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NEWS ANALYSIS: TAX NOTES AUDITS THE CLINTONS.

"The fact that we made investments, some of which we lost money on, some of which we made money on, has nothing to do with the indictment I made about the excesses of the '80's. And we always made every effort to pay our taxes. I would remind you that we, like most middle-class folk, we turned our records over to an accountant. We did -- I always told the accountant to resolve all doubts in favor of the government. I never wanted any question raised about our taxes." President Clinton, press conference, March 24, 1994.

One reader wonders why this publication has devoted so much space to the amalgam of President Clinton's personal business affairs that goes under the general heading of Whitewater (see p. 121). The questions raised by the president and first lady's business dealings in Arkansas fall into two categories. The larger and more important question, for which the Clintons' tax returns serve as a window, is the mixture of politics and personal business in Washington and Little Rock. Is it unusual for politicians who have neither financial assets nor business experience to be let in on potentially lucrative land and commodities futures dealings? But that is not the focus of our interests.

The second question -- the more important one for Tax Notes readers -- is whether some of the deductions claimed on the Clintons' tax returns for the period 1977 to 1992 were proper. Although the Clintons have admitted mistakes as to some deductions and may have colorable arguments for others, their returns contain some questionable items. Do these returns show a pattern of questionable deductions suggesting something other than inadvertent error was involved? Were doubts resolved in the government's favor? These questions may be of greater importance to those who take the tax return filing obligation very seriously than to the general public, who (having been told by every president since World War II that the income tax is unfair) believe that taxpayers should be able to hide behind their return preparers (which, legally, is impossible).

How much did the Clintons "lose," as they put it, in the Whitewater venture? The White House's revised version of events -- the administration having backed off the March 1992 assertion that the Clintons' loss was $68,900 -- now states that the Clintons had $46,636 in the Whitewater deal, largely in the form of interest payments. The revised version asserts that all but $3,979 of that sum was properly deductible. The following discussion does not reach conclusions as to numbers but argues that a smaller part of the asserted loss is deductible.

Whitewater

In August 1978, the two Clintons borrowed some $203,000, together with Arkansas banker James McDougal and his wife, to purchase a 230- acre tract of raw land on the White River in the Ozarks that was to be developed for recreational fishing cabins. No development ever took place except for the installation of gravel roads. The $20,000 down payment was borrowed on an

unsecured note from the Union Bank to James McDougal and Bill Clinton. The remainder of the purchase price took the form of a $182,600 mortgage from the Citizens Bank & Trust of Flippin, Arkansas, signed by McDougal, Clinton, and their respective wives. Though the loan was secured by the property, the lender legally had recourse to the four individual borrowers if the land was not worth enough to satisfy the debt. McDougal has stated that the lender was looking to his personal creditworthiness and not that of the Clintons, who had no assets to speak of at the time.

Sometime in 1979, when Bill Clinton was in his first term as governor, the Arkansas Game and Fish Commission approved the use of federal funds to build an access road to the Ozark property, which would otherwise have been unreachable and unmarketable. Whitewater Development Co. Inc. was organized in August 1979 as a C corporation equally owned by the Clintons and the McDougals. The shareholders contributed the Ozark real property to the corporation in September 1979, but the corporation did not formally assume the loan at that time. The corporation did, however, make payments on the loan from the time it acquired the property. The corporation's initial capitalization was $1,000, and its equity capitalization remained at $1,000 throughout its history. The acquisition loans were finally paid off in 1992.

The claimed interest deductions at issue in this discussion are these: $10,131 paid to Great Southern Land Company in 1978; $11,749 paid to banks and Whitewater Development Company in 1979; $9,000 paid to James McDougal in 1980, and $4,350 paid to Citizens Bank in 1980. There are several problems with these deductions. In some cases, the payee was not the lender. Payments made after 1979 may not have been deductible by the Clintons because they were guarantors of loans that the corporation assumed. Also there has been some speculation whether the payments were made or reimbursed, although the White House has affirmed that the payments were made.

CLINTONS' WHITEWATER PAYMENTS

Year	Type of Payment	Amounts
1978	Interest	$10,130.58
1979	Interest	$11,752.52*
	Interest	$237.50
	Capital Contribution	$500.00**
1980	Interest	$4,350.00
	Interest	$9,000.00
1981	Interest	$243.82
1986	Interest	$1,635.51
1987	Interest	$2,561.33
1988	Interest	$1,473.60
	Real Estate Tax	$1,275.15
1989	Real Estate Tax	$291.35**

1990	Franchise tax	$345.15**
	Accountant's bill	$2,839.24**
Total Payments		$46,635.75

* The amount deducted was $11,749.

** These amounts not deducted on tax returns.

Source: Documents released by the White House following President Clinton's March 24 press conference.

The White House has taken the position that the corporation did not assume the property acquisition loans, so that the shareholders should be treated as having lent the proceeds of the loans to the corporation. Thus the corporation should be treated as owing money to the shareholders, who owed money to two banks. The problem with this argument is that the parties did not adhere to their asserted form -- nor did they even document it. The corporation did not pay interest to the shareholders, nor did they report the receipt of any interest from it. The corporation did pay the banks.

According to the Citizens Bank mortgage document, the individual borrowers remain liable on the loan to the extent the proceeds of sale of the property securing the loan do not satisfy the debt plus expenses of sale. The tax lawyers designated by the White House to answer questions concerning the Clintons' returns argue that because the Clintons formally remained personally liable on the acquisition loans, payments claimed by the Clintons as interest payments on these loans are deductible.

That characterization, however, conflicts with the accepted doctrine that would treat the corporation as the de facto obligor on the acquisition loans because it had become the owner of the property that secured the larger loan. Even though the loan documents were not changed and the loan was not formally assumed by it, the corporation, as the owner of the property, became the obligor on the loans for tax purposes and was entitled to deduct the interest payments. Under this view, the Clintons and McDougals occupied the position of guarantors of the loan. (For discussion, see Tax Notes, Feb. 14, 1994, p. 811.)

That leaves the question of the identity of the payee for some payments. When the Clintons paid $10,131 to the Great Southern Land Company in 1978, they had what the tax law would consider a partnership with the McDougals. If it was not conducting a business, this partnership would not have been required to file partnership tax returns for the period August 1978 to September 1979, according to the small investment partnership exception to the filing requirement contained in regulation section 1.761-1(a). The partnership's only activity during that period appears to have been seeking state approval for an access road. Great Southern Land Company was a corporation controlled by McDougal that paid the interest on the loans and was reimbursed by the Clintons. Other than that, this entity's role is not clear.

Great Southern does not appear to have had any formal agency for the parties to the acquisition loans; according to the White House, it had no relationship to the parties or the deal. Yet the tax lawyers for the White House argue that Great Southern is some sort of agent for the individual

borrowers. Its status as a separate entity should be ignored, not because it passes the test of Bollinger v. Commissioner, 485 U.S. 340 (1988), but rather because it is the alter ego of James McDougal. McDougal, under partnership law, functions as an agent for his partners, the Clintons. The lawyers sought to excuse the informality of these arrangements by arguing that this interest deduction would pass muster with an IRS examiner.

Another payee identity problem crops up for 1979, when $2,900, part of the amount the Clintons deducted as interest, was paid to the Whitewater Development Company. According to the lawyers, a casual notation somewhere indicates that $500 of this amount was intended as a contribution to capital, for the Clintons' purchase of their shares, with the rest intended to reimburse the corporation for interest on the acquisition loans. Even according to the view that the corporation did not assume the loans, the deduction for $2,400 still has problems unless the use of the funds can be traced to an interest payment by the corporation. And under the theory that the corporation did assume the loans, the payment would be a nondeductible contribution to capital unless it reimbursed the corporation for interest accrued at the time of the assumption.

As has been previously discussed, the $9,000 payment to James McDougal in 1980 suffers from problems of payee identity and the theory that the corporation assumed the acquisition loans. (For discussion, see Tax Notes, Jan. 31, 1994, p. 517.) It should be noted that this $9,000 payment is a large part of the basis for McDougal's continuing assertion that the Clintons had invested only $13,500 in the Whitewater deal. The $4,350 payment that the Clintons made to Citizens Bank that year is -- contrary to the Clinton's return -- not deductible because by that time the corporation had assumed the loan. Also part of the Clinton's asserted loss in Whitewater is $1,275 of other people's real property taxes improperly deducted in 1988. (For discussion, see Tax Notes, Mar. 14, 1994, p. 1347.)

The Model House

The question of the corporation's assumption of loans secured by a parcel of land, tract 13, that the corporation distributed to Hillary Clinton in 1980 is somewhat simpler, but this transaction raises other tax questions.

The Clintons have already admitted that $5,133 of interest deductions they took in 1984 and 1985 were improper. Those interest deductions, for amounts the Whitewater Development Company paid to the Security Bank of Paragould, did not relate to the acquisition loans for the Whitewater property, though the White House characterizes them as Whitewater-related and includes them in their sums of the Clintons' asserted losses. The Clintons claimed interest deductions for the following amounts on the Paragould loan: $244 in 1981; $1,636 in 1986; $2,561 in 1987; and $1,474 in 1988. The Clintons' own doubts about the deductibility of this interest is shown by their tax returns; in 1987, the interest is classified as personal, while in 1988, it is deducted as investment interest.

The admittedly improper interest deductions were for corporate payments made on a $20,000 loan that Bill Clinton took out in 1983 to refinance a $30,000 loan that Hillary Clinton took out in December 1980 from the Kingston Bank & Trust, a bank controlled by McDougal. The security for these loans was tract 13, the parcel of land (part of the original 230-acre parcel) that Whitewater distributed to Hillary Clinton two weeks after she got the loan. McDougal has explained that Hillary Clinton was a nominee borrower. (Perhaps Hillary Clinton was a nominee

borrower to save McDougal the trouble of having to borrow from his own bank.) A modular house was constructed on this lot and used as a model house by Whitewater until it was sold to an individual purchaser on an installment contract for deed in 1981. Importantly, the corporation, not Bill or Hillary Clinton, made all the payments on the Kingston and Paragould loans on behalf of the Clintons. It is not clear from the returns and other documents released by the Clintons whether the corporation wrote the checks to the bank or Hillary Clinton wrote them and was reimbursed by the corporation.

Here again the White House asserts that the principal amount of the Kingston and Paragould loans was advanced to the Whitewater Development Company, which did not assume either loan, even though it carried the loans on its books. Can the corporation be treated as having assumed the Paragould and Kingston loans even though the Clintons retained possession of the property securing these loans? Assumption is the most reasonable interpretation consistent with Hillary Clinton's role as nominee borrower, and would make the other four interest payments on the loan nondeductible. Nonetheless, the Clintons asserted their ownership of the property by selling it and by taking steps to repossess it when the purchaser defaulted in 1988. The gain on the resale of the house and lot to the present owner in 1988 is reported as a long-term capital gain on the Clintons' 1988 tax return, even though the repossession occurred in 1988.

In 1980, the General Utilities rule prevented the corporation itself from having to recognize any income on the distribution of tract 13 to Hillary Clinton. But she would have had a section 301 distribution in the amount of the fair market value of the lot at the time of distribution, which value appears to have been between $11,000 and $17,000, according to sale and real property tax records. If the distribution was not a dividend, it still could be ordinary income if the corporation was determined to be collapsible under section 341. No income attributable to the distribution of tract 13 shows up on the Clintons' 1980 return, which shows a total income of $87,275.

Tax Returns

Little things mean a lot. Steven Bankler, a San Antonio certified public accountant and return preparer, and Money magazine have separately discovered several items that are wrongly reported on the Clintons' tax returns, for several years running in each case. (Money, April 1994, p. 84.) The dollar amount of these problematic items is not large. Their number is sufficient, however, to cause some commentators to ask if there is a pattern of disregard for the rules on the part of the Clintons and their preparers. Money made a big deal out of charitable deductions for prosaic items such as underwear and payments to odd-sounding payees such as a sporting goods store; though not a lot of money is involved, the charitable deductions may raise the question whether all doubts were in fact resolved in favor of the government.

Before the formation of the Whitewater Development Company, the Clintons and McDougals had a partnership. Schedule D of the Clintons' 1978 return shows income from installment sales of what appeared to be Whitewater lots; the lots were usually sold on contract for deed, with title passing to the purchaser when the payments were complete. Bankler takes the position that the partnership was a dealer in real estate, so that the Clintons should have reported the gain from the installment sales as ordinary. Moreover, the partnership, he argues, should have filed partnership returns for 1978 and 1979 since it appears to have been in the business of selling land, and partnership items for the Clintons should have been reported on a Schedule E. Bankler also

wonders why no income from Whitewater land sales was reported in 1979, when sales apparently did take place.

The Clintons seem to have difficulty getting the tax reporting right for items relating to their various residences. In 1975, they purchased a house in Fayetteville for $22,000, which they sold in 1983 for $47,000. In 1981, the house was converted to a rental property; rental income was reported, and the house was depreciated. Bankler told The Wall Street Journal that the depreciation was vastly overstated for each of the three years the house was a rental property because the Clintons used ACRS. According to section 168(e)(4)(B), as it read for that period, real property owned by the taxpayer at any time during 1980 is ineligible for ACRS. According to Bankler, the Clintons claimed excess depreciation deductions of $2,413 in 1981, $1,863 in 1982, and $351 in 1983. That the depreciation was recaptured on the sale of the house does not eliminate the timing advantage of the excessive claims.

The success of Hillary Clinton's foray into futures trading gave the couple the $54,000 they put down on a $111,000 house in Little Rock in 1980. They also sold this house in 1983, but did not report the sale until their 1987 return, when the purchaser had paid off the mortgage he had assumed. The sales price was $118,000. Bankler is suspicious of not just the failure to report the sale when it was made. He also notes that $7,000 of improvements just happens to prevent the couple from realizing any gain.

Hillary Clinton's treatment of her business expenses suddenly changed in 1987, perhaps because the law changed in 1986. As The Wall Street Journal reported, her business use of her low-mileage car, which had been reported to be 40 percent, suddenly jumped to 52 percent in 1987, after the law changed to require greater business usage to sustain a business expense deduction. (The Wall Street Journal, March 28, 1993, p. A3.) Beginning in 1987, after the 1986 changes restricted the deduction of IRA contributions, Bankler believes that Hillary Clinton maximized her contribution to a Keogh plan by classifying, as employee business expenses, items that should have been reported on Schedule C. Reporting these expenses on Schedule C would have reduced her outside income, largely from directors' fees, against which her deductible contribution to a Keogh plan is measured.

Bill Clinton's business expenses are likewise interesting reading. As governor of Arkansas, he had a large expense account, called the Public Relations Fund, at his disposal. Over the years he was governor, this account permitted him to spend between $13,000 and $19,000 annually as he saw fit. This was just the sort of expense account that Congress saw numerous executives, in both the private and public sectors, abusing before it enacted section 62(c) in 1988 - - the expense reimbursement equivalent of the infamous "call Karen" cafeteria plan. (See Tax Notes, Feb. 20, 1984, p. 687 and June 25, 1984, p. 1358.) Section 62(c) states that reimbursements of employee business expenses can only be excluded from gross income if the employee both substantiates the expenses and is required to return employer advances that are not used for substantiated business expenses. This section has a very generous transition rule, admittedly because federal and state government employees were having trouble bringing themselves into compliance.

Insofar as his reporting is concerned, Bill Clinton was not doing anything different from anyone else fortunate enough to have a no-holds-barred expense account -- the state began complying only after section 62(c) clarified congressional intent. IRS positions and regulations prior to the

mid-1991 effective date of section 62(c) state that employees should report income from reimbursement arrangements in which adequate accounting was lacking, but the administrative position was widely flouted. This despite the fact that section 125 has never permitted cash to be recharacterized as an excludable working condition fringe or other excludable benefit. (See also regulation sections 1.6041-3(i), 1.162-17(b)(4), 1.274-5(e), and 1.274-5T(f).)

The items that Clinton reported as business expenses deserve mention. Money suspected that the governor was using his Public Relations Fund for campaign expenses when they noticed large expenditures for printing, travel, and advertising. Money also wondered why the sizeable costs of feeding large groups of political seminar participants were listed for the Public Relations Fund when a more appropriate vehicle, the governor's $51,000 annual Mansion Account, was available to pay for official entertaining. Other expenses are likewise hard to explain. In 1990, Bill Clinton managed to spend $2,311 on flowers, and in 1989 he spent $808 on flowers and gifts. In Japan, politicians are expected to show up at constituents' funerals; it is not clear that this custom has migrated to Arkansas.

Penalties

The section 6501(a) statute of limitations, which is three years from the time the return was filed, has probably closed on most of the Clintons' tax returns discussed in this article. Under section 6501(e), the statute of limitations is six years from the time the return was filed in the case of an omission of more than 25 percent of gross income; section 6501(c) keeps the statute open forever in the case of fraud. At his March 24 press conference, however, the president indicated that back taxes found owing would be paid even though the statute of limitations may have run on the return in question. This discussion of possible penalties will proceed as though the tax returns in question were still open.

What constitutes negligence? According to section 6662(c), as described in the conference report accompanying the 1989 revision of the negligence penalty, "negligence includes any careless, reckless or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the code." A taxpayer is not subject to the negligence penalty if he or she had a reasonable basis for a return position. Though arguments about just what constitutes a reasonable basis continue unresolved, it is clear that a taxpayer lacks a reasonable basis for return positions that are flat wrong under the law as applied to the facts. On the facts known, an IRS agent might argue that the Clintons were negligent, but considerably more would have to be known to decide whether those penalties would stick.

Could Bill Clinton be an innocent spouse? Under section 6013(e), one spouse can escape joint and several liability for tax, interest, and penalties due to a substantial understatement attributable to the other spouse's omission of income or claim of a deduction having no basis in fact or law. Though Hillary Clinton handled the family finances and presumably the tax returns as well, Bill Clinton might have trouble showing that he did not know of any understatement of tax and had no reason to know of any. The president is, after all, a Rhodes scholar and Yale Law School graduate, in addition to being a public official who by his own admission should pay attention to the propriety of his income tax returns.

From all appearances, the Clintons' preparers seem to have been the sort who take the taxpayer's word for something and sign off on the return. Under section 6701, a preparer's assistance in the

preparation of a return that would result in an understatement of tax liability is called aiding and abetting; the return preparer is tagged with the sins of the taxpayer for failing to prevent them. Of course, if the Clinton preparers were negligent themselves, they would incur penalties under section 6694.

-- Lee A. Sheppard

Relevant Code Sections

Section 6662 -- Accuracy-Related Penalty

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