



Cumby, Spencer & Associates Financial Group

Guiding your financial path



An alternative to cash on the balance sheet.

Cash reserves are important to the operation of a healthy and successful business. But business owners often feel establishing reserves means those dollars are no longer “working for the business.” Many are considering permanent life insurance as an alternative.

Why do businesses build and hold cash?

Most successful businesses accumulate a substantial cash savings account in order to run the day-to-day operations of their business (vendors, employees, building payment). If they have not, they certainly understand the value – and, need -- of having cash at their disposal.

Business owners also maintain a reserve of readily available cash in the event of unforeseen circumstances or emergencies. For

example, it can be very expensive to repair or replace a machine or appliance that the business depends on for its operations. Often, the timing of these obligations are unexpected and inconvenient.

Access to cash can also give business owners the ability to take advantage of a profitable opportunity that presents itself.

Ironically, though all or a portion of such opportunities can be financed through a bank, without cash, businesses can also have a difficult time obtaining adequate financing for growth and expansion.

How can a business build cash reserves?

Cash in a business comes from saving; just as it does for an individual. To generate cash, a

business must spend less than it earns. Most business owners are readily familiar with this concept and have already been doing some form of saving. Even though saving can be a challenge, it can be much worse for a business to encounter unforeseen events or expenses without cash being available. Many businesses have failed due to a lack of cash.

Alternative sources of cash include:

- Loans.
 - o short-term, such as a Line of Credit; o long-term, such as those on vehicles, equipment, or property;
 - o loans can leave the owner and heirs deep in debt in the event of a significant loss event;
 - o they are deceiving, because they are tax-free when

received and after-tax when paid back;

- o in a 33% tax bracket, a loan can require income equal to 150% of the loan amount in order to be repaid;
- o repaying a loan obligates future earnings.
- Sale of assets.
 - o deprives the business of the use of those assets;
 - o most businesses do not have access to assets that are not immediately necessary for the business.
- Sale of equity.
 - o represents a last resort for a privately held company;
 - o dilutes overall earnings due to new shareholders.

Business owners should consider these important questions:

- If you urgently needed cash today, where would you go to get it?
- Does the business have enough cash in reserve to survive a significant loss event (such as the death of an owner)?

When it comes to cash, how much is enough?

The amount of savings a business needs is unique to each situation. One important key is to diversify the savings.

Business owners have three levels of cash needs:

1. The cash they need for day-to-day obligations such as payroll; often obtained through a line of credit.
2. Period savings: money set aside for future purchases such as equipment or additional space; sometimes acquired through long-term loans.
3. Money, they hope they never have to touch. It is there in case of emergencies.

Where should a business keep its long-term cash reserves?

Cash reserves should only be used for unexpected, business-related emergencies. Thus, the need for that reserve to be kept safe and

accessible. In this historically low interest rate environment, it can be challenging to find low-risk places to keep cash reserve assets that produce a suitable return that can perhaps, at least keep pace with inflation. Seeking a higher rate of return typically involves taking on more risk or tying the money up for some period of time. Take a CD for instance; a one-year CD might pay more interest than a 90-day CD because you are willing to give up access to the funds for a year as opposed to 90 days. But, accessibility – a potentially critical aspect of a cash reserve – may be sacrificed for a higher return.

As a result, some business owners are considering permanent cash value life insurance as a tool for their cash reserve strategies.¹ Here's why:

- most owners need the life insurance death benefit for their beneficiaries or business, and may already be buying term insurance to meet these needs²;
- policy cash values grow tax deferred;
- if designed correctly, these policies can build cash value rather quickly;
- the cash value can be accessed as needed through policy loans³. Using permanent life insurance as part of the reserve account can also help with other important planning needs such as funding a buy-sell arrangement, covering the loss of a key employee, or providing for the business owner's retirement.

Other benefits include:

- the business will be showing the same amount of cash on its balance sheet, since policy cash values are a business asset;
- the business can use the policy death benefit to meet

other important planning needs;

- long-term internal rate of return on cash values may exceed other cash alternatives;
- the business can transfer ownership of the policy if the owner exits the business.

Two major threats to business longevity are death and access to cash: permanent life insurance can help mitigate both risks.

- 1 Since life insurance is subject to underwriting, any existing coverage should be maintained until new coverage is assured. In the future, the cash value of the permanent policy could be used as a portion of the reserve account.
- 2 The primary purpose for purchasing life insurance is for death benefit coverage. Permanent life insurance also offers the opportunity for building cash value, subject to payment of premiums. Policy fees and expenses will reduce any cash value.
- 3 Loans against your policy accrue interest at the current rate and decrease the cash value and death benefit by the amount of the outstanding loan and interest.

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