Principal® Deferred Compensation — Select Reward

Giving your key employees a big reason to stay

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.

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 great recruiting tool that creates more engaged and loyal employees.

Multiple benefits in one solution

This deferred comp plan could really have an 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 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.

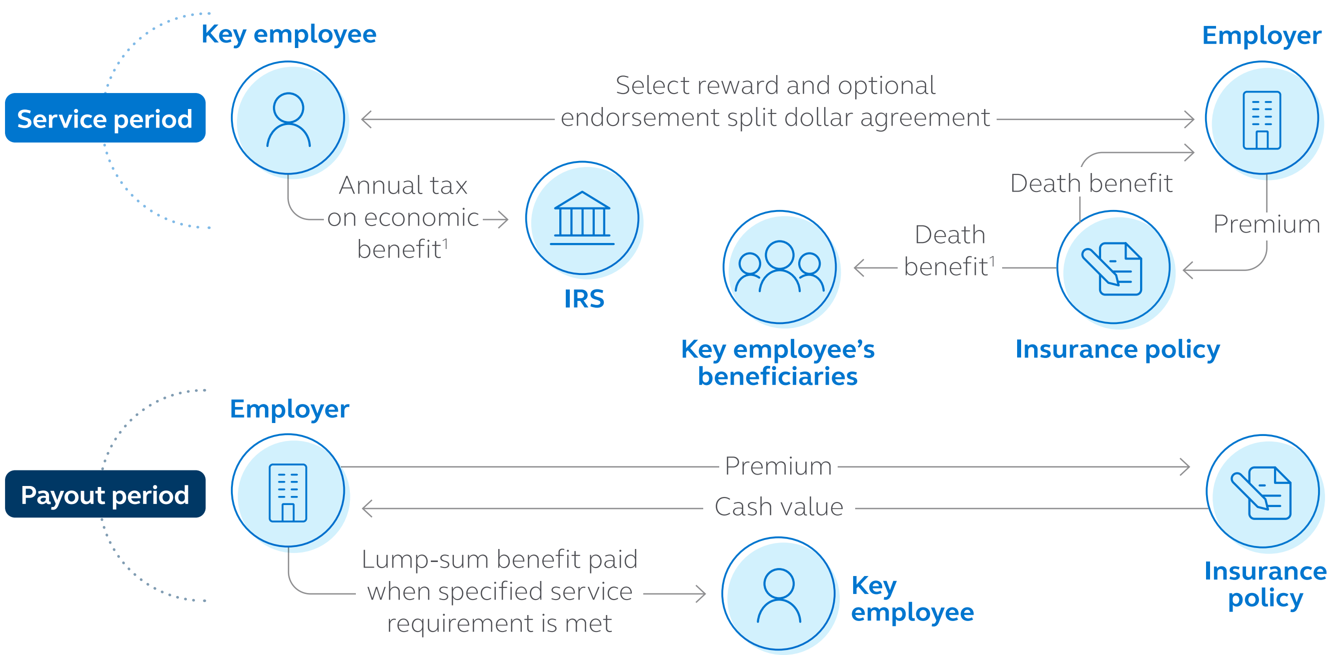
Before we dive into the details of the design elements, let's take a quick look at how the plan works and its benefits and considerations.

Here's how it works

A deferred comp agreement is established with select key employees. You and your key employee enter into an agreement that promises a lump-sum benefit if the employee satisfies a service requirement. The benefit can be a specified amount, or it can be an account balance value, based on the value of the life insurance policy used to informally finance the plan. The company then purchases and pays the premium on a life insurance policy that builds cash value.

When the service requirement has been met, the lump-sum bonus will be paid to the key employee. You choose how the bonus will be paid. You may use current cash flow or a withdrawal of cash value from the life insurance policy to meet this bonus requirement. As an alternative, ownership of the policy can be transferred to the key employee.

If desired, an endorsement split dollar agreement can be set up so that part of the policy's death benefit goes to the beneficiaries if the key employee should die during the service period.



[1] These items only apply if the optional endorsement split dollar agreement is used.

Benefits and considerations

For you

Encourage loyalty. You provide an incentive for the key employee to remain loyal to your company for a pre-determined service period.

Receive a tax deduction. In the year the bonus is paid or the life policy is transferred to the key employee, your company receives a tax deduction for the entire bonus. If the policy is transferred to the key employee, any gain in the policy at the time of transfer is taxable to you.

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 you own the policy at the time of the employee's death, the life insurance policy's tax-free death benefit[2] may be used to recover the cost of the premiums you paid.

For your key employees

Pay minimal cost. If you provide the optional endorsement split dollar benefit, the key employee will pay tax on the value of the life insurance death benefit that's endorsed to their beneficiary during the service period. This cost is much less than if the key employee was to personally purchase that amount of life insurance.

Help with taxes. This plan design does not allow the option to defer the lump-sum bonus, nor does it offer another payment choice. In the year the bonus is received, the employee recognizes income in the amount of the lump-sum bonus or the fair market value of the policy, if it's distributed. However, the policy's cash value may be used to pay the income tax due.

Use for personal needs. If ownership of the life policy is transferred to the key employee, its cash value and death benefit may be used for personal financial needs.

Must qualify. The key employee must be healthy enough to qualify for the life insurance policy.

[2] If the requirements of IRC Section 101(j) are not met, then death proceeds from employer-owned life insurance contracts may be taxable as ordinary income in excess of the cost basis.

Give your top talent a big reason to stay

This plan can help you build a path for loyalty with key employee rewards. From determining which key employees are offered the reward bonus to defining what the service requirements are, you have flexibility. And, there are even additional benefits to be gained from the company-owned life insurance financing vehicle.

So, you're in control of making this plan yours, based on your company goals. Together with your financial professional, we'll help you consider the plan design decisions that make sense for your company. Think about the following as you tailor your plan:

Who's eligible to participate in the plan?

You select the key employees you want to include in the plan to receive the lump-sum reward bonus. Generally, those employees are part of a select group of management or highly compensated employees who qualify for the top-hat exemption. However, the plan can be modified to reward key employees who do not qualify as top-hat employees.

What amount can you contribute for your key employees?

- You commit to make annual contributions 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 may define the reward bonus in one of two ways:
  - You state a specified lump sum.
  - You commit to pay a future benefit, calculated based on the cash value of the life insurance policy.
- Employees aren't allowed to contribute to the plan that informally finances the plan.

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.

What happens with the contributions?

This is an unfunded, contractual obligation for you to pay a benefit to each participant after a set service period. You can choose whether to informally finance the plan through the purchase of a permanent life insurance policy by you, as the plan sponsor.

How and when are benefits paid to key employees?

With this plan, benefits can be paid out in two different ways:

1 During the service period:

If an endorsement split dollar agreement is used and a key employee dies before the end of the service period, a portion of the life insurance death benefit can be endorsed to the key employee's beneficiaries. You have flexibility in establishing this amount and can also retain some of the death benefit to meet your key person life insurance needs. The key employee will be taxed on the economic benefit costs relative to the life insurance death benefit endorsed to them during this period.

2 At the end of the service period:

When the service period has ended, a reward bonus is paid out as defined in the Select Reward plan agreement that you establish at plan implementation.

Regardless of how the bonus is defined, it must be paid out to the key employee in a lump sum. The sample agreement from Principal states that the payment should be made within 30 days of the end of the service period.[1] The lump-sum payment can be handled in a number of ways. These include:

Cash

- Paid from company cash flow.
- Paid from life insurance policy using partial withdrawals and loans.[2]

Transfer ownership of the life insurance policy

If the policy is transferred, the key employee can access policy cash values as allowed by the policy. Partial surrenders can be received as:

- A single distribution to pay income taxes due from the transfer of the policy.
- Annual distributions over a fixed period.
- Requested distributions as needed.

Vesting

The reward bonus isn't subject to vesting, as it's not available until (or if) the service requirement has been met (generally 12-15 years from plan implementation). The only benefit available to the key employee prior to meeting the service agreement is the portion of the life insurance death benefit (if any) endorsed by you to the key employee's beneficiary.

[1] The bonus must be paid in a lump sum within 2½ months of the end of the tax year in which the key employee meets the service requirement to avoid being considered a deferred comp plan that would be subject to IRC Section 409A requirements.

[2] Withdrawals are generally income tax-free until cost basis has been recovered. Thereafter, policy loans are generally income 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 informally finance the plan?

In order to pay your key employees their benefits at some point in the future, you may want to informally finance the plan. Using after-tax dollars, you can pay premiums on a corporate-owned life insurance policy that builds cash value. This deferred comp plan offers fixed, indexed, and variable life insurance product options.

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

- Cash value may be used to make the benefit payment to the key employee.
- Death benefits may provide key person insurance coverage, as well as covering any survivor benefit endorsed to the key employee's beneficiary.
- Since the company owns the policy, you can also use cash values for other business purposes.

Additional information about financing the plan

During the service period:

- In the event of a disability, the key employee may be entitled to a pro-rata bonus benefit, to be specified in the agreement. Disability insurance policies may be available to help further finance this benefit.
- In the event of death, a tax-free death benefit may be payable to the key employee's beneficiary, if an endorsement split dollar agreement is in place during this time.

After the service period:

If you, as the employer and owner of the life insurance policy, choose to retain ownership of it, the policy can continue to provide key person life insurance protection for your business.

What control do you have over the plan?

Participation. You select the key employees you want to include in the plan.

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

Retention. You determine the service requirement and benefit or contribution amount that meets your business needs, while tying key employees more closely to your organization.

What are the tax implications of this plan?

For you

- Premium payments don't incur payroll taxes.
- Life insurance cash values accumulate tax-deferred.
- At the end of the service period, you may generally deduct the bonus paid to the key employee.
- Any life insurance death proceeds are received by the company income tax-free, if the plan is structured properly.

For the key employee

- If the optional endorsement split dollar plan is used, meaning part of the death benefit is endorsed to the key employee's beneficiary, the employee pays taxes due annually on the economic benefit of the death benefit during the service period. Under this arrangement, the death benefit paid to the key employee's beneficiaries will be received income tax-free.
- Income taxes will be due in the year that the lump-sum reward bonus is paid.
- Penalties for distributions before age 59½ may be avoided.
- If the policy is transferred to the key employee to satisfy the promised benefit, any death benefit paid to beneficiaries following that transfer will generally be received income tax-free.

What are the primary benefits of this plan?

For you

- You own the life insurance policy and can use cash values for business purposes during the service period.
- The benefit not only helps you recruit, reward, retain, and retire key employees, but may also be used to provide funding for business succession strategies.
  - Funding part of the key employee's buy-in to the business or practice.
  - Funding part of the owner's buy-out.
- You have the flexibility to tie key employee benefits to performance.

For your key employees

- Providing supplemental income following completion of the service period.
- Funding a business succession plan.
- Reducing or eliminating debt, including post-graduate student loan debt such as medical or law school.
- Funding children's education.
- Purchasing a vacation home or travel.
- Protecting the employees' loved ones with additional life insurance coverage.

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 and basic information about the policies covering those key employees.

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.

Note: It's the responsibility of the employer to ensure that the reward bonus is paid out within 2½ months of the end of the tax year in which the key employee meets the service requirement. Failure to meet this timing requirement may result in a 20% excise tax to the key employee on the bonus amount.

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 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 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. These include a sample Select Reward Plan Agreement, Endorsement Split Dollar Agreement (or Death Benefit Only plan), and also the Endorsement Split Dollar Beneficiary Instructions.

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 $635 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.[1]
- 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® 2023 Company Profile, December 2022 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. Based on the plan design of this deferred comp benefit, the actual payment of the benefit requires the key employee to complete the service period. A number of factors, such as termination or death, may impact whether the participant is able to complete the service period and receive the benefit payment. Under normal accounting contingency rules, the contingency must be probable and reasonably estimated before a liability is booked. Another consideration for your tax advisors would be whether the present value is material to the company's financial statements. Decisions regarding the booking of the liability and the proper amount should be reviewed with your corporate financial officers and your professional tax advisors.

If you're a for-profit employer, and you and your tax advisors choose to book the liability, the accounting for this deferred comp plan is made up of two separate categories of entries:

- The first set of entries is to account for deferred comp as a compensation expense and to record the deferred comp account(s) as a liability.
- 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

GAAP provides the methods to calculate the liability associated with promising a deferred comp benefit.

The deferred comp plan account is a contractual obligation from the company to pay the plan participant in the future and is treated as a long-term liability. This plan liability is accounted for under "Compensation-General" at ASC 710-10-25 (APB 12).

Income taxes (SFAS 109)

If your tax advisor does record a liability, the corresponding tax impact should also be recorded based on ASC 740-10-25 (SFAS 109). The company would record a deferred tax asset to reflect the future deduction of the plan benefit. However, you should consult with your tax advisor on best practices in this regard.

Life insurance

In this plan, you can also offer a pre-retirement death benefit for the key employee through an endorsement split dollar or death benefit only arrangement. Under this type of 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).

Journal transaction example

1. The company sets up a deferred comp liability account and debits a deferred comp expense account, which may be calculated based on the cash surrender value of the insurance contract.
2. After the key employee completes the service period, the company pays the lump-sum bonus to the key employee equal to the deferred comp account balance, which may be calculated based on the cash value of the life insurance policy with cash ($300,000 in the example below) and the payment is currently deductible for tax purposes.
3. The company pays $20,000 in life insurance premium out of company cash flow.
4. The cash surrender value (CSV) is accounted for as an asset and offsets the life insurance premium expense.

Informal financing with life insurance	Balance sheet		Income statement	
	Debit	Credit	Debit	Credit
Creating the deferred comp account				
Deferred comp wage expense			$18,791	
Deferred comp liability		$18,791		
Payment of reward bonus				
Deferred comp liability	$300,000			
Cash		$300,000		
Company pays premium into insurance contract				
Life insurance premium expense			$20,000	
Cash		$20,000		
Cash surrender value (CSV) in the insurance contract				
Life insurance CSV	$18,791			
Life insurance premium expense				$18,791

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

- This arrangement is designed to qualify as an exception to the definition of deferred comp under IRC Section 409A, Reg. §1.409A-1(b)(4). To meet the exception qualification criteria, a benefit that might otherwise be considered deferred comp will not be treated as deferred comp if the benefit is paid no later than 2½ months after the close of the tax year in which the participant becomes eligible to receive the benefit. (A shorter time frame for payment is suggested for the employer's convenience. Our sample agreement states payment will be made within 30 days of the key employee meeting the service requirement.)
  - You may also want to consider using a November 30 end date for the service period.
  - Failure to pay the bonus on a timely basis may result in a 20% excise penalty and interest penalty to the key employee on the bonus amount.
- You are required to have the key employee sign a Notice and Consent Form (IRC Section 101(j)).
- There's no tax deduction for premiums paid (IRC Section 264(a)(1)).
- If you transfer the life insurance policy to the key employee, you will be responsible for paying income taxes on any gain in the life insurance policy in the year of transfer.
- You receive a tax deduction for the amount bonused to the key employee (IRC Section 162).
- Income tax-free death benefits may be available should the key employee die prior to meeting the service requirement.
- Federal income tax withholding is required for any bonus paid. If you distribute the life insurance policy, you may wish to make a partial withdrawal from the cash value prior to the distribution to cover this requirement.

For your key employees

- If the optional endorsement split dollar plan is used, the current economic benefit costs are calculated annually 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.
  - Under an endorsement split dollar plan, tax-free death benefits will be paid to the key employee's beneficiary should a death occur prior to the end of the service period.
- Income taxes (including FICA and FUTA) will be due in the year in which the reward bonus is paid to the key employee in a lump sum.
- Failure by you, the employer, to meet the 2½ month timing requirement on the lump-sum bonus payment may result in a 20% excise penalty and interest penalty to the key employee on the bonus amount.
- 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.

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 6.

If the plan is a top-hat ERISA pension plan, 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 “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.