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Tax-Deferral Transactions: 
Installment Sales, Like-Kind Exchanges and Involuntary Conversions

by William T. Hutton

Deferral of tax is, in some measure, avoidance of tax. It is always financially advantageous to discharge a liability tomorrow rather than today, where the privilege of deferral does not involve an interest charge. If payment can be postponed for 20 or 30 years, by present-value reckoning the liability virtually disappears.

The major opportunities for tax deferral, as they relate to land conservation transactions, are found in the Internal Revenue Code provisions governing installment sales, like-kind exchanges, and involuntary conversions. This article attempts to provide a working knowledge of each of those three statutory opportunities.

Installment Sales (IRC § 453)

The occasional seller of land or other capital assets, who reports her gain on the installment method, may in effect enjoy a long-term interest-free loan from the government. Consider the situation of Sadie Gump. She owns land with a basis of $100,000 and a fair market value of $600,000, and she contemplates a sale to a land trust. If she sells for cash, assuming a 28% capital gains tax rate, she will immediately have a $140,000 Federal income tax liability, and after-tax proceeds of $460,000. If she invests those proceeds for a 7% return, her income stream from the sale proceeds will be $32,200 per year.

Suppose, in the alternative, that Sadie takes the buyer’s 7% note for $600,000, which provides for annual payments of interest and payment of the entire principal at maturity, in 2003. For the next ten years she will have annual income of $42,000 (interest). She will in effect enjoy a present economic return on the $140,000 deferred tax liability. Although she sacrifices liquidity, the assurance of an interim return which is about 30% higher than could be realized on the after-tax proceeds of a cash sale is apt to be a compelling attraction.

The mechanics

The definition of an installment sale is one of the most approachable sentences in the Internal Revenue Code:

“The term ‘installment sale’ means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.” IRC § 453(b)(1).

When an installment sale occurs, gain is reported on the installment method (essentially, prorated over...
the payments received, as explained more fully below) unless the taxpayer elects not to do so.

Installment sale reporting involves multiplying each payment received under the contract, including the down payment, by a fraction, the numerator of which is called “gross profit,” and the denominator “total contract price”.

**Problem (1).** Zelda McGillicuddy is about to sell a six-acre beachfront parcel to the Sasquatch Land Trust for $360,000, payable $60,000 down and $60,000 in each of the succeeding five years. Zelda’s basis in the property, inherited from her father, is $120,000. Assume that the deferred payments bear interest at not less than the applicable federal rate (to be explained below).

**Gross profit**

Determination of gross profit is simply a calculation of the taxpayer’s realized gain — amount realized minus adjusted basis. The amount realized consists of the down payment, relief of liabilities (if any), and the principal amount of the deferred-payment obligation. As in the determination of gain and loss generally (IRC § 1001(a)), transaction costs reduce the amount realized. Here, since there are neither transaction costs nor liabilities, Zelda’s amount realized equals $360,000 ($60,000 down payment plus $300,000 principal amount of the buyer’s note). Subtracting her adjusted basis of $120,000 yields a gross profit of $240,000.

**Total contract price**

The denominator of the fraction, total contract price, is the total amount committed to be paid by the buyer (here $360,000), reduced by any liability of which the seller is relieved or to which the property sold is subject. That reduction attributable to liabilities may not exceed the seller’s basis in the property.

Thus, as to Zelda’s sale, we derive a gross profit/total contract price fraction of $240,000/$360,000, or two-thirds. Of each $60,000 payment, then, two-thirds will represent gain, and one-third will be attributable to a recovery by Zelda of her basis in the property sold. (As a useful check on the accuracy of our computation, note that, by the time Zelda has received all six $60,000 payments, she will have reported the proper total amount of gain — $40,000 times six equals $240,000.)

**Impact of liabilities**

Where the buyer takes subject to, or assumes, a pre-existing liability with respect to the property sold, adjustments in the computation are required.

(i) Liabilities not in excess of seller’s basis

Where the buyer takes subject to or assumes a liability not in excess of the seller’s basis, the total contract price is reduced by the amount of such liability.

**Problem (2).** Suppose that Zelda’s property is subject to a mortgage of $60,000, and that the buyer takes the property subject to that liability, pays $60,000 down, and gives a $240,000 installment note, payable at $60,000 per year over the succeeding four years.

The fraction now becomes $240,000 (realized gain is unchanged) over $300,000 (selling price less the mortgage), and four-fifths of each payment, including the down payment, will represent gain. (Note that by reporting four-fifths of each payment received Zelda will again recognize her entire gain over the five-year payment period — $48,000 x 5 = $240,000.)

(ii) Liability in excess of basis

Where the liability (or aggregate of liabilities) exceeds the seller’s basis, the total contract price is reduced by an amount equal to the seller’s basis, and the excess of liability over basis is considered a year-of-sale payment.

**Problem (3).** Suppose that Zelda’s property were subject to a mortgage of $180,000, and that the buyer, accordingly, paid $30,000 down, gave a note providing for five payments of $30,000 each in the succeeding five years, and took subject to the existing liability.

The payment deemed received in the year of sale is now $90,000 ($30,000 cash less the excess of the mortgage liability over Zelda’s basis). The applicable fraction is $240,000 (gross profit) over $240,000 (selling price less liability to extent of basis). Thus 100% of each payment, including the down payment, is gain. Zelda will have $90,000 gain in year one, and $30,000 gain in each of the succeeding five years, for a total of $240,000.

**Transaction costs**

Applicable transaction costs, such as brokers’ fees, will affect the profits fraction, since they reduce realized gain but do not affect the total contract price. Thus in problem (3), if Zelda pays a $30,000
broker's commission, reducing her realized gain from $240,000 to $210,000, the gross profits fraction becomes 7/8 or 87.5% ($210,000 over $240,000), and only $78,750 of the year-of-sale payment and $26,250 of each subsequent payment will be taxed.

Interest payments

Interest payments are of course not part of the installment gain computation, but the installment sale contract must provide for interest at not less than the "applicable federal rate" ("AFR"). Each month the Internal Revenue Service publishes short-term (up to three years), mid-term (over three but not over nine years) and long-term (over nine years) AFR's. The rates published for November, 1993, for example, were 3.68% (short-term, annual payments), 4.92% (mid-term, annual payments) and 5.84% (long-term, annual payments). The parties may use the AFR applicable for the month in which the sale occurs, or the rate for either of the two preceding months.

Failure to specify a rate of interest at least equal to the AFR will cause some of the stated principal amount of the deferred-payment obligation to be recharacterized as interest, and the effect of that recharacterization will be to alter the installment-sale fraction. A full explication of the impact of the imputed interest rules on deferred-payment sales is beyond the scope of this article. Suffice it to say, for present purposes, that an installment sale contract which fails to provide adequate statutory interest will present a misleading picture of both the economic and the tax consequences, and that any potential installment seller with the slightest financial sophistication (or competent advice) will quickly recognize the quite measurable financial disadvantages.

Securing the buyer's performance

In order to secure the buyer's obligation, the seller may maintain a security interest in the property sold (for example, a mortgage or deed of trust). On occasion, as where the buyer intends to remarket the property, such an arrangement will not meet the needs of the parties. The regulations provide that the buyer may look to a third-party guarantee, and that a "standby letter of credit" will be considered such a guarantee. A letter of credit is typically issued by a bank or other financial institution, and serves to guarantee the indebtedness it secures. A buyer-provided letter of credit obviously will increase the overall cost of the acquisition, generally by the guarantor's charge of a fee equal to 1-to-2% of the amount of the guaranty, computed and charged annually.

Dispositions of installment obligations

If the installment seller disposes of an installment obligation prior to its maturity, the gain lurking in the obligation will be accelerated. It is important to understand, then, that an installment sale effectively "locks in" the tax obligation attributable to the gain on the asset sold. Neither a subsequent charitable contribution of the installment obligation, the seller's death prior to maturity, nor any other transaction will provide relief from that lurking gain.

Problem (4). Ike Feeney owns Culpepper Dunes, a large tract joining a state park. His basis is $50,000, and the property has recently been appraised at $350,000. He is apparently willing to make a bargain sale of that property to the Pucky Huddle Land Trust, which will resell the property to a state parks authority, but would prefer to make his contribution by forgiving the Trust's debt on installment notes. He proposes, accordingly, to sell the property to Pucky Huddle for $50,000 down and six $50,000 notes, with the intent (but not obligation) to forgive at least two of those notes.

Ike's plan, when compared to a bargain sale for $250,000, is patently inferior. By locking in the certainty of recognition of his entire $300,000 gain, Ike in effect turns a gift of appreciated property into a gift of cash, and thus loses the opportunity to donate untaxed appreciation in value. In either case his charitable contribution deduction will be $100,000 (whether consisting of two $50,000 installment notes or an undivided two/sevenths interest in the property), but the bargain sale permits him to donate approximately $85,714 in untaxed appreciation ($100,000 - $14,286 allocated basis per IRC § 1011(b)). The installment sale plan thus causes Ike to pay about $24,000 more in Federal income tax (at the 28% capital gain rate).

The installment sale/bargain sale combination

It is entirely feasible to conjoin an installment sale with a bargain sale intended to give the seller/donor the benefit of a current charitable contribution deduction. In such a case, the charitable contribution equals the fair market value of the property less the present value of the consideration paid and committed to be paid by the donee organization. The seller/donor's basis is allocated between the gift and the sale aspects of the transaction, as in any bargain

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sale, and the installment sale fraction is thereafter computed with reference to the allocated basis, as an aspect of the "gross profits" computation.

**Problem (5).** Abe Ruffin proposes to sell a wetland property known as Fantail Flats to a local land trust for $80,000, payable $10,000 down and $10,000 per year over the succeeding seven years. The property has recently been appraised at $100,000. Abe's basis is $20,000.

The amount of Abe's charitable contribution is $20,000, required to be established by a "qualified appraisal" pursuant to Treasury Regulation § 1.170A-13. His basis of $20,000 is allocated between the sale and gift portions of the transaction — $16,000 to the sale and $4,000 to the gift. The gross profits fraction for installment sale reporting purposes is thus four-fifths ($64,000/$80,000) and $8,000 of each $10,000 payment will be subject to tax. The charitable contribution of $20,000 may be used entirely in the year of sale, subject to the 30%-of-adjusted-gross-income limitation.

**Final cautions**

Although the rudiments of installment selling are exceedingly approachable, and the land trust project manager should have little trouble gaining a working knowledge of these rules, you should be aware that the statute is also larded with highly technical provisions intended to deter or eliminate abusive transactions. Sales to related parties and controlled entities, sales of property in a corporate liquidation context, and sales of property subject to depreciation recapture are all subject to special rules. Most dealer dispositions do not qualify for installment reporting at all, nor do dispositions of marketable securities. Dispositions for an installment price in excess of $5 million will generally require the taxpayer to pay interest on the deferred tax liability. In negotiating an installment sale, therefore, the project manager should seek the timely advice of a tax professional so as to avoid the potential minefields.

**Like-Kind Exchanges (IRC § 1031)**

Unlike the installment sale, the like-kind exchange of property affords an opportunity for indefinite (perhaps even permanent) deferral of potential gain. Although the unrecognized gain will lurk in the replacement property, several pathways will lead to permanent nonrecognition: holding the new property until death, contributing it to a qualified charity, selling it through the medium of a charitable remain-
to-back escrows so as to preclude the possibility of the exchange falling through, leaving the land trust as owner of unwanted property).

2. Exchange effected as first step

A second (and much rarer) possible transaction involves the owner of the replacement property first exchanging her property for Alf’s, then selling the timberland to the land trust. This clearly works for Alf, but Amy (who is, after all, only a seller) will understandably be reluctant to place herself in the middle of a two-step deal, even if the conveyances are effected simultaneously.

3. Direct deeds

Cases and rulings sanction three-cornered transactions; i.e., in a single escrow, Alf’s property is deeded to land trust, land trust pays cash to Amy, and Amy conveys the desired replacement property to Alf. This avoids double-deeding, but perhaps more for historical than logical reasons, it is nonetheless not a common transaction.

4. Four-party transactions

By placing an escrow agent, operating independently, or an “exchange company” in the center of the transactional maelstrom, all parties may be satisfied. The land trust’s cash and Alf’s and Amy’s properties go to the exchange company, which then redirects them to their new owners — Amy’s former property to Alf, Alf’s property to land trust, and the cash to Amy. Despite the double-deeding of both Alf’s and Amy’s properties, and the fee for services exacted by the exchange company, this is a popular mode.

Tax consequences

It is rare, if not unprecedented, for a like-kind exchange to involve properties of equal value. Consider: Charlie Compezzi has unencumbered pastureland worth $175,000, and seeks to parlay this, tax-free, into a single-family residence to be held for the production of rental income. How likely is it that Charlie will find a desirable property at a price of exactly $175,000?

Accordingly, cash and/or the assumption or relief of liabilities are often used to “balance the deal.” For example, if Charlie finds a house worth $375,000, he may designate that as replacement property, and it will be conveyed to him subject to a $200,000 mortgage. Note that the equities balance. The deal is fair. (In this example, Charlie has “traded up”;

that is, he has acquired more valuable property, subject to a substantial liability.)

Receipt of cash or nonqualifying property

The receipt of cash or nonqualifying property (sometimes called “boot”) will cause the taxpayer to recognize gain up to the extent of his realized gain.

Problem (6). Happy Ruff exchanges 40 acres of wilderness property, held for investment, with a basis of $30,000 and a value of $150,000, for a one-tenth undivided interest in a mineral lease worth $125,000, and $25,000 cash.

Happy’s realized gain is $120,000; her recognized gain is $25,000 (the cash boot), and her basis in the replacement property will be $30,000 (thus preserving the remaining $95,000 of potential gain).

Problem (7). Suppose, instead, that Happy acquires a condominium, to be held for investment purposes, with a value of $300,000, subject to a mortgage of $175,000, and $25,000 cash.

Even though the liability on the new property far exceeds the cash boot, gain must still be recognized, under applicable regulations, to the extent of the cash received. Thus, of Happy’s $120,000 of realized gain, $25,000 must be recognized. Her basis in the condo will be $205,000, again preserving the $95,000 of unrecognized gain.

Netting liabilities

Not infrequently both properties involved in an exchange will be subject to liabilities. When that occurs, the taxpayer will recognize gain only to the extent of a favorable net of liabilities; i.e., only to the extent that the liabilities of which the taxpayer is relieved exceed the liabilities assumed or taken subject to.

Problem (8). Ajax Boodle exchanges a 350-acre farm (basis $210,000, value $650,000, subject to a mortgage of $175,000) for a small suburban shopping center worth $850,000, subject to a mortgage of $375,000. Ajax will realize a gain of $440,000, none of which will be recognized, since the net of liabilities is unfavorable. Ajax’s basis in the shopping center will be $410,000, thus preserving Ajax’s entire $440,000 unrecognized gain.

Problem (9). Suppose, in the foregoing situation that Ajax received, in exchange, a municipal dumping site, worth $575,000, subject to a mortgage of $100,000. Under these circumstances, Ajax would recognize $75,000 gain,
since the net of liabilities is favorable to him in that amount. His basis in the dump site would be $210,000.

Problem (10). To vary the facts one final time, suppose, in the foregoing example, that the dump site is worth $675,000, is subject to a mortgage of $100,000, and Ajax pays $75,000 in cash to balance the deal? Although cash received is always taxable boot, cash paid is permitted to offset a favorable balance of liabilities. Thus, in these circumstances, Ajax would recognize none of his $440,000 realized gain, and his basis in the dump site would be $235,000.

Deferred exchanges

From time to time, it may be necessary or desirable for a taxpayer to make a conveyance of his property prior to designating appropriate replacement property. The statute provides a limited opportunity to gain the benefits of nonrecognition treatment on such a deferred exchange (sometimes called a “Starker exchange” after a famous case of that name). The replacement property must, however, be identified within 45 days after the date of transfer of the taxpayer’s property, and received not later than 180 days after the date of transfer (or the due date for the filing of the income tax return for the year of such transfer, if earlier). Recently promulgated regulations contain elaborate rules as to the means by which designation of replacement properties may occur, and the limits on the numbers (or values) of such properties, as well as considerable guidance as to the security mechanisms that may be used to insure performance of the transferee’s replacement obligation. Since the deferred exchange should be considered only when circumstances render a simultaneous exchange impossible, and since such an exchange must be a carefully planned transaction, mastery of the deferred exchange rules should not be considered a high priority for the project manager.

Sales Under Threat of Condemnation (IRC § 1033)

Where property is taken by a governmental entity through eminent domain, or sold under a threat of condemnation, the taxpayer has a generous interval of time to reinvest the sales proceeds in order to avoid recognition of gain. Although condemnation may seem inevitably to involve a confrontation between the landowner and the condemning authority, in fact, many such sales are relatively amicable, involving a real but negotiated threat intended to provide access to the nonrecognition afforded by the statute.

Existence of a “threat”

Where property is taken by eminent domain and the landowner receives a condemnation award, there is of course no need to inquire whether the landowner has been threatened by condemnation; it has happened. But in many cases, the landowner seeks to reinvest, tax-free, the proceeds of a sale to a private party or nonprofit organization. In those cases, access to the nonrecognition sanctuary of Section 1033 becomes mainly a matter of determining whether a governmental “threat” has existed. Under applicable cases and rulings, a sale is deemed to have been made under threat of condemnation where the taxpayer has “reasonable grounds to believe” that a condemnation proceeding would eventuate. In assessing the reasonableness of the taxpayer’s belief, several factors are relevant:

1. Whether the putative condemning authority has the power of eminent domain (or could obtain that power via routine proceedings);
2. Whether that agency had begun condemnation proceedings, or intends to do so;
3. Whether the taxpayer has knowledge of the condemning authority’s condemnation plans; and
4. Whether it is reasonable for the taxpayer to believe, from the known facts, that exercise of the power of condemnation would occur in the absence of an alternative disposition or arrangement satisfactory to the condemning authority.

Some years ago, as to projects on which government agencies and private conservation groups acted cooperatively, it was not uncommon for a government agent to inform a landowner by letter that her property was intended to be acquired, and that condemnation would occur in due course if an acceptable alternative disposition did not occur. Under those circumstances, and with reference to the factors distilled above, it was entirely reasonable for the taxpayer to assume that a sale made to the cooperating private conservation group would qualify for nonrecognition, provided that the proceeds of sale were timely and appropriately reinvested. With the growth of the doctrine of “inverse condemnation,” however, government agencies are increasingly and understandably reluctant to set the stage for a landowner proceeding by issuing such a letter. The result has been a considerable diminution in the number of opportunities for “friendly” sales to meet the requirements of the statute.
For an excellent discussion of the principal cases and rulings involving the “threat” issue, see Silva, “Internal Revenue Code Section 1033 and the Threat of Involuntary Conversion,” The Back Forty (Vol. 1, No. 9, March 1991).

Reinvestment

Section 1033 permits reinvestment, unlike the statute governing like-kind exchanges, which demands an exchange and is defeated if the taxpayer receives, or is deemed to receive, cash.

Nature of reinvestment property

Section 1033 may apply to the condemnation, or sale under threat, of any type of property, including personal-use properties (e.g., residences or second homes), and property held as inventory or for sale to customers in the ordinary course of a trade or business. In general, the statute requires reinvestment in property “similar or related in service or use” to the property sold. That standard is interpreted by the IRS to require a functional similarity between the taxpayer’s relationship to the old property and his relationship to the new. For example, it has been held, in interpretation of the “similar or related” standard, that a hotel, owned and managed by the taxpayer, is not sufficiently similar to a commercial office building, on account of the considerably different levels of service required to be rendered by the owner.

An important exception to this standard, and one normally applicable in cases involving the reinvestment of proceeds of a sale of land intended for conservation purposes, applies to real properties “held for productive use in trade or business or for investment,” IRC § 1033(g). As to such properties, the “like-kind” standard governs, and the taxpayer has considerably greater latitude to reinvest in real estate to be held either for business or investment purposes. (See the immediately foregoing portion of this article for a discussion of the like-kind exchange requirements.) The two major categories of properties which will fail to qualify for “like-kind” reinvestment under Section 1033(g) are personal-use properties (residences, second homes and recreational properties), and “dealer” properties. (As to the former, another statutory reinvestment provision, Section 1034, allows the tax-free “rollover” of gain on the sale of a principal residence into a new principal residence within two years of the date of disposition.) As a practical matter, then, it is relatively unusual for a project manager to encounter a condemnation case which is not governed by the “like-kind” standard.

Reinvestment deadlines

Under the general rule of Section 1033(a)(2), pertaining to acquisitions of property “similar or related in service or use,” the taxpayer has two years from the close of the first taxable year in which any part of the gain from the conversion or sale is realized to reinvest the sale proceeds. For business or investment properties subject to the “like-kind” rule, however, the taxpayer has an additional year; i.e., until the close of the third year following the year in which gain is first realized.

Problem (11). Ernie Mellow sold his farm to the Aspen Meadows Conservancy on January 15, 1993, under a reasonable apprehension that Visitation County would condemn it for public purposes were he to refuse to agree to a sale to an organization equipped to preserve the property for public purposes.

Ernie’s farm will likely qualify as “business” property; he thus has the benefit of the special three-year rule applicable to like-kind properties. Provided that his amount reinvested (i.e., the cost of the new property) exceeds the amount realized on his sale to Aspen Meadows, and that such reinvestment occurs on or before December 31, 1996, none of his gain will be recognized.

Computing recognized gain and new basis

In order fully to protect gain realized on a sale under threat of condemnation, the taxpayer must reinvest, within the period described above, an amount equal at least to the amount realized on the sale. Reinvestment is measured in terms of the cost of the replacement property, which is to say, its fair market value per IRC § 1012. To the extent that the taxpayer’s reinvestment falls short of the amount realized on the sale, gain will be recognized up to, but not of course in excess of, the taxpayer’s realized gain on that sale.

Problem (12). Minnie Motley sold a tract of timberland, held for investment and subject to the threat of condemnation, in which her basis was $160,000, to the Manteca County Parks Authority on August 23, 1993 for $725,000. She therefore has until December 31, 1996, to acquire suitable replacement property and avoid recognition of her $565,000 realized gain. Suppose that, before that date, she buys a 12-unit apartment complex, paying $500,000 down and...
giving a $1.2 million mortgage note for the balance of the $1.7 million purchase price. (The additional $225,000 cash is reinvested in stocks and bonds).

Despite the fact that Minnie has used only $500,000 of the $725,000 received from the Parks Authority, her reinvestment, partly debt-financed, comfortably meets the requirements of the statute, since the cost of the replacement property ("cost" = fair market value = $1.7 million) far exceeds the sale proceeds. Under these circumstances, Minnie will have produced substantial liquidity ($225,000) without tax reckoning. (This may seem too good to be true, but consider that one may always borrow, without tax consequence, against the equity in real estate or other property, and that is, functionally speaking, exactly what happens here.)

The basis of replacement property will reflect the realized gain on the sale under threat of condemnation which is protected from recognition by Section 1033. The basis of the new property is derived therefore, by reducing the cost of the new property by such unrecognized gain. In problem (12), Minnie's basis in the apartment complex will thus be $1,135,000.

The condemnation sale/charitable contribution possibility

The possibility of achieving bargain-sale treatment in a condemnation setting may not readily occur to a taxpayer faced with the threat of condemnation. Condemnation proceedings are often highly confrontational, with primary focus on the appraisers' conclusions. Provided that the landowner is made aware of the possibility of avoiding a long and costly adjudication over valuation through a bargain sale (often to a private charitable organization rather than the condemning authority), there appears to be no conceptual barrier to allowance of the charitable deduction attributable to the bargain price.

Problem (13). Ducky Webb has been directly informed that his 60-acre in-holding will be acquired by the State Parks Service out of next year's appropriations for acquisitions. Informal meetings have already begun with the State Parks representatives, who have suggested a value of $1,000 per acre. Ducky believes this is ridiculously low, and has commissioned an appraisal which indicates a $2,500 per-acre value. Ducky's attorney, a condemnation specialist, believes that the state would pay $1,500 per acre if it could be assured that a dispute over value could be avoided. Suppose Ducky sells to the state for $1,500 per acre. May he claim a charitable contribution equal to the bargain element ($1,000 per acre, according to his appraisal)? Might Ducky be better advised to consider a sale to a private conservation organization for a slightly lower price, say $1,400 per acre?

Considerable judgment is required here, in order to assure the evidence of "disinterested generosity" requisite to any charitable contribution. In a recent case, where the adjudication over value was permitted to run its long and bitter course before any assertion of bargain was raised, the U.S. Claims Court opined that "a charitable contribution tax deduction should not be based on a completed condemnation proceeding, in which the state takes the land for a legitimate public purpose, and the landowner receives compensation...." Hope v. U.S., 91-2 USTC ¶50414 (Claims Court, 1991).

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