Principal®

Principal® Bonus – S Owner

Give yourself a retirement bonus

Presented to

Sample firm

Presented by:

Producer Name
(555)123-4567
Produceremail@email.com

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Proprietary and confidential

We appreciate the opportunity to prepare and present this bonus plan.

The information contained in this proposal has been developed based on our years of knowledge and experience in the key employee benefits industry. Rest assured that the information contained in this proposal will be kept strictly confidential.

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A retirement benefit that offers tax leverage and flexibility

As an owner of an S corporation, you've likely experienced some tax advantages. However, this business structure can also present you with challenges when it comes to retirement planning.

Taxes on profits. You must pay income tax on profits even if you don't receive the distributions in cash.

Raising capital. You may be hampered by restrictions on the number of shareholders and classes of stock that are allowed.

Fringe benefit limitations. You may be taxed unfavorably or they may be unavailable altogether.

When it comes to your assets and planning for retirement, an S corporation owner typically has three kinds of assets. Let's take a look at what those are and some potential considerations.

Qualified retirement plans	Investments	Personal assets
Pre-tax assets • 401(k) plans • SIMPLE IRAs • Defined benefit plans • Simplified employee pension plans (SEPs)	**After-tax assets** • Mutual funds • Certificates of deposit (CDs) • Stocks • Bonds • Annuities	**After-tax assets** • S corporation ownership • Home ownership • Property
Considerations • Contributions are made on a pre-tax basis and grow tax-deferred. • Distributions are taxable. • Restrictions limit money going into and coming out of these plans.	**Considerations** • These are typically purchased with after-tax dollars. • Distributions may be subject to capital gains, dividend income, or ordinary income taxes.	**Considerations** • A successful business introduces growth to your wealth and helps provide you with a controlled asset. • Growth in the company is taxable.

Multiple benefits in one solution

We understand you've likely become accustomed to a certain standard of living. To maintain that standard of living in retirement, consider a bonus plan designed specifically for S corporation owners. It offers benefits for you and your family.

Retirement income. You can save more for retirement than you might be able to through other means that limit contributions and restrict compensation.

Tax leverage. By using life insurance to finance the plan, you can take advantage of tax benefits not available through other savings or financing vehicles.

Protection. You gain peace of mind knowing your family will receive a benefit upon your death. You may also use the plan to fund disability protection.

WHAT TO EXPECT

Let's walk through the flexibility of this plan and how it can be tailored to fit your specific needs. You're in control of key decisions and determining next steps. This proposal will help you do that by covering the following areas:

Design. Choose the plan design that can help you accomplish your goals.

Financing. Decide which financing option best balances long-term costs and plan benefits.

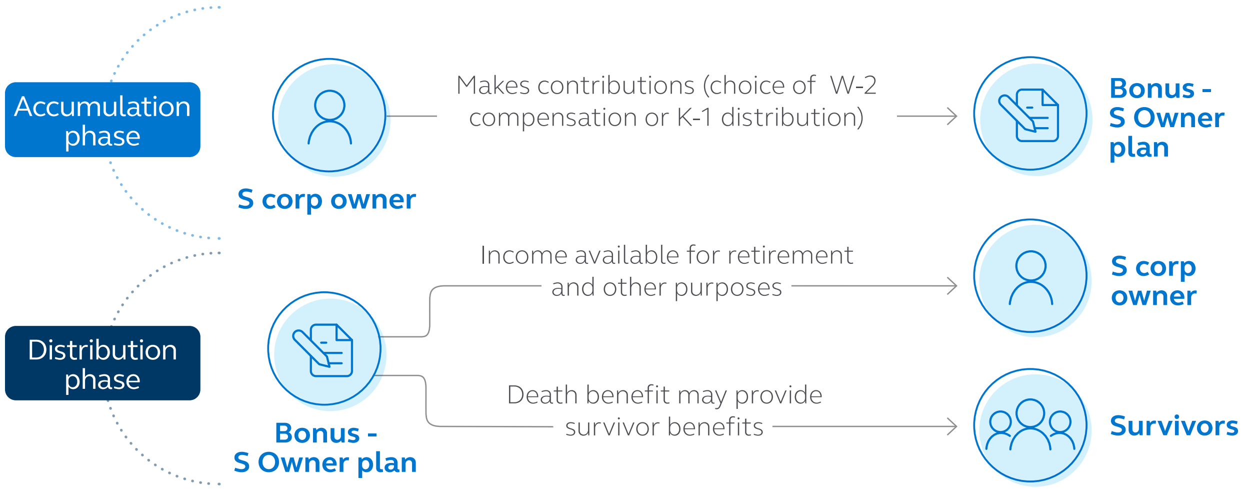
Support. Understand the valuable support services available to maintain this plan.

Next steps. Review how to implement your plan.

Before we dive into the details of the design elements, let's take a quick look at how the plan works and its benefits and considerations.

Here's how it works

You select an amount to contribute from W-2 compensation or K-1 distributions[1] and your dollars are used to finance the personally owned asset—like life insurance. At retirement, you may access the values in the financial asset to help supplement your retirement income.



BENEFITS AND CONSIDERATIONS

Save more. While qualified plans and Roth IRAs offer tax benefits, they have limits on compensation and contributions that don't apply to this bonus plan.

Choose from contribution options. As an S corporation owner, you can choose to take income as W-2 compensation or a K-1 distribution, allowing some payroll tax leverage.[1]

Pay out distributions properly. If there's more than one owner and K-1 distributions are used, distributions need to be in proportion to ownership.

Pay income tax now. Whether profits are distributed or retained for business expansion, you and any other owners are taxed on the profits of the business.[2]

Need to be healthy. You must be able to qualify for life insurance if you choose to use it for financing the plan.

Choose alternate financing options. If you or another owner is unable to qualify for life insurance, other options for financing the plan are available. These options will have different tax implications regarding accumulation and distribution.

[1] Contributions must meet reasonable compensation regulations.

[2] S corporation owners report their share of business profits on their personal tax returns. Depending on your type of business and other personal income, you might be entitled to a deduction under IRC Section 199A, of up to 20% of your passthrough income, as a result of the Tax Cuts and Jobs Act.

You're in control of making this plan yours—it's based on your personal needs as an owner. Together with your financial professional, we'll walk you through the decisions that need to be made to design a plan that makes sense for you. Consider the following as you tailor your plan.

Who's eligible to participate in the plan?

Any owner of the S corporation may participate. This plan is not limited to highly compensated owners or those qualifying for the "top-hat" exemption.

What amount can you and the other owners contribute?

You select the amount you want to contribute on an after-tax basis. Your contributions can be treated as compensation (W-2) or dividends (K-1).

Compensation (W-2) design. You contribute a portion of your current salary/W-2 compensation to the plan. Your contribution is subject to income tax and FICA taxes. Depending on the asset selected, growth may be tax deferred and distributions tax favored. This offers not only tax advantages in retirement, but also tax diversification benefits.

As an S corporation owner, your ability to take the deduction under the Tax Cuts and Jobs Act for passthrough income might depend in part on the W-2 compensation paid by your company (not only to you, but to all employees). Amounts paid under the compensation design would be included in this W-2 calculation.

Dividend (K-1) design. If you are an employee of the business, you must take at least a reasonable salary and should consult with a tax advisor. You may also take a K-1 distribution from the company. If there's more than one owner, dividends distributed need to be in proportion to ownership. The K-1 distribution is taxable for income tax purposes, but may avoid FICA taxes. However, dividends are not included in the calculation of W-2 income for purposes of the deduction for passthrough income.

Depending on the asset selected, growth may be tax deferred and distributions tax favored. So, this model potentially offers favorable payroll and income tax planning opportunities.

What happens with the contributions?

Plan contributions are used to fund a personally owned life insurance policy.[1] You pay income tax on the contributions going into the plan. However, benefit distributions from the plan may be income tax-free when life insurance is used to finance the plan.[2] This contrasts the taxation of qualified plans, where contributions going into the plan are tax deferred, but the benefit is taxed when paid out. Together, these plans can provide you with a more income tax-diversified and comprehensive retirement program.

[1] Additional financing options may be available.

[2] Withdrawals are generally tax-free until cost basis has been recovered. Thereafter, policy loans are generally tax-free unless the policy lapses. Withdrawals and loans will reduce the policy cash surrender value and net death benefit and may cause the policy to lapse. Lapse of a life policy may cause loss of death benefit and adverse income tax consequences. A life insurance policy classified as a modified endowment contract (MEC) will have less favorable tax treatment during the life of the insured compared to other life insurance (non-MEC policies). Such tax treatment would be similar to tax treatment of a deferred annuity.

How and when are benefits paid?

There may be some restrictions on access to funds based on the plan's financial asset. But generally, you determine when to take distributions.

What are the tax implications of this plan?

A lot depends on the financing vehicle that you choose, but benefits and considerations may include:

- The opportunity for tax diversification planning
- Potential favorable taxation at distribution
- Possible annual taxation of earnings inside the plan
- Asset building outside of your business, which provides potential tax-deferred growth
- Avoiding mandatory distributions at age 72
- Possibly avoiding penalties for distributions before age 59½
- S corporation owners may receive both W-2 compensation and K-1 distributions based on their percentage of ownership. Wide variances between the two from year to year may increase chances of an Internal Revenue Service audit.

Are there other things to consider with this plan?

- Can provide enhanced retirement benefits and may provide survivor benefits
- Offers an opportunity to reduce your exposure to business creditors and diversify your investment and tax portfolios
- Provides exemption from certain annual reporting requirements
- Requires no administrative services expenses to administer the plan
- Gives you maximum control, because you select and own the asset
- Financing asset may be subject to the owner's general creditors (depending on the financial asset selected and applicable state laws)

Financing your plan

A financing asset is needed so that plan contributions may accumulate for future distributions. What can you use? Well, you have some options. The one that works for you depends on your age, health, needs, and objectives, as well as the degree of risk that's acceptable to you.

- **Taxable asset.** Contributions are invested in vehicles such as stocks, bonds, CDs, or mutual funds.
- **Deferred annuity.** Contributions are paid into an annuity—fixed, indexed, or variable.
- **Life insurance.** Contributions are paid into a life insurance policy—fixed, indexed, or variable.

	Taxable asset	Deferred annuity	Life insurance
Benefits	• Many investment options • Direct crediting of earnings • Flexible contributions • No medical underwriting • Long-term gains taxed at capital gains rates	• Earnings accumulate tax deferred • No medical underwriting • Guaranteed death proceeds may bypass probate process • Can provide guaranteed income for life	• Earnings accumulate tax deferred • Tax-advantaged distributions such as loans and partial surrenders (subject to policy limitations/charges)[2] • Tax-free life insurance death proceeds may bypass probate process and protect dependents
Considerations	• Earnings taxable to owner annually • No death benefit • Distributions in excess of basis are taxable • Fees and expenses	• 10% penalty on earnings imposed for distributions prior to age 59½ • Should the owner die, any money that is due is taxable to the beneficiary • Surrender charges may apply[1] • Distributions are "gain out first" (taxable as ordinary income) • Fees and expenses	• Owner must be insurable • Medical underwriting • Impact of loans and withdrawals[2] • Cost of insurance, policy fees, and expenses

To help you better weigh your options, review the detailed financial model included with this proposal.

Investing in mutual funds, variable annuities, or variable life insurance involves risk, including the potential for loss of principal. Guarantees are based on the claims-paying ability of the issuing insurance company.

[1] If the contract has surrender charges, withdrawals beyond the free withdrawal provision may have an additional charge.

[2] Withdrawals are generally tax-free until cost basis has been recovered. Thereafter, policy loans are generally tax-free unless the policy lapses. Withdrawals and loans will reduce the policy cash surrender value and net death benefit and may cause the policy to lapse. Lapse of a life policy may cause loss of death benefit and adverse income tax consequences. A life insurance policy classified as a modified endowment contract (MEC) will have less favorable tax treatment during the life of the insured compared to other life insurance (non-MEC policies). Such tax treatment would be similar to tax treatment of a deferred annuity.

Tax diversification can help maximize income

As you review your overall retirement income strategy, you may realize that a lot of your other retirement income will be taxable. This bonus plan for owners offers options with varying tax implications. It allows for tax leverage similar to a Roth IRA without restrictions on eligible income or contribution limits.[1] The tax leverage is found in the life insurance product used to finance the plan, rather than being based on a plan-level tax code provision.

Let's compare three different financing assets for your bonus plan to another likely source of retirement income—a 401(k) plan.

		Bonus plan financing options		
	401(k) plan	Mutual fund	Deferred annuity	Life insurance
At time of contribution				
Income taxable	No	Yes	Yes	Yes
FICA taxes apply	Yes[1]	Yes[2]	Yes[2]	Yes[2]
Growth				
Tax deferred	Yes	No	Yes	Yes
At time of distribution				
Income taxable	Yes	Yes[3]	Yes (LIFO)[4]	No (FIFO)[5]
Capital gains apply	No	Yes[3]	No	No
Tax to heirs				
Income taxable	Yes	No	Yes	No

LIFO: Last in, first out
FIFO: First in, first out

The above comparison provides an overview of the possible tax outcomes and is provided for educational and informational purposes only. It is not intended to provide a complete comparison of all asset types. All features of a product should be reviewed when selecting a product. Specific situations may vary and should be discussed with your professional tax advisor.

[1] Employer contributions to a qualified plan are excluded from the definition of "wages" under Social Security and are not subject to Social Security taxes.

[2] If business is an S corporation, FICA applies only if W-2 compensation is used.

[3] Mutual funds pass their dividends, interest, and capital gains to their shareholders. Capital gains or loss may also be recognized upon sale of mutual funds shares. To the extent the funds are invested in tax-exempt bonds, interest may be federal and/or state income tax-free.

[4] Withdrawals may be subject to surrender charges, and are taxable as ordinary income to the extent of the gain in the contract. Withdrawals prior to age 59½ may be subject to a 10% penalty.

[5] Withdrawals are generally tax-free until cost basis has been recovered. Thereafter, policy loans are generally tax-free unless the policy lapses. Withdrawals and loans will reduce the policy cash surrender value and net death benefit and may cause the policy to lapse. Lapse of a life policy may cause loss of death benefit and adverse income tax consequences. A life insurance policy classified as a modified endowment contract (MEC) will have less favorable tax treatment during the life of the insured compared to other life insurance (non-MEC policies). Such tax treatment would be similar to tax treatment of a deferred annuity.

Focused on your plan's details—today and tomorrow

It takes a lot of work to run your business. We understand that you may not have time to think about the details associated with administering a benefit plan like this one. That's why we're here. We have the expertise and services to help you with implementation today and administration throughout the life of your plan.

Our Business Market Administration team at Principal provides dedicated, ongoing support for your employer-owned and employer-sponsored plans funded with life insurance. And as your needs change, or regulations change, we'll help you keep up with both.

Supporting you every step of the way

Beginning at plan implementation, we understand what you need and what needs to be done. You'll benefit from the complimentary administrative services offered by Principal.

Dedicated administrator. Personally assists you with enrollments, policy adjustments, service requests, policy illustrations, and more.

Plan-level reporting. Consolidated reports show current coverage amounts, policy values, and premium information for all owner-participants with life policies under your plan.

List billing. Delivers consolidated payment reminders covering all policies under your plan – billed annually, semi-annually, quarterly, or monthly.

Online access. Allows you to view policy information 24/7 at principal.com. You can view consolidated plan-level information. Policy owners may also make changes or initiate service requests.

Walking you through a successful implementation

Helping you tailor a plan to your specific needs and goals is a top priority. Once you're comfortable with the plan design and the financing to support it, attention will shift to you and your financial professional putting the plan in place using the Principal platform.

As everyone works together to successfully implement your plan within your desired timing, our goal is to deliver a positive experience for everyone involved. Here's what you can expect:

Next steps

1 Strategy development

- Finalize designated documents[1]
- Confirm funding levels

2 Application process

- Educate owners on the funding program
- Collect applications and signatures, if applicable

3 Administrative set-up

- Finalize underwriting, if applicable
- Enter plan information into recordkeeping systems

4 Implementation

- Begin premium payments
- Issue new insurance policies, if applicable

[1] Proper documentation for this plan is particularly important, since many of the plan benefit details need to be documented in agreements. Principal offers sample documents that your attorney can use.

An industry leader in your corner

You know the importance of an affordable and valuable benefit. An important part of that is the company you work with to implement, and provide funding solutions and reporting services for these plans.

Everything you need in one place

Once you decide this plan is right for you, we'll bring our expertise and resources to the table to help you put the plan in place. Everything you need to successfully implement and maintain a plan is available at Principal:

- Innovative plan design
- Multiple financing options
- Efficient plan implementation
- Dedicated plan administrative services

You can trust our expertise and leadership[1]

We've been providing administrative services for business solutions for more than 30 years, making it a priority to understand where you want to be and how you plan to get there. This means you'll get expertise and innovative ideas when you need them to help make your financial progress possible.

- A member of the *FORTUNE* 500®, we have $714 billion in total assets under management[1] and serve clients worldwide of all income and portfolio sizes.
- Year after year we receive strong financial ratings from the four major rating agencies—A.M. Best Company, Moody's Investor Services, Standard & Poor's, and Fitch Ratings.[2]
- No. 1 provider of nonqualified deferred compensation plans.[3]
- We're the leader in the small-case business life insurance market.[4]

[1] Principal® 2022 Company Profile. Data for the trailing 12 months ended December 31, 2021. For the latest and additional information, visit www.principal.com.

[2] Third-party ratings relate only to Principal Life Insurance Company, the largest member company of the Principal Financial Group, and Principal National Life Insurance Company, and do not reflect any ratings actions or notices relating to the US life insurance sector generally.
While ratings can be objective indicators of an insurance company's financial strength and can provide a relative measure to help select among insurance companies, they are not guarantees of the future financial strength and/or claims-paying ability of a company and do not apply to any underlying variable investment options. The broker/dealer a life insurance policy is purchased from, the insurance agency and any affiliates of those entities make no representations regarding the quality of the analysis conducted by the rating agencies. The above mentioned entities are not affiliated with any rating agency nor are they involved in any rating agency's analysis of the insurance companies.

[3] Based on total number of Section 409A plans, PLANSPONSOR Recordkeeping Survey, July 2021.

[4] July 2021 COLI/CSIO survey of participating life insurance carriers, IBIS Associates, Hamilton, VA.

Accounting

As an owner of an S corporation, you're interested in the accounting effects of financial transactions as they impact both your company and your stock value in the company. With this bonus plan, the accounting will vary depending on whether you use the compensation (W-2) design or the dividend (K-1) design. However, the net effect of the value of the stock you own is the same no matter which design you use. The asset is owned by you, and not by your company, and it does not appear on the company's balance sheet.

Here's an example of how the accounting varies between the two designs. It assumes an S corporation owner has an initial basis and is considering how to treat some current profit generated by the business. A dividend (K-1) distribution will also reduce your basis in the S corporation.

	Compensation (W-2) design	Dividend (K-1) design
Beginning shareholder basis	$200,000	$200,000
Profit	$20,000	$20,000
Additional compensation	$20,000	$0
Adjusted basis after profit	$200,000	$220,000
Dividend paid	$0	$20,000
Decrease in basis from dividend	$0	$20,000
Ending shareholder basis	$200,000	$200,000

Note: This model does not reflect that, because of employment taxes, there might be higher tax costs associated with the compensation (W-2) design than with the dividend (K-1) design. Also, this does not reflect the deduction that may be available under the Tax Cuts and Jobs Act.

Compensation (W-2) design

If you use this design, the contribution is treated as additional compensation and treated as such in the financial statements.

	Balance sheet		Income statement	
Payment of base compensation to the S corporation owner[1]	Debit	Credit	Debit	Credit
Wage expense			$20,000	
Cash		$20,000		

Since the $20,000 is paid out as compensation, it's a reduction in the net profit to the company. So, it doesn't become an available distribution to you as an owner of the company's stock and it has no effect on the basis of your stock.

Dividend (K-1) design

With this design, the contribution is treated as a distribution with an accompanying reduction in basis. The $20,000 distribution is a Schedule K-1 item included with Tax Form 1120S. And, because you're the owner of an S corporation, it reduces the basis in your stock.

1 The company provides additional compensation of $20,000 to the owner as a W-2 item and deducts the $20,000 in the year paid.

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