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News Analysis: Whitewater Committee Reports On Clinton Tax Returns.

In news analysis, contributing editor Lee A. Sheppard examines the Senate Whitewater Committee's final report, which all but accuses the Clintons of tax fraud over a surprisingly petty set of deductions.

Date: Jul. 8, 1996

====== HIGHLIGHT ======

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Meanwhile, the Senate Whitewater Committee (officially the Special Committee to Investigate the Whitewater Development Corporation and Related Matters) on June 17 produced its final report, which all but accuses the Clintons of tax fraud over a surprisingly petty set of deductions. The committee rejected the advice of its accountant on the larger questions, like a taxable incorporation, in favor of a laundry list of improper interest deductions. Still, little things mean a lot. The committee accused the Clintons of understating their income by $33,771. Add that amount to the $16,099 of understatements to which the Clintons have admitted, and their understatements of income over the period from 1978 to the present total $49,870.

The Clintons' lawyer, David Kendall of Williams & Connolly, did a separate analysis of the couple's tax returns, with the help of some former government tax officials. That report was sent to House Banking Committee Chairman Jim Leach, R-Iowa, in response to a 1995 report prepared by the Banking Committee. (For discussion, see Tax Notes, August 28, 1995, p. 1034.) Therefore the Kendall report, which was released at the beginning of the Memorial Day weekend, does not answer every question raised by the Whitewater Committee report. It is confined to specific tax return questions raised by the Banking Committee. Kendall himself argues that the Clintons did not deduct some unreimbursed Whitewater expenses, which would have offset the tax due on the improper items they admit to in his report.

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

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The Whitewater Committee had some harsh but lawyerly words for the Clintons' attempt to pin their problems on their accountants. "The Clintons have explained that errors on their tax returns relating to Whitewater were due to mistakes made by their accountants. The Clintons did not fully disclose, however, all of their financial information to their accountants, did not discuss the details of important financial transactions with them, and sometimes simply ignored their accountants' advice," the committee report states. Thus the enumerated problems "cannot be dismissed as merely mistakes by the Clintons' personal accountants." The committee interviewed the Clintons' various tax accountants at a May 15 hearing, and had its own outside certified public accountant, Steven Bankler of San Antonio, reconstruct the Clintons' tax returns.

Reliance on a tax adviser is not a defense to negligence, only a factor in determining whether a taxpayer was negligent. And just having a person with a professional license sign the returns is not enough. Reliance has to be reasonable, and the return preparer has to be working with all of the relevant information. Reg. section 1.6664- 4(b)(1) states that "Reliance on an information return or on the advice of a professional (such as an appraiser, attorney, or accountant) does not necessarily demonstrate reasonable cause and good faith." On this question, the IRS Penalties Handbook at (20)333.7 (7-27-92) advises agents that the tax adviser whom the taxpayer relied on should be competent in the tax matter at issue, and should have been furnished with the necessary and relevant information.

In its response to the Whitewater Committee report, the Whitewater Committee minority glosses over the specifics of the Clintons' tax problems and comes close to arguing that the Clintons should be able to rely on their accountants. None of the problems, caused by poor recordkeeping and what the minority gently refers to as a failure to communicate, were mortal sins in the minority's view, because the Clintons were not seeking improper tax benefits and Whitewater was not a tax shelter. The minority asserts -- contrary to the findings of the majority and the House Banking Committee and just about everyone else who has looked at the returns -- that the Clintons did not knowingly take improper deductions.

Instead, the minority maintains that the Clintons have redeemed themselves by fessing up to some of their errors and paying back taxes, despite the statute of limitations having runout. The minority even dismisses as "esoteric" the arguments of this writer and others that the first couple had income when Whitewater Development Co. and Arkansas banker James McDougal picked up the Clintons' obligations. In the real world, apparently, there is no such thing as algebra or cancellation of indebtedness income. Readers will recognize this as a dressed-up, lawyerese version of "we lost money" -- the Clintons' original excuse for why everyone else should ignore this sweetheart deal.

The Fishing Hole

In August 1978, the two Clintons borrowed roughly $203,000, together with James McDougal and his wife, Susan, 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, so to speak, ever took place, except for the building of gravel roads.

The $20,000 down payment for the purchase took the form of an unsecured demand loan from the Union Bank to James McDougal and Bill Clinton. According to the Pillsbury report, McDougal repaid that loan in 1980 with another $20,000 loan he personally borrowed from the Bank of Cherry Valley. (The Pillsbury report is a report prepared by Pillsbury, Madison & Sutro for the Resolution Trust Corporation about the relationship between Madison Guaranty Savings & Loan and Whitewater Development Corporation. Its purpose was to determine whether any Madison Guaranty money went into Whitewater, not to analyze the Clinton finances. For discussion, see Tax Notes, August 7, 1995, p. 653.)

The remainder of the purchase price for the Whitewater land took the form of a $182,611 note from the Citizens Bank & Trust of Flippin, Ark., signed by James McDougal, Bill Clinton, and their wives. Though the loan was secured by the property, the lender 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 credit worthiness and not that of the Clintons, who had no assets to speak of at the time. The Citizens Bank loan was a six-month demand note that was renewed nine times before it was paid off in 1992. Though the loan formally remained the personal obligation of the McDougals and Clintons, McDougal gradually replaced this recourse debt with nonrecourse debt, which had the effect of excusing the Clintons from liability, according to the Pillsbury report.

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 Ozarks property, which would otherwise have been unreachable and unmarketable. Whitewater Development Company Inc. was organized in August 1979 as a C corporation. According to the Pillsbury report, it is not entirely clear who owned the corporation; at one point Mrs. Clinton even asked someone what exactly she owned.

Corporate formalities were ignored and financial records were patchy; the corporation only had a general ledger, which itself was incomplete. The shareholders contributed the Whitewater land to the corporation in September 1979, but the corporation did not formally assume the Citizens Bank loan until its sixth extension in 1984, which the Clintons and McDougals also signed as

individuals. The corporation did, however, make payments on the loan from the time it acquired the property. (For discussion, see Tax Notes, August 28, 1995, p. 1034.)

Unreported Income

The Kendall report found that the Clintons underreported capital gain on the 1988 sale of Whitewater lot 13 and the model house on it by some $1,673. Though the ownership of this parcel was initially in question, by 1988 the Clintons owned it outright, having purchased it in a bankruptcy auction that same year. (For discussion, see Tax Notes, March 7, 1994, p. 1327, and March 21, 1994, p. 1499.) Readers may find it difficult to believe that anyone invested in real estate in the 1970s for reasons other than sheltering income from taxes, but another earlier land deal that the committee examined adds credence to the Clintons' assertion that they expected to make a big capital gain on the Whitewater project.

In 1977 Bill Clinton, who was then attorney general of Arkansas, paid $11,400 to buy 20 acres of land from Rolling Manor Inc., a company controlled by McDougal, his Whitewater partner, who now has been convicted of bank fraud. In 1978 the Clintons sold five acres for $5,000 cash and properly reported a capital gain of $2,150 on their 1978 return. But also in 1978, they sold the remaining 15 acres on the installment method for $14,985, which would give them a total gain of $6,435 -- $886 of which was reported on their 1978 return. The Clintons reported an additional $144 of gain in 1980, and none after that.

Some $5,405 of the remaining gain of $5,549 just disappears. It is not clear that the Clintons ever received the money. If the buyer had defaulted, the Clintons would have been entitled to deduct their $7,194 remaining basis in the property, the committee report notes. The Kendall report does not comment on this transaction.

The committee report does not stick the Clintons with large amounts of cancellation of indebtedness income, probably because the lending relationships were so amorphous. (For discussion, see Tax Notes, August 7, 1995, p. 653.) In 1979, the Clintons borrowed $5,000 from the Citizens Bank of Jonesboro, but it is not clear what for. The Clintons made only one $244 payment on that loan. Whitewater Development Co. made a $5,691 payment on the loan on the Clintons' behalf in 1982. According to the Pillsbury report, McDougal described this payment in a March 1, 1982 letter as follows: "I have paid from Whitewater Development Corporation the note you owed Citizens Bank of Jonesboro. You are correct in your belief that the sum of money borrowed was a part of your investment in Whitewater."

Well, not exactly. The Whitewater Committee pointed out that the Clintons listed that debt as a liability on their 1981 personal financial statement. The committee finds the evidence on the loan's relationship to Whitewater "inconclusive." There is no evidence that Whitewater Development Co. ever received the proceeds of this loan or recorded it as a liability. The committee concluded that the Clintons had debt cancellation income of $5,691. The president, in a sworn answer to Resolution Trust Corporation questions, stated that the loan could have been Whitewater-related, but he remembered little about it. The Kendall report, seizing on this uncertainty and relying on the McDougal letter, argues that the loan is Whitewater-related, so that there should be no debt cancellation income.

This is not unique to the Clintons; the problem of finding debt cancellation and enforcing the tax law was endemic in recent years as tax shelter investors and lenders alike walked away from see-through buildings and other failed projects. The 1993 tax changes attempted to address the government's problem in this area by adding section 6050P, which requires lender information reporting of discharges of indebtedness exceeding $600. Recent changes to this provision relaxed the filing requirement for lenders that are governmental entities.

Because the Clintons were jointly and severally liable on the Union Bank loan for the down payment on Whitewater, McDougal's 1980 full payment of that loan caused them to incur $20,000 of cancellation of indebtedness income. The Whitewater Committee report tags the Clintons with $10,000 of income for this payment. (For discussion of proportionate income for a co-obligor, see Tax Notes, August 28, 1995, p. 1034.) This payment was run through Whitewater, even though the corporation never was an obligor on either the Union Bank or Cherry Valley loans. The Clintons have stated that they considered themselves to have a continuing obligation on the Cherry Valley loan, which they did not sign. The bank and the documents established otherwise. The Kendall report does not address this item.

Interesting

The remainder of the items that the Whitewater Committee discussed in its report were improper deductions for interest and real estate taxes. What the committee report euphemistically calls "an aggressive approach to the tax treatment of their investment" appears to be a strategy on the part of the Clintons that when in doubt, deduct a payment as interest.

The Kendall report acknowledges that two of these deductions were indeed improper. Through this report, the Clintons are admitting to the impropriety of a $144 deduction for real estate taxes in 1984, which was reimbursed, and a $1,665 deduction for interest in 1987, which had previously been paid and deducted in 1986. The Kendall report is defensive about the $10,131 deduction for purported interest paid to a McDougal entity in 1978, which the Whitewater Committee report does not question. (For discussion of this question and other substantive questions raised by the Clinton returns, see Tax Notes, April 4, 1994, p. 18.)

Whether the Clintons were entitled to many of the interest deductions they claimed depends on whether they remained liable on loans made to them and the McDougals and secured by that dubious plot of upstate Arkansas land. The White House has argued that there were back-to-back loans between Whitewater Development Co. and its shareholders, but there is no formal documentation of any such arrangement. (For discussion, see Tax Notes, February 14, 1994, p. 811.)

In December 1979, the Clintons deposited $2,900 in the bank account of the Whitewater Development Co., and deducted $2,400 as interest. A casual notation in the corporation's ledger 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 because the use of the funds must be traced to an interest payment by the corporation. The Clintons argue that this payment relates to a $4,353 interest payment that the corporation made to Citizens Bank in May 1980.

The Whitewater Committee report found some evidence that $2,400 of the $2,900 payment was a shareholder loan to the corporation. The report came to no conclusion about how that payment should be treated. The Kendall report argues that the Clintons remained personally liable on the loans, which the corporation did not formally assume until 1984, so they should be entitled to an interest deduction. The Kendall report sees no evidence that the Clintons intended to lend $2,400 to the corporation, and cites the clean IRS audit that the Clintons' 1979 income tax return got. But how does a deposit that may or may not have been used by the recipient for an interest payment in 1980 become deductible in 1979? And if the corporation had already assumed the acquisition loans, the payment would be a nondeductible contribution to capital, not deductible in either year.

Then there is the matter of the $9,000 Clinton check with no payee, which found its way to Citizens Bank, the Whitewater acquisition lender. Both the committee report and the Kendall report assume that the Clintons were liable on the Whitewater acquisition loan when the check was written. This is in doubt; it is more likely, given the parties' actions and expectations, that Whitewater Development Co. assumed the acquisition loans. (For discussion, see Tax Notes, August 28, 1995, p. 1034.)

On their 1980 return, the Clintons deducted $9,000 for "interest" paid. The Whitewater Committee was exercised about the lack of a payee on this check and stated that there is no evidence that it was used to pay interest. The committee and the Pillsbury report pointed out that the Citizens Bank records indicate that this money may have been used to pay principal on the Whitewater acquisition loan. The tax law does allocate payments from a debtor, which Mrs. Clinton arguably was, to a creditor first to accrued and unpaid interest and then to principal. The trouble is that Whitewater Development Co. was current in its interest payments when the check was written; the committee report points out that the next interest payment was not due until two months later.

The Kendall report states that the payment must have been interest because the Clintons intended it to be interest. Annual interest on the note was between $18,000 and $20,000. This report points out that two weeks earlier, the note had been extended and renegotiated so that it was an interest-only note with a balloon payment of principal due at the end of the term. The Kendall report alternately raises the theory that the Clintons meant to reimburse the McDougals for the Clintons' share of interest paid by them. This, however, would not make the Clintons' reimbursement payment deductible as interest. Most likely, it would be a principal payment on a little informal loan by McDougal. (For analysis, see Tax Notes, February 14, 1994, p. 811.)

On their 1988 return, the Clintons deducted $1,275 for real property taxes. This time they did not write a check to the appropriate tax authority. Rather, the taxes for several other Whitewater lots owned by the corporation and private householders were paid by Ozark Realty, a real estate agency owned by Chris Wade. Payment of the taxes by the real estate agent is consistent with common real estate practice of escrowing tax payments so that the mortgagor can make one monthly payment covering interest, taxes, etc. Mrs. Clinton reimbursed Wade's agency for $1,275 of real property taxes paid. Whitewater Development Corporation and the other owners apparently reimbursed Mrs. Clinton for the $1,275 by means of small individual checks. The corporation apparently asked the private owners for the reimbursement, then turned the checks over to Mrs. Clinton. It is not clear whether the corporation reimbursed Mrs. Clinton for taxes paid on its lots.

For 1988 Hillary Clinton did not own any of the lots for which she deducted real property taxes; Whitewater Development Corporation and private householders owned them. The real estate agent handling the corporation's sales of vacation property had already paid the taxes, and Hillary Clinton, apparently acting on behalf of the corporation, had reimbursed the agent. Then Mrs. Clinton herself was evidently reimbursed by the owners of the lots.

The Whitewater Committee report concluded that this payment was not deductible because the Clintons were not the owners of the lots on which the taxes were paid, so they cannot be said to be the persons on whom the taxes were imposed by the taxing jurisdiction. The Kendall report does not discuss this item, though it was first raised more than two years ago. (See Tax Notes, March 14, 1994, p. 1347.)

Other Items

The Whitewater Committee rejected its outside accountant **Bankler**'s advice that the Clintons may have been entitled to a capital loss of more than $20,000 on the sale of their Whitewater shares. Various Clinton advisers, most prominently among them the late Vincent Foster, rejected the claim of a capital loss because the Clintons could not substantiate a basis for their Whitewater investment. (For discussion, see Tax Notes, August 7, 1995, p. 653.)

Among the reasons that the Clintons could not substantiate a basis is that it was never really clear who owned Whitewater Development Co., or what the nature of the Clintons' investment was. **Bankler** believed that the Clintons and the McDougals botched the creation of the Whitewater Development Co., so that what everyone assumes was a section 351 nonrecognition transaction was a taxable sale.

In 1979, when the Clintons and McDougals transferred the Whitewater land to the Whitewater Development Co. subject to the note, the corporation recorded notes payable to the Clintons and the Great Southern Land Co., a McDougal-controlled entity, with each note having a principal amount of half of the $222,872 stated value of the land. The notes did not exist in any written form; they were on the corporation's books. According to Clinton advisers, the notes were intended to mirror the six-month demand note held by the note lender and the demand note held by the down payment lender.

But the Clintons never listed the notes on their asset disclosure forms, and the corporation never paid them interest. The corporation also recorded an initial loan of $26,393 from the Great Southern Land Co. About the same time, a subchapter S election filed with the IRS showed Whitewater Development Co. shares held 50 percent by Hillary Clinton, 25 percent by Susan McDougal, and 25 percent by bookkeeper Charles James.

If the transferors of the land -- the Clintons and the McDougals -- did not have 80 percent control of Whitewater Development Co. immediately after the transfer, the transfer would not literally satisfy section 351. It is not clear whether bookkeeper James transferred anything for his shares. If the transferors took back both shares and notes in the amounts recorded in the corporation's books and its subchapter S election, then the transfer likewise would not qualify for section 351. Not only would the transferors lack the requisite control, but the notes would not be securities for purposes of section 351.

Moreover, Bankler noted, the parties failed to file the appropriate statement of the transfer with the corporation's initial tax return as required by reg. section 1.351-3(a). Nor did they elect installment sale treatment. Mere intent to have section 351 apply does not help, Bankler added.

Bankler concluded that no debt between the corporation and the Clintons existed, so that the corporation either assumed the Citizens Bank note or took the land subject to it. The transfer of the land to the corporation was a taxable sale. Bankler would account for the difference between the transferors' purchase price for the property and the value the corporation carried on its books as an additional contribution to capital. The Clintons should have recognized income on the transfer to the extent of the difference between their basis in the land ($101,304) and the amount that the corporation recorded ($111,435) for taxable income of $10,131. That amount just happens to equal the amount that the Clintons attempted to deduct as a prepaid interest paid to the Great Southern Land Co. for 1978. This is because bookkeeper James booked up the value of the land on the corporation's books by the amount of the interest that the Clintons paid in 1978.

When did Whitewater Development Company assume the two acquisition loans? The House Banking Committee staff believes that the corporation assumed the loans in 1979 when the property securing the Citizens Bank loan was transferred to it. Even though the loan documents were not changed, the corporation, as the owner of the property, became the de facto obligor on the loans for tax purposes and was entitled to deduct the interest payments. Under this view, the Clintons and the McDougals occupied the position of guarantors of the loan. This means that the Clintons could not deduct $19,131 they claim to have paid on the Citizens Bank loan because it was not their liability and because the payees were not the lenders. This makes sense if the Citizens Bank loan was nonrecourse, which it was not. (For discussion, see Tax Notes, February 14, 1994, p. 811.)

The White House has taken the position that the corporation did not assume the property acquisition loans until 1984, when it became a co-obligor. According to the Citizens Bank loan document, the individual borrowers remained 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. Whitewater joined the Clintons and the McDougals as co-obligor on the Citizens Bank loan in 1984. But at that time, Citizens Bank continued to insist that the Clintons sign the renewals for themselves and furnish personal financial statements. The Citizens Bank loan remained a recourse loan. Had the Citizens Bank loan not been recourse, one would surmise that the parties would not have gone through the machinations of cash infusions from other entities to get it paid down; they would simply have tossed the bank the deed to the under-water Whitewater property. (For discussion, see Tax Notes, August 28, 1995, p. 1034.)

The lawyers who prepared the Kendall report mused that if the Clintons had only had better tax advice, they should have acted as a Subchapter S corporation, as they elected, so that the corporation could pass through the various deductions for interest and other expenses that it threw off while its cash flow was inadequate to cover those costs. The lawyers overlooked the Clintons' self-help -- the fact that the Clintons, rightly or wrongly, asserted deductions approximately equal to their out-of-pocket cost of participating in Whitewater.

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