



# ED SLOTT'S IRA ADVISOR

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## TAX & ESTATE PLANNING FOR YOUR RETIREMENT SAVINGS

### Distributions from an IRA – Loan or Taxable Distribution?

**James T. Colegrove, et ux. v. Commissioner,  
U.S. Tax Court Summary Opinion 2010-44 – April 13, 2010**

Tough economic times cause individuals to support their families in any way they can.

This court case involves James T. Colegrove, under age 59½, who was a real estate agent in Florida. The economic recession affecting Florida real estate in 2006 resulted in a dramatic reduction in income for Mr. Colegrove, causing him to seek other employment. Undergoing financial hardship as a result, Mr. Colegrove took a series of distributions from his IRA totaling \$52,132 in order to meet business, mortgage and living expenses for his family of four. In Mr. Colegrove's mind, these distributions were merely loans from his IRA to help his family through tough times. Both the IRS and U.S. Tax Court thought otherwise.

**A loan from an IRA to its owner is always a prohibited transaction.**

Unfortunately for the Colegrove family, IRA owners (and beneficiaries) are prohibited from taking tax-free loans from their accounts. The rule of law is, with limited exceptions, that if you take out money from your IRA prior to age 59½, you will incur a 10% early distribution penalty in addition to ordinary income tax on the amount withdrawn, excluding the return of any after-tax

contributions. While there are several exceptions to the 10% penalty, contrary to popular belief, there is no exception for financial or economic hardship.

Mr. Colegrove's erroneous assumption that these withdrawals were loans and not taxable distributions may have stemmed from his understandable confusion over the fact that different rules apply to employer qualified plans, such as 401(k)s. While a tax-free loan from such a plan may be permitted, a loan from an IRA to its owner is always a prohibited transaction. You cannot borrow from or loan money to your IRA.

In fact, if treated as loans, these withdrawals would have resulted in the loss of the IRA's tax exemption and all its assets would have been deemed distributed as of the first day of the year in which the payments occurred. Fortunately, the court did not consider the withdrawals to be loans, and Mr. Colegrove's IRA did not lose its tax-exempt status. He did not have to pay income tax and the early distribution penalty on the entire IRA balance. However, the withdrawals were considered early distributions and thus subject to tax and penalty. No good solution existed for Mr. Colegrove.

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#### *Guest IRA Expert*

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