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How to Select a Great IRA

There are several types of IRAs, and each provides different tax benefits.

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Outside of saving for retirement through employer plans, which include pensions, 401(k)s, 403(b)s and 457 plans, individual retirement accounts are your most effective tax-advantaged savings tool. These accounts were created in 1974, and designed to allow individuals who do not have access to pensions to save for retirement.

IRAs started out simple. You could contribute up to 15 percent of your pay (or a maximum of $1,500 per year), receive a deduction on your tax return and allow the account to grow without incurring annual taxes. Then, when you pulled money out of the account in the future, you would pay ordinary income tax on the withdrawals.

But a lot has changed with IRAs. Since the 1970s, the IRA has evolved in complexity, and deciding which version is the best fit for your retirement savings plan has become more complex. Here's a guide to the different IRAs, and how to maximize their benefits.

Traditional IRA. As the name implies, the traditional IRA is the most similar to the original design. Depending on your income, you may qualify for a tax deduction. For 2016, if you are covered under a workplace retirement plan, the deduction phases out for couples whose modified adjusted gross income is between $98,000 and $118,000 ($61,000 to $71,000 for individuals). If you are not covered, but your spouse is, the income limit increases to $184,000 to $194,000 in 2016.

Planning opportunity. IRAs can be used by people who don't have a workplace retirement account or individuals who have maxed out all their other tax-advantaged savings opportunities. Traditional IRAs can also be used by individuals hoping to fund Roth IRAs, even though their income exceeds the Roth contribution limits, via a Roth conversion strategy.

Limits. The current funding limit for a traditional IRA is $5,500 for those under 50 and $6,500 for people age 50 and over.

Rollover IRA. The average baby boomer held nearly 12 jobs by age 50, according to the Bureau of Labor Statistics. This means you are likely to participate in quite a few retirement accounts at various employers. A rollover IRA is a traditional IRA that is used to consolidate old retirement accounts.

Planning opportunity. Not all retirement plans are created equally. You may have left assets in an old employer plan that has high fees, expensive funds and limited investment options. Once you have a separation in service you can take those assets and invest them with a low cost IRA provider. It also makes your financial life easier to consolidate accounts.

Inherited IRA. If you are the beneficiary of an IRA and not the spouse of the deceased person, you will need to open an inherited IRA. This allows the assets of the person who died to pass to you while maintaining their tax-advantaged status. Inherited IRAs operate differently than regular IRAs, and the passing of the assets usually triggers (or continues) the processing of required minimum distributions.

Planning opportunity. These IRAs provide the opportunity to stretch out the benefit of tax deferred growth since required minimum distributions can now be based upon the life expectancy of the beneficiary rather than that of the deceased. It may be beneficial to seek professional guidance from either a financial advisor or accountant to make sure the required distributions are correctly processed moving forward.

Roth IRA. The Roth IRA came about in 1997. Rather than getting a tax deduction on your current return, contributions made to a Roth IRA go in after-tax. But the account grows tax-deferred, just like a traditional IRA. And, assuming certain requirements are met – you must be age 59 1/2 and have an account that is at least 5 years old – the money can be withdrawn tax free.

Planning opportunity. Roth IRAs are a tremendous saving opportunity for younger individuals and individuals in low tax brackets. If you feel you will be in a higher tax bracket in retirement than you are now, growing Roth assets is likely to be a smart strategy. Roth IRAs are not subject to required minimum distributions, which can provide for additional tax savings and estate planning opportunities later in life.

Limits. The current funding limits for a Roth IRA are $5,500 for those under 50 and $6,500 for those 50 and over. The ability to contribute to Roth IRAs phases out for single tax filers with a modified adjusted gross income of $117,000 to $132,000 and married filers with between $184,000 and $194,000 in 2016.

Honorable Mentions:

SEP IRA. A simplified employee pension IRA is an employer-sponsored plan that can be set up for businesses of any size, including sole-proprietors, partnerships or companies with a number of employees. All contributions to the plan are made by the employer. These plans usually make the most sense for self-employed business owners.

SIMPLE IRA. A savings incentive match plan for employees is an employer-sponsored retirement plan that allows both employees and employers to contribute on the employee's behalf. This plan is most suitable for small businesses with fewer than 100 employees. The current limit an employee may contribute through salary deferral contributions is $12,500 for those under 50 years old and $15,500 for those over 50.

Coverdell education savings account. This is a tax-advantaged plan that can be established for individuals under age 18 that allows parents to save for qualified primary and secondary education expenses. The maximum amount that can be contributed to an ESA is $2,000 per year. You can't deduct contributions to a Coverdell ESA on you tax return, but the money grows without taxation until you withdraw it and is tax-free when used to pay for qualifying education costs. There are two benefits that Coverdell ESAs offer over 529 college savings plans: ESAs can be used for private kindergarten through grade 12 education, and they have less restricted investment opportunities.

Retirement savers have many types of IRAs to choose from. Understanding the benefits each type of IRA provides allows you to select the retirement account that will help you to best reach your financial goals.