Sometimes *how* much is in tax-deferred retirement accounts may be *too* much

Contributing as much as possible to tax-deferred retirement accounts such as traditional 401(k)s and IRAs is a common recommendation. Contributions generally are pretax or deductible, and the power of tax-deferred compounding can help turbocharge growth. But some taxpayers can reach a point where maximizing tax deferral may become counterproductive.

Potential downsides of tax-deferred saving

After you're retired, you'll no longer be earning a salary or full-time wages. So the assumption generally is that taxpayers will be in a lower federal income tax bracket and pay tax at a lower rate when taking withdrawals during retirement than when making contributions during their working years.

That's likely the case for many, if not most, taxpayers if tax rates stay the same (or go down). But, currently, federal income tax rates may have bottomed out and could be more likely to increase in the future. If this happens, you might pay higher tax rates on withdrawals from traditional accounts during your retirement years, even if you're in a lower tax bracket.

Also, retirement plan distributions are subject to your ordinary income tax rate and don't benefit from the lower long-term capital gains rates that normally apply to realized gains from assets held more than one year and qualified dividends. So you pay a higher tax rate on dividends and growth in a tax-deferred account than you would if the investments were held in a taxable account.

Something else to remember is that with traditional retirement accounts, most withdrawals before age 59½ will be subject to a 10% early withdrawal penalty (though there are some exceptions for IRAs). If you need to make a withdrawal before that age, you may owe the penalty on top of any applicable income tax.

Traditional accounts also come with required minimum distributions (RMDs). You could be subject to a 25% penalty for failing to take RMDs each year after you reach age 73 (or 75 if you'll turn 73 after December 31, 2032). (Roth accounts set up in your name aren't subject to RMD rules during your life and will never be subject to federal income taxes as long as you take out only qualified withdrawals after reaching age 59½.)

You can avoid the penalty by taking your RMDs each year. But RMDs generally will be included in your taxable income and, depending on the size of the RMD and your other income, this could push you into a higher tax bracket, affect deductions or credits with income-based limits, or cause some of your Social Security payments to become taxable.

For these reasons, some taxpayers may be better off moving from a strategy primarily focused on tax-deferred traditional accounts to one that puts a greater emphasis on Roth and taxable accounts — even though it may mean paying more taxes now.

Shifting your retirement strategy

Whether your tax-deferred retirement savings are excessive, insufficient or just about right depends on variables such as your current marginal income tax rate, your expectations about future tax rates and the type of income or gains earned in your retirement accounts. Each person's situation is different, and there's not always a clear-cut answer.

If you conclude you have too much in tax-deferred accounts, one or more of these strategies can help address the situation:

1. Start making at least some of your annual retirement savings contributions to Roth accounts if possible. Contributions to these plans don't reduce your current-year taxable income, but distributions are tax-free — including distributions attributable to growth in the account. And Roth accounts aren't subject to RMDs during the original owner's lifetime. However, the ability to contribute to a Roth IRA is phased out if a taxpayer's income exceeds certain amounts. No such limit applies to employer-sponsored Roth accounts, such as Roth 401(k)s.

2. Put some money into taxable accounts. If Roth savings opportunities aren't available to you or you've already maxed them out, think about putting some of the money you're saving for retirement into taxable investment accounts. You'll be eligible for the lower long-term capital gains rate on long-term gains and qualified dividends, and you won't be subject to the various rules and restrictions that apply to IRAs, 401(k)s and other employer-sponsored retirement accounts.

3. Convert some or all of your traditional IRA balance into a Roth IRA. A conversion can let you turn tax-deferred future growth into tax-free growth and avoid being subject to RMDs. There's no income-based limit on who can convert. But the converted amount is taxable in the year of the conversion. So consider your current tax rate and whether a conversion could push you into a higher tax bracket or trigger other negative tax consequences.

4. If you're age 59½ or older, withdraw money from your traditional retirement accounts sooner and faster than required. You won't owe early withdrawal penalties, and you pay tax now at a rate that might be lower than what you'd have to pay in the future. You can reinvest the after-tax proceeds in taxable accounts where future long-term gains and qualified dividends will be taxed at your lower long-term capital gains rate. But as with Roth conversions, you need to consider your current tax rate and whether the retirement plan distribution could push you into a higher tax bracket or trigger other negative tax consequences.

Tax-smart wealth accumulation

As you can see, there are many considerations to evaluate when assessing whether you're investing too much in tax-deferred retirement accounts and, if so, how to address the situation. We can help you determine the best course of action for wealth accumulation using traditional tax-deferred retirement accounts, Roth accounts and taxable accounts.