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News Analysis -- A Look at the Clinton and Gore Tax Returns

by Lee A. Sheppard

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=============== FULL TEXT ===============

Scalamandri is an old, family-run manufacturer of fine upholstery and drapery fabrics. The firm wove the Metropolitan Opera's huge gold stage curtain, and it has made many specially commissioned historic textile reproductions for important houses, including the White House. That sort of skill does not come cheap. Individuals can buy fabrics from Scalamandri through decorators, and it goes without saying that those customers tend to be rich individuals.

When The New York Times went to the Scalamandri mill in Long Island City on a roving interview with a prominent New York decorator recently, a member of the Bitter family, which owns Scalamandri, proudly pointed to some "peach-beige" fabric on one of the looms. The fabric, he explained, is intended for Hillary Clinton's living room in her infamous $1.7 million house in Westchester County. (The New York Times Magazine, part 2, Home Design, Apr. 16, 2000, pp. 80, 123.)

Here we've been led to believe that the First Lady was moving her old college books and "Impeach Nixon" buttons to Chappaqua, N.Y., and now there's this expensive fabric. We've been told in chapter and verse that the Clintons could barely afford the house, and now there's a decorator involved. Who is paying for that? The various White House press offices -- everyone but the dog has his or her own press office -- were unable to confirm the hiring of a decorator.

Decorators generally are not a breed given to excessive worrying about where their customer's money comes from. Unlike decorators, however, Tax Notes is accustomed to asking about the sources of money. (Back before journalists began peering into politicians' finances, friends of former Presidents Nixon and Reagan bought each of them a posh California house to retire to, and no one batted an eye.) Over the past eight years, we have asked many financial questions about the Clintons. We're really going to miss them. This article looks at their last presidential tax return and at the return of Vice President and Mrs. Gore.

Then again, we're looking forward to W, around whom financial questions circulate like flies around buttermilk. (Mother Jones, April 2000, p. 48.) Governor Bush, who has not yet filed his return, has released only a synopsis of his tax return information. The governor reported that he

has paid $514,000 in withheld and estimated tax on $1.3 million of income. Of that income, $97,964 represented the governor's state salary, and $130,000 was a book advance. The rest was investment income. The Bushes gave $78,650 of the book advance, which they treated as royalty income, to charity. Bush's campaign could not say when the governor would disclose his return. (The New York Times, Apr. 18, 2000, p. A23.) We'd rather have the book than the movie script, Governor Bush.

Disclosure of these public officials' tax returns is a touchy issue, and not just because this is an election year. During the past 12 months, we have been around the block with disclosure of APAs, disclosure of Forms 990, and now disclosure of prefiling agreements. Nobody who has two nickels to rub together wants to disclose anything, even when they are on the government dole and the law says they have to disclose.

Every year, politicians and office seekers voluntarily disclose their returns, and we write articles like this one seeking explanations. And earnest, well-meaning employees of their press offices scurry around to find someone capable of answering our questions about those returns.

There is a better way. If a public figure voluntarily discloses his or her tax return, then section 6103 protection should come off. That suggestion was made by Steven **Bankler**, a San Antonio accountant and return preparer, in response to the Joint Committee on Taxation's request for public comment on confidentiality and disclosure provisions. "Section 6103 impedes open communication, discussion of the code, and compliance EVEN when the taxpayer has voluntarily released the tax returns to the public (such as elected officials and candidates)," said **Bankler**, who helps Tax Notes analyze the president's return each year. (For **Bankler**'s and other public comments received by the JCT, see the JCT confidentiality and disclosure study, Vol. 1, Doc 2000-3034 (316 pages); 2000 TNT 21-9.)

The Clintons

The Clintons reported an adjusted gross income of $416,039, of which $200,000 was the president's salary; $179,849 was capital gain. Some of that capital gain was used to make the down payment on the Chappaqua house. The Clintons paid $92,104 in federal income tax.

Last year, we carped about how much the Clintons were paying for tax return preparation. The Clintons' 1998 Schedule A showed $7,215 for tax preparation and accounting services. The entries for 1997 and 1996 were even higher: $8,910 for 1996, and $8,030 for 1997. Someone must have given those expenses some thought, because they are lower for 1999. The Clinton's 1999 Schedule A shows $5,625 for tax preparation and accounting services.

The big question about the Clintons' return this year involves not home decorating but the tax treatment of rehabilitating one's public image. Like last year, we are once again asking whether the Clintons might owe alternative minimum tax. (See Doc 1999-15123 (5 original pages), 1999 TNT 79-3, or Tax Notes, Apr. 26, 1999, p. 470.) For 1999, the Clintons reported $4,943 of minimum tax attributable to adding back Schedule A deductions. But they might owe more AMT for a different reason.

Paula Jones was paid her $850,000 settlement in January 1999. The sources of that money were an insurance policy, which paid $475,000, and the president's personal assets, which made up the remaining $375,000. That is why the president complained recently that Ms. Jones had cleaned

him out. The president's lawyers, who were vastly more expensive than the settlement, were paid from the president's legal defense fund, which is still in operation and last had an accounting in February.

The Clinton Legal Expense Trust, formed in 1998 to accept larger contributions than its predecessor, has been a success -- helped, no doubt, by the impeachment trial. The Clintons have run up $10.7 million in legal bills during the president's two terms in office, of which $5.9 million have been paid. The Clintons still owe $4.3 million to lawyers.

According to its February 2000 financial statements, the legal defense fund took in $3.2 million in 1999, and paid $2.25 million in legal bills in that year. During 2000, it has raised $400,000 so far. During its existence, the fund has raised a total of $7.3 million, and currently holds $500,000. (The Arkansas Democrat-Gazette, Feb. 24, 2000, p. A1.) The fund, which uses cash accounting, costs nearly $1 million per year to administer. Most of that expense is for direct mail solicitations.

The president and his tax advisers have long taken the position that the monies received by the legal defense fund are not income to the president, and even if they were, the payments to Ms. Jones and her lawyers would be deductible, so it would be a wash. (For discussion, see Tax Notes, Mar. 9, 1998, pp. 1226, 1325.) Assuming for purposes of argument that the legal defense fund's intake is income to the president and the fund's outflow is deductible by him, there may still be a tax problem.

The result may be a wash for the president's regular income tax liability. But not for AMT. The IRS has fought a number of court battles recently on the question whether legal fees paid to plaintiffs' lawyers on a contingency basis are added back to income for AMT purposes. The IRS takes the position that the plaintiff's alternative minimum taxable income should include the 30 to 40 percent of the award that was paid to the plaintiff's lawyer. For a taxpayer who pursued a nonbusiness cause of action, any deductible legal fees are miscellaneous itemized deductions under section 212, so they have to be added back to compute AMT. (For discussion, see Doc 2000-2782 (7 original pages), 2000 TNT 22-22, or Tax Notes, Jan. 31, 2000, p. 663; and Tax Notes, Apr. 17, 2000, p. 409.)

According to state law, a lawyer that takes a case on a contingent fee basis has a lien on the plaintiff's recovery, which is an encumbrance that does not rise to the level of a property right. So the IRS takes the position that both plaintiff and lawyer are taxable on the lawyer's share of the award ab initio, before the plaintiff deducts the fee. Nonetheless, the Sixth Circuit in Estate of Arthur L. Clarks v. U.S., Dkt. No. 98-2437 (6th Cir. 2000), somehow found a way to exclude the lawyer's share from the client's gross income on the ground that the plaintiff and the lawyer had entered a joint venture in the form of a lawsuit.

The Sixth Circuit, which does not appear to have considered the legal ethics question of the joint venture theory, relied on Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), a widely discredited decision based on an Alabama statute that gave the lawyer an equitable lien. Indulging in the same thoroughly botched reading of Lucas v. Earl and Helvering v. Horst that the Cotnam concurring judges had, the Clarks court found that the plaintiff's claim was an intangible, contingent expectancy that could not have come to fruition without the efforts of his lawyer, who earned his portion himself. "Although the underlying claim for personal injury was

originally owned by the client, the client lost his right to receive payment for the lawyer's portion of the judgment," Circuit Judge Merritt stated.

All of which is very flattering to the plaintiffs' bar but flat wrong. There is a conflict among the circuits on this question. In Baylin v. U.S., 43 F.3d 1451 (Fed. Cir. 1995), the plaintiffs, partners in a partnership, argued that their attorney's fee was never part of their gross income. The Federal Circuit saw a lien as a lien, calling the ownership argument "unsound."

While the Clarks court relied on the fact that the plaintiff never had possession of the amount paid to the lawyer, the Baylin court analogized the assignment to discharge of indebtedness. Relying on Lucas v. Earl and Helvering v. Horst, the Federal Circuit held that uncertainty as to amount did not defeat taxation of income over which the plaintiffs had exercised control by assigning it. "The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees," Circuit Judge Mayer wrote.

Clinton is not a plaintiff and has received no recovery. But his legal defense fund situation is analogous to that of plaintiffs whose recoveries are subject to lawyers' liens for contingent fees. Money comes into Clinton's legal defense fund. This discussion assumes that this money is income. In Rev. Rul. 60-14, 1960-1 C.B. 16, the IRS ruled that contributions to an official's legal defense fund are income. In a series of rulings, the IRS analyzed donative intent to rule that politicians had income from contributions received to help defray the expenses of their offices. (Rev. Rul. 73-356, 1973-2 C.B. 31; Rev. Rul. 75-146, 1975-1 C.B. 23; Rev. Rul. 76-276, 1976-2 C.B. 14.)

Money goes out of the fund to pay lawyers. This discussion assumes that this outflow is deductible by Clinton. A politician can deduct the cost of protecting his office. In Rev. Rul. 74-394, 1974-2 C.B. 40, the IRS held that a judge could deduct the costs of defending himself against charges of misconduct while in office under U.S. v. Gilmore, 372 U.S. 39 (1963), because the charges arose out of his conduct in office. Similarly, in Rev. Rul. 71-470, 1971-2 C.B. 121, a public official was permitted to deduct the cost of defending himself against a recall. (For discussion, see Tax Notes, July 4, 1994, p. 12.)

Clinton's deduction would be a personal deduction that must be added back for minimum tax purposes. Clinton has a trade or business of being an employee of the federal government. (If his trade or business was other than as an employee, his legal expenses would appear on Schedule C, and there would be no minimum tax problem.) In Rev. Rul. 73-356, the IRS pointed out that although section 7701(a)(26) provides that the term "trade or business" includes the performance of the functions of a public office, an office holder's section 162 expenses are below-the-line deductions, which must appear on Schedule A. According to section 62, expenses attributable to the performance of a trade or business as an employee are deductible only in computing taxable income.

So the Clintons would have income of the $3.2 million the legal defense fund took in 1999, and a Schedule A deduction for $2.25 million of legal fees paid in 1999, which must be added back to the AMT bases, making the Clintons taxable on $2.25 million of additional income at the 28 percent minimum tax rate.

The Gores

The Gores have begun using the same tax preparer as the Clintons, Robert Jones of Hariton, Mancuso & Jones in Rockville, Md. The Gores paid $4,440 for tax preparation.

We in the newspaper business believe that sunlight is the best disinfectant, a view that states that publicity is enough to shame public figures out of doing things they would rather not see above the fold. But politicians, like tax shelter promoters, have a high threshold of embarrassment. Though the vice president has been questioned about his family's relationship with Occidental Petroleum, he has not severed his ties to the company. Occidental founder Armand Hammer helped make Gore's father a rich man.

The Gore's Schedule E shows $20,000 of income from the Gordonsville Mine in Gordonsville, Tenn. That item represents a mineral lease, a virtual gift from Occidental Petroleum, that pays Gore $20,000 annually for the privilege of extracting zinc from farmland in Tennessee. Gore has earned roughly $450,000 from the lease since 1974. Though there was no mining for the first decade of the lease, the $20,000 annual lease payment was above market when the lease was signed. The lessee is now Pasminco, an Australian mining company. Gore has publicly defended the lease as the result of free- market negotiation. (The New York Times, Mar. 19, 2000, p. A23.)

The Gores' Schedule H shows $35,570 paid to a nurse for Mrs. Gore's mother. The Gores withheld $5,443 in social security and Medicare taxes for the employee, but did not withhold income tax. Nor did the Gores answer the question, at the top of Schedule H, whether they withheld income tax for the nurse. Income tax as well as employment taxes must be withheld from the pay of most persons who are acknowledged to be employees.

"It's voluntary," chirped an unbearably polite young lady in Mrs. Gore's press office when asked why income tax had not been withheld for the nurse. Oh, really? "That's what I was told."

Employers must withhold social security, Medicare, and unemployment taxes for domestic help paid more than $1,100 in 1999, but need not withhold income tax in the absence of a voluntary section 3402(p) agreement to do so between employer and employee. Section 3510, enacted after Zoe Baird's disclosure that she had not paid tax on her domestic makes the employers' return a part of their regular Form 1040 income tax return.

Is a nurse a domestic servant? "Domestic services" are services of a household nature performed by an employee in or about a private home of the person by whom he or she is employed. (Reg. section 31.3121(a)(7)-1(a).) In general, the definition includes services performed by cooks, waiters, butlers, housekeepers, governesses, maids, valets, baby sitters, janitors, laundresses, furnacemen, caretakers, handymen, gardeners, footmen, grooms, and chauffeurs of automobiles for family use. (Reg. section 31.3401(a)(3)-1(a)(2).) Certainly a lot of professional nurses would not consider themselves in the class of maids and babysitters, but householders take the position that nurses who work in the home are domestic servants -- unlike nurses who work in hospitals and clinics -- purely because they work in the home.

Sounds a lot like comfort class greed, but there is a return position here. Section 3401(a)(3) excludes wages paid for domestic service from the definition of wages for which income tax withholding is required. The IRS ruled that full-time nurses working in the homes of their

employers were domestic servants, for which employment tax withholding but not income tax withholding was required. (TAM 9123005, LTR 8845049.)

The rulings were issued despite the implication of regulation section 31.3121(a)(7)-1(a) that skilled professionals who perform services in the house should not be considered domestic servants. That regulation states: "Services not of a household nature, such as services performed as a private secretary, tutor, or librarian, even though performed in the employer's home, are not included within the term `domestic service in a private home of the employer'." Perhaps the IRS should further develop the skilled/unskilled distinction in determining who is a domestic servant.

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