

FREE LIFE INSURANCE PRACTICE EXAM

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1. A beneficiary received \$200,000 in proceeds from a Life Insurance policy. He selected a 20 year fixed period payout at 5% interest and received annual payments of \$12,500. How much of each payment will be excluded from tax:
 - A. None
 - B. \$2,500
 - C. \$10,000
 - D. \$12,500

2. A client paid \$20,000 in cash to buy a Single Premium Deferred Annuity, which after 10 years has grown to \$35,000. If he takes a partial distribution of \$15,000, how will it be taxed:
 - A. No tax is due since the amount withdrawn is less than his cost basis
 - B. The entire distribution is taxable as ordinary income
 - C. The entire distribution is taxable as capital gain
 - D. The entire \$35,000 is taxable since partial distributions are not allowed

3. A client paid \$4,500 in premiums into a \$50,000 Whole Life insurance policy. If he dies when his cash value is \$5,000, how much will be taxable to the beneficiary:
 - A. None
 - B. \$ 5,000
 - C. \$45,500
 - D. \$50,000

4. The Doctrine of Reasonable Expectations applies to what type of law:
 - A. Tort
 - B. Criminal
 - C. Contract
 - D. Corporate

5. The money that an insurer is required to set aside to honor future liabilities to customers is known as:
 - A. Retained equity
 - B. Net worth
 - C. Legal reserves
 - D. Capital surplus

6. An insurer domiciled in another country, but doing business in this state, is known as a(n) _____ company:
- A. International
 - B. Foreign
 - C. Off shore
 - D. Alien
7. Recognizing hazards and exposures and making plans to avoid them is known as:
- A. Risk classification
 - B. Risk management
 - C. Risk transfer
 - D. Risk avoidance
8. A peril is defined as a:
- A. Risk
 - B. Exposure
 - C. Cause of loss
 - D. Uncertainty of loss
9. Which of the following is true about Variable Life insurance:
- A. Insurers must determine the value of the separate account daily
 - B. The minimum death benefit is guaranteed
 - C. The cash value is guaranteed
 - D. The death benefit cannot increase above the minimum
10. When a policy owner adds a rider to a Life Insurance policy to cover all of his children, the premium is based upon:
- A. The number of children
 - B. The health of the children
 - C. The ages of the children
 - D. A flat premium
11. Upon annuitization of an annuity, proceeds are usually paid to the:
- A. Beneficiary
 - B. Owner
 - C. Annuitant
 - D. Insured
12. When a corporation buys life insurance on their shareholders and names themselves as beneficiary, it is to:
- A. Provide Group Life benefits to the shareholder's beneficiary
 - B. Provide Key Person benefits in the event a shareholder dies
 - C. Fund a buy/sell agreement
 - D. Fund an executive bonus

13. All of the following are true about Adjustable Life insurance EXCEPT:
- A. Both the premium and the amount of coverage may change
 - B. It is a type of Whole Life insurance
 - C. Adjusting the premium downwards will increase the cash value
 - D. Decreasing the face amount will cause the premium to go down
14. All of the following are true regarding Modified Endowment Contracts (MEC) EXCEPT:
- A. Cash surrender of the contract prior to age 59 ½ may lead to taxes plus penalties
 - B. Increasing the premium on an existing Whole Life policy could cause it to become a MEC
 - C. A decrease in the death benefit on an existing Whole Life policy could cause it to become a MEC
 - D. Issuing an MEC is a violation of the state Insurance Code
15. Which of the following is eligible for an IRC Section 1035 exchange:
- A. Variable annuity to life insurance
 - B. Fixed annuity to universal life
 - C. Endowment to universal life
 - D. Whole life to universal life
16. Which of the following is true regarding Variable Life insurance:
- A. The death benefit and the face amount are always the same
 - B. The minimum face amount is guaranteed
 - C. The death benefit can vary above or below the face amount
 - D. The insured's premiums are invested in a general account
17. Straight Whole Life and Limited Pay Whole have all of the following in common EXCEPT:
- A. Both reach maturity at age 100
 - B. The cash value equals the face amount at maturity
 - C. Both require premium payments as long as the insured lives
 - D. Both have level premiums
18. All of the following are true regarding Viatical Settlements EXCEPT:
- A. Amounts received are taxable to the policy owner
 - B. They are done by clients who need to raise money to pay medical bills
 - C. The policy is sold at a discount
 - D. An absolute assignment of policy ownership is required
19. If an IRA participant dies before distributions begin and his spouse is his beneficiary:
- A. All funds must be distributed within 5 years
 - B. Required minimum distributions must begin when participant would have been age 70 ½
 - C. The spouse can roll-over all funds to a new IRA
 - D. All funds must be distributed immediately

20. Which of the following types of annuities will continue to make payments to a beneficiary after the annuitant has died:
- A. Pure life
 - B. Period certain
 - C. Straight life
 - D. Life income
21. If not kept in force for a long period of time, which type of Life Insurance is most expensive:
- A. Whole life
 - B. Decreasing term
 - C. Annual renewable term
 - D. Level term
22. When an annuitant dies before annuitizing the contract, his beneficiary will receive:
- A. Nothing
 - B. The face amount of the policy
 - C. The premiums paid in
 - D. The value of the account
23. All of the following are true regarding Decreasing Term life insurance EXCEPT:
- A. It is often used by financial institutions who write Credit Life for debtors
 - B. The face amount goes down over the term of the policy
 - C. The premium goes down as the coverage decreases
 - D. It is often used as Mortgage Protection coverage
24. All of the following are true about Life Insurance provisions EXCEPT:
- A. The reinstatement provision applies after a policy lapses for non-payment
 - B. An absolute assignment is a change in the ownership of the policy
 - C. A revocable beneficiary may be changed at any time
 - D. Mutual insurers may pay dividends to stockholders
25. A mutual policyholder who wants to minimize his annual insurance cost should select which of the following dividend options:
- A. Interest
 - B. 1 year term
 - C. Paid-up additions
 - D. Apply to premium when due

ANSWERS & RATIONALES

1. **C** Although life insurance proceeds are not subject to tax, the interest is. To find the tax free amount, divided \$200,000 by 20 years, so \$10,000 a year is tax free. Any amount received in excess of that amount is interest and is taxable as ordinary income.
2. **B** On annuity partial distributions, the first money out is the interest portion, which is this case is \$15,000, all of which is taxable as ordinary income. If the annuitant is under age 59 ½, a 10% IRS premature distribution penalty could also apply.
3. **A** Proceeds payable to a Life Insurance beneficiary are never taxable.
4. **C** The Doctrine of Reasonable Expectations is closely associated with the Doctrine of Adhesion. Both doctrines state that any ambiguity in the policy (which is a contract) will be construed against the insurance company, since they wrote it. Tort law is also known as injury law.
5. **C** Insurance is regulated by state law. All states require that insurers have a prescribed amount of liquid assets (or legal reserves) on hand to honor their future liabilities to customers, such as Life Insurance death claims or cash surrenders. Insurers must file annual, audited financial statements to prove that they meet this requirement.
6. **D** Insurers may be domestic, foreign or alien, depending upon where they are incorporated (domiciled). An alien insurer is domiciled in a foreign country. A foreign insurer is domiciled in another state. A domestic insurer is domiciled in this state.
7. **B** Risk is defined as the chance of loss. An exposure is defined as a condition that could result in a loss. Risk classification is known as underwriting. Insurance is defined as the transfer of risk. Recognizing hazards and exposures and making plans to avoid them is known as risk management. Know your definitions!
8. **C** A peril is a cause of loss, such as death in Life Insurance, or accident or sickness in Health Insurance.
9. **B** Producers selling Variable Life need a state Life Insurance license and a federal Securities license. Although the cash value is not guaranteed, the minimum death benefit is, although the death benefit may increase above the minimum. Most insurers value the separate account on a quarterly basis.
10. **D** Most insurers offer a Children's Rider, which covers all of the insured's children up to a certain age for a flat fee, regardless of how many children there are or their health. Coverage usually ends at age 18 (or 21), at which time the child may convert their coverage to an individual Whole Life policy without evidence of insurability.

11. **B** On an annuity, the contract owner is the party who buys the annuity and receives proceeds when the contract is annuitized. The annuitant is the party whose life the annuity contract is based. The beneficiary receives the proceeds if the annuitant dies and is often the owner of the contract as well. There is no 'insured' in an annuity contract.
12. **C** 'Closed' corporations often buy life insurance on their shareholders. If a shareholder dies, the proceeds are paid to the corporation who uses the money to buy out the stock of the deceased shareholder, as per the terms of a 'buy/sell' agreement.
13. **C** Adjustable Whole Life is usually sold to clients who have fluctuating incomes, such as real estate agents. The policy contains adjustment provisions that allow premiums to be increased or decreased, the face amount to be increased or decreased, and additional premiums to be paid. Whenever these adjustments occur, the plan of insurance may also change. Remember, an increase in premium increases future cash values and a decrease in premium reduces cash values. In other words, an adjustment in one area will cause an adjustment elsewhere.
14. **D** A MEC is a life insurance policy whose premiums exceed what would have been paid to fund a similar type of life insurance with 7 annual premiums. In other words, since MECs build cash value too fast, they are considered to be an investment rather than life insurance. Although they are not illegal, a policy classified as a MEC loses its favorable tax treatment. Cash surrenders prior to age 59 ½ may lead to both taxes and penalties and loans are taxable as well.

A 'material' change could also cause an existing life insurance to become a MEC, such as decreasing the death benefit during the first 7 years of the policy or increasing the premium after the initial 7 year policy period. All MECs issued by the same insurance company to the same policy owner during any 12 month period will be treated as one MEC.

15. **D** The Internal Revenue Code allows certain policy holders to make a tax deferred exchange of one life insurance policy for another if certain criteria are met. The laws states that: 1) an ordinary life contract may be exchanged for another life insurance contract, or for an endowment or for an annuity; 2) an endowment may be exchanged for another endowment; and 3) an annuity may be exchanged for another annuity. An annuity or endowment cannot be exchanged for ordinary life insurance.
16. **B** At inception date, the face amount and death benefit of a Variable Life insurance policy are the same. However, although the minimum face amount is guaranteed, the death benefit may vary above the minimum if the separate account does well.
17. **C** Limited-pay Whole Life (such as LP 65 or 20 PL) only require that the insured pay premiums for a limited period of time. For example, a LP 65 must be paid up by age 65 and a 20 PL must be paid up in 20 years. Straight Whole Life requires premiums to be paid until age 100, or prior death, whichever ever occurs first. However, both reach maturity at age 100.
18. **A** When a policy owner with a terminal illness sells their life insurance policy to an investor, it is known as a Viatical Settlement. The policy owner assigns his ownership in his policy to an investor in return for a discounted current payment. The investor names

himself as beneficiary and will receive tax free proceeds upon the death of the insured. Income received is not taxable to the former policy holder.

19. **B** If the spouse is the IRA owner's sole beneficiary and the owner dies before distributions begin, the surviving spouse can take withdrawals over her life expectancy, but withdrawals must start no later than the date on which the deceased IRA owner would have been age 70 1/2.

Or, the surviving spouse may elect to treat the IRA as being her own and start distributions when she turns age 70 1/2, with required minimum distributions based upon her life expectancy at that time.

20. **B** Pure life, straight life or life income annuities are all the same thing, and have no beneficiary. If the annuitant dies, payments stop. However, a period certain annuity guarantees a certain number payments, even if the annuitant dies. For example, if an annuitant with a 10 year period certain dies after 5 years, payments would continue on to the beneficiary for another 5 years.
21. **A** In the long run, Whole Life insurance is the cheapest due to its cash value accumulation. However, since it takes a long time for the cash value to accumulate, it is the most expensive in the short run. Term insurance is the cheapest in the short run, but most expensive in the long run, since it never has a cash value.
22. **D** When an annuitant dies during the accumulation period of an annuity, the beneficiary will receive the accumulated value of the account, which includes all premiums paid in by the annuitant plus any accumulated interest. Of course, the interest will be taxable to the beneficiary.
23. **C** On Decreasing Term life insurance, the premium stays the same as the face amount goes down. It is often used in Credit Life and Mortgage Protection insurance. Remember, term life insurance has no cash value.
24. **D** Mutual insurers might pay dividends to policyholders, not stockholders. Mutuals are owned by their policyholders and do not issue stock. Instead, they issue 'participating' policies, where the policyholders might participate in the company profits in the form of dividends, which are never guaranteed.
25. **D** Mutual policyholders may select from several dividend options, if a dividend is declared. If the policyholder elects to apply his dividend to his annual premium when due, this cash outlay will be reduced. However, dividends may not be guaranteed.