Principal® Deferred Compensation – SERP

# Help protect your business with incentives for key employees.

Presented to:

Sample Company

Presented by

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## Proprietary and confidential

We appreciate the opportunity to prepare and present this nonqualified deferred comp 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.

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|---|
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# Key employee benefits can be your key to success

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

Having the right tools to recruit, reward, retain, and retire those key employees can have a valuable impact on your business. 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 creates more engaged and loyal employees

## Multiple benefits in one solution

This selective executive retirement plan (SERP) is a deferred comp plan that can have a positive impact on your business. Specifically, it's designed to help you:

**Recruit.** Attract the best employees as part of a competitive benefits package.

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

**Retain.** Encourage key employee 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 permanent life insurance product best meets your plan objectives.

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

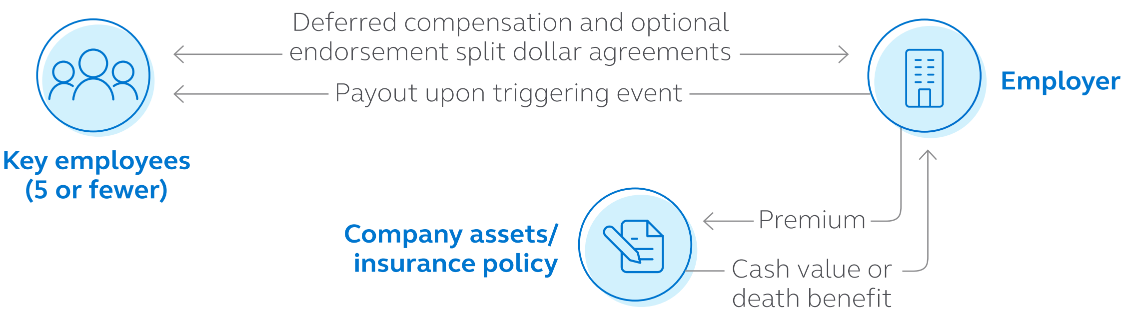
**Next steps.** Review how to implement your plan.

## Here's how it works

A defined contribution deferred comp agreement is established with select key employees. You determine how much you want to contribute to the plan for each key employee. Then, you have some plan design options, such as choosing a vesting schedule and payout terms that allow the plan to be easily customized to fit your objectives.

You also have options when it comes to informally financing your plan. You may choose to insure some or all of your key employees. In addition, an optional endorsement split dollar agreement may be used, so that part of the policy death benefit goes to the key employee's survivors if the key employee should die during the service period.

Upon a triggering event (separation from service, retirement, disability, or death), a payout may begin for the key employee. Payouts can be made in a lump sum or annual installments over varying periods.




## Benefits and considerations

### For you

**Encourage loyalty.** You provide an incentive for the key employee to join your company and stay for the long term.

**Enjoy flexibility.** Based on your business needs and goals, you can choose from a range of life insurance products to insure some or all participating key employees. You can also choose a vesting schedule and payout options.

**Receive a tax deduction.** The company receives a tax deduction in the year the benefit is paid.

**Reduce cash flow.** Premiums are paid with company after-tax dollars, so each premium payment reduces your annual cash flow.

**Recover the premium cost.** If a key employee dies before a triggering event, the life policy's tax-free death benefit may be used to recover the cost of the premiums paid by the company.

### For your key employees

**Receive tax-deferred growth.** Earnings and employer contributions accumulate in the plan tax-deferred.

**Review investment options.** The key employee may be given the opportunity to choose the deemed investments (also known as reference investments) used to measure the value of their account. This might include offering a fixed interest rate.

**Help provide for the future.** Benefits from the plan can meet multiple needs, including paying off student loan debt, accumulating supplemental retirement income, and providing financial support to a key employee's beneficiary(ies) if death occurs during the service period.

**Must qualify.** One or more policies could informally finance the benefit of multiple key employees. Any key employee you choose to insure must be healthy enough to qualify for the life insurance policy.

**Pay taxes.** Employer contributions will be treated as wages and subject to payroll taxes. Generally, this occurs when the employer contributions become vested. Income tax is due on the deferred comp benefit amount in the year it's received.

# Build a path for loyalty with key employees

You're in control of making this plan yours—it's based on your company goals and your key employees' needs. We're here to help you consider the plan design decisions that make sense for your business. Consider the following as you tailor your plan.

## Who's eligible to participate in the plan?

You select up to five key employees you want to include in the plan. Plan participants are a select group of management or highly compensated employees that qualify for the top-hat exemption.

## What amount can you contribute for your key employees?

- You commit to a specified annual contribution for each key employee for a set number of years. The actual amount is up to you, based on the level of benefit you want to provide. You use after-tax dollars to informally finance this plan.
- Employees aren't allowed to contribute to the plan.

## What happens with the contributions?

Because this is a deferred comp plan, it's an unfunded, contractual obligation for you to pay a benefit to the key employee at some point in the future. The benefit is equal to your total contributions to each key employee's account, plus earnings or losses based on the performance of their chosen deemed investments (also known as reference investments).

**While there are no explicit statutory or regulatory guidelines, many companies consider the following when selecting eligible participants:**

- Is participation in the plan offered to less than 5% to 10% of the total employee population?
- Is the employee's total compensation in excess of the IRS Highly Compensated Employee (HCE) limit?
- Is the employee's average compensation at least three times greater than the average compensation of non-top-hat employees?
- Does the employee understand the design, operation, and risk of the plan and have the ability to influence the plan design?
- Does the plan agreement state its intent to qualify as a top-hat plan?

Because there is no bright line test, the eligibility of participants in your plan should be carefully evaluated.

### Measuring benefit growth

How are earnings or losses in the participant's benefit account value calculated? When the plan is set up, you and your key employee select the deemed investment option below that best meets financial objectives. The Business Market Administration team at Principal uses the actual performance of that deemed investment to measure the value of the key employee's benefit account.

- Fixed rate[1]
- Principal LifeTime 2030 Account
- Principal LifeTime 2040 Account
- Principal LifeTime 2050 Account
- Principal LifeTime 2060 Account

[1] Selecting a fixed rate of interest to measure growth may have FICA implications. The company will need to determine whether the selected rate will be deemed a reasonable rate of return under the FICA regulations. See the Tax Considerations section.

Principal LifeTime portfolios, which are target date portfolios, invest in underlying Principal Funds. Each portfolio is managed toward a particular target (retirement) date or the approximate date the participant or investor starts withdrawing money. As each Principal LifeTime portfolio approaches its target date, the investment mix becomes more conservative by increasing exposure to generally more conservative investment options and reducing exposure to typically more aggressive investment options.

The asset allocation for each Principal LifeTime portfolio is regularly re-adjusted within a time frame that extends 10-15 years beyond the target date, at which point it reaches its most conservative allocation. Principal LifeTime portfolios assume the value of an investor's account will be withdrawn gradually during retirement. Neither the principal nor the underlying assets of the Principal LifeTime portfolios are guaranteed at any time, including the target date. Investment risk remains at all times.

### Vesting

Vesting creates a contractual obligation for you to pay the benefit when a plan participant becomes eligible to receive it.

You have three options:

- Immediate vesting
- Cliff vesting—100% in any year, up to year 10
- Graded vesting—20% each year, until 100% vested after five years

However, you can tailor your plan to vest earlier based on other criteria, such as an employee's death or disability.

## How and when are benefits paid to key employees?

You, as the plan sponsor, decide how and when payouts can be received from the plan.

### Standard benefit payment events

- Separation from service
- Retirement
- Death—If prior to separation from service, the key employee may be entitled to a benefit. The benefit may be tax-free if an endorsement split dollar agreement is used. However, if using endorsement split dollar, you should retain a sufficient portion of death benefit to meet the vested payout obligation.
- Disability—If occurs during the service period, the key employee may be entitled to a benefit to be specified in the agreement.

### Benefit payment options

- Benefit payments can be made from company cash flow or distributions from life insurance policies that informally finance the plan using withdrawals and loans[1].
- The employer may offer any or all of the following options: a lump-sum payment option or annual installment payments over a 3-, 5-, or 10-year period.

[1] Withdrawals are generally tax-free until cost basis ha s 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 can you finance the plan?

This plan uses corporate-owned life insurance (COLI) to informally finance the plan benefits. Premiums are paid with after-tax dollars. As described above, distributions from the life insurance policy values may be used to fund the benefit payments. This deferred comp plan offers fixed, indexed, and variable life insurance product options.

When selecting a life insurance product, it's important to consider its design features.

- Cash value may be used to make the benefit payment to the key employee.
- One or more life insurance policies can be used to informally finance the benefit of multiple key employees.
- Death benefits may provide key person insurance coverage, as well as covering any survivor benefit endorsed to the key employee.
- Since the company owns the policy, you can also use cash values for other business purposes.

## What control do you have over the plan?

**Participation.** You select the key employees (up to a maximum of five) you want to include in the plan—as long as they meet the top-hat exemption.

**Contributions.** You decide how much you want to contribute to the plan for each key employee.

**Retention.** You determine the vesting and benefit payment options that meet your business needs, while tying key employees more closely to your organization.

## What are the tax implications of this plan?[1]

### For you

- Premium payments don't incur payroll taxes.
- Life insurance cash values accumulate tax-deferred.
- You may deduct the benefits paid to the key employee at the time of any distribution event.
- Life insurance death proceeds are received income tax-free, if the plan is structured properly.

### For your key employees

- Earnings and employer contributions accumulate in the plan tax-deferred.
- If a portion of the life insurance death benefit is endorsed to the key employee (via the optional endorsement split dollar agreement), they pay taxes due on the economic benefit cost of the death benefit annually.
- Penalties for distributions before age 59½ may be avoided.
- Mandatory distributions at age 72 may be avoided.

[1] Additional tax details are available in the Appendix.

# 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 experience 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, asset and liability reports, and basic information about the policies covering those key employees.

**Annual benefit statements.** Provides individualized statements for each key employee participating in the plan.

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

**Economic benefit information (if applicable).** Makes reporting on key employees' income simpler by providing amounts reflecting the value of the insurance coverage provided under any endorsement split dollar agreement that may be in place.


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

# Walking you through a successful implementation

Helping you tailor a deferred comp 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, the 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 contribution and benefit levels

### 2 Application process

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

### 3 Administrative set-up

- Finalize underwriting, if applicable
- Enter plan information into recordkeeping system
- Participant plan summaries and projected benefit statements are available.

### 4 Implementation

- Begin premium payments
- Issue 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.

# You benefit from a company that knows business.

As a business decision maker, your financial needs are different than those of other individuals. So, it only makes sense to work with a company that understands the financial needs of businesses and their owners. We help business owners like you every day. Leverage our expertise, solutions, and services as we consult with you on financial solutions that help address specific needs.

- A member of the FORTUNE 500®, we have $714 billion in total assets under management and serve clients worldwide of all income and portfolio sizes.[1]
- 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 small-case business life insurance provider.[1]
- No. 1 provider of nonqualified deferred compensation plans.[1]
- Preparer of thousands of informal business valuations since 2011.
- Reviewer of more than 1,800 buy-sell agreements since 2011.

[1] Principal® 2022 Company Profile, December 2021 https://secure02.principal.com/publicvsupply/GetFile?fm=DD730&ty=VOP&EXT=.VOP.

# Accounting

The accounting principles that apply to this deferred comp plan are outlined below. Consult with your accountants and tax advisors to determine the accounting treatment that will be used for financial reporting for your particular plan.

If you're a for-profit employer, accounting for this deferred comp plan is made up of two separate categories of entries:

1. The first set of entries is to account for deferred comp as compensation expense and to record the deferred comp account(s) as a liability.
2. The second set of entries is to account for the informal financing of the deferred comp plan using life insurance policies.

## GAAP guidelines

The Financial Accounting Standards Board (FASB) is responsible for establishing non-governmental U.S. Generally Accepted Accounting Principles (GAAP). Effective for accounting periods ending after September 15, 2009, the FASB Accounting Standards Codification (ASC Codification) is the single source of authoritative U.S. GAAP. For convenience, these accounting guidelines include both pre- and post-codification references to GAAP.

## Expense and liability

Deferred comp accounts are contractual obligations from the employer to pay the key employee in the future and are treated as a long-term liability. This liability is accounted for under ASC 710-10-25 (APB 12).

## Life insurance

If corporate-owned life insurance (COLI) is used to informally finance a deferred comp plan, ASC 325-30-35 (TB 85-4 and EITF 06-5) entitled "Accounting for Purchases of Life Insurance" should be your reference.

In this plan, you may offer a pre-retirement death benefit for the key employee through the use of an endorsement split dollar arrangement. You own the contract, pay the premium, and record the policy as a corporate-owned asset according to ASC 325-30-35 (TB 85-4 and EITF 06-5) and FASB Technical Bulletin No 85-4.

## Income taxes

The deferred comp liability is an expense that's deductible for tax purposes, but only when it's paid to the key employee. The liability would be grouped with all other deductible temporary differences to compute the deferred tax asset. However, flow-through entities (S corporations and partnerships), do not record a deferred tax asset. Owners will receive tax benefits at the time the deferred comp payments are paid to the key employee.

The deferred tax asset is accounted for under ASC 740-10-25 (SFAS 109). A deferred tax liability is recognized for temporary differences that result in taxable amounts in future years. These deferred tax accounts are based on ASC 740-10-25 guidance.

## Expense and liability entries

**Journal transaction example**

1. The employer that is a C corporation contributes $100,000 for the benefit of the key employee, and the company sets up and credits a deferred comp liability account and debits a salary or deferred comp expense account.

2. Accounting for the earnings credited to the deferred comp account, assuming a hypothetical 4% rate of return. This cost may be partially or fully offset by the earnings in an employer-owned life insurance policy used to informally finance the plan. The company may book the tax effect (assuming a 25% combined federal and state tax rate) of the increase in the deferred comp account, but since it is not currently deductible, it increases the deferred income tax asset.

3. Paying out the key employee with cash and closing out the deferred comp liability account. The payment is currently deductible for tax purposes, which closes the deferred income tax asset.

| Expense and liability entries | Balance sheet | | Income statement | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| **1 Creating the deferred comp account** | | | | |
| Salary expense | | | $100,000 | |
| Deferred comp liability | | $100,000 | | |
| **2 Crediting earnings to the deferred comp account** | | | | |
| Deferred comp expense | | | $4,000 | |
| Deferred comp liability | | $4,000 | | |
| **3 Distributing the deferred comp liability account to the key employee and closing the account** | | | | |
| Deferred comp liability | $104,000 | | | |
| Cash | | $104,000 | | |

| Tax effects | Balance sheet | | Income statement | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| **1 Nondeductible deferred comp expense** | | | | |
| Deferred income tax asset | $25,000 | | | |
| Cash | | $25,000 | | |
| **2 Nondeductible effect of earnings credited to the account** | | | | |
| Deferred income tax asset | $1,000 | | | |
| Tax expense | | | | $1,000 |
| **3 Deductible effect on the distribution** | | | | |
| Cash | $26,000 | | | |
| Deferred income tax asset | | $26,000 | | |

### Journal entry example for financing the deferred comp plan

1. Employer contributions are used to pay a premium into the life insurance contract.
2. The cash surrender value (CSV) is accounted for as an asset and offsets the life insurance premium expense.
3. The employer can withdraw money from the CSV in the form of a surrender or loan and deposit into employer cash to pay a deferred comp benefit to the key employee.
4. When the key employee dies, the employer receives the death benefit proceeds and recognizes the non-taxable income and closes the cash surrender value account.

| Life insurance entries | Balance sheet | | Income statement | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| **1 Employer pays premium into insurance contract** | | | | |
| Life insurance premium expense | | | $42,000 | |
| Cash | | $42,000 | | |
| **2 CSV in the insurance contract** | | | | |
| Life insurance CSV | $42,790 | | | |
| Life insurance premium expense | | | | $42,790 |
| **3 Partial withdrawal of CSV (Surrender or loan) and deposit into cash** | | | | |
| Cash | $10,000 | | | |
| Life insurance CSV | | $10,000 | | |
| **4 Insured key employee dies at end of year with $1,000,000 death benefit** | | | | |
| Cash | $967,210 | | | |
| Life insurance death proceeds | | | | $967,210 |
| Cash | $32,790 | | | |
| Life insurance CSV | | $32,790 | | |

### Tax effects

1. No tax effect—Life insurance premiums are not tax deductible.
2. No tax effect—Life insurance cash values grow tax-deferred.
3. No tax effect—Return of cost basis from a life insurance policy is non-taxable.
4. No tax effect—Proceeds from death benefits are non-taxable.

# Tax considerations

There are some tax considerations to keep in mind with this plan—for both your business and your key employees participating in the plan.

## For you

- Your key employees must sign a Notice and Consent form (IRC Section 101(j)).
- Deferred compensation will be treated as wages for purposes of FICA (payroll tax) and FUTA the later of (1) when services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amounts. This usually occurs when the employer contributions become vested. At this time, you are responsible to pay your portion and withhold the key employee's portion.
- Each key employee's account balance is equal to your total contributions to the account, plus earnings or losses based on the performance of the chosen deemed investment. If a fixed interest rate is selected as the deemed investment to measure the growth of the account, any amount of earned interest that is determined to be above a reasonable interest rate must be treated as an additional employer contribution and subject to FICA tax. Generally, this calculation of excess interest should be done at the time of vesting by reporting both the employer and employee portion of FICA tax on any amount above the rate determined by the company to be reasonable. (Treas. Reg. §31.3121)
- There are no tax deductions for premiums paid (IRC Section 264(a)(1)).
- You receive a tax deduction when the benefits are paid to the key employee (IRC Section 162).
- Income tax-free death benefits may be available should the key employee die.
- Life insurance used to informally finance the plan may represent a valid business purpose when considering the accumulated earnings tax.
- Tax impacts related to Tax Cuts and Jobs Act:
  - C corporation federal tax rate is now 21% and the corporate alternative minimum tax (AMT) has been repealed.
  - Business owners of pass-through entities are taxed at lower individual federal tax rates. And, an income tax deduction of up to 20% of "qualified business income" may be available. However, the lower tax rates resulting from the deduction are scheduled to sunset after 2025 (IRC Section 199A).
  - Due to the change in tax rates, sunset provisions, and the timing of contributions and distributions, your after-tax costs may vary.

## For your key employees

- Employer contributions are pre-tax and earnings accumulate tax-deferred.
- Income taxes will be due in the year in which benefits are paid to the key employee and will be treated as wages subject to FICA and FUTA the later of (1) when services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amounts. This usually occurs when the employer contributions become vested.
- If endorsement split dollar is used, the current economic benefit costs are calculated for the life insurance death benefit based on the pure insurance protection that would be paid to the key employee's beneficiary at death. This amount must be reported annually, by the key employee, as income.
- Income tax-free death benefits will be paid to the key employee's beneficiary should a death occur prior to separation from service, if an endorsement split dollar agreement is in place.
- Any life insurance death benefit that may be paid to the key employee's beneficiary will be included in the key employee's gross estate for estate tax purposes.
- The account balance will be included in the key employee's estate.
- Tax impacts related to Tax Cuts and Jobs Act:
  - Key employees may be taxed at lower individual federal rates. However, the lower tax rates are scheduled to sunset after 2025.
  - Benefits are taxed in the year in which they are paid. Due to the change in tax rates, sunset provisions, and the timing of distributions, key employees' income tax liability may vary.

## ERISA

You may significantly limit exposure to Employee Retirement Income Security Act (ERISA) requirements by offering this benefit only to a select group of management or highly compensated employees that qualify for the top-hat exemption. For specific guidelines about top-hat eligibility, see page 5.

You must electronically file a  top-hat letter with the U.S. Department of Labor (DOL) when the plan is established.

- Go to https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/e-file/tophat-plan-filing-instructions.
- Or, go to: https://www.dol.gov/ebsa and search for “file top hat”
- This statement must be filed within 120 days after the plan becomes subject to Part 1 of Title 1 of ERISA.
- Be sure to list your company or a company contact as the plan administrator—Principal is not the plan administrator.
- Enter the number of eligible key employees for the deferred comp plan(s)—as opposed to your total number of employees.

## Securities and Exchange Commission (SEC)

- 8-K filings are required for compensation agreements between the corporation and executive officers and directors.
- The Securities Act of 1933 prohibits the offer or sale of securities, unless a registration statement has been filed or an exemption is available.
  - › In 1995, the SEC stopped issuing no-action letters on deferred compensation plans, which started a debate as to whether a deferred compensation plan is a security.
  - › Clarification has been sought from the SEC, but there is no clear determination. It appears that the position of the SEC as to whether deferred compensation plans need to be registered as a security depends on the participant’s motives.
  - › If the participant’s motive is tax deferral, the plan may not be considered a security.
  - › If it’s determined that the deferred compensation is a security subject to registration, there are exemptions that provide relief:
    - – For plan participants residing in a single state.
    - – For certain small offerings.
    - – For transactions not involving public offerings.

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Variable life insurance has annual fees and expenses and has both life insurance-related charges and investment management fees. See the variable life insurance prospectus for complete details on fees and expenses.

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