What Is a Traditional IRA?

Traditional individual retirement accounts (IRAs) can be a good way to save for retirement. If you do not participate in an employer-sponsored retirement plan or would like to supplement that plan, a traditional IRA could work for you.

A traditional IRA is simply a tax-deferred savings account that has several investing options and is set up through an investment institution. For instance, an IRA can include stocks, bonds, mutual funds, cash equivalents, real estate, and other investment vehicles.

One of the benefits of a traditional IRA is the potential for tax-deductible contributions. In 2015, you may be eligible to make a tax-deductible contribution of up to $5,500 ($6,500 if you are 50 or older). Contribution limits are indexed annually for inflation.

You can contribute directly to a traditional IRA or you can transfer assets directly from another type of qualified plan, such as a SEP or a SIMPLE IRA. Rollovers may also be made from a qualified employer-sponsored plan, such as a 401(k) or 403(b), after you change jobs or retire.

Not everyone contributing to a traditional IRA is eligible for a tax deduction. If you are an active participant in a qualified workplace retirement plan — such as a 401(k) or a simplified employee pension plan — your IRA deduction may be reduced or eliminated, based on your income.

In 2015, for example, if your modified adjusted gross income (AGI) is $61,000 or less as a single filer ($98,000 or less for married couples filing jointly), you can receive the full tax deduction. On the other hand, if your AGI is more than $71,000 as a single filer ($118,000 for married couples filing jointly), you are not eligible for a tax deduction. Partial deductions are allowed for single filers whose incomes are between $61,000 and $71,000 (or between $98,000 and $118,000 for married couples filing jointly). If you are not an active participant in an employer-sponsored retirement plan, you are eligible for a full tax deduction.

Nondeductible contributions may necessitate some very complicated paperwork when you begin withdrawals from your account. If your contributions are not tax deductible, you may be better served by another retirement plan, such as a Roth IRA. (The maximum combined annual contribution an individual can make to traditional and Roth IRAs is $5,500 in 2015.)

The funds in a traditional IRA accumulate tax deferred, which means you do not have to pay taxes until you start receiving distributions in retirement, a time when you might be in a lower tax bracket. Withdrawals are taxed as ordinary income. Withdrawals taken prior to age 59½ may also be subject to a 10% federal income tax penalty. Exceptions to this early-withdrawal penalty include distributions resulting from disability, unemployment, and qualified first home expenses ($10,000 lifetime limit), as well as distributions used to pay higher-education expenses.

You must begin taking annual required minimum distributions (RMDs) from a traditional IRA after you turn 70½ (starting no later than April 1 of the year after the year you reach 70½), or you will be subject to a 50% income tax penalty on the amount that should have been withdrawn. Of course, you can always withdraw more than the required minimum amount or even withdraw the entire balance as a lump sum.

An IRA can be a valuable addition to your retirement and tax management efforts. By working with a financial advisor, you can determine whether a traditional IRA would be appropriate for you.