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# Nonforfeiture: Round And Round It Goes And Where It Stops Nobody Knows

As I age, occasional confusion is an integral part of my life and seems to be a common affliction among those involved on both sides of the long term care insurance sales equations.

In fact, most long term care insurance specialists probably spend much of their time explaining away consumer confusion. The 1997 National Council on Aging/John Hancock survey revealed that the majority of Americans believe Medicare will take care of them. But we know Medicare's actual portion of the total cost of financing long term care is in the 20 percent range.

The latest buyer/non-buyer data from LIMRA International found that buyers believe they purchased cash indemnity benefits twice as often as we know they were actually purchased. *Hopefully they are simply confused.*

**However, I believe long term care insurance producers exhibit the greatest confusion on many occasions.**

**The most common example is those who continue to become disoriented when discussing elimination period versus certification period.** While 90 days is the most common elimination period, it represents only one possible option among 0 to 365 days. It has absolutely no relationship to the HIPAA tax-qualified policy request that a prospective claimant is required to produce certification from a licensed healthcare practitioner, but care will be needed for at least 90 days. Subsequent to HIPAA the Internal Revenue Service clarified the fact that the 90-day certification is not a waiting period.

The 90-day criteria in no way presents access to benefits. Perhaps it is the number 90 that captures an inordinate amount of misguided neural activity.

**The greatest confusion seems to occur when the subject of nonforfeiture appears.** I have seen eyes glaze over, faces flush and synapses overload at the mere mention of the word. Some common misconceptions are:

- Nonforfeiture is simply return of premium or the converse, return of premium is nonforfeiture. Both these theorems are only partially true.
- Nonforfeiture turns the premium into life insurance so that the death benefit is tax-free. That statement is not exactly correct either.

Let's start at the beginning. Nonforfeiture represents the insureds equity in the policy based on termination prior to maturity. Nonforfeiture surrender values were first codified in 1879 and were standardized from the NAIC in 1948 as the "Standard Nonforfeiture Law."

The process by which an actuary determines the exact level of surrender value is called an "asset share calculation." In long term care insurance, this can best be seen in the contingent nonforfeiture formulas used in all long term care insurance policies compliant with NAIC guidelines.

Nonforfeiture values appear in three forms: (1) cash surrender values, (2) extend term insurance and (3) reduced paid-up insurance.

Nonforfeiture is, by definition and history, basic consumer protection. Level premium

life and LTC policies generate reserves. These reserves must in some way be available to the policyholder in the form of cash, extended benefits or paid-up benefits.

NAIC guidelines for LTCI nonforfeiture are part of the 1993 NAIC Long Term Care Insurance Model Act and Regulation and appear as part of the tax-qualified policy definitions in HIPAA. These adopted provisions are required options.

Policies *must offer* optional nonforfeiture benefits; if they are not selected, the insurer must provide a contingent benefit upon lapse, which is referred to as *contingent nonforfeiture*. In other words you can (and many would argue should) “buy up” the nonforfeiture benefit.

No other form of health insurance includes nonforfeiture benefits. Consumer pressure driven by a fear of rate increases and the often heard comment, “What if I don’t claim on this policy?” focuses attention on nonforfeiture in long term care insurance policies.

**LTCI nonforfeiture appears in four option benefits.**

**1. Premium cash surrender value similar to permanent life insurance.** This is not an option with tax-qualified policies, as this represents return of premium on dollars deducted from taxable income.

**2. Return of premium for the same reasons are not available except upon death with tax-qualified policies.** Return of premium usually has a qualification period of five or more years of premium payment before eligibility for refund.

**3. A reduced paid-up option is also available with tax-qualified policies but is rarely utilized.**

**4. Shortened benefits periods are the most commonly offered and NAIC recommended nonforfeiture benefit.** The benefit provides policyholders who have kept their policy in force for three years or more and then lapsed coverage to receive a benefit equal to the sum of premium paid with a minimum of 30 days coverage. In California, it is 90 days after 10 years.

**Now let’s talk about the marketing or creative side of nonforfeiture.** Return of premium has also become a marketing “catch all” word for benefits paid at death to a named beneficiary. Payment cannot exceed the sum of all premiums. Full nonforfeiture is just that—all premiums paid regardless of claim. Limited nonforfeiture is premium net of claims.

Please note that premium refunds are considered regular income to the extent the insured deducted premiums from his taxes and benefits were received during his lifetime.

However, HIPAA is silent regarding taxation of nonforfeiture benefits received by a named beneficiary at the death of the insured (Sec. 7702B(b)(2)(c)).

**Current interpretation is that these benefits would be received the same as a paid-up life policy benefit.** It is specifically this widely held belief that premium dollars may be received as a tax-free death benefit that has come to provide such great momentum in the executive carve-out market.

Corporate deductibility of LTCI premiums and the subsequent receipt of these same dollars to a chosen beneficiary on a tax privileged basis has proven to be an irresistible sales incentive to business owners.

Limited and full nonforfeiture can also be utilized in the individual market for wealth transfer and sales to high net worth clients. (*This conversation requires a later column*).

More than 90 percent of all policies sold are tax-qualified. Thus, you will offer nonforfeiture and all clients will receive some benefit (contingent nonforfeiture). This means you must discuss the subject, which does provide the opportunity to explore additional buy-ups of limited and full nonforfeiture.

In conclusion, let’s attempt to sort this out. Nonforfeiture is a basic inherent consumer protection. Return of premium is a nonforfeiture option used in non-tax-qualified policies and is also used generally to refer to what takes place with limited or full nonforfeiture in tax-qualified policies at death. A shortened benefit is the most popular NAIC recommended nonforfeiture option, and it is included in some policies and sold as an option in others based on a lapse. All tax-qualified policies contain contingent nonforfeiture. And benefits received at death to a named beneficiary with limited or full nonforfeiture are believed to be received tax-free.

Bottom line, nonforfeiture is a good thing—everybody gets a little in return, and it might not be a bad idea if they bought more. □