Kiplinger

Timely, Trusted Personal Finance Advice and Business Forecasts

Test-Drive Your Budget

Try out your spending plan before you give up your paycheck.

From *Kiplinger's Personal Finance,* September 2013
Follow @JaneBClark

Creating a budget based on future circumstances can be a challenge. Still, you owe it to yourself to anticipate your income and expenses in retirement and come up with a plan before you have to depend on it. "If the budget looks as if it isn't doable, you can work longer or make an adjustment in your lifestyle," says Gil Armour, a certified financial planner in San Diego, Cal. "It's an eye-opening exercise."

Pore over expenses. As with any budget, the first step is to record average monthly expenses for at least four to six months. Separate essentials, including mortgage payments, food, utilities and clothing, from discretionary expenses, such as dining out, vacations and gifts. Distinguishing between the two doesn't mean you'll have to forgo the fun stuff in retirement, but it lets you see what you could cut if you had to, says Larry Rosenthal, of Rosenthal Wealth Management Group, in Manassas, Va.

Don't forget to include occasional big-ticket items in your tally. "If you get a new car every seven years, that's potentially three cars in retirement, at $25,000 to $40,000 each," says Rosenthal. Support for adult kids—say, helping them buy a house—is another often-overlooked category, says Judy Lawrence, author of *The Budget Kit* (Kaplan Publishing) and founder of www.moneytracker.com.

Also consider how your expenses might change as you age. For instance, you might spend more on travel and less on health care in the first few years of retirement, but a decade or two later it could be the reverse. Or you could pay off your mortgage. Some budget templates have you estimate your expenses at different ages—say, 55 to 64, 65 to 74, and 75 and older. (To see how average annual expenditures in different categories change for people in those age groups, go to www.bls.gov/cex.)

Don't base your future budget on today's dollars. At about 3%, the long-term average annual inflation rate, a $4,000 annual grocery bill would become a $5,376 bill in ten years and a $7,224 bill in 20 years. Kiplinger'sretirement savings calculator can show how a 3% annual inflation rate will affect the amount you'll need to save.

Consider cash flow. To find out whether your income will cover your expenses, add up payouts from pensions and other annuities, Social Security benefits (see "Estimate Your Retirement Benefits" atwww.socialsecurity.gov), income from investments and distributions from retirement accounts. You must take a minimum annual distribution from traditional IRAs and 401(k)s after age 70 1/2, but you can withdraw more than the minimum. (Roth IRAs do not require a minimum distribution.) One rule of thumb is to withdraw 4% from your total nest egg in the first year after you retire and increase that amount each year by the rate of inflation. The strategy improves the odds that you won't outlive your money, but if your investments take a dive, you could end up draining your nest egg. Another strategy is to base annual spending on the required minimum distribution rules for a traditional IRA (see IRS Publication 590).

Include the tax bite. You'll owe income tax on payouts from employer-sponsored pensions and withdrawals from tax-deferred retirement accounts. If you buy an immediate annuity with after-tax dollars, part of each payment will be taxable and part tax-free (the insurance company will tell you what's what). You'll owe tax on 85% of your Social Security benefits if your taxable income, plus half of your benefits, exceeds $34,000 if you're single or $44,000 if married filing jointly.