

NEWS ANALYSIS

Notes on the Presidential Tax Returns

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Michelle Obama and Jill Biden have been on the road together for a couple of weeks, campaigning for support for military families at various locations in the United States. Mrs. Biden looks tired and a bit pained, as though she's been perusing the family financial records. Mrs. Obama, with her helmet hair and heavy showbiz makeup, is starting to resemble Supremes-era Diana Ross and seems to be enjoying the gig.

People marvel at the way that the first couple stay in shape, but the short answer is that they have achieved physical fitness the same way George W. Bush did: by not being too distracted by the task of governing. The president has been a figurehead at least since the 2010 election, if not before, given the degree to which banks have had their way. The tall, good-looking guy from Chicago who is running the country is Jamie Dimon.

Is there something wrong with the president being a figurehead? Not necessarily. When the country has three wars going in Middle Eastern countries, two of which involve oil, the face that the rest of the world sees should look like them, as commentator Andrew Sullivan argued before the 2008 election.

Mrs. O got some stick from the Council of Fashion Designers of America for not wearing American designers — the offending dress being a rather ugly red Alexander McQueen gown she wore to a state dinner for the Chinese president. The first lady's diva-like response was that she will wear what she wants. Nonetheless, she has been wearing more American clothes recently, along with more costume jewelry, and even wearing outfits more than once. Apparently Ikram Goldman is no longer dictating her wardrobe.

Speaking at George Washington University, the president argued that well-off people like himself could easily afford to pay more individual income tax. "We cannot afford \$1 trillion of tax cuts for every millionaire and billionaire in our society. And I refuse to renew them again," he said. (For prior coverage, see *Tax Notes*, Apr. 25, 2011, p. 351.)

Particularly in the president's sights is the lopsided mortgage interest deduction, which, as he and the Simpson-Bowles commission noted, mainly benefits households with incomes of \$75,000 or more (half again as much as the median household income). Most of the higher-income itemizers who

benefit from it live in blue states, where housing costs are higher. The tax reform commissions of two administrations have suggested replacing the mortgage interest deduction with a credit. (For discussion, see *Tax Notes*, Jan. 24, 2011, p. 364, *Doc 2011-1232*, or *2011 TNT 15-3*; and *Tax Notes*, Mar. 7, 2011, p. 1110, *Doc 2011-4466*, or *2011 TNT 44-2*.)

'We cannot afford \$1 trillion of tax cuts for every millionaire and billionaire in our society. And I refuse to renew them again,' Obama said.

The president and vice president are still claiming the mortgage interest deduction, because they both still have mortgages, against their better financial judgment. (For the presidential tax returns, see *Tax Analysts' Tax History Project* at <http://www.taxanalysts.com/www/website.nsf/Web/PresidentialTaxReturns>.)

First Family

When circumstances change, so should financial behavior. Interest rates are down, so the president should pay off his mortgage. His considerable earnings from book publishing can't all be going into the first lady's wardrobe. On the signature line, Obama's occupation is listed as president, but his chief income-producing activity is publishing.

The president reported salary income of \$398,000 and book royalties of \$1,383,000, plus roughly \$20,000 of investment income. The Obamas put \$49,000 in a Keogh plan and deducted half his self-employment taxes, for an AGI of \$1,728,000. Itemized deductions were \$373,000, of which \$245,000 were charitable gifts. Roughly half of the gifts went to the Fisher House Foundation, which benefits military families.

The president paid \$454,000 in income tax, taking into account self-employment tax and a \$22,000 foreign tax credit. On Schedule A, the Obamas deducted \$50,000 of mortgage interest, \$53,000 in state and local income taxes (they claim residence in Illinois), and \$26,000 in real estate taxes.

Why do the Obamas still have a mortgage? They bought a \$1.65 million house in 2005, shortly after he was elected to the Senate. They took out a 30-year mortgage for \$1.32 million at a fixed interest rate of 5.625 percent from Northern Trust, which also happens to be custodian of their blind trust. At the time, this was regarded as a very advantageous loan. Comparable jumbo loans bore interest of 5.94 percent or higher (*The Washington Post*, July 2, 2008).

The Obama residence, a restored Georgian-style mansion, has six bedrooms, five fireplaces, five full bathrooms, a wine cellar, a music room, a library,



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Michelle Obama in the Alexander McQueen dress that caused a ruckus. The president's tax return attests to his popularity abroad.

and a four-car garage. There has been speculation in the blogosphere that the Obamas are under water, which would be a reason for not paying off the mortgage. Price declines in Kenwood, where the Obama residence is located, have been sharp.

The Obamas' interest income is piffling — their liquid assets appear to be in short-term treasuries. They have roughly \$3 million at Northern Trust. Those assets earn far less than the cost of servicing the debt on the house. There's enough income reported on this return to pay the entire mortgage, and the couple have no living expenses. Moreover, the investment choice of short-term treasuries is too conservative for a relatively young couple with children. They should be looking for growth investments.

Steve Bankler, the San Antonio CPA and tax return preparer who helps us with the presidential tax returns, exclaims that the president does not

know how to manage his personal finances. He notes that both the president and vice president used preparers but did not deduct their fees.

Bankler also quibbles with the choice to report royalty income on Schedule C rather than Schedule E, which previous White House occupants have used. He points out that the use of Schedule C enables the \$49,000 deductible contribution to a Keogh plan, but at the considerable cost of \$37,000 in self-employment taxes, half of which are deductible.

No one is forced to file Schedule C. A taxpayer has to qualify as the sole proprietor of a profession or a business under laws that make it difficult to escape hobby status (e.g., section 183). Obama has written three lucrative books — the most recent being an open letter to his daughters — so he has a track record of an established business. The main benefit from using Schedule C might be to prepare for a post-political career of books and speeches. Like Bill Clinton, who uses Schedule C for his books and speeches, Obama will be relatively young when he leaves office.

The Obamas had a Treasury note redeemed. They deduct \$3,000 in capital losses every year, because they have no capital gain and are running down a large capital loss carryover. The big capital losses come from the Obamas' habit of purchasing short-term Treasury securities, collecting the interest, and then selling the securities at a short-term capital loss. (For prior coverage, see *Tax Notes*, Apr. 19, 2010, p. 241, *Doc 2010-8392*, or *2010 TNT 73-1*.)

The president and first lady used part of their estate and gift tax unified credit to make gifts to section 529 plans for their daughters. The couple pre-funded their section 529 plan in 2007, and the law allows taxpayers to spread their gifts, using a little of the unified credit each year.

Foreign Tax Credit

President Obama is very popular abroad, and his book income so indicates. Of his \$1,568,000 of gross publishing income, \$821,000 is foreign source. While the president is advocating further tightening of the foreign tax credit rules, he is reducing his own foreign tax credit under current rules.

The president has two publishers. Competition among publishing agents appears to be lighter outside New York, since \$157,000 of the president's \$185,000 of commissions is directly allocable to his foreign income. This item is specifically identifiable as related to the foreign income (reg. section 1.1861-8(a)(2)).

In the land of the foreign tax credit, money is fungible and interest is interest. So Obama allocates a ratable share of his Chicago home mortgage

interest against his foreign income, even though he has never claimed a home office deduction for that house.

The instructions to Form 1116 state that deductions allocated to foreign income include not only deductions that “definitely relate” to that foreign income, but also a ratable share of other deductions that cannot be pegged to any of the taxpayer’s income, domestic or foreign. So the taxpayer is told to enter a ratable share of real estate taxes on line 3.

The first family’s foreign income is 41 percent of its income from all sources. So the president allocates \$21,000 of his home mortgage interest using this fraction on Form 1116. Interest has to be proportionally allocated between domestic and foreign income (reg. section 1.861-8(e)(9)).

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When deductions are not definitely related to gross foreign or domestic income, the foreign tax credit rules require ratable allocation anyway (reg. section 1.861-8(c)(3), (e)(6), and (9)). So Obama also allocates \$32,000 of his \$78,000 of other non-charitable itemized deductions to his foreign income, including state income taxes and real estate taxes. These allocated deductions, plus the specifically allocated commission expenses, reduced his foreign income by \$210,000.

Nonetheless, the president still is allowed to deduct all of his foreign taxes, because the ceiling on the deduction is \$179,000, after application of the alternative minimum tax rules. This represents roughly 45 percent of his income tax of \$438,000 — 45 percent being the proportion that his foreign taxable income, recomputed under U.S. allocation rules, bears to his total taxable income. The president only incurred \$22,000 of foreign tax in 2010.

But he is in an excess credit position, having incurred foreign tax in previous years that left him with \$314,000 of excess credits. His remaining unused foreign tax credit limitation for 2010 is \$178,000, after reduction for the \$22,000 of foreign tax paid in 2010. Uncredited foreign tax can be carried forward 10 years. The Obamas have enormous foreign tax credit carryforwards.

The Bidens

What more can we say about those gauche Bidens? The vice president was originally recruited for his ability to talk to ordinary people, and his finances are very ordinary, too. He has too much

house and not enough income to sustain it. (For prior coverage, see *Tax Notes*, Apr. 26, 2010, p. 366, *Doc 2010-8800*, or *2010 TNT 79-3*.)

The Bidens reported \$380,000 of adjusted gross income and paid roughly \$87,000 of federal income tax. They claimed \$67,000 of itemized deductions, \$30,000 of which was mortgage interest. Their Delaware lakefront estate carries two mortgages totaling more than \$700,000.

But they appear to have found an income generator in their excessive real estate holdings. On the lakefront estate that carries so much mortgage debt is a cottage formerly occupied by Biden’s late mother. It has been rented out for \$13,000 per year, and the Bidens pay a hefty commission of \$2,000, reported on Schedule E.

The Bidens are including the rent in income, but they are not claiming depreciation deductions for the cottage. This is a mistake, according to Bankler, because should they ever sell the property, depreciation would be recaptured if it could have been claimed, regardless of whether it actually was claimed (section 1245(a)(2)(A), reg. sections 1.1016-3(f) and 1.1245-2(a)(7)).

The Bidens deducted \$950 for clothing donated to charity. The Clintons did this during his presidency, before becoming suddenly rich when the president left office. Readers, it is just plain unbecoming for a high-profile public officeholder to be chintzy about old clothes. Yes, they’re entitled to a deduction, but they should just forgo it. Both couples have forgone any deduction for return preparation fees. Some things are better off not being broadcast.

Some years back, the Joint Committee on Taxation staff suggested capping at \$500 annually the charitable deduction for clothing on the ground that it was the subject of overvaluation, which may or may not be deliberate (JCS-02-05, *Doc 2005-1714*, *2005 TNT 18-18*). The staff’s suspicions were substantiated by a Tax Court case in which the taxpayer, an investment banker, overvalued donations of expensive clothing to thrift shops. The court did not impose an accuracy-related penalty (*Stamoulis v. Commissioner*, T.C. Summ. Op. 2007-38, *Doc 2007-6036*, *2007 TNT 47-12*).

In the ordinary case, yes, the JCT staff is correct. And the staff was generally cynical about any used personal item having value. But there is a category of high-end designer clothing, for which market prices exist, that goes to museums that have clothing collections and would otherwise have to purchase these garments. Does this mean that socialites who buy fabulously expensive clothes would get charitable donation deductions while other people would not? Yes, but the control factor is the museums, which don’t accept everything they are offered. ■