TAX NOTES TODAY®

News Analysis: Hillary and the Hedge Funds

by Lee A. Sheppard

In news analysis, Lee A. Sheppard dissects the tax returns released by the Democratic presidential candidates.

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Ralph Nader is running for president again. Democrats, who blamed him for their 2000 loss, haven't made a squeak about it. They probably figure they can lose the election with or without him. The election is theirs to lose, and they're doing their utmost to lose it. (Before you start writing letters, readers, your correspondent's choice for president is "none of the above.")

Nader's point is that there is no discernible difference between the candidates on economic issues. In this he is absolutely correct. There is no major-party candidate for voters of a leftish bent on these issues.

The two remaining Democratic candidates would essentially maintain the status quo. Ironically, one of the more populist candidates emerged from the Republican side. That'd be former Arkansas Gov. Mike Huckabee, a social conservative and economic liberal whose emergence was predictable once the religious right noticed their economic interests do not align with those of the business wing of the party.

Oh, but aren't the voters finally noticing their economic prospects have been permanently lowered by laissez-faire economic policies? Aren't the Democrats making noises about raising taxes on rich people and big companies? Aren't big companies and hedge fund managers revving up lobbying efforts to prevent this from happening?

All true. But two years of narrow Democratic majorities in Congress -- which are likely to increase no matter who becomes president -- have not even succeeded in getting the minimum wage to a level acceptable to progressive thinkers. Weak leaders in both houses have capitulated to a president whose popularity ratings are at historic lows. Watch what they do, not what they say.

What does this mean for taxation? The status quo is likely to prevail. Presenters at recent tax conferences are running around saying the outcome of this or that question depends on the presidential election. They should stop it right now, because it doesn't. Here are the reasons:

First, Sen. John McCain, R-Ariz., is likely to win the election. The two remaining Democratic candidates have what pollsters call "big negatives." One candidate's negatives are bigger than the other's, though it is not clear which is which. Moreover, the flyover states, where neither Democrat is especially appealing, are overrepresented in the electoral college.

McCain is making nice to the antitax wing of his party. The blot on him with that group is that he sensibly voted against the Bush tax cuts. He has confessed ignorance of economic issues --

which at least shows some self-awareness -- and has hired the very conservative Douglas Holtz-Eakin, an economist who worked in both Bush administrations, as his principal economic adviser.

Second, neither Democrat is as left-wing as the Republicans would like to paint him or her. Neither would fully repeal the Bush tax cuts. Recall that the Clinton administration, much to the distress of the party's left wing, essentially allowed financiers to determine its economic policy. Sen. Hillary Rodham Clinton, D-N.Y., could be expected to do the same. Her blue- and pink-collar supporters would fare no better in the long term under her than they did under her husband.

Oh, but hasn't Sen. Barack Obama, D-Ill., suggested removing the limit on employment taxes and tinkering with cross-border business taxation? Obama's legislative record is one of a lot of talk and no action. Both Clinton and Obama often support the same small, timid, symbolic tax measures intended to help average people without involving actual spending. (For coverage, see *Tax Notes*, Mar. 10, 2008, p. 1072, *Doc 2008-4556 [***PDF***]*, or *2008 TNT 43-6*.)

"We've developed creative ways to remove the burden from the well-off," Obama says. He's got a point there, but his youthful supporters aren't hippies. They're economic conservatives and social liberals. If Clinton becomes the nominee, many will defect to McCain (despite his very conservative record on social issues), and if Obama becomes the nominee, many of her supporters will defect to McCain. (For Obama's tax ideas, see *Tax Notes*, Sept. 24, 2007, p. 1119, *Doc 2007-21276* [**PDF**], or *2007 TNT 182-1*.)

Third, American fall fashion is essentially conservative. Fashion is the zeitgeist, readers. Not for nothing does Michelle Obama, who usually dresses like a normal woman of her socioeconomic status, periodically channel Jacqueline Kennedy in a retro-'60s bracelet-sleeved suit. Mrs. Obama jokingly referred to her husband as an "accessory" at a campaign event the other day. (http://www.newsobserver.com/politics/story/1030379.html.)

There is a new first lady whose husband truly is an accessory. That'd be Carla Bruni-Sarkozy, who has been making dowdy fall 2008 Christian Dior clothes look glamorous. Henceforth, all first ladies will want to look like her. Flats are the new power heels.

McCain has not released his tax returns yet, but the two Democratic contenders have, so we look at their returns in this article. In the interest of equal time, we promise to analyze Mrs. McCain's dress sense when her husband releases his returns.

Clinton Returns

The Clintons made a boatload of money since Bill Clinton left office, and they paid tax on it at an average rate of 31 percent over seven years. They have ascended to the bracket that allows them to benefit from the Bush tax cuts, which Sen. Clinton routinely denounces on the campaign trail. (For the Clintons' 2000-2006 tax returns, visit http://www.taxhistory.org/www/website.nsf/Web/PresidentialTaxReturns?OpenDocument.)

So what's wrong with this picture? The problem is the way they obtained their vast fortune, not the way they reported it on their tax returns.

We've been around the block with the Clintons and their tax returns. There have been some amusing stories of bizarre deductions and inexplicable reporting positions. (For a taste of that, see http://blogs.abcnews.com/theblotter/2008/04/tax-expert-reme.html.)

But that was when the Clintons had no money. Now that they are rich, and presumably getting better advice, their returns are pretty clean. There are unexplained aspects of their financial life, but few unexplained return positions.

Since the former president left office, the Clintons have amassed enough money to finance a presidential campaign by themselves. The Clintons earned $109 million in eight years. They paid $33.8 million in federal income tax. They donated $10.3 million to charity, of which $5.9 million went to their own charitable foundation, which has disbursed $2.53 million to favored causes.

Since 2003, Bill Clinton has received a total of $15.4 million from Los Angeles-based Yucaipa Cos., an investment fund management company run by billionaire and Clinton contributor Ron Burkle. Precisely what services does he perform to earn his multimillion-dollar annual guaranteed payment from Yucaipa?

The Clinton campaign press spokesman, Jay Carson, responded: "The former president provides his advice on potential investments, advocates generally on behalf of the funds, and seeks to create opportunities for investors to consider investing in the fund."

Bill Clinton receives large fixed sums from Yucaipa. He reported $1 million in 2003, $4 million in 2004, and $5 million in 2005. Those are obviously guaranteed payments for services, because Bill Clinton reports them as self-employment income and as nonpassive income. For 2006 he reported a guaranteed payment of $2.5 million from Yucaipa.

"President Clinton is a partner in Yucaipa Global Partnership Fund and its parent company, Yucaipa Global Holdings (formerly the Yucaipa Global Opportunities Fund)," Carson explained. "To date, as has been disclosed on Senator Clinton's financial disclosure reports, his income from the fund has been in the form of guaranteed payments to a fund partner."

He has invested in Yucaipa Global Partnership Fund, both as a limited partner and as an owner of the general partner, Yucaipa Global Holdings. One of the other owners of the general partner is the sovereign wealth fund of Dubai. In 2006 he received $156,611 of partnership profits. Yucaipa also passes investment interest expense through to him. Carson added that Bill Clinton has also contributed money in response to capital calls. He is permitted to opt out of fund investments and has done so.

Bill Clinton's compensation arrangement with Yucaipa entitles him to a share of the profits from two Yucaipa domestic partnerships if they meet certain profit hurdles, Carson explained. The two are Yucaipa American Funds and Yucaipa Corporate Initiative Fund.

"The president advocates generally on their behalf and seeks to create opportunities for investors to consider investing. He does not have a role in the investment decisions or the business operations of the funds," said Carson. "The former president will receive compensation for his advisory role with the Yucaipa domestic funds if they meet certain benchmarks over their lifetime. President Clinton to date has not received compensation from the domestic funds."

The domestic funds made a lot of money last year when they sold equity investments in a pair of supermarket chains. The Clintons have not released a 2007 return, having asked for an extension because of uncertainty about the former president's share of this gain. But their press release states that Bill Clinton estimates he will receive $2.75 million from partnerships in 2007. The Clintons paid $5 million of estimated tax for 2007 on an estimated total income of $20.4 million.

In 2006 and 2007, Bill Clinton also received $400,000 annually from infoUSA Inc., a data-mining company whose founder is being sued by shareholders, in part over payments to the Clintons, and investigated by the Securities and Exchange Commission. What does he do for infoUSA? "The president serves as an adviser to infoUSA, sharing his thoughts on the domestic and global economy and world affairs," says Carson.

The Clintons have told newspapers that the former president will extricate himself from these relationships if the senator becomes the Democratic nominee. Bill Clinton may receive as much as $20 million when he severs his relationship with Yucaipa. He is no longer providing whatever advice he was providing. (*The Wall Street Journal*, Jan. 22, 2008, p. A1.)

How much does Bill Clinton earn for a speech? He appears to earn roughly $125,000 per speech, as indicated by his foreign tax credit forms. Bill Clinton has earned $51.9 million from giving speeches since leaving office. The former president reports no travel expenses.

"President Clinton's travel expenses for his speech activities are paid directly by the speech host, withheld by the agent as reflected on Schedule C, or personally paid by the president, and he does not seek reimbursement or a deduction," said Carson.

Writing books has been good to the Clintons. Bill Clinton got a huge advance for his autobiography and earned $28.6 million from it. Hillary Clinton earned $10.1 million from her two books and spent $124,000 on what appears to have been salary for her collaborator on her autobiography, *Living History*.

The Clintons have two houses, one in New York that cost $1.7 million, and one in Washington that cost $2.9 million. They are paying large sums in mortgage interest, most of which is nondeductible, on $3.3 million in mortgages at the end of 2006. The $1 million limitation on deduction of home mortgage interest prevents the deduction of more than 60 percent of the Clintons' mortgage interest. Carson reported that the Clintons paid off the mortgage on the Washington house late last year.

The Clintons' house in Chappaqua, N.Y., a Westchester County suburb, had roughly 10 percent of its square footage dedicated to their home offices. From 2001 through 2004, they claimed more than $77,000 in home office expenses. For the years 2005 and 2006, no home office deductions were claimed.

Of course, each has an office paid for by the government, hers in Washington and his in Harlem (yes, the government pays for his office). But the law no longer requires that the home office be the only office available to the taxpayer. During the Clinton administration, section 280A was loosened so that the relative importance of the two offices available to the taxpayer need no longer be compared in determining whether the taxpayer's home office was the principal place of business.

The statute, even after amendment, is unclear and heavily factual. The Clintons appear to be arguing that their home offices are the principal place of business for their book writing. The government-provided offices, presumably, are the principal place of business for their occupations as an ex-president and U.S. senator.

Dubious though the home office deduction may be, in some years it was also incorrectly reduced for hourly use because the preparer appears to have treated the offices as day-care centers, according to Steven **Bankler**, the San Antonio CPA who helps us with presidential tax returns. Perhaps having Bill around qualifies as day care?

Bankler noted that expenses have been incorrectly allocated to the home offices. In 2001 mortgage interest was directly allocated to the home office when it should have been indirectly allocated, like utilities were allocated.

Why do the Clintons' home office deductions suddenly cease after 2004? Carson responded that the pair were done writing their books.

"Senator Clinton and President Clinton each claimed a deduction for their home office while they wrote their books. Senator Clinton wrote her book *Living History* from 2001 to 2003, and President Clinton wrote his book *My Life* from 2002 to 2004," he said. "After that time, neither Senator Clinton nor President Clinton have deducted home office expenses."

The Clintons left the White House with millions of dollars in outstanding legal bills and are quite conservative with their investments. A big chunk of the Clintons' money is invested in interest-bearing accounts and money market funds. These investments pay fairly low rates of interest, which is fully taxable. The Clintons had a small investment in a hedge fund through their blind trust.

How much did the Clintons have invested in Quellos Alpha Engine LP? Quellos is a Cayman-organized hedge fund run out of Seattle that normally requires a $5 million minimum investment. Quellos was investigated by the Senate Homeland Security and Governmental Affairs Subcommittee on Permanent Investigations for its role in tax shelters. (Bloomberg, Apr. 7, 2008.)

"The Clintons do not have any funds currently invested in Quellos," said Carson. "The original investment was made by the trustee of their blind trust, without the Clintons' participation as required by the Senate ethics rules."

"The Clintons were unaware of the Quellos investment until the trust was unblinded, at which point the assets of the formerly blind trust were sold -- with the exception of U.S. Treasury notes and federal bonds -- to avoid the appearance of conflict of interest," Carson explained. "Senator Clinton's public financial disclosure form reports that the Quellos asset was valued between $250,000-$500,000 when it was sold."

The Clintons reported relatively small amounts of income and loss from Quellos. Hedge funds tend to have straddles, so the Clintons reported small amounts of straddle gain and loss. Hedge funds have a lot of straddles, more than they attempt to report, because they can't identify all of them. (For discussion, see *Tax Notes*, Feb. 4, 2008, p. 597, *Doc 2008-2141 [***PDF***]*, or *2008 TNT 24-8*.) And as the Clinton returns attest, no straddle gain is too small to be reported.

Democratic strategists debate whether there is anything wrong or hypocritical about their candidates being rich. They have a bad habit of putting up candidates with inherited money. The Clintons have the virtue of being self-made, but their new membership in the hedge fund class would tend to sow doubt about their willingness to tax the rich. The tax benefit for capital gains was restored on President Clinton's watch.

Readers will recall that Obama, fully aware of the large contributions Sen. Clinton had received from hedge funds, goaded her into saying that she would join him in supporting taxing hedge fund managers' profits interest at ordinary rates. (*Doc 2007-22260 [***PDF***], 2007 TNT 194-54; Doc 2008-202 [***PDF***], 2008 TNT 4-2*.) When the Clintons' involvement with hedge funds is tallied -- including daughter Chelsea's employment at one -- the senator's assertion looks a bit hollow.

Obama Returns

Obama's returns are not as interesting as Clinton's for the simple reason that, despite the success of his book, he doesn't have as much money. While the Clintons' newfound riches are being examined, Michelle Obama has been dispatched to discuss her family's recent repayment of their student loan debt. The point is to argue that the Obamas are middle class while the Clintons are not. (For the Obamas' 2000-2006 tax returns, visit http://www.taxhistory.org/www/website.nsf/Web/PresidentialTaxReturns?OpenDocument.)

But the Obamas are not free of questions about where their money came from. Most of the Obamas' income comes from book royalties. Up through 2004, all of their income was from salary, and they were middle class. In 2005 more than $1 million of book royalties came in the door, but other sources of income seem to have increased greatly as well. Obama was elected in 2004 and assumed office in 2005.

Michelle Obama seems to be climbing out of the middle class quite rapidly. Her hospital salary skyrocketed when her husband became a senator. Her 2004 salary was $122,000, but when her husband assumed office in 2005, it more than doubled to $317,000, which included a pension payout and a bonus. She was promoted to vice president two months after her husband was sworn in as senator. Her salary was $274,000 in 2006. She is on leave to help with the campaign.

Mrs. Obama's full title is vice president for community and external affairs at the University of Chicago Hospitals, which puts her in charge of community relations and also the hospitals' business diversity program. Her previous title was executive director for community affairs. The Obama campaign is somewhat defensive about Mrs. Obama's salary, noting that she is paid less than her counterpart at her hospital's Chicago rival, Northwestern Memorial Hospital. (*Chicago Tribune*, Apr. 22, 2007.)

"We have been impressed with the care, imagination and energy that Michelle has brought to every project she has worked on since coming to the Hospitals," Michael Riordan, president and CEO of the Hospitals, said in a press statement. "We are excited to have her join the ranks of senior management. She brings to our team a new level of compassion, commitment and close connections to the community."

Also in 2005, Mrs. Obama received $45,000 in other income from two food companies, Bay Valley Foods and TreeHouse Foods. In 2006 she received $51,000 from TreeHouse Foods, a Wal-Mart affiliate of which she was a director. She left that board when her husband criticized Wal-Mart.

The Obamas bought a $1.65 million house in 2005, getting a questionable sweetheart deal on the land from a developer who is now on trial in Chicago on unrelated corruption charges. Bankler points out that the interest expense is rather low, indicating that either the loan may have been financed at a favorable rate or the Obamas spent his book advance on the house. We could not obtain information about the size of the mortgage.

The Obamas are middle class in that they have "next to no stake in the investor class," according to *The Wall Street Journal*. They report tiny amounts of taxable dividends, but their investments could easily take the form of tax-favored retirement accounts, which would show up on Form W-2 but would not show up on their publicly disclosed returns. (*The Wall Street Journal*, Mar. 27, 2008.)

Most of the Obamas' charitable contributions have gone to the Trinity United Church of Christ, formerly headed by the Rev. Jeremiah Wright. The Obamas incorrectly deducted a $13,000 contribution to the Congressional Black Caucus as a charitable contribution but have since amended that return.

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