Principal®

Principal® Bonus (Tax Exempt)

A bonus that does so much more.

Presented to:

Sample company

Presented by:

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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.

This proposal was created by and is the proprietary property of Principal®. This material is provided for informational purposes only. It is presented with the understanding that Principal is not rendering legal, accounting or tax advice. Please consult with your professional advisors to review your specific situation.

Key employee benefits can be your key to success.

We understand that you have select key employees who play important roles in your organization. Would your organization be as successful without them?

Having the right tools to recruit, reward, retain, and retire key employees can have a noticeable impact on your organization. Key employee benefits can play a big role in helping you by helping them. These nonqualified plans can provide additional benefits and/or help them make up for benefits lost due to limitations on qualified retirement plans and Social Security. The result? A valuable recruiting tool that helps to create more engaged and loyal employees.

Multiple benefits in one solution

A bonus plan could really have an impact on your business. Specifically, it's designed to help you:

Recruit. Attract top talent as part of a competitive benefits package.

Reward. Provide performance-based contributions to achieve organizational goals.

Retain. Encourage loyalty by helping to secure financial futures.

Retire. Offer additional savings and long-term income diversification options.

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. So, 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.

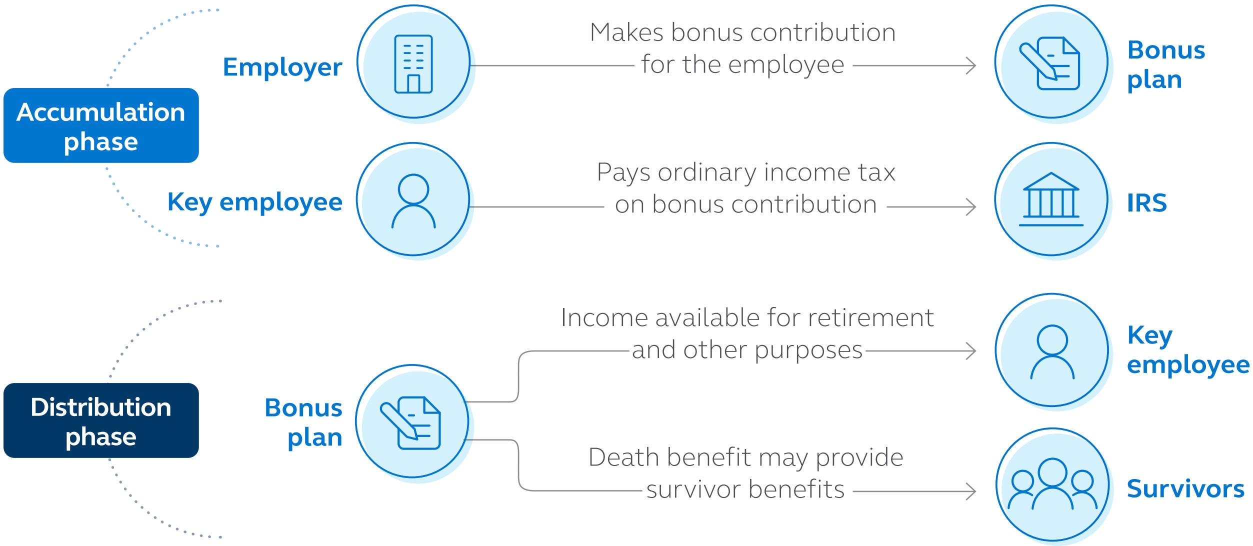
Support. Understand the valuable support services available to maintain this plan.

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

Typically, the bonus you contribute to the plan for select key employees is used to buy a life insurance policy from Principal[1]. This policy funds the plan and can provide retirement income, death benefit protection, as well as additional living benefits.



BENEFITS AND CONSIDERATIONS

For you

Increase morale. It's an effective way to recruit, reward, retain, and retire the employees who are most valuable to your organization.

Enjoy simplicity. Avoid complexities and legislative impact of 457 plans.

Communicate easily. The simple and flexible plan design is easy to communicate and maintain.

Save time. You won't have annual reporting or Employee Retirement Income Security Act (ERISA) requirements to complete.

Impact to cash flow. Bonuses you pay reduce the organization's cash flow.

For your key employee

Save more. Additional money can be saved for retirement; above the limits of a qualified plan, such as a 401(k) or 403(b).

Receive multiple benefits. Distributions may be used for planned events, such as supplementing retirement income, funding a child's education, or purchasing a second home. The plan can also provide access to funds to address unplanned events—such as disability, chronic illness, and other financial needs.

Help enhance financial security. The employee's family can receive income tax-free benefits at the employee's death.

Owns the policy. The key employee owns the life insurance policy[1], but must stay with the organization to be eligible for the bonus.

Pay potential taxes. An additional tax may be due if the employer's bonus doesn't cover all the income tax. However, the tax on the bonus may be partially or fully offset with another employer bonus.

[1] Additional financing options may be available.

Build a path for loyalty with key employees.

You're in control of making this executive bonus plan yours—it's based on your organization's goals and your key employees' needs. Together with your financial professional, we'll walk you through the necessary plan design decisions that make sense for your organization. Consider the following as you tailor your plan.

Who's eligible to participate in the plan?

You can select any employee or group of employees to participate. This plan isn't limited to a select group of management or highly compensated employees that must qualify for the "top hat" exemption, as may be required by other plans.

What amount can you and your key employees contribute?

You can allow key employees to contribute and/or provide employer contributions with the flexibility to vary benefits by employee.

Employee contributions. Key employees may select an amount to contribute from their current salary (using after-tax dollars).

Employer contributions (bonuses). These may be structured in different ways to achieve various objectives, including:

- Reward the key employee for a job well-done.
- Offset the cost of taxes paid by the key employee on the bonus, any matching contributions, and/or any after-tax contributions (for a pre-tax effect).
- Match contributions made by the key employee.

Types of bonuses

Single bonus. You give a bonus that's paid into the life insurance policy.[1] The key employee pays any taxes due on that bonus.

Double bonus. You give a bonus that's paid into the life insurance policy.[1] The key employee pays any taxes due with additional money bonused by you.

Simulated salary deferral. The key employee allocates a portion of their salary that's paid into the financial asset. The key employee receives a cash bonus from you to make their contribution to the plan feel like a pre-tax contribution.

[1] Additional financing options may be available.

What happens with the contributions?

Plan contributions are used to fund a life insurance policy[1] that's selected and owned by the key employee. Investment options within that asset will vary, but any earnings (or losses) within that asset are directly credited to the key employee's plan.

How and when are benefits paid to key employees?

There may be some restrictions on the employee's access to funds based on the plan's financial asset or optional restrictions placed on distributions by you. But generally, the key employee determines when to take distributions.

What control do you have over the plan?

Participation. You select the key employees that you want to include in the plan—there are no limitations.

Retention. You may add one or both of the following optional agreements to more closely tie the key employee to your organization.

- **Agreement to restrict policy owner's rights (available with life insurance financing only).** Restricts the key employee's access to asset values without your consent during a specified period. However, the key employee still owns the asset.
- **Repayment obligation agreement.** Requires that the key employee must repay bonuses given if they leave the company before meeting a service requirement. This can be structured like a vesting schedule. However, the promise to repay is not secured by the asset.

What are the tax implications of this plan?

For you

- Due to your tax-exempt status, there may be no tax implications for your company.[1]

For the key employee

- Contributions are from after-tax salary or bonuses. All plan contributions from the organization are taxable as ordinary income to the key employee.
- Employers may choose to structure the bonuses in a way that reduces or eliminates out-of-pocket tax costs for the key employee.
- Earnings in the plan may accumulate tax-deferred (depending on the financial asset selected).
- Penalties for distributions before age 59½ may be avoided (depending on the financial asset selected).
- Mandatory distributions are avoided.

[1] The Tax Cuts and Jobs Act imposes an annual 21% excise tax to any applicable tax-exempt organization on compensation more than $1 million on any covered employee. IRC § 4960.

Financing your plan

A financing asset is needed so plan contributions may accumulate for future distributions. What can you use? Well, you have some options. The one that's best for your key employees depends on their objectives, timing of contributions and distributions, as well as tax sensitivity.

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

	Taxable asset	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 • 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 key employee annually • No death benefit • Distributions in excess of basis are taxable • Fees and expenses	• Key employee must be insurable • Medical underwriting • Impact of loans and withdrawals[2] • Cost of insurance, policy fees and expenses

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).

Focused on your plan's details—today and tomorrow

It takes a lot of work to run your organization. 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.

The 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 and your key employees will 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. Makes participant communications and any needed tax reporting easier. Consolidated reports show a census of covered key employees and basic information about the policies covering those key employees.

List billing. Delivers consolidated payment reminders covering all policies under your plan.

Online access. Allows you to view all policies associated with your plan.

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 participants 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] Step 1 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 your plan is available at Principal:

Innovative plan design	Life insurance 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, 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

With this bonus plan, the financial asset is owned by the key employee. As such, it's not an asset of the employer and doesn't appear on the employer's balance sheet. The bonus is generally treated as additional compensation in the employer's financial statements. In some situations with owners of pass-through entities, the bonus is treated as a distribution with an accompanying reduction in basis. Consult with your accountants and other tax advisors to determine the accounting treatment that will be used for financial reporting for your particular plan.

Journal transaction example:

1. In this hypothetical example, the organization provides compensation of $20,000 to the key employee.
2. Utilizing a double bonus plan design, the organization makes an additional $8,571 payment to the key employee to compensate the key employee for the taxes on the base compensation in a combined 30% marginal income tax bracket (federal and state).

	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
Base compensation to key employee				
Bonus wage expense			$20,000	
Cash		$20,000		
Income taxes on the base bonus to key employee				
Bonus wage expense			$8,571	
Cash		$8,571		

Tax considerations

Key employee income tax

Single bonus. The key employee pays any taxes due on the bonus from the employer using this formula:

Bonus x Employee income tax rate = Tax

For example, if an employer plans to bonus $20,000 to the employee who has a 30% income tax rate, the key employee will owe income tax on the $20,000 bonus, which equals $6,000. Bonuses received are taxable under IRC § 61(a).

$\$20{,}000 \times .30 = \$6{,}000$

Double bonus. Under the double bonus plan design, the key employee has a "zero net tax". To calculate the total bonus needed to cover the tax on the planned employee bonus and the tax on the additional bonus to cover the taxes, use this formula:

$$\frac{\text{Planned employee bonus}}{(1 - \text{Employee income tax rate})} = \text{Total bonus}$$

For example, if the planned employee bonus is $20,000 for an employee who has a 30% income tax rate, the total bonus would be $28,571. Thus, the amount of bonus needed to cover the tax is an additional $8,571.

$$\frac{\$20{,}000}{(1 - .30)} = \$28{,}571$$

Simulated salary deferral. The key employee allocates a portion of their salary that's paid into the financial asset. The key employee receives a cash bonus from you to make their contribution to the plan feel like a pre-tax contribution using this formula:

$$\frac{\text{Key employee contribution}}{(1 - \text{Employee income tax rate})} - \text{Key employee contribution} = \text{Tax bonus from employer}$$

For example, if the key employee allocates $20,000 of their salary, and they have a 30% income tax rate, the employer would bonus $8,571.

$$\frac{\$20{,}000}{(1 - .30) \;-\; \$20{,}000} = \$8{,}571$$

Any additional contribution by the organization is also taxable income to the key employee. However, if the employer wants to reduce the key employee's out-of-pocket tax costs on the contribution, an additional bonus, which covers some or all the tax costs, may be given. Bonuses received are taxable under IRC § 61(a).

Organization taxes

Tax Cuts and Jobs Act imposes an annual 21% excise tax to any applicable tax-exempt organization on compensation more than $1 million on any covered employee. The $1 million compensation includes wages and parachute payments. Remuneration to licensed medical professionals for medical services are not included in this calculation. Covered employees include the organization's five highest-paid employees (IRC Section § 4960).

Social Security taxes

The bonus is treated as compensation and is subject to both FICA and FUTA.

Estate taxes

The fair market value of the benefits, if using mutual funds or annuities, will be included in the key employee's estate. If using personally owned life insurance policies, the death benefit will be included in the estate.

ERISA

This bonus plan would generally be treated as a welfare benefit plan under ERISA. The requirements differ depending on the number and type of employees who are participants. If the plan is top hat (applying only to a select group of management or highly compensated employees), it's subject to the "selected employees exemption" described below. If the plan is not top hat, but covers fewer than 100 employees, the "small welfare plan exemption" requirement below will apply. If there are 100 or more participants, the summary plan description must be filed with the U.S. Department of Labor, as well as an annual report (Form 5500).

However, most plans will be subject to one of the following exemptions:

Selected employees exemption. This exemption is available only to employee benefit plans:

- That are maintained by an employer primarily for providing benefits for a select group of management or highly compensated employees.
- Where benefits are paid solely from the general assets of the employer. Or, where benefits are provided exclusively through insurance contracts, the premiums for which are paid directly by the employer from its general assets.

Under this exemption, the employer is exempt from reporting and disclosure requirements under Part I of Title I of ERISA, except for providing plan documents to the U.S. Secretary of Labor upon request.

Small welfare plan exemption. This exemption provides an employer will not be required to file numerous forms with the Department of Labor and the Internal Revenue Service (IRS) if:

- Fewer than 100 employees are participating in the plan at the beginning of the year,
- The employee benefits are either paid out of the employer's general assets or are provided exclusively through insurance contracts issued by an insurance company or a qualified health maintenance organization where the premiums are paid directly by the employer from its general assets,
- Any employee contributions for premium payments are forwarded to the insurance company within three months of their receipt,
- Under an insured plan where the employees contribute toward the premiums, any refunds to which employees are entitled are returned to the employees within three months of receipt by the employer, and
- Contributing employees are informed of the plan's provisions concerning the allocation of refunds upon entry into the plan.

If the preceding requirements are not met, the employer must file with the Department of Labor:

(1) A summary plan description

(2) An annual report, Form 5500, (filed with the IRS, which forwards a copy to the Department of Labor)

(3) A description of material modifications and

(4) Terminal reports

There's also authority for the position that a benefit negotiated by an employer and a single employee is not a plan for purposes of ERISA. For an employer relying on this position, to strengthen the argument that there's no ERISA plan, each arrangement should be individually negotiated and include an employment agreement. It shouldn't be written as part of a plan or set up in such a way that any employee meeting certain requirements is entitled to have this arrangement included in their compensation package. The specific terms and potential forfeiture provisions of the plan should be subject to negotiation.

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