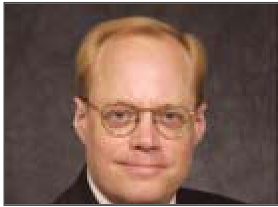
Forbes



Robert W. Wood
THE TAX LAWYER

TAXES | 7/25/2013

IRS Agent's Oral Contract With Mother-In-Law? Even IRS Won't Buy It

How much is an oral contract worth? Not much. In court? Even less. And in Tax Court? Probably less still.

The adage about oral contracts not being worth the paper they aren't printed on rings true. But proof varies, and even oral contracts are sometimes good enough. What's more, even IRS employees sometimes have to defend their tax deductions.

In *Brooks v. Commissioner*, the Tax Court overruled IRS objections and allowed an IRS employee to keep her deduction despite thin documentation. Ms. Brooks only had an oral contract. It covered her renovation of her residence.

She claimed the verbal deal promised her a share of the proceeds when the house was sold. It all started in 1983, when Pamela Brooks moved into a Los Angeles house owned by her then-mother-in-law. In 1990, under an oral agreement with her mother-in-law, Brooks invested $34,000 to improve the residence.

In exchange, Brooks was to get 50% of the proceeds on sale of the home. Brooks's mother-in-law died in 1991, and Brooks continued to live there until 1993. She divorced her husband, but he remained living at the house until 2000. In 2000, Brooks learned that the mother-in-law's family was attempting to sell the house.

Worried she wouldn't get her 50%, she sued the estate. In 2003, after spending $2,000 on legal fees, Brooks settled with the estate for $17,000. She had invested $34,000, and got back only $17,000. But hey, she worked for the IRS. She claimed tax losses.

Section 165(a) of the tax code allows you to deduct a loss that isn't paid by insurance or otherwise. Losses can be claimed only to offset gains, plus $3,000 per year. However, you need an ***economic interest*** in property to claim a loss.

Brooks reported $3,000 of capital loss carryovers on her 2005, 2006 and 2007 returns. The IRS—her employer—audited her. IRS claimed she was not entitled to a deduction since she didn't have an enforceable property interest. But the Tax Court sided with the IRS employee.

The court wasn't bothered by the oral agreement either. It believed Ms. Brooks' testimony about the oral agreement. Who wants to do a deal with your mother-in-law? Who expects it to be honored after a divorce?

Ms. Brooks had been promised a share when the property was sold. Her actions in filing a lawsuit against the estate to enforce her claim supported these facts. The Tax Court said the contract right she had was an economic interest sufficient to claim her loss.

But the IRS wasn't done yet–it also argued this was all just ***personal***. Here too, the Tax Court sided with Brooks. She had invested $34,000 in the house to make a profit, the court ruled. The fact that she temporarily lived there did not make the house personal.

Brooks invested $34,000 with the "predominant, primary, or principal objective" of realizing a profit, the court found. She vacated it shortly after the renovations were complete. She was entitled to a deduction.

OK, the little guy/gal won this one. Still, there are a whole bunch of "don'ts" in this case. Don't get audited (if you can help it). Don't do a deal with your mother- in-law. Don't do an oral deal involving $34,000. Don't mix business and personal.

You can reach me at Wood@WoodLLP.com. *This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*