State Air Pollution Control Act,* THE COUNCIL OF STATE GOVERMENTS, 26 SUGGESTED STATE LEGISLATION A-3 (1967), and METROPOLITAN WASHINGTON COUNCIL OF GOVERNMENTS, MODEL LOCAL AIR POLLUTION CONTROL ORDINANCE (1966).

35. *See* N.Y. PUB. HEALTH LAW § 1291 (McKinney 1933).

is explicit in its grant of power to the executive director.[36]

Sections (b)(6) and (7) give the Commission power to obtain necessary information from records or testimony. Sections (b)(8) through (11) provide powers which are less important than those preceding, but which are still necessary for effective operation of this Compact. They are taken from the Model State Act.[37]

Article IV(b)(12) provides the power to require registration of contaminant sources, thereby allowing assembly of data for an air emission inventory. Such an inventory is important to effective planning for air pollution abatement. Requirement of permits prior to construction ensures the builder that his facility will comply upon completion with the Commission's rules and regulations. The possible scope of section (b)(13) is not presently clear. It is possible that some important power has been omitted from those listed in this Article, so this provision is included to avoid curtailment of the effectiveness of the Commission or the necessity for amendment of the Compact.

Article IV(c) is intended to provide a method for the implementation of the policy outlined in Article I(c). A Local Air Quality Authority may be created under IV(c)(1) in either of two ways: at the initiative of the Commission, in which case the local government may accept or reject the Commission's proposal, or at the initiative of a local government or any person or group of persons. If the latter approach is taken, the Commission holds a hearing on the proposal, as prescribed in Article VI(c). This hearing would satisfy the requirement of a hearing before the issuance of the final regulation establishing the Authority, which is provided in Article VI(a).

Article IV(c)(2) makes it clear that a Local Air Quality Authority need not be confined to the arbitrary political boundaries of cities, counties, or states. Rather, it may overlap to include any desirable area within the jurisdiction of the Commission. The Commission may grant to the Authority any or all of its powers provided that the Commission retain those powers specified in subparagraphs (A), (B), (C), and (D). Subparagraphs (A) and (B) charge the Commission with the role of a beneficent supervisor; the role is one of guidance and aid rather than domination. Subparagraphs (C) and (D) reserve to the Commission the powers of modification and revocation of the Authority's powers and the right to exercise concurrent jurisdiction. They may be used either to discipline the Authority or otherwise to assure that the policies of the Compact are being carried out by the Authority.

Article IV (c)(3) leaves the determination of the membership of the Authority's governing body to the Authority itself, subject to Commission approval and provided that the chairman of the Authority is an elected official of some political subdivison within the Authority's jurisdiction.

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36. *Cf.* Art. VI(e).

37. Article IV(b)(8), (9), (10), and (11) correspond to § 4(5), 4(14), 4(7), and 4(15), respectively, of the *Model State Air Pollution Control Act, supra* note 34.

Two policies are advanced by this approach. First, the Authority is assured of having some politically responsible local representative in a position of authority, thus preventing the Authority from becoming completely independent of all local interests. Second, freedom is left to a local, non-governmental group to establish an effective Authority, even though local political representatives may be opposed or hesitant about air pollution control. To require more extensive representation of local elected officials might destroy the value of allowing non-political persons to initiate Authorities, for hostile or uninterested politicians might prefer to allow the Commission to revoke the Authority's power altogether, rather than run an effective air pollution control program.

ARTICLE V. *Enforcement.*

(a) Whenever the executive director has reason to believe that a violation of any provision of this Compact or rule or regulation issued pursuant thereto has occurred, he may serve written notice upon the alleged violator or violators. The notice shall specify the provision of this Compact or rule or regulation alleged to be violated and the facts alleged to constitute the violation, and may include an order that necessary corrective action be taken within a reasonable time. The order shall become final unless, within ten days after the date on which it was served, the person or persons named therein request a hearing before the Commission. Upon request, the Commission shall hold a hearing as prescribed in Article VI(d). In lieu of an order, the executive director may require that the alleged violator or violators appear before the Commission for a hearing at a time and place specified in the notice and answer the charges set forth therein.

(b) If, after hearing held pursuant to section (a), the Commission finds that a violation has occurred, it may

(1) affirm or modify the order of the executive director,

(2) issue an appropriate order or orders for the prevention, abatement, or control of the emissions involved or for the taking of other appropriate corrective actions, or

(3) retain jurisdiction and defer final action to permit the state air pollution control agency to effect a satisfactory remedy.

If, after hearing held pursuant to section (a), the Commission finds that no violation has occurred or is occurring, it shall rescind the order. Any order issued as part of a notice or after hearing may prescribe the date or dates by which the violation or viola-

tions shall cease and may prescribe timetables for necessary action to be taken to prevent, abate, or control the emissions.

(c) Nothing in this Compact shall prevent the Commission from making efforts to obtain voluntary compliance through warning, conference, or other appropriate means.

(d) It shall be unlawful for any person to fail or refuse to comply with any order issued by the Commission or the executive director. Any court of competent jurisdiction shall entertain and determine any action or proceeding brought by the Commission to enforce any order. The court may review the order and affirm it unless it is found to be arbitrary or capricious, in excess of the power conferred on the Commission by this Compact or other law, or not based on substantial evidence.

COMMENT: Article V provides the means by which the Compact or rules or regulations issued thereunder are enforced.[38] The executive director here assumes the role of police officer, as it is he who issues to a potential offender the order to remedy a violation. The person notified has a right to a hearing before the Commission, if he requests it within ten days of notice. Instead of issuing an order, the executive director may require the violator to appear for a hearing, a procedure which will probably be used when the Commission desires more information before it concludes that abatement is necessary. Any hearing so held will be in accordance with Article VI(d).

Article V(b) provides that, after any hearing held pursuant to V(a), the Commission shall decide whether or not a violation has occurred. If one has occurred, the Commission may affirm or modify the executive director's order, issue an order if the hearing was not held as an appeal from an order, or defer final action. The last course of action is included to allow settlement by the state agency in cases where this is more appropriate than action by the Commission. This allows some flexibility in dealing with violators and permits cooperation with the party states. If no violation is found, the Commission must rescind the order. Article IV(b)(10) gives the Commission the power to encourage voluntary compliance, and Article V(c) here specifies that the Commission may and should try to obtain voluntary compliance. This is particularly helpful in air pollution situations because the continuing nature of most violations permits the development of a working relationship between the polluter and the Commission.

Article V(d) makes failure to comply with an order unlawful, and provides for judicial enforcement of the orders issued. When the Commission goes to court to enforce the order, the scope of review of the court is the same as in Article VII. However, the procedure by which the Commission

38. Based on § 9 of the *Model State Air Pollution Control Act, supra* note 34.

obtains judicial enforcement of an order is substantially different from that prescribed for judicial review in Article VII.

ARTICLE VI. *Hearings.*

(a) No rule or regulation shall be issued, amended, or repealed by the Commission or executive director except after notice and hearing as provided in this Article. All hearings held by the Commission shall be open to the public and all testimony received shall be under oath and recorded in a written transcript. The recorded transcript shall be made available to any person upon payment of a reasonable charge as fixed by the Commission. This section shall not apply insofar as is necessary to prevent disclosure of secret processes or methods of manufacture and production.

(b) Hearings shall be held before one or more members of the Commission or before an officer or employee whom the Commission expressly designates to act as hearing officer. Any person conducting the hearing, and the executive director, may issue in the name of the Commission notices of hearings and subpoenas requiring attendance and testimony of witnesses and production of evidence relevant to any matter involved, and may administer oaths and affirmations and examine witnesses.

(c) At any hearing on rules or regulations, other than procedural rules issued pursuant to Article III(j), any person may appear and offer testimony, with or without counsel, subject to the reasonable rules which the Commission may prescribe. At least twenty days prior to a hearing, notice shall be published in a newspaper generally circulated in the area concerned and shall be mailed to the air pollution control agencies of each of the party states.

(d) At any hearing on an order issued pursuant to Article V, on an application for the issuance of a variance, or in any other case where permitted by a rule of the Commission, the person or persons subject to the order, applying for the variance, or designated in the rule, and the air pollution control agencies of the party states, shall be entitled to be parties. Each party shall receive notice by registered mail of the hearing at least twenty days prior thereto, and the notice shall be published in a newspaper generally circulated in the area concerned. Such notice

shall also be sent by regular mail to any person who has in writing requested notice of the hearing. Any party shall be entitled to appear in person or by representative, with or without counsel, make oral or written argument, offer testimony, and cross-examine witnesses. Any person aggrieved by the alleged air contaminants may submit written arguments. The executive director shall issue subpoenas at the request of any party and seek enforcement thereof in any court of appropriate jurisdiction.

(e) Nothing in this Article shall be construed to apply to any emergency procedure established by the Commission pursuant to Article IV(b)(5). However, within two days after the issuance of any emergency order, the Commission shall hold a hearing as prescribed in section (d), except that the requirements as to time of notice shall not apply.

COMMENT: The provisions of the hearings section are closely related to those regarding judicial review (Art. VII). The two sections taken together provide a more restricted system than that envisioned by the Indiana-Illinois Compact, but still provide an ample measure of due process for the parties and facts for the Commission.[39]

Article VI(a) describes the public nature of all hearings held before the Commission, whether on orders (Art. V(a)) or rules and regulations (Art. VI(c)). As in Article III (1), an effort is made to provide the maximum exposure of the Commission's operations as consistent with the desired protection of secret industrial processes. Article VI(b) is similar to the Indiana-Illinois law, but adds powers regarding duties of the presiding officers.[40]

Unlike the Indiana-Illinois statute[41] the hearing requirements here are divided into two categories, according to the type of action which is under Commission consideration. Their functions are best seen when Article VI(c) is contrasted with Article VI(d). In (c), notice is given in a rather general manner, while in (d) it is provided by registered mail to certain specified classes of persons. This is consistent with the nature of the proceedings in (d), which consist of a judicial proceeding directing specific persons to conform to rules or regulations issued pursuant to Article IV(b)(3). Similarly, the nature of the participation allowed at the two types of hearings differs. Because of the difficulty of defining in advance the persons who will have a legitimate interest in a rule or regulation of general applicability, (c) provides that "any person" may make his views known before the Commission. Note, however, that the Commission may prescribe rules regulating such presentations, and that there is

39. INDIANA-ILLINOIS COMPACT Art. V(a), (b), and (c).
40. *Id.* Art. V(b).
41. *Id.* Art. V(a), (b).

no inviolable right to an opportunity for oral argument.

In (d), the proceeding is more limited with regard to the types of persons who may participate, but those who are allowed to participate have more elaborate rights. A person subject to an order or applying for a variance shall always be considered a party. In addition, the Commission may designate as parties any persons involved in any other class of proceedings it may select. An example of this might be an application for a construction permit. Indeed, if found to be administratively feasible, the Commission might extend the privileges of the (d) hearing to cases where the result will not be applicable to a limited class of persons.

Persons who are designated as parties have broad rights (particularly to make oral argument and cross-examine witnesses) that cannot be diluted by action of the Commission. Also, persons who are affected by the air contaminants involved may participate, but are not denominated parties and therefore cannot make oral argument or cross-examination. The distinction is intended to prevent a quasi-judicial proceeding from becoming extremely complicated due to confusing and over-extended oral presentations and cross-examinations. If the Commission were to determine that there is little danger of such interferences with due process, it could designate "any person aggrieved" as a party, thus returning to the substance of the Indiana-Illinois Compact.[42]

Article VI(e) is required to avoid damaging delays in the issuance of emergency orders. Although the hearing procedure prior to the issuance of an order is dispensed with, the requirements of due process are met by the provision for a hearing almost immediately after the issuance of the order. If the order was improperly issued, it can be dissolved, and the person who was subjected to it will have been hampered in his operations for only a limited period of time.

ARTICLE VII. *Judicial Review.*

(a) Judicial review of an order of the Commission issued pursuant to Article V may be had by any party aggrieved by the order and any other person who submitted written arguments at the hearing on the order. This review may be had by filing with a court of competent jurisdiction a verified petition setting out the order and alleging specifically wherein the order is arbitrary or capricious, in excess of the power conferred on the Commission by this Compact or other law, or not based on substantial evidence. The petition for review shall be filed within twenty days after receipt of written notice that the order has been issued by the executive director or the Commission, whichever is later.

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42. *Id.* Art. V(c).

Written notice of the filing of the petition for review and a copy of the petition shall be personally served upon the Commission. Within fifteen days after filing the petition, the petitioner shall secure from the Commission a certified copy of the transcript of any hearing or hearings held in connection with the issuance of the order and file it with the clerk in the court in which the proceedings for review is pending. An extension of time in which to file the transcript may be granted by the court for good cause. Inability to obtain the transcript within the specified time shall be good cause. Failure to file the transcript within fifteen days, or to secure an extension of time therefor, shall be cause for the dismissal of the petition.

(b) No review of a Commission order shall be had except in accordance with the provisions of this Compact.

COMMENT: Judicial review of the Commission's actions is available in three ways: upon petition for enforcement pursuant to Article V, on appeal from the Commission's decision through Article VII, or an enforcement proceeding involving a state law as provided in Article IX. In Article VII, review of a rule or regulation is available only upon appeal of an order that has been issued requiring compliance with it. No direct appeal of a rule or regulation without an order is allowed.

The appeal procedure is open to persons who were parties to the proceedings leading to the issuance of the order. It is also available to persons who obtained standing to appeal by filing written arguments below. The latter procedure is similar to that followed in the Federal Communications Act, which provides that any person "aggrieved" by an order may appeal, but that persons who were not parties in the administrative proceeding must first file a petition for rehearing to obtain standing.[43] The method here established is somewhat more restrictive than that allowed in the Indiana-Illinois Compact ("any person aggrieved by any order"), but does provide adequate review for the persons most directly affected.

The standard for legality of the Commission's actions to be applied on appeal is intended to allow the Commission more discretion than the comparable Indiana-Illinois provisions.[44] Article V(c)(5) of that Compact, for example, allowed reversal when the court found that the action taken was "not within the purposes and guiding principles set forth in Article I of this Compact." It is felt that the standards employed in the present statute allow the Commission more freedom in determining whether actions in the complicated air pollution field are consistent with the compact's purposes. The procedures regarding filing of petitions and transcripts are taken from

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43. 47 U.S.C. §§ 402(b)(6), 405 (1958).
44. INDIANA-ILLINOIS COMPACT Art. V(c)(1)-(6).

the Indiana-Illinois Compact.[45]

No effort is made to define the court to which an appeal may be taken. Because the compact itself is not federal law,[46] it cannot confer jurisdiction on the federal courts to the exclusion of the state courts. On the other hand, a state statute, even though enacted by two states and approved by Congress, cannot deprive persons of their right to seek a remedy in the federal courts if diversity of citizenship is found to exist. A complicating factor for purposes of federal diversity jurisdiction is the ambiguity of the citizenship of the Commission itself. Again, for the purposes of the federal judicial system, a state statute cannot conclusively determine the citizenship of one of the state's agencies. Therefore, it is best to allow the judicial system to work out these issues as the cases arise.

Except for the time periods involved, the remainder of Article VII closely follows Article V of the Indiana-Illinois statute. An additional phrase is required by the conferring on the executive director of the power to issue orders pursuant to Article V. It must be made clear that the petition for judicial review need not be filed within the twenty-day period after receipt of the order of the executive director if the named person requests a hearing before the Commission. Therefore, the phrase "whichever is later" is added.

ARTICLE VIII. *Right of Entry.*

Any duly authorized officer, employee, or representative of the Commission may enter and inspect any property, premise, or place at any reasonable time for the purpose of investigating either an actual or potential source of air contaminants or of ascertaining the state of compliance with this Compact and rules and regulations in force pursuant thereto. No person shall refuse entry or access to any authorized representative of the Commission who requests entry for inspection purposes and presents appropriate credentials, nor shall any person obstruct, hamper, or interfere with any such inspection. If requested, the owner or operator of the premises shall receive a report setting forth the levels of emissions and any other facts which relate to compliance status. Nothing in this Article shall be construed to authorize entrance to or inspection of private homes or places of residence unless a warrant has been obtained.

COMMENT: The Article providing the right of entry to authorized

45. *Id.* Art. V(d).

46. *See* F. ZIMMERMAN & M. WENDELL, *supra* note 5, at 7, *citing* Hinderlider v. La Plata River and Cherry Creek Ditch Co., 304 U.S. 92 (1938).

Commission personnel is largely drawn from section 7 of the Model State Act.[47] The first sentence of the Article requires only that an authorized agent of the Commission exert his right of entry (a) at a reasonable time and (b) with the purpose to investigate an actual or suspected source of air pollution or to ascertain whether or not a person has complied. The Article makes clear that entry is a matter of right and not subject to the permission of any person, provided that a warrant must be obtained for private homes or places of residence. The private home exception is not provided in the Model State Act. However, as noted by Chief Justice Warren in a recent argument before the Supreme Court, there is a genuine need to require various health inspectors to obtain a warrant from a magistrate before entering private homes.[48] In addition to the danger of abuse by criminals impersonating officers, the fundamental right of privacy is believed to justify the requirement of a warrant in this limited situation. In multiple dwellings, particularly the high-rise apartment, a warrant should be required only for entry to individual places of residence; there should be free access to common hallways or lobbies and to any common incinerator.

ARTICLE IX. *Concurrent Jurisdiction.*

Nothing in this Compact shall limit or otherwise affect the powers of either party state or any of their subdivisions to enact and enforce laws or ordinances for the prevention, abatement, or control of air pollution, provided that such laws or ordinances are not inconsistent with the provisions of this Compact or any rules, regulations, or orders issued thereunder. Upon request by any person who alleges the inconsistency of a law or ordinance to which he is subject, the Commission shall rule on the consistency of the law or ordinance. In any proceeding in a court of either of the party states in which the consistency of a state law with any rule, regulation, or order issued pursuant to this Compact is involved, the Commission may intervene. Unless the court finds that the position expressed by the Commission is arbitrary or capricious, it shall be bound by that position on the issue of consistency. The court may, however, review the rule, regulation, or order to determine if it is arbitrary or capricious, in excess of the power conferred upon the Commission by this Compact, or not based on substantial evidence.

COMMENT: Article IX is similar to Article VIII of the Indiana-

47. THE COUNCIL OF STATE GOVERNMENTS, 26 SUGGESTED STATE LEGISLATION A-18 (1967).
48. N.Y. Times, Feb. 16, 1967, at 35, col. 1.

Illinois Compact in providing that regulatory activities of the party states shall not hamper the administration of the Compact. It recognizes that air pollution control is a joint undertaking and encourages the party states or their political subdivisions to supplement the Commission's efforts. However, the real need for uniformity demands that no such law shall be inconsistent with the rules, regulations, or orders of the Commission or any Local Authority created under Article IV(c).

The present compact goes much further than the Indiana-Illinois proposal, however, in providing a system for rectifying inconsistencies. It should be noted that only the state statutes are diluted by this Article. All persons remain obligated to comply with any order issued by the compact agencies; escape obviously cannot be had by a plea of compliance with a state statute, unless such statute is merely more strict than the regulation issued by the Commission or Local Authority. In that case, the proper plea would be one of compliance with the Commission's lesser standard, rather than an assertion of compliance with the complementary state statute.

A difficulty arises, however, if a person is prosecuted by the state for failure to comply with the state's law, and the defense is made that such law is inconsistent with a regulation of the Commission and therefore invalid. This is the only situation in which any judicial review of the Commission's opinion on consistency could be obtained, because a person is obligated to comply with Commission (or Local Authority) regulations regardless of state law. The Commission would not necessarily be a party to such a state proceeding without the provision in Article IX that allows it to intervene in the state court proceeding. Upon intervention, the Commission may express its opinion on the consistency, and the state court is bound by it unless the Commission's position is arbitrary or capricious. It is also provided that the court may determine the legality of the Commission regulation in question, using the same standards of review provided in Article VII. Because the state could not otherwise obtain review of the Commission's power to issue the regulation if its own law is found to be inconsistent, review is provided in this section. This right to review would be required if the state's law were held inconsistent, and the polluter does not appeal the Commission's order, because upon a successful appeal he would then be subjected to a more rigid state requirement.

It is clear that no such problem arises if the Commission's order is alleged to be inconsistent with some federal regulation. Not only does the present Article IX not cover such a situation, but the compact could not provide that the Commission's authority overcomes the federal law, due to the supremacy clause. No provision is made, therefore, for the Commission to intervene in a federal proceeding.

ARTICLE X. *Finances.*

(a) The Commission shall submit to the Governor or desig-

nated officer or officers of each party state, for presentation to the legislature, a budget of its estimated expenditures for the period required by the laws of that state.

(b) Each of the Commission's budgets of estimated expenditures shall contain specific recommendations for the amount to be appropriated by each of the party states. Aside from the support that may be available to the Commission pursuant to Article III, sections (h) and (i), the cost of operating and maintaining the Commission shall be apportioned between the party states, one-half according to the relative value of the real estate of each state within the Compact Area as determined by the Commission and one-half in the proportion that the population of each state bore to the total population of the Compact Area at the last preceeding federal census.

(c) The Commission may meet any of its obligations in whole or in part with funds available to it under Article III (i) of this Compact, provided that the Commission takes specific action setting aside such funds prior to the incurring of any obligation to be met in whole or in part in this manner. Except where the Commission makes use of funds available to it under Article III (i), the Commission shall not incur any obligations prior to the allotment of adequate funds.

(d) The expenses and any other costs incurred by each member of the Commission shall be met by the Commission in accordance with such standards and procedures as it may establish under its bylaws.

(e) Upon establishment of a Local Air Quality Authority pursuant to Article IV(c), the Authority shall submit to the Commission a budget of its estimated expenditures for any period which the Commission may require. Upon approval of the Authority's budget, the Commission shall appropriate the amount approved from its general funds. The Authority shall follow accounting and auditing procedures as the Commission shall require.

(f) The Commission shall keep accurate accounts of all receipts and disbursements. The receipts and disbursements of the Commission shall be subject to the auditing and accounting procedures established under its bylaws. However, all receipts and disbursements of funds handled by the Commission shall be

audited yearly by a certified or licensed public accountant and the report of the audit shall be included in and become a part of the annual report of the Commission.

(g) The accounts of the Commission and any Local Air Quality Authorities shall be open at any reasonable time for inspection by duly constituted officers of the party states and by any persons authorized by the Commission or the Local Air Quality Authorities.

(h) Nothing contained herein shall be construed to prevent compliance by the Commission or Local Air Quality Authority with laws relating to audit or inspection of accounts by or on behalf of any government contributing to the support of the Commission or Local Air Quality Authorities.

COMMENT: This Article provides for the appropriation and accounting of funds for the interstate Commission and the Local Authorities created under Article IV(c). The basis of this Article is Article IX of the present Indiana-Illinois Compact. However, the method chosen for the appropriation of funds for the Commission is different than that of the Indiana-Illinois Compact, which provided for equal support from the party states. The determination of the amounts allocable to each state on the basis of population and property value is more justified than an equal division, because the states should share the burden of the costs in proportion to the benefit received, which will be in terms of individual health and preservation of property values. In an important change, section (b) allows the Commission to resolve disputes over the property values of each state in case the methods of assessment differ. It should be remembered that all these funds from the party states are increased by funds received from the federal government under the Clean Air Act.[49]

It is felt that state support of the Commission is preferable to county support because (1) fewer parties (two) need to be persuaded as to the size of their fair share, (2) direct county support might cause a very unpopular increase in county tax rates, and (3) county tax rates may be limited by state constitutions or statutes.

Direct Commission support of a Local Authority is preferable to county support because (1) direct county support would not provide an incentive to create an Authority, due to the increase in county tax rates, (2) it provides the most effective control of local programs by the Commission due to the threat of cessation of funds, and (3) it precludes excessive dispute among counties in the Authority over the proper shares and prevents total non-compliance in fiscal contribution by one county. This would seriously disrupt the administration of an effective local program.

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49. 42 U.S.C.A. § 1857a (1964).

Another suggestion is that the Commission be financed one-half by the states and one-half by the counties within the Compact Area. Upon formation of an Authority, the counties within its jurisdiction would support it and not the Interstate Commission. This plan has the advantage of creating no financial disincentive for the creation of a locally administered program. At least until the formation of an Authority it has the same disadvantages outlined above when discussing the raising of money in the counties. Also, since the local agency would be a smaller model of the Interstate Commission and probably not as efficient, the air pollution control per dollar would be less.

As a third alternative, the Interstate Commission might be supported by a direct federal tax on the Compact Area. This is the approach advocated by Robert G. Dixon, Jr.,[50] based on the case of *Binns v. U.S.*[51] Dixon argues that the federal government can tax a specific area (in this case the compact area) and, so long as the expenses of governing the area exceed the tax collected, no constitutional limitations are encountered. This analysis of *Binns* overlooks the fact that this case involved Alaska, when still a territory, and Congress' power to regulate territories and other property owned, not the federal taxing power. The case does not offer a precedent for a direct federal tax. And even if it did, the political appeal of such action is doubtful.

The advantages and disadvantages of these examples frequently overlap. Therefore the choice made was based on administrative simplicity, effectiveness of pollution control, and political appeal.

Article X (c), (d), (g), and (h) are substantially the same as the Indiana-Illinois Compact[52] and provide the mechanics for the accounting and other financial matters of the Interstate Commission.

Article X (e) and (f) provide guidelines for the Commission in the formation and financing of Local Air Quality Authorities. Since the Commission will provide, by donation, most of the local agency's funds (any other funds being private donations or various governmental grants,) the Commission is given power to provide the other details of the finances and accounting through rules and regulations.

ARTICLE XI. *Effective Date and Termination.*

This Compact shall enter into force and effect when enacted into law by the states of Missouri and Illinois. The Compact shall continue in force and remain binding upon each party state

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50. Dixon, *Constitutional Bases for Regionalism: Centralization; Interstate Compacts; Federal Regional Taxation,* 33 GEO. WASH. L. REV. 47 (1964).

51. 194 U.S. 486 (1904).

52. Article X(c), (d), (g), and (h) correspond to INDIANA-ILLINOIS COMPACT Art. IX (c), (d), (f), and (g), respectively.

until one year after it is expressly repealed by the legislature of either party state.

COMMENT: Article XI provides that the compact shall become effective upon being enacted into law by the legislatures. There is no need for the governor of each state to formally "execute" the compact, even though he may still have to sign the enacting legislation for it to become a law. Zimmerman and Wendell point out that the requirement for execution was originally thought necessary due to the analogizing of interstate compacts to treaties. It is clear that it is not necessarily required and is dispensed with in both the Indiana-Illinois Compact and this one.[53]

There was some argument that, if the Compact were terminated, any orders issued prior to termination should still be enforceable so that the work of the Commission would not be undone. Article X(b) of the Indiana-Illinois Compact so provides. It was decided, however, that this would be inequitable, since some similarly situated polluters might have been proceeded against, and thus be subject to an order, while others were not. If orders survived the termination of the Compact, then those previously subject to orders would have to continue compliance, while the others would never be subject to similar requirements. The only equitable solution is that when the Compact is terminated, all rules, regulations, and orders become void simultaneously. The section has therefore been eliminated.

ARTICLE XII. *Construction and Severability.*

It is the legislative intent that the provisions of this Compact be reasonably and liberally construed. The provisions of this Compact shall be severable and if any phrase, clause, sentence, or provision of this Compact is declared to be contrary to the constitution of either party state or the United States, or the applicability thereof to any government, agency, person, or circumstance is held invalid, the validity of the remainder of this Compact and the applicability thereof to any government, agency, person, or circumstance shall not be affected thereby.

[If any provision of this Compact or the application thereof to any person is held invalid, the invalidity shall not affect other provisions or applications of the Compact which can be given effect without the invalid provision or application, and to this end the provisions of the Compact are severable].

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53. *See* F. ZIMMERMAN & M. WENDELL, *supra* note 18, at 12.

COMMENT: The Article is a standard form.[54] The language is taken directly from the Interstate Compact on the Placement of Children. The second alternative paragraph is patterned on the model severability section recommended by the National Commissioners on Uniform State Laws. It is intended to save the remaining parts of the Compact in the event that a court finds part of it invalid.

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54. Recommended *id.* at 35.

A STATE STATUTE TO PROVIDE CONTROLS FOR EQUITABLE DISTRIBUTION OF WATER

I. INTRODUCTION

Water is almost unique in importance as a natural resource. Of the three prime requisites for the preservation of life — air, water, and food — water is the one currently in shortest supply.

In the eastern half of the United States in past years water has been plentiful. Growth in population and increased water use per capita, however, have led to water shortages in some areas of almost every state. Among the states which have enacted water rights legislation are water-rich areas such as Florida,[1] Maryland,[2] Mississippi,[3] Iowa,[4] and Minnesota.[5] These states face problems of allocation of water resources. Some other states have enough water in at most a few areas and must carefully watch all current uses.

While water shortages pose a problem, they appear susceptible to solution. Many water uses such as water power and recreation are only shifts in the position of water or use of the water in its natural flow. These uses can be increased without substantially affecting the amounts available for other purposes. In addition, present patterns of water use are highly inefficient due to wasteful allocation and pollution. An administrative system which can effectively check the misallocation and pollution will insure the best possible supply of water for the future. An administrative system which gathers information about each region's hydrological cycle[6] can give greater assurance that with proper management supplies of water will continue to be available.[7]

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1. FLA. STAT. §§ 373.071-.251 (1965).
2. MD. ANN. CODE art. 96A §§ 1-58 (Supp. 1966).
3. MISS. CODE ANN. § 5956 (Supp. 1964).
4. IOWA CODE § 455A.1 (Supp. 1966).
5. MINN. STAT. § 105.71-79 (1964).
6. "The term 'hydrologic cycle' is applied to the march of events marking the progress of a particle of water from the atmosphere through various environments upon or under the earth's surface and back to the atmosphere again." UNIV. OF MICH. LAW SCHOOL, WATER RESOURCES AND THE LAW 8 (1958).
7. Piper & Thomas, *Hydrology and Water Law: What Is Their Future Common Ground?* in UNIV. OF MICH. LAW SCHOOL, WATER RESOURCES AND THE LAW 7 (1958).

II. BACKGROUND OF THE STATUTE

Most early immigrants to the United States came from humid regions, especially Europe. On the east coast they found a relative abundance of water. With little cause for rationing water and little ability to transport it outside the immediate environs, they adopted the doctrine of riparian rights used in areas from which they came.[8] Riparian rights doctrines[9] take many different forms, but common to all is the notion that one riparian's use is limited by the needs of other riparians. As the water supply changes, the amount of water riparian owners may use may change. As the population moved west where water was not always abundant, means for transporting water were of necessity developed, use was more restricted, and the riparian rights doctrine was rejected in favor of a system of prior appropriation.[10] With shortages for the first time in the eastern half of the United States, the theory of riparian rights is being reexamined and in many jurisdictions replaced by administrative systems that combine advantages of both riparian and prior appropriation theories.

Critics claim the riparian theory is inefficient for two reasons. First, water use is restricted to land adjacent to a water course. The use must be within the watershed[11] and is limited to the smallest trace abutting the watercourse held under one chain of title leading to the present owner.[12] In many states land sepa-

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8. The doctrine of reasonable use, the most common of riparian rights doctrines, was originally a civil-law concept. The common law initially followed prior appropriation, but by the 1830's had switched to a natural flow theory.

9. "The riparian doctrine provides that the owner of land that adjoins or is traversed by a natural watercourse (called a riparian owner) has certain rights to use its waters that accompany the ownership of such land. These are rights of use, not ownership, of the flowing waters. But they ordinarily are regarded as property rights and entitled to appropriate legal protection." H. H. Ellis, *Development and Elements of the Riparian Doctrine with Reference to the Eastern U.S.* (1960), in UNIV. OF MISSOURI COLLEGE OF AGRICULTURE RESEARCH BULLETIN 889, WATER-USE IN MISSOURI 25 (1965).

10. States with a prior appropriation approach include Arizona, California, Colorado, Idaho, Kansas, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, and Wyoming. "The doctrine of prior appropriation... holds that title to all water rests in the state or the 'public,' that individuals can appropriate water for beneficial use, that as between appropriators 'the first in time is the first in right,' that the right of water use is forfeited after a statutory period of nonuse, but the right is neither contingent nor proportional to landownership." UNIV. OF MICH. LAW SCHOOL, WATER RESOURCES AND THE LAW 19 (1958).

11. Stratton v. Mt. Hermon Boy's School, 216 Mass. 83, 103 N.E. 87 (1913).

12. *E.g.*, Gozales v. Arbelbide, 155 Cal. App. 2d 721. 318 P.2d 746 (3rd Dist. 1957).

rated from the watercourse by a road or railway is not riparian.[13] Those who are not riparian owners can only sit and watch as the unused water flows out to sea.

The second disadvantage of the riparian system is the indefiniteness of each riparian owner's rights. A company thinking of establishing a plant along a small river can not be guaranteed any absolute amount of water. Its allocation will vary with the changing demand and the supply available.[14] While this variation fits with notions of justice, it may discourage investment.

The administrative approach many states are moving towards today[15] attacks the first criticism by not restricting use to riparian owners. Anyone who applies will be considered for a permit. In granting a conditional right for a specified number of years, the administrative approach reduces the uncertainty of the riparian doctrine.

First in time, first in right is the essence of prior appropriation. Uses once established may be established forever.[16] Since some change in the desirable water use allocation is always expected, the greater flexibility of an administrative approach is preferable to prior appropriation.

The current popularity of the administrative approach stems from a number of other expected advantages. (1) A regulatory agency can gather the information necessary to plan for future needs. (2) A regulatory agency can establish and administer restrictions on water use in the case of an extreme water shortage. (3) An agency can formulate a comprehensive plan for allocation whereas a court is better suited to settling disputes between individual water users. (4) A regulatory agency can evaluate the public interests often unrepresented in court such as the desire to preserve recreation and wild life uses. (5) Through its greater expertise a regulatory agency can help the courts in formulating new standards in water rights law.

If some protection against arbitrary and capricious government action is given, an administrative system offers an improvement on both riparian and prior appropriation theories.

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13. Morris v. United States, 174 U.S. 196 (1898); McCloskey v. Pacific Coast Co., 160 F. 794 (9th Cir. 1908); Webb v. Demopolis, 95 Ala. 116, 13 So. 289 (1893); Cook v. City of Burlington, 30 Iowa 94 (1870).

14. *See* discussion in Trelease, *Coordination of Riparian and Appropriative Rights to the Use of Water*, 33 TEXAS L. REV. 24, 67-9 (1954).

15. *See, e.g.*, notes 1-5 *supra*.

16. *E.g.*, Lux v. Haggin 69 Cal. 255, 10 P. 674 (1886).

III. THE STATUTE IN PERSPECTIVE

Minnesota,[17] Maryland,[18] Mississippi,[19] Iowa,[20] and Florida,[21] are the states previously riparian which have attempted a comprehensive legislative solution to the water rights problem.[22] In addition the Legislative Research Center at the University of Michigan Law School has drafted a Model Water Use Act.[23] These statutes can be compared with the proposed statute in terms of the types of water regulated, the uses regulated, and the manner of regulation.

Historically ground water has been treated as distinct from surface water.[24] Recent legislation and the proposed statute[25] have moved toward treating the two types of water alike.[26] All water resources are part of the hydrological cycle. If subsurface water[27] is left unregulated, as in Mississippi,[28] the user can escape direct regulation by drawing off ground water. His use of subsurface water may result in a depletion of surface water elsewhere just as a direct taking from a surface stream would. The proposed statute includes all waters of the state within the jurisdiction of the Board for investigation and emergency purposes. Under the permit system, however, it regulates only channeled as opposed to diffuse water. Uses of diffuse water[29] are assumed to be insubstantial and to fall within the 5000-gallon-per-day unregulated use of section 501.

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17. MINN. STAT. § 105.71-79 (1964).
18. MD. ANN. CODE art. 96A §§ 1-58 (Supp. 1966).
19. MISS. CODE ANN. § 5956 (Supp. 1964).
20. IOWA CODE § 455A.1 (Supp. 1966).
21. FLA. STAT. §§ 373.071-.251 (1965).
22. Examples of statutes in prior appropriation states are KAN. GEN. STAT. ANN. §§ 82a-701-725 (1964); ORE. REV. STAT. § 536.210.590 (1965). *See* note 10 *supra* for other prior appropriation states.
23. The Model Act is set forth in UNIV. OF MICH. LAW SCHOOL, WATER RESOURCES AND THE LAW 533 (1958).
24. Acton v. Blundell, 12 Mees. & W. 324, 152 Eng. Rep. 1223 (1843).
25. *E.g.*, section 102(k), Bureau Draft; Iowa Code § 455 A.1 (Supp. 1966).
26. Ground water is any water occurring beneath the surface of the earth other than subflow and underground streams. Surface water is all water occurring on the surface of the earth except diffused surface water. The Model Act, *supra* note 23.
27. Subsurface water is all water occurring below the surface of the earth including ground water. The Model Act, *supra* note 23.
28. MISS. CODE ANN. § 5956-01(c) (Supp. 1964).
29. Diffused surface water is water occurring generally upon the surface of the earth, other than contained water. Contained water is underground streams, water upon the surface of the earth in bounds created naturally or artificially, and the subflow of such water, including, but not limited to, rivers, creeks, canals, streams, lakes, and reservoirs. The Model Act, *supra* note 23.

All of the other statutes have exempted domestic uses.[30] Exemption in the proposed statute is instead by volume. Section 501 allows the use of up to 5000 gallons per day before a permit is required. This figure was chosen to exempt domestic uses as well as non-domestic uses too small to be worth the administrative burden.

The temporary three-year exemption of section 502 is unique to the proposed statute. It and perhaps the Iowa statute[31] are the only ones which do not exempt existing water uses. These changes from prior statutes will hopefully give the Water Resources Board less of an administrative burden in handling smaller uses, yet greater authority over existing uses whose regulation is necessary to carry out the purposes of the statute. A survey of water uses would determine whether or not the present approach and the 5000-gallon-per-day figure are suitable.

The Florida statute[32] gives the broadest delegation of authority. Where other states have spelled out detailed regulatory procedures, Florida has granted its conservation board power to do whatever is necessary to achieve the aims of the act. It is no longer necessary to make such a broad delegation because more specific, clearly defined standards have been developed for the proposed statute. The proposed statute is also narrower than the Mississippi[33] and Iowa[34] statutes allowing changes in permits after original approval only for very limited reasons (*see* section 503(b)). Security for potential investors is of greater value than the potentially unrestricted increase in the Board's flexibility provided by clauses such as Mississippi Code Ann. § 5956-05: "Upon good cause shown, the board may modify or terminate any appropriation at any time."

The proposed statute is designed to balance the needs of cer-

30. IOWA CODE § 455.A1 (Supp. 1966); MD. ANN. CODE art. 96A § 11 (Supp. 1966); MINN. STAT. § 105.41; MISS. CODE ANN. § 5956-04a (Supp. 1964); MODEL WATER USE ACT § 301 (1958); Domestic use means any use of water for personal need and for household purposes, including (a) uses for drinking, bathing, cooking, and sanitation; (b) uses for maintaining household pets and livestock kept for household sustenance; and (c) uses for heating and cooling private residences and for maintaining non-commercial lawns ,gardens, and orchards. The Model Act, *supra* note 23.

31. The Iowa Act is ambiguous as to whether existing uses are regulated. Section 455A.18-10 preserves "vested rights," but nowhere is this term defined. According to Jeffrey O'Connell in *Iowa's New Water Statute — the Constitutionality of Regulating Existing Uses of Water,* 47 IOWA L. REV. 549, 634 (1962), the act has been administered to include uses within those regulated.

32. FLA. STAT. §§ 373.071-.251 (1965).

33. MISS. CODE ANN. § 5956 (Supp. 1966).

34. IOWA CODE § 455 A.28 (Supp. 1966).

tainty for investors with the requirements of flexibility for the Board to achieve a solution that will be effective without being harsh.

IV. CONSTITUTIONAL PROBLEMS

It still must be questioned whether the proposed statute violates due process provisions of federal or state constitutions or whether it is a taking of property for public use without just compensation. No recent water rights legislation has been ruled unconstitutional; but only the Iowa statute,[35] which has not been tested, resembles the present one in regulating existing uses, and regulation of these uses is the part of the statute most threatening to due process.

The proposed statute should be within the police power of the states for three reasons:

(1) "The test of constitutionality of economic regulation should be (1) whether it is rationally designed to help solve the problems it purports to affect and (2) whether the change in property rights affected by the legislation is so drastic and unexpected that fairness calls for compensation to those whose rights are affected. It would seem to follow that to the extent rights are uncertain to begin with, they are more subject to changes by regulatory legislation under the police power without being constitutionally impaired."[36] Riparian rights are highly uncertain. They are only usufructuary rights — rights to use, not ownership. These rights have always been subject to change with changes in the total water supply.[37] State and federal governments have supervening rights for such purposes as navigation.[38] Riparian rights have always been subject to limitations which may be just as drastic as the proposed ones. The regulation of existing uses should be constitutional since existing uses are too uncertain to be property rights in the constitutional sense.

(2) Property values reflect potential as well as existing uses. Regulation of potential uses in constitutionally tested statutes[39] should be no less a taking of property than the regulation of existing uses in this Act. Since other statutes have been upheld,

35. MISS. CODE ANN. § 5956 (Supp. 1964).
36. O'Connell, *supra* note 31.
37. *See* note 14 *supra*.
38. Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824); United States v. Willow River Power Co., 324 U.S. 499 (1945).
39. *E.g.*, California-Oregon Power Co. v. Beaver Portland Cement Co., 295 U.S. 143 (1935).

the proposed draft should be, too.

(3) Any resource as vital to the public good as water must be subject to state economic regulation under the police power. Cases upholding legislation exempting existing uses have described the state's power in such terms. In *In re Willow Creek,*[40] the state court upheld an Oregon statute establishing a prior appropriation system in a previously riparian area, saying that water rights "are subject to such reasonable regulations as are essential to the general welfare, peace and good order of the citizens of the state." Close parallels can be found in regulation of oil and gas resources.[41] If this form of regulation can be justified as necessary for the public good, water rights legislation should be equally valid.

Although no court has ruled on the Iowa statute, which poses the same constitutional questions as the proposed statute, at least one authority, Jeffrey O'Connell,[42] argues that the legislation should be upheld, using most of the arguments summarized above.

V. THE STATUTE

Article I. Short Title and Definitions

Section 101. *Short Title.*

This Act shall be known and may be cited as the Water Resources Act.

Section 102. *Definitions.*

(a) "Applicant" means a person who applies for a permit under this Act.

(b) "Aquifer" means a specific, geological, subsurface, water-bearing formation having reasonably ascertainable boundaries.

(c) "Average daily use" means the total use of water during a given period of time divided by the total number of days during that period.

(d) "Beneficial use" means a water use that is reasonable and consistent with the public interest in the proper utilization of water resources and with the policy of this Act.

(e) "Board" means the Water Resources Board established by section 301.

40. 74 Ore. 592, 617, 144 P. 505, 514 (1915).

41. *Upheld* in Ohio Oil Co. v. Indiana, 177 U.S. 190 (1900). *See also* King, *Regulation of Water Rights Under the Police Power,* in Univ. of Mich. Law School, Water Resources and the Law 285-90 (1958).

42. O'Connell, *supra* note 31.

(f) "Permit" means the written authorization issued by the Board for a beneficial use of water resources.

(g) "Permittee" means the person who obtains a permit from the Board as required by this Act, or that person to whom such permit may be transferred in accordance with section 505.

(h) "Person" means any natural person, partnership, association, corporation, government, political subdivision of a government, governmental agency, or other legal entity.

(i) "Pollution" means any alteration of the physical, chemical, or biological properties of the water resources, including change of the temperature, taste, or odor, or the addition of any liquid, solid, radioactive, gaseous, or other substances, or the removal of such substances which will render the water resources unsatisfactory under the standards established in conjunction with 33 U.S.C. 466g(c) (Supp. 1966).

(j) "Watercourse" means a lake, river, creek, or other natural body of water, a ditch or channel having definite banks and bed with visible evidence of flow or occurrence of water except such lakes or ponds without outlet to which only one landowner is riparian.

(k) "Water resources" means all water occurring on or below the surface of the ground.

(l) "Water use" means a diverting, pumping, impounding, or other taking of water directly from an aquifer or watercourse or a pollution of the water resources of the state.

(m) "Water user" means a person who enjoys a water use.

COMMENT: The definition of "Aquifer" is taken from the draft of a Missouri bill prepared by the Missouri Water Resources Board (Clifford P. Summers, Executive Director). Withdrawal of water from an aquifer above the exempted quantity limits requires a permit under section 501.

"Average daily use" is the standard for comparison of water use before and after the date on which permits will be required under sections 501 and 502. By using a daily standard, it is hoped that seasonal distortions of water use will be minimized. Since the standard is an average one, the total use of water in any given period is still of utmost importance; thus if a plant which had been operating five days per week decides to go to a six-day operation, it will need a new permit if the total amount of water used is more than the amount specified in the permit, even though the amount used on the sixth day is not more than the amounts used on each of the other five.

"Beneficial use" covers every case of constructive use of water and excludes all depleting uses and waste. The Board will grant permits only to

those who have or propose to have a beneficial use of water. The definition used here is a shortened version of the one in the Model Water Use Act, section 102.[43]

"Person" is intended to be all inclusive, encompassing both private and public legal entities as well as natural persons.[44]

The definition of "pollution" is taken from the Model Water Use Act, section 102. Although the Act is primarily concerned with the control of the quantity of water use, the Board, under the Act, will have incidental powers to control the quantity of the water. If the state should choose to set up a comprehensive program of quality control, it could use the existing Board as the watchdog agency.

Under 33 U.S.C. 466g(c) (Supp. 1966), by June 30, 1967, each state is to submit a letter of intent that the state will adopt water quality criteria applicable to interstate waters. If the state does not file the letter of intent, or does not set up water quality criteria, or if the criteria are not approved by the Secretary of Health, Education, and Welfare, the Secretary can promulgate standards. These standards will then go into effect six months after promulgation unless the state has adopted water quality criteria which are approved by the Secretary.

The standards for water quality in this definition are the standards of the state approved or established by the Secretary with respect to interstate waters. If the quality of the water after release by the water user conforms to those standards, the use of the water should not be considered a polluting use.

In effect, this definition provides that the minimum quality criteria for all the waters of the state must be those standards established or approved for interstate waters of the state.[45]

"Watercourse" includes all bodies of water whether natural or artificial except those which have no outlet and are completely enclosed by a single person's property.[46]

The definition of "water resources" includes all the waters of the state except atmospheric water. It encompasses all waters whether or not of the type which is regulated by the permit system; this gives the Board power to make all inclusive studies of the waters of the state without giving it the authority to regulate all the water by the permit system.[47]

"Water use" includes both beneficial uses and pollution and waste.

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43. *See* IOWA CODE § 455A.1 (Supp. 1966); MISS. CODE ANN. § 5956-01(e) (Supp. 1964; CAL. WATER CODE ANN. §§ 100, 101 (1956); KAN. GEN. STAT. ANN. §§ 82a-701, 82a-703 & 704, 82a-706 & 707 (1964).

44. *See* MODEL WATER USE ACT § 102(k) (1958); CAL. WATER CODE ANN. § 401(b) (1956); IOWA CODE § 455A.1 (Supp. 1966); N.Y. PUBLIC HEALTH LAW § 1202(a) (Supp. 1966).

45. For comparable definitions *see* ARK. STAT. § 82-1901(5) (Supp. 1965); MD. ANN CODE art. 669, § 34 (Supp. 1966); OHIO REV. CODE ANN. § 6111.01(A) (Supp. 1966); ORE. REV. STAT. § 537.515(4) (1965); 35 PA. STAT. ANN. § 691.1 (1964).

46. For a comparable definition *see* IOWA CODE § 455A.1 (Supp. 1966).

47. For comparable definitions *see* MODEL WATER USE ACT § 102(s) (1958); IOWA CODE § 455A.1 (Supp. 1966); N.Y. PUB. HEALTH LAW § 12026 (Supp. 1966).

ARTICLE II. POLICY

SECTION 201. *Declaration of Policy and Standards.*

(a) In view of the rapid growth of population, agriculture, industry, and other economic activities, the water resources of the State must be protected, conserved, and controlled to assure their reasonable and beneficial use in the interest of the people of the State. Therefore, it is declared to be the policy of the State that

(1) the development, utilization, and control of all water resources shall be directed to make the maximum contribution to the public benefit, and

(2) the State, in the exercise of its sovereign power, acting through the Water Resources Board established in section 301 of this Act, should control the development and use of the water resources of the State so as to effectuate full utilization, conservation, and protection of the water resources of the State.

(b) The legislature hereby makes the following findings concerning the development, utilization, and control of the water resources of the State:

(1) The development, utilization, and control of the water resources of the State are vital to the people in order to assure adequate supplies for domestic, industrial, power, agricultural, and other beneficial uses.

(2) The development and utilization of water resources must be regulated to assure that the water resources of the State are employed for beneficial uses and not wasted.

(3) The regulation of the development and utilization of the water resources of the State is essential to protect beneficial uses and to assure adequate supplies for beneficial users.

(4) The water resources of the State must be protected and conserved to assure adequate supplies for public recreational purposes and for the conservation of wildlife and aquatic life.

(5) The water resources of the State must be protected from pollution in the interest of the health and safety of the public.

(6) The water resources of the State can best be utilized, conserved, and protected if utilization thereof is restricted to

beneficial uses and controlled by a state agency responsible for proper development and utilization of the water resources of the State.

(7) Planning for the development and utilization of water resources is essential in view of population growth and the expanding economic activity within the State.

COMMENT: The wording used here is a modified version of section 101 of the Model Water Use Act. The section is general so as to give the Board an area of concern which is broad even though its powers are more limited. The Water Resources Board must act within the framework of the policy declarations set out in the section. The policy declarations include: that water must not be wasted, that the water resources should be used for the public good, and that the development of the resources should proceed upon a rational rather than a haphazard system.[48]

ARTICLE III. THE WATER RESOURCES BOARD

SECTION 301. *Establishment of the Board.*

There is hereby established a Water Resources Board consisting of five members appointed by the Governor and eligible for reappointment. If for any reason a vacancy occurs the Governor shall appoint a new member to fill the unexpired term.

COMMENT: The present version of Article III is intentionally concise. The structure of the Board should be in accordance with the current practice in the state of enactment. Each state may wish to include supplemental or replacing provisions. Section 301 establishes the administrative agency which will regulate the water resources of the state. The power of appointment is given to the Governor. Some states may wish confirmation of appointees by the Senate; others may wish the Governor to appoint a chairman. No quorum provision is included: states enacting this statute should either provide quorum figures, or allow the Board to determine the quorum.[49]

SECTION 302. *Term and Compensation of Board Members.*

(a) The first five appointments made under this Act shall be for terms of one, two, three, four, and five years respectively. Each subsequent appointment shall be for a term of five years.

(b) Each Board member shall be entitled to compensation of ..... per day.

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48. This provision is based upon MODEL WATER USE ACT § 101 (1958). For comparable provisions *see* IOWA CODE § 455A.2 (Supp. 1966); MD. ANN. CODE art. 66c, § 718 (Supp. 1966); MISS. CODE ANN. § 5956-01 (Supp. 1964).

49. For comparable statutory provisions *see* MD. ANN. CODE art. 66C § 15 (Supp. 1966); MINN. STAT. § 105.71 (1965); MISS. CODE ANN. § 5956-08 (Supp. 1964).

COMMENT: Compensation in this draft is based upon a per diem rather than annual scale. The per diem approach is used on the theory that after the Board has been operating for several years the work load will be considerably reduced and that salaries should be commensurate with the actual time spent on the job. States may wish to have a provision for annual salary for the first few years and then change to per diem compensation.

Section 302 (a) provides for staggered terms to maintain a certain amount of stability in the Board and to insure the continuation of expertise among the members.

SECTION 303. *Removal of Board Members.*

The Governor may remove a Board Member for neglect of duty, misconduct, or disability.

COMMENT: Section 303 allows removal of members only for three specified reasons so as to minimize the political pressures on the members of the Board.

ARTICLE IV. JURISDICTION AND POWERS OF THE BOARD

SECTION 401. *Jurisdiction.*

The Board shall have jurisdiction, necessary for the purposes of carrying out the provisions of this Act, over the water resources of the state and the lands on which the water is used.

COMMENT: The grant of jurisdiction is necessarily broad so that the Board's ability to plan for and operate during emergencies under section 404 is ensured. While the Board's jurisdiction is wide in matters of planning and emergency, its authority to regulate under the permit system (sections 501-503) is considerably narrower.[50]

SECTION 402. *General Powers.*

The Board is authorized

(a) to develop comprehensive plans for the utilization, conservation, development, improvement, and regulation of the water resources of the state and the elimination of pollution of such waters;

(b) to conduct experiments and research and to collect data on the water resources of the state;

(c) to enter at all reasonable times upon any land, without doing damage, for the purposes of conducting studies and inspecting water resources and their use. Nothing in this section shall authorize access to any confidential information relative to

50. *See* IOWA CODE § 455A.18 (Supp. 1966).

secret processes or to economies of operation;

(d) to issue rules and regulations requiring filing of plans, drawings, or reports by all water users regarding any aspect of water use or pollution;

(e) to consult and advise the public as to the availability of water resources and methods of water development;

(f) to seek enforcement of this Act by bringing an action in the courts of this state to enjoin any acts or practices which are in violation of this Act or any rule, regulation, or order of the Board;

(g) to subpoena witnesses and records and be competent to hear and rule on evidence presented at any hearings ordered under Article VI of this Act.

COMMENT: Under section 402(a), the Board is made the central agency for the planning of future development of water resources. It is to be expected that much of the Board's work in this area will lead to future legislation and state sponsored development and conservation programs.[51]

The Board is authorized under section 402(b) to undertake a survey of the existing water resources and to conduct scientific experiments and collect statistical data on present and future water uses.[52]

Section 402(c) gives the Board the power effectively to police the permit system which is created in Article V. It also gives the Board the power necessary to carry on meaningful research.[53]

Section 402(d) gives the Board the authority to request information from prospective and present water users so that the Board may rationally regulate water use. This information may also be necessary for any survey of existing and proposed water consumption.[54]

Section 402(e) enables the Board to disseminate information concerning modern techniques of water development and conservation.[55]

Section 402(f) gives the Board enforcement powers by allowing it to bring an action in court to enjoin actual or contemplated violations of the Act.[56]

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51. For comparable provisions *see* MINN. STAT. § 105.39 (1964); MODEL WATER USE ACT § 202(1) (1958).

52. *See* IOWA CODE § 455A.17 (Supp. 1966); MINN. STAT. § 105.39 (1964); MODEL WATER USE ACT § 202(2) (1958).

53. For comparable provisions *see* ARK. STAT. ANN. § 82-1905 (Supp. 1965); MISS. CODE ANN. § 5956-22 (Supp. 1964); MODEL WATER USE ACT § 202(3) (1958). The provision protecting secret processes is based upon MASS. GEN. LAWS ch. 685 § 40 (Mass. Legislative Service, Acts of the General Court 1966).

54. *See* ARK. STAT. ANN. § 82-1905 (Supp. 1965); MODEL WATER USE ACT § 202 (6) (1958).

55. *See* MODEL WATER USE ACT § 202(9) (1958); *cf.* MINN. STAT. § 105.40 (1964).

56. For comparable provisions *see* ARK. STAT. ANN. § 47-801 (1964); MODEL WATER USE ACT §§ 202(8), 210 (1958).

Section 402(g) gives the Board the power to gather information for any hearings it may order under Article VI.

SECTION 403. *Duties.*

The Board shall

(a) provide procedures for measurement of water use in this state;

(b) act for the state in cooperation with federal officers and agencies and representatives of other states in the conservation, development, and control of water resources;

(c) submit to the Legislature and the public an annual report, which shall include a statistical summary of permit applications and awards and a description of investigations and actions undertaken by the Board.

COMMENT: The provisions in section 403, unlike those in section 402, are mandatory. Subsection (a) requires the Board to provide procedures for the measurement of water use. This should be the first step the Board should take upon passage of the Act. Since the permit system under Article V is dependent upon accurate measurements, the Board's success in setting up a measurement procedure will largely determine the effectiveness of the Act. The expense of instituting a measurement system may be considerable, especially if the State has had no serious water problems in the past and water meters are uncommon. Some states may wish to consider a governmental subsidy of the measurement system.

Section 403(b) requires the Board to represent the state at multistate meetings and conferences with federal officials.[57]

The annual report required by section 403(c) should present an overall view of the Board's activities during the past year. The annual report is considered the minimum the Board must do to inform the public of its policies and activities, and is in no way intended to imply that the Board should limit its publications to an annual report.[58]

SECTION 404. *Emergency Powers.*

(a) The Board may declare a water emergency on either a state-wide or a local basis when it is necessary to protect the public health or safety or the public interest in any lands or waters against imminent danger of substantial injury. By written order to the water user the Board may require the water user to modify or suspend his water use during a water emergency to prevent, mitigate, or remedy injury.

57. *See also* MISS. CODE ANN. § 5956-11 (Supp. 1964); MODEL WATER USE ACT § 202(10) (1958).

58. *Cf.* IOWA CODE § 455A.13 (Supp. 1966) (Report to the Governor).

(b) No such order shall be in effect for more than thirty days. Thereafter the Board may declare extensions at no more than thirty day intervals, provided that no extension may be ordered without a prior public hearing.

COMMENT: The power to declare an emergency is given to the Board rather than to the Governor on the theory that the specialized agency is better equipped to determine when this extreme measure should be in effect. The Board may declare the emergency to be in effect either on a state-wide or a local level; this will enable the Board to react to many different situations. The initial suspension or modification of the permits must be individually communicated to the water users.

Rather than hold individual hearings after the expiration of the initial thirty-day period, the Board must hold a public hearing before it orders any extension of the emergency procedures. It is thought that if the emergency is statewide it would be impossible to hold hearings for every individual water user. The public hearing will enable opposition to the Board's extension to be heard, and will enable public pressure against the Board's proposal to be felt without causing a disruptive effect on the Board's action to meet the emergency.[59]

ARTICLE V. PERMIT PROCEDURE

SECTION 501. *Permits.*

Subject to the provisions of this Act, it shall be unlawful for any person to divert, pump, impound, or otherwise take more than five thousand gallons per day of water from any water course or aquifer without first receiving a permit describing the proposed beneficial use, the quantity of maximum use expressed as an average daily use over a three month period, water quality standards to prevent pollution, and the land on which the use is desired. The Board may require a permit for a water use otherwise exempt if the water use threatens to pollute the water resources of the state.

COMMENT: The terminology "divert, pump, or otherwise take," is intended to include most anticipated water uses. The only uses excluded from the permit system are those of less than 5000 gallons per day, those which are taken from a lake without an outlet which is enclosed by a single person's property, and those which are taken from a municipal water supply or private water company. The minimum figure of 5000 gallons is necessary so that domestic uses may go unregulated and so that the Board is not unnecessarily burdened with relatively minor water uses. Those water users

59. For comparable provisions *see* IOWA CODE § 455A.28 (Supp. 1966); MODEL WATER USE ACT §§ 501, 502 (1958).

who receive their water supply from a municipal or private water company need not be regulated, since the company is already regulated. The Board indirectly regulates these users by regulating the suppliers; if the Board cuts back the supply of the company, the supply of water to the ultimate user will necessarily be reduced.

The amounts allowed in the permit are a maximum use of water over a three-month period, expressed as an average use per day. Spreading the total amount used over three months allows the user some flexibility in changing his use from day to day, and allows the Board to reflect seasonal variations in use by granting different amounts for different three-month periods.[60]

The exemption from the permit system granted to water users using less than 5000 gallons a day should be modified according to the state's existing water resources before enactment. The figure used here is thought to be adequate to cover generous domestic use of water.

Prior administrative approval of the water use is considered necessary to minimize the risk of expensive investments being rendered useless if the Board should disapprove the proposed use.

The Board shall include water quality control standards in the permits to implement its pollution regulation authority. The Board may require a permit for one whose quantity of use is small but whose polluting use might otherwise undermine the Board's regulation.

SECTION 502. *Temporary Exemption.*

A beneficial use during the three-year period preceding the effective date of this Act may be continued for a period of up to three years. However, a permit shall be required if the average daily use over any three-month period exceeds by more than three percent the average daily use in the comparable three-month period during the year immediately following the effective date of this Act.

COMMENT: Section 502 grants a temporary exemption from the permit system to those water users who had a beneficial use during the specified time before the passage of the Act. This section is considered necessary merely because of the administrative impossibility of granting permits to all existing water users immediately upon passage of the Act.

The periods of comparison of quantities of water used are both subsequent to the passage of the Act. This is thought to be required because not every water user will have had adequate measurement mechanisms before enactment. The initial measuring period should be delayed if the legislature believes that swift implementation of a measuring system will be impossible.

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60. *See* IOWA CODE § 455A.25 (Supp. 1966); MODEL WATER USE ACT § 401 (1958) (exempts domestic uses).

The periods of comparison must be the same three months in each year; this will eliminate the possibility of seasonal variation. The percentage figure (in this Act — three percent) may be varied according to the state's existing resources. It is felt that an increase of three percent is a substantial increase and that the Board should at least be aware of the increased consumption.[61]

SECTION 503. *Duration of Permit.*

(a) A permit issued by the Board shall be valid for no more than ten years. The permit shall be renewable upon application.

(b) A permit may be modified, suspended, or cancelled by the Board

(1) for breach of the terms of such permit,

(2) for violation of this Act or rules and regulations promulgated by the Board, or

(3) in accordance with sections 404 and 504 of this Act.

COMMENT: The duration of the permit has varied in other statutes from ten to fifty years. Despite the fact that industry has criticized the ten year duration in the Iowa statute as being insufficient to justify long term investments, that figure appears to give the Board the most flexibility in order for it adequately to supervise the use of the water resources of the state.[62] It is at best difficult to anticipate future developments in methods of water use and conservation, and a review of existing uses every ten years seems necessary.[63]

Under 503(b) the Board may modify, suspend, or cancel a permit if the owner of the permit acts contrary to law or a regulation of the Board. The Board may also modify or suspend a permit in accordance with the emergency provisions of the Act under section 404, and may cancel a permit if the owner neglects his use as provided in section 504.[64]

SECTION 504. *Lapse of Permit.*

The right of a permittee and its successors to the use of the water shall terminate when he ceases for three consecutive years to use it substantially for the beneficial use authorized by the permit.

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61. *Cf.* IOWA CODE § 455A.25 (Supp. 1966) (temporary exemption to industry); MODEL WATER USE ACT §§ 303, 304 (1958) (preservation of existing uses subject to certification).

62. O'Connell, *Iowa's New Water Statute — The Constitutionality of Regulating Elisting Uses of Water,* 47 IOWA L. REV. 549, 579 (1962).

63. *See* IOWA CODE § 455A.20 (Supp. 1966).

64. *See* IOWA CODE § 455A.28 (Supp. 1966); MODEL WATER USE ACT § 412 (1958).

COMMENT: The Board is responsible for the efficient use of water resources. It should not be bound for ten years to an allocation which the recipient has judged to be no longer necessary by his failure to take advantage of it. The Board should in most cases avoid hardship by granting a new permit when a permit has lapsed but the water user, unaware of this fact, reinitiates the use with concurrent investment. If, for example, a plant is shut down for three years and the owner who had not been notified of the imminent lapse of the permit begins operations anew, it is anticipated that unless there are strong countervailing reasons, he will be granted a new permit.[65]

SECTION 505. *Transfer of Permit.*

A permittee may sell, transfer, or assign the rights under its permit by conveying, leasing, or otherwise transferring the interest of the land described in the permit.

COMMENT: The transfer clause has been included to ease the administrative burden upon the Board. A transfer of the permit will be effective only if the transferee uses the water for the same beneficial use as did the transferor, and only if he uses the same quantities of water. The duration of the permit will be ten years from the time the transferor received the permit, not ten years after the transferee received the rights to it.[66]

SECTION 506. *Recording of Permits.*

A permittee shall record the permit within thirty days after issuance at the office where the title to land on which the water is to be used is recorded.

COMMENT: By utilization of the existing recording system, any interested person can ascertain the rights of any person entitled to the water of a specific area. This provision will aid in the enforcement of the permit system; any interested person can determine whether a permittee is violating the conditions of its permit by checking the public record.

ARTICLE VI. APPLICATION AND HEARING

SECTION 601. *Application.*

An application for a permit shall be made in writing to the Board and shall set forth the beneficial use for which the permit is sought and shall include the specific limits as to quantity, time, place, and rate of diversion, storage, or withdrawal of waters.

COMMENT: The primary purpose of this Act is the control of the

65. *See* MISS. CODE ANN. § 5956-06 (Supp. 1964); MODEL WATER USE ACT § 412 (1958).

66. *See* IOWA CODE § 455A.30 (Supp. 1966).

quantity of water used. To this end, the details enumerated in section 601 include quantity rate and place of diversion of water. This list is not meant to be exhaustive, and either the Board or the Legislature can require more information so that it can have a record of the quantity and quality of water use.[67]

SECTION 602. *Fee.*

The applicant for a permit shall pay a fee to the Board in the amount of ( ) at the time of filing his permit application. All fees received by the Board shall be deposited in the general fund of the state.

COMMENT: The fees which must accompany an application for a permit are to be set by the legislature. The legislature may wish to have a sliding scale of fees commensurate with the quantity of the proposed water use. Under this section, the fees are to be deposited in the general fund of the state. An alternative to this is to set up a special "Water Resources Fund" which will be used to cover the cost of publication and hearings.[68]

SECTION 603. *Time and Place of Hearing.*

Upon receipt of an application, the Board shall set the earliest convenient time and a place for a hearing. The hearing shall be in the county where the withdrawal of water is proposed, except that it may be held in any other convenient place in the state when the effects of the use will be wide-spread.

COMMENT: This section recognizes that individual water use allocations are normally matters of local concern, but where the effects are more widespread, the Board can consider the convenience of all the interested parties in setting a place for the hearing.[69]

SECTION 604. *Notice.*

(a) The Board shall cause notice of the hearing to be published in a newspaper of general circulation in the county in which the proposed beneficial use is sought. The notice shall be published three times within a period of thirty days prior to the hearing. At least one notice more than one week prior to the hearing and each notice published within the last week shall specify the date, time, and place of the hearing, describe the purpose of the hearing, give sufficient detail to enable judgments to be made on

67. *See* IOWA CODE § 455A.19 (Supp. 1966).
68. *Cf.* IOWA CODE § 455A.19 (Supp. 1966); MISS. CODE ANN. § 5956-16 (Supp. 1964).
69. *See* IOWA CODE § 455A.19 (Supp. 1966).

the effect of the proposal to be heard, and describe the lands and waters that may be affected.

(b) A copy of the notice shall be provided to the applicant, to the appropriate state agencies, and to other persons who have filed a written request for notification of hearings affecting a designated area.

COMMENT: Notice of the hearing is required so that adjoining riparian owners of the prospective water user can be made aware of a proceeding which may affect their rights.[70]

SECTION 605. *Hearing.*

(a) Any interested person may appear in person or by counsel. He may introduce evidence and may cross-examine others who present evidence.

(b) The Board shall prepare a written record of the hearing. All evidence, including records and documents in the possession of the Board of which it desires to avail itself in deciding whether to grant the permit applied for shall be offered and made a part of the record of the hearing, and no other information or evidence shall be considered in the decision of the application.

COMMENT: The procedure of the hearing should conform to the procedure of other administrative agencies of the state of enactment.

SECTION 606. *Rules.*

The Board may prescribe rules of procedure for the conduct of the hearings.

SECTION 607. *Decision.*

The decision on a permit application shall be in writing and shall be provided to the applicant and to any person who requests in writing a copy of the decision.

ARTICLE VII. JUDICIAL REVIEW

SECTION 701. *Judicial Review.*

Any rule, regulation, order, or decision of the Board under this Act shall be subject to review by the courts of this state as provided in .....

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70. IOWA CODE § 455A.19 (Supp. 1966); MODEL WATER USE ACT § 404 (1958).

ARTICLE VIII. MISCELLANEOUS POWERS

SECTION 801. *Severability.*

If any provision of this Act or the application thereof to any person is held invalid, the invalidity shall not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are severable.

SECTION 802. *Repealer.*

All acts and parts of acts inconsistent with this Act are hereby repealed.

SECTION 803. *Effective Date.*

This Act shall take effect on .....