



BWEA Advisor

Baltimore–Washington Financial Advisors, Inc.

Fee-Only Retirement & Estate Planning, Investment Management, & Tax Services



**By Saxon Birdsong,
MBA**

Class Action Lawsuits—What Should You Do?

Every investor's nightmare is a thick envelope full of legal documents which only a securities lawyer might understand. What do you do with it? You've tried to read the fine print before, and tried to follow the instructions, gather the necessary documentation and fill out the forms. But you have never been confident that you have done it right. Or, more likely, you have convinced yourself that you probably won't get that much anyway and tossed it all away.

Don't fret about it; BWFA takes care of Class Action Lawsuit Settlement claims for you.

Class Action Lawsuits are a fact of life in the investment business. In recent years, there has been a large increase in the number of Class Action Lawsuits, prompted by stricter legislation, increased regulatory scrutiny, and outrage over greed and breach of fiduciary responsibility by executives and board members. While many of the suits have merit, still too many of them appear to have none. And, even when the suits have merit, the stockholders' share of the settlements resulting from these suits is frequently a fraction of what they deserve.

We want to make sure our clients know that we handle all the work associated with Class Action Lawsuits. Typically, this involves the following steps (in order):

1. Notification of the settlement

What usually happens is that one of our clients receives the notice of settlement and forwards the legal documents to us. It happens this way because our clients' securities are registered in THEIR names, not in our name. So, our clients get the notices first.

2. Determining who is entitled to initiate a claim

Typically, the individuals who can participate in the settlement are those who purchased or sold securities within a specified

date range. We use our accounting records to identify who can participate.

3. Is a claim worth making?

The best we can do here is an estimate, based on the facts provided. The actual amount available to pay a claim varies considerably, based on the number of people who initiate a claim, the amount of accounting and legal fees, and other factors. If we determine that you might be awarded an amount in excess of \$50, we will initiate a claim.

4. Initial notification by email or letter

We send you an email or letter explaining that you will be receiving important documents from us in the next several days which will require your signature.

5. Receipt of the claim forms

We complete all the information on the forms, so all you have to do is sign and return the claim documents to us by a specified date.

6. Claim forms and documentation to the settlement agent

We organize and package all the documentation and claim forms to make the process easy for the settlement agent, so that there are no unnecessary delays. Our recent procedure has included notifying you when we send the claim forms to the settlement agent, to keep you informed.

7. Receipt of settlement proceeds

This can take up to a year or more, based on the particulars of the lawsuit. The amounts vary, but it has not been unusual for our clients to receive several hundred to several thousand dollars.

So, what should you do? When we send you a claim form, sign and return it to us promptly. We do the rest, at no additional cost to you.

Retirement & Estate Planning



By Mark Stinson,
CPA

Background

On February 1, 2005, *The Wall Street Journal* reported that in 1960 there were five workers for every Social Security beneficiary. Today there are slightly more than three. In thirty years there will be two. If tax rates and benefits remain as they are under the current law, the Social Security system will begin paying out more than it collects in 2018. Actuaries estimate that, if changes are not made, benefits will have to be cut 30% in 2042 to maintain the system.

Why the urgency?

Although Social Security can pay promised benefits for many years, workers need time to save more if benefits will be cut and notice if the retirement age is going to change. The longer the government delays, the bigger the tax increases or benefit cuts will be.

What is the private account option?

President Bush is proposing “private accounts.” Under his plan:

- Initial retirement benefits for all workers will shrink.
- Workers under age 55 could divert about one third of their payroll taxes (up to \$1,000) to invest in mutual funds.
- Government-paid Social Security benefits to workers with private accounts would be reduced further, to reflect taxes diverted to private accounts.
- At retirement, workers would get access to the money in their private accounts (more or less than they would under traditional Social Security, depending on how their mutual funds perform).

Would private accounts stabilize Social Security?

In the short run, the government would have to find \$1 trillion to \$2 trillion over the next 10 years (to replace tax revenues diverted to private accounts) to pay current retirees. Over the long run, private accounts are a wash. Diverting payroll taxes to private accounts would reduce the flow of tax money into the system in

Will Privatizing Social Security Impact Your Retirement?

As I write this, the proposal to “privatize” Social Security changes daily. With all the press this issue is receiving, many of you may be concerned about how it could affect you, now and in the future.

exchange for reducing government benefits for workers with private accounts. Therefore, private accounts will not fix Social Security’s financing problems; other measures will have to be taken.

How do we stabilize Social Security?

There are a several basic ways to stabilize the system:

- Increase the payroll tax (currently 12.4%: 6.2% for employees and 6.2% for employers)
- Increase the full-retirement age
- Increase the payroll-tax income limit (currently \$90,000)
- Decrease benefits
- Change the formula used to calculate benefits

Most of the alternatives circulating include some combination of these alternatives. No single measure will be significant enough to stabilize Social Security.

Who will be affected?

Current retirees and those over 55 – Under the commission’s plan, only those under 55 will be eligible for private accounts. For current retirees and those 55 and older, there is no change to the current system. However, some proposals would change the cost-of-living adjustments to Social Security benefits, which could impact this group. People who are planning to retire within the next five years will want to watch this issue closely, particularly as they determine their retirement spending levels.

Younger workers – The bulk of the changes proposed will affect this group. It is likely that they will pay more into the system while working and may receive less guaranteed benefits in retirement. This makes it more important than ever for people to start planning early.

Conclusion

It will be some time before a clear picture of the changes (if any) to the Social Security system emerges and before changes are implemented. There is no reason to believe that the system will go away, and currently the worst-case scenario is that benefits will be cut 30% in 2042. We will keep you updated on the changes and their impact on your retirement.

Investment Management



By Rob Williams

What Should You Do If Social Security Offers Private Accounts?

This article offers a glimpse at how Social Security “private accounts” might work and what you should do if private accounts become part of the Social Security system. We’ll leave the vexing questions regarding whether private

accounts are good social policy to the political arena and focus on how private accounts might affect our clients if they come into effect.

Participation is optional

Most experts think the Bush Administration wants to model private accounts after the plan described in the President’s 2002 Commission to Strengthen Social Security. According to this plan, workers who are under 55 would have an option to redirect a portion of their Social Security taxes to private accounts dedicated to their retirement, and to direct how this money is invested. Initially, the limit would be 4% of a worker’s salary, up to \$1,000. This represents about one third or less of the total 12.4% Social Security tax paid by workers and their employers. The small limit might be expanded in the future.

Broad inexpensive index funds

Workers would have limited control over how to invest money in their private accounts. They would probably have a short list of broadly diversified index funds, offered by the Social Security Administration but run by private money management firms. The thinking regarding these options is that such funds would limit the possibility of investors making bad mistakes and ruining their retirements. Plus, large index funds are inexpensive to manage. The goal is to keep expenses at a low 0.30%, which would be quite reasonable. However, this will limit investment performance to a mundane level.

Break-even rate

Workers who contribute to private accounts will receive a proportional reduction in their benefits from the traditional Social Security system. Therefore, in order for workers to benefit from private accounts, they will have to earn a greater rate of return on their contributions. This “break-even” rate will be the annual inflation rate (historically, 3.1%) plus 3% per year. If workers earn more than the break-even rate, they will have a

greater retirement income than under the traditional system. If they earn less, they will have a smaller retirement income.

Obviously, workers who choose to participate in private accounts need to find investments that are expected to earn more than the break-even rate, and that means stocks. The numbers below show that safe investments, like bonds and treasury bills, are not likely to make the grade.

	Annual % Rate (1926 through 2000)
Inflation	3.1%
Treasury Bills	3.8%
Long-Term Government Bonds	5.3%
Long-Term Corporate Bonds	5.7%
Large Cap Stocks	11.0%
Small Cap Stocks	12.4%

We think this means that younger workers (up to age 50) should participate in private accounts. They have the time to withstand the ups and downs of the stock market and thus can tolerate the risk. We note that the average annual return for investors who bought and held stocks for ten-year periods exceeded the average inflation rate over those ten-year periods by at least 3%, in 77% of the cases. Given that only one third or less of a worker’s Social Security benefit would be in a private account, the risk of loss is low and the potential for gain is high.

Older workers should be careful. The time until they retire is shorter, so their risk is greater. We think that workers who will depend on Social Security for a major portion of their retirement income, and those who are uncomfortable with the stock market, should not participate in private accounts. The certainty of the existing Social Security system and its protection against inflation are too valuable for these people to give up.

Older workers with greater retirement resources should consider private accounts. However, we are concerned about protecting them against big drops in the stock market just before their retirement. The proposed plan may force many people to annuitize (lock in) the value of their private accounts at retirement, thus preventing them from waiting for an eventual stock-market recovery. We will be watching this issue closely.

Tax Services



By **Bob Cassel, EA,**



The Tax Consequences of Social Security and Privatization

It is certainly not clear whether privatization of Social Security will become a reality. It is also not clear how this privatization will affect your overall tax bill. However, from the proposals currently being considered, it appears that changes to our Social

Security system will likely increase payroll taxes for workers and have mixed effects on the taxation of retirement benefits.

Under current law, there are two ways in which your tax bill is affected by Social Security: 1) Social Security payroll taxes and 2) federal income taxes on the Social Security benefits you receive in retirement or on disability. Let's begin with the payroll taxes.

Payroll Tax System

Your compensation, whether in the form of wages, salaries or self-employment income, is subject to Social Security payroll taxes. As an employee, you pay 6.2% of your compensation. In addition, your employer matches these taxes. If you're self-employed you pay the entire Social Security tax, amounting to 12.4%.

The Social Security tax is applied to compensation up to a yearly maximum of \$90,000. (This income ceiling is increased annually.) That means that, once your compensation reaches \$90,000, you are finished paying Social Security taxes for the year.

Looking at current proposals to shore up Social Security, it seems likely there will be an increase in payroll taxes. Some proposals advocate raising payroll taxes by 2%. Other proposals suggest removing the cap on compensation subject to Social Security taxes or applying a reduced tax rate above a certain income level. Either way, this amounts to a tax increase on working people. If the cap is eliminated, for every \$10,000 of salary above \$90,000, you would pay at least \$620 more in Social Security taxes each year. Self-employed people would pay \$1,240 more per year.

Since payroll taxes apply to gross wages, not taxable income, there are very few planning opportunities to reduce these taxes.

Retirement and Disability Benefits

Social Security retirement and disability benefits have been taxable to higher-income taxpayers for some time now. Single persons with taxable income over \$34,000 and married filers with income over \$44,000 pay tax on 85% of the benefits.

The proposal to privatize a portion of Social Security will not solve the system's financing problems. Therefore, it will likely be combined with a reduction of Social Security retirement benefits. This would have the effect of lowering your income in retirement, and consequently your income taxes.

The net effect of privatization on your income tax bill will depend on the amount of time you participate in private retirement accounts. If you are closer to retirement, your contributions to private accounts will be small. Most of your retirement benefits will come from the traditional system and will be taxed as they are today.

Younger participants will have many years of tax-deferred growth. A greater portion of their retirement income may be made up of distributions from these accounts. This could have a positive affect on their taxes. After 30 years of participation in a private retirement account, assuming an investment return of 7% and contributions made with after-tax money, approximately 65% of each distribution would be taxable. Compared to the 85% of Social Security retirement benefits taxable today, the combination of Social Security and private-account distributions would likely generate a lower overall tax liability for future retirees.

The Bottom Line

Workers can expect to pay more in payroll taxes, and future retirees may pay less income tax on their Social Security retirement benefits.

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