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# NEWS ANALYSIS: WHITEWATER: WHAT WE NEED TO KNOW NOW.

Whitewater has hit the general-interest press. On the one hand, the March 14 Newsweek cover features a caricature of the first couple going over the falls in a canoe, with Mrs. Clinton at the rudder, while on the other, the cover of last week's issue of The Economist shows water gushing out of cracks in the White House. Congressional hearings have become inevitable, despite the protests of the Democratic leadership. London bookmakers are giving odds of 8 to 1 that President Clinton will resign over the Whitewater affair. This article summarizes the most important tax-related questions about this mess.

Until they were backed into a corner, White House officials have been hiding behind the assertion that the tax questions involved in Whitewater were just too complicated for the general public to understand. Nonsense. Though the American tax law is inordinately complicated in many respects (and has been made more so by this administration's efforts), the tax questions involved in Whitewater are neither complicated nor ambiguous. There is a right answer and a wrong answer to the question of whether one is entitled to deduct interest incurred and paid by someone else. The main questions are: Did the Clintons invest any of their own money in the Whitewater deal? Have the Clintons engaged in a pattern of questionable income tax reporting? What was the point of involving Hillary Clinton in the financing and construction of a model house?

**Sweetheart Deal**

Previous articles in this magazine have questioned whether the Clintons had any of their own money invested in the Whitewater Development Corporation, and now The New York Times is beginning to ask the same question. (The New York Times, March 16, 1994, p. B6.)

The Clintons appear to be backing off their assertion that they lost a total of $68,900 in the Whitewater deal, as stated in the now- discredited March 1992 report provided by Denver lawyer and Clinton crony James Lyons. Mrs. Clinton stated at a March 14 news conference that she and her husband were "trying to get an exact figure" for the amount they lost in the Whitewater deal. The Times and others have concluded that the 1990 tax return prepared for Whitewater by the late Vincent Foster is irreconcilable with the Lyons report. The Clintons' erstwhile partner, former Arkansas banker James McDougal, has put the amount of their investment in the deal at $13,500. And through an apparent mistake that now seems ironic, the Clintons reported the 1992 sale of their Whitewater Development Company shares as though they had a zero basis in them.

What does it matter if the Clintons put no money in? Mostly, it matters because, if they didn't, their half-interest in the real estate deal takes on the appearance of plain old-fashioned graft rather than a question of tax treatment of an investment. The situation becomes one in which a prominent banker let the state attorney general in on a potentially lucrative land deal in exchange for political favors to be rendered in the future. Favoritism is also indicated because the Clintons do not appear to have been qualified borrowers; their household income, their meager assets, and their lack of experience in the real estate business would not inspire confidence on the part of even the most eager lender unless something else were going on. To the general public this deal says that pols get favorable business deals that are not offered to ordinary people, and that the Clintons' claims of being just plain folks are a bit overstated.

On the tax side, if the Clintons were given their half-interest in the Whitewater Development corporation, they would have income in the amount of the fair market value of their shares under Duberstein v. Commissioner, 363 U.S. 278 (1960). The holding in Duberstein establishes that the recipient of a purported gift has income if the giver had an expectation of economic benefit to himself. In this case, McDougal might have expected lenient regulation of his controlled financial institutions or other future political favors that would redound to his financial advantage. Seemingly, the Clintons paid no tax on receipt of their shares gratis, if that is what happened.

And then there's the question of the interest deductions. The reason the Clintons were not entitled to some of the interest deductions they claimed is due to the corporate structure of the deal and the nonrecourse nature of the loans, rather than to any amount of their own capital they might have had in the deal. The McDougals and the Clintons borrowed the $20,000 down payment for the 230-acre tract of Ozark land that was to be developed for fishing cabins. They then borrowed some $183,000 from Citizens Bank & Trust of Flippin, Arkansas to complete the purchase, secured by the raw land. The couples then formed the Whitewater Development Corporation, a C corporation to which they contributed the land in a transaction governed by section 351. That the couples probably overpaid for the land and Hillary Clinton's assertion that the development was something of a disappointment do not exonerate them from the tax ramifications of their actions.

The parties' attempt to keep the nonrecourse purchase debt away from the corporation nonetheless failed. Even though the corporation did not formally assume the purchase loans, the tax law treats the owner of property securing these nonrecourse loans as the obligor because it is the party that would be affected by a default. (Regulation section 1.163-1(b).) The corporation was the party servicing the loans after it took possession of the land; McDougal recently stated that the corporation made all the payments on the loans after that time. The corporation's de facto assumption would put the shareholders in the position of guarantors, so that they would not be entitled to an interest deduction for any interest payments they might have made as guarantors. (For discussion, see Tax Notes, Feb. 14, 1994, p. 811.)

**Only Little People Pay Taxes**

Democratic Party Chairman David Wilhelm, doing his job to defend the president's honor, remarked at a recent party pep rally that "Being attacked on ethics by Bob Dole is like being called a tax cheat by Leona Helmsley." Wilhelm may have spoken too soon. Readers will recall that the infamous hotel queen went to jail for criminal tax fraud for causing her hotels to absorb personal expenses, large and small, and deduct them as business expenses. A salient feature of the Helmsley modus operandi was her thoroughgoing chintziness; she easily could have been able to afford all the expenses she sought to have the taxpayers absorb. A similar pattern is beginning to show up in examinations of the Clintons' tax returns, though their improper deductions do not seem to have reached the level of tax fraud yet.

The Clintons have already admitted that $5,133 of interest deductions they took in 1984 and 1985 were improper. The public does not appear to make much of this admission; for the average person, mistakes on a tax return are no big deal. Hillary Clinton, however, has alluded to more tax return errors in her recent interviews. "Mistakes were made" on the tax returns, she has admitted. The White House has told the Arkansas Democrat that the Clintons expect to pay more tax. Mrs. Clinton admitted to The Washington Post that the Clintons may have taken a deduction that had already been taken by another entity. (The Washington Post, Mar. 17, 1994, p. A2.)

More of these so-called mistakes have been showing up each time a news organization gets a tax expert to examine the Clintons' returns. And more questionable items, not always connected to Whitewater, are about to be disclosed in two yet-to-be-published articles in broadly circulated financial publications. Though the dollar amount of each error is small, such as the $1400 in improper real property tax deductions for 1984 and 1988 (see Tax Notes, Mar. 14, 1994, p. 1347), the number of peccadilloes is large.

"There is a pattern," said Steven Bankler, a San Antonio certified public accountant and return preparer who has examined the Clinton returns for news organizations. "It's very disconcerting for the tax community. The reason it is disconcerting is because we in the tax community are held to a standard of reasonable basis. Clearly, no preparer would have a reasonable basis for some of the deductions on the Clinton returns," Bankler explained.

"Some of the Whitewater deductions are very technical, and perhaps the preparer did not have a firm knowledge of the facts," he said. "But little things like reimbursement of taxes and interest deductions on loans for which you are not liable should not escape the attention of Yale Law School graduates." In accounting firms and normal law firms, a professional goes across the hall to ask a partner tax questions for which he or she does not have the answer, he noted. "That leaves you to wonder what Hillary Clinton knew. At some point you cannot blame it all on the preparer," Bankler commented.

A tax return is not an offer to contract. It is a self-attested declaration of the taxpayer's income and the amount of tax owing on it. When a taxpayer signs a return, he or she declares, under penalties of perjury, that the contents of the return are "true, correct and complete" to the best of his or her knowledge. Under prevailing IRS ethical standards and long-standing practice, a taxpayer must have a reasonable basis for a position taken on a return. A taxpayer does not just put deductions on a return for the purpose of seeing whether the IRS will accept them. Yet the Clintons' mistakes on their tax returns were so obvious and so pervasive over the period for which returns have been made available that one has to wonder whether they were not playing the audit lottery.

Columnist William Safire has demanded to know why the Clinton returns had not been audited, and whether the IRS had shown favoritism in failing to do so. (The New York Times, Mar. 14, 1994, p. A17.) The short answer to Safire's question is that the IRS audits hardly any returns. The IRS audits fewer than 1 percent of individual returns, meaning that there are very good odds for those who wish to play the audit lottery. (For coverage of the audit rate, see Tax Notes, Feb. 21, 1994, p. 947.)

Furthermore, based on information released to date, even an IRS commissioner who was a political enemy would have no grounds for insisting on a special audit of the Clintons. A completely forthcoming president might, however, insist on an audit.

**Squirrel Stew**

In December 1980, Hillary Clinton borrowed $30,000, presenting as security for the loan a piece of land, tract 13, that was part of the Whitewater Development parcel in the Ozarks. At the time she signed the note for the one-year loan, Mrs. Clinton did not own the lot against which she was borrowing; the corporation distributed it to her almost two weeks later. At the corporation's behest, Mrs. Clinton used the proceeds of the loan to assemble a modular house on the property, to be used as a model house to sell vacation houses. The corporation serviced Mrs. Clinton's loan and carried the loan on its books. (For discussion, see Tax Notes, Mar. 14, 1994, p. 1347.)

Was there a business purpose for the distribution of the parcel to Hillary Clinton in the first place? A corporation in the real estate development business has no apparent reason to recruit a shareholder who is not a contractor to build a model house for it. The only ready explanation is that McDougal could not have the borrower be his own corporation because he controlled the lender, the Kingston Bank & Trust. The White House has stated that Mrs. Clinton was necessary as a borrower because the corporation's borrowing capacity was tapped out -- as if Mrs. Clinton had borrowing capacity herself. Her posture as a nominee borrower, however, is belied by her later actions asserting ownership of the property and, according to McDougal, her retention of the proceeds of the 1981 sale of the property on a contract for deed. (See Tax Notes, Mar. 7, 1994, p. 1327.)

The worst case is that the loan and the model house provided cash to Hillary Clinton, who apparently regularly complained to McDougal about being short of cash. If so, Mrs. Clinton must recognize income from constructive distributions from the corporation, including the distribution of tract 13 itself -- these distributions would have to be tested for dividend treatment. If the corporation, which made all the payments on the loans secured by tract 13, should not be treated as having assumed those loans, then the Clintons would have constructive distributions in the amount of the payments of principal and interest that the corporation made. Then the corporation's potential status as a collapsible corporation would have to be determined to see whether any income from these distributions should be treated as ordinary. (For discussion, see Tax Notes, Feb. 14, 1994, p. 811.)

-- Lee A. Sheppard