Insurance Test Practice

Washington Insurance Practice Test

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1. Under IRC Section 72, annuity income payments from a non-qualified contract received during the annuitization phase are taxed using:

A) Capital gains treatment on all payments above basis
B) Ordinary income treatment on the full payment amount regardless of cost basis
✓ C) The exclusion ratio — a portion of each payment is excluded from income tax as a return of cost basis
D) LIFO (last in, first out) treatment — gains taxed first

Explanation: During the annuitization (distribution) phase of a non-qualified annuity, each payment is divided using the exclusion ratio: Investment (cost basis) ÷ Expected Return = Exclusion Ratio. The portion equal to the exclusion ratio is tax-free (return of basis); the remainder is taxable ordinary income. Once the cost basis is fully recovered, all subsequent payments are fully taxable.

2. The person or entity designated to receive the death benefit of a life insurance policy is the:

A) Insured
B) Annuitant
C) Policyowner
✓ D) Beneficiary

Explanation: The beneficiary is the individual, entity (like a trust or corporation), or class of people (like 'my children') named in the policy to receive the death benefit proceeds upon the insured's death.

3. A client, age 65, receives her first monthly payment of $500 from a non-qualified immediate annuity. She paid a $90,000 premium, and her life expectancy gives her an expected return of $120,000. How much of the $500 payment is taxable?

A) $375.00
✓ B) $125.00
C) $0.00
D) $500.00

Explanation: The exclusion ratio is cost basis / expected return = $90,000 / $120,000 = 0.75 or 75%. This means 75% of each payment is a tax-free return of principal (75% of $500 = $375). The remaining 25% is taxable income (25% of $500 = $125).

4. An insurance policy is considered a unilateral contract because:

A) The contract is created by only one party.
B) Both parties make legally enforceable promises.
C) The contract's terms are not negotiable.
✓ D) Only one party, the insurer, makes a legally enforceable promise.

Explanation: In a unilateral contract, only the insurer makes a promise that can be legally enforced (the promise to pay a claim). The insured is not legally obligated to pay premiums, although they must do so to keep the contract in force.

5. What is the Medical Loss Ratio (MLR) requirement for large group health insurance plans under the ACA?

A) 80%
B) 75%
✔ C) 85%
D) 90%

Explanation: Large group health insurers must spend at least 85% of premium revenue on medical claims and quality improvement, leaving no more than 15% for administrative costs and profit. This 85/15 standard is stricter than the 80/20 rule applied to individual and small group plans.

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6. The insurer's consideration in an insurance contract is the:

✔ A) Promise to pay for covered losses
B) Underwriting of the policy
C) Agent's binding authority
D) Collection of premiums

Explanation: The insurer's consideration is its promise to pay benefits or claims in the event of a covered loss, as described in the policy.

7. Delayed retirement credits under Social Security increase benefits for each year a worker delays retirement past full retirement age up to age:

A) 72
B) 68
✔ C) 70
D) 67

Explanation: Workers who delay receiving Social Security retirement benefits past their full retirement age earn delayed retirement credits, which increase their benefit by a certain percentage for each year of delay up to age 70. There is no additional credit for delaying beyond age 70.

8. What is a 'dread disease' or 'limited risk' policy?

A) A comprehensive policy covering all illnesses.
B) A policy designed for individuals with pre-existing conditions.
✔ C) A policy that covers only specific illnesses, such as cancer or heart disease.
D) A short-term medical policy.

Explanation: A limited risk policy, such as a cancer policy, provides benefits only for the diagnosis and treatment of a specific disease named in the policy. It is not a substitute for comprehensive health coverage.

9. Life insurance proceeds paid directly to a named beneficiary (not the insured's estate):

- ✔ A) Generally bypass probate and are paid directly to the beneficiary
- B) Are always subject to income tax for the beneficiary
- C) Are subject to federal estate tax in all cases
- D) Must be held in trust for minor beneficiaries by law

Explanation: Life insurance proceeds paid to a named beneficiary generally bypass the probate process entirely and are paid directly to the beneficiary. This is a significant advantage of naming specific beneficiaries rather than using the estate as beneficiary. Estate taxes may still apply depending on who owns the policy.

10. A policyholder dies. The insolvent insurer is unable to pay the death benefit. What is the maximum amount the Washington Life and Disability Insurance Guaranty Association will pay for a single life insurance death benefit?

- A) $100,000
- B) $250,000
- C) $300,000
- ✔ D) $500,000

Explanation: The Washington Guaranty Association provides protection up to $500,000 in life insurance death benefits per individual.

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11. To be considered fully insured under Social Security (OASDI) a worker generally needs how many quarters of coverage?

- A) 6 quarters
- ✔ B) 40 quarters
- C) 30 quarters
- D) 20 quarters

Explanation: A worker is considered fully insured under Social Security after earning 40 quarters of coverage (equivalent to 10 years of work). Fully insured status qualifies the worker for retirement benefits and provides survivor benefits to dependents.

12. A disability policy that covers accidents but not sickness is known as:

- A) A limited risk policy
- B) An accidental death and dismemberment (AD&D) policy
- ✔ C) An accident-only disability income policy
- D) A comprehensive disability policy

Explanation: An accident-only policy provides coverage for disability resulting from an accident and does not cover disability due to illness or sickness. It has a lower premium than a comprehensive policy.

13. What is a 'Taft-Hartley Trust'?

A) A type of MET for non-profit organizations.
✔ B) A trust established by a labor union and employers to provide health and welfare benefits to union members.
C) A trust used for estate planning.
D) A trust for funding executive retirement plans.

Explanation: Taft-Hartley trusts, or multi-employer plans, are formed through collective bargaining agreements between a labor union and multiple employers. They are managed by a board of trustees with equal representation from labor and management.

14. In which type of annuity does the owner bear the investment risk?

A) Immediate Annuity
✔ B) Variable Annuity
C) Deferred Annuity
D) Fixed Annuity

Explanation: In a variable annuity, the contract owner directs their premium payments into various investment subaccounts (similar to mutual funds). The contract's value and the future income payments depend on the performance of these investments, so the owner assumes all investment risk.

15. In an annuity, the 'accumulation value' represents:

✔ A) The total amount accumulated inside the annuity before surrender charges or market value adjustments
B) The account's value if the owner annuitizes immediately
C) The surrender value net of all charges
D) The future value of annuity income payments

Explanation: The accumulation value (also called account value or policy value) is the total amount accumulated in the annuity contract, including contributions and credited interest or investment returns. The surrender value is the accumulation value minus any applicable surrender charges or market value adjustments (MVA).

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16. In a Medicare Part D plan, what is 'catastrophic coverage'?

A) Coverage for catastrophic illnesses like cancer.
B) Coverage that has no deductible.
✔ C) The phase of the benefit where the plan begins to pay nearly all of the drug costs for the rest of the year.
D) A special plan for those with low incomes.

Explanation: After a beneficiary's out-of-pocket spending (including costs paid in the donut hole) reaches a certain high limit, they enter the catastrophic coverage phase. In this phase, their cost-sharing for covered drugs is significantly reduced to a small coinsurance or copayment for the rest of the year.

17. The 'guaranteed minimum income benefit' (GMIB) rider in a variable annuity:

A) Guarantees the owner receives their original premium back in income payments
B) Guarantees minimum monthly income payments regardless of the account value or annuitization
✔ C) Guarantees the owner can annuitize for at least a minimum income amount even if the account value has declined
D) Guarantees a minimum account value at all times

Explanation: A GMIB rider guarantees that the owner can annuitize the contract for a specified minimum income amount (based on a benefit base that grows at a specified rate), regardless of the actual account value at annuitization. This provides income security even in a market where the actual account value is lower than the benefit base.

18. A 'residual disability benefit' in a disability income policy:

A) Is paid to the insured's estate if they die while receiving benefits
B) Pays full disability benefits during a hospitalization
✔ C) Pays a proportional benefit when the insured can work but earns less than before due to disability
D) Pays a fixed daily amount regardless of actual income loss

Explanation: A residual (or partial) disability benefit pays a proportional benefit when the insured can return to work but earns less than their pre-disability income due to the disability. The benefit is typically calculated as: (income loss / pre-disability income) × total disability benefit. This incentivizes returning to work.

19. ERISA (Employee Retirement Income Security Act) governs employer-sponsored benefit plans including group life insurance by:

A) Requiring all group plans to be underwritten individually
B) Requiring all group life insurance to be issued as permanent coverage
✔ C) Setting minimum funding, vesting, and fiduciary standards for benefit plans and preempting most state insurance laws for self-funded plans
D) Prohibiting employers from contributing to group life premiums

Explanation: ERISA governs employer-sponsored benefit plans and sets requirements for fiduciary standards, reporting, disclosure, and plan administration. For insured group plans, ERISA coexists with state insurance regulation. For self-funded plans, ERISA preempts state insurance laws. Employers must adhere to ERISA's fiduciary standards in managing benefit plans.

20. If a corporation owns a non-qualified annuity, how is the growth taxed?

A) It is tax-free.
✔ B) It is taxed annually as ordinary income.
C) It grows tax-deferred.
D) It is taxed at corporate capital gains rates.

Explanation: The tax-deferral benefit of annuities generally does not apply when the contract is owned by a non-natural person, such as a corporation. In this case, the annual growth in the contract is treated as taxable ordinary income to the corporation each year.

21. A client age 45 wants to save for retirement but has a very low risk tolerance and wants to protect their principal. Which annuity would be most suitable?

A) Immediate annuity
B) Annuity with a market value adjustment
C) Variable annuity
✔ D) Fixed annuity

Explanation: A traditional fixed annuity would be the most suitable choice. It guarantees the principal against loss and provides a guaranteed minimum interest rate, aligning perfectly with the client's low risk tolerance and goal of safe accumulation.

22. An agent, Melissa, gives a prospective client a $50 gift card to convince them to purchase a life insurance policy. What is this practice called under Washington law?

✔ A) Rebating
B) Twisting
C) Churning
D) Referral fee

Explanation: Giving anything of value (including gift cards, cash, or services) not specified in the insurance policy to induce a purchase is rebating, which is illegal.

23. A client, age 62, wants to take a lump-sum distribution from their annuity. What are the tax consequences?

A) The earnings portion is taxed as a capital gain.
B) The entire distribution is tax-free.
✔ C) The earnings portion is taxable as ordinary income, but there is no IRS penalty.
D) The earnings portion is tax-free, but subject to a penalty.

Explanation: The client is over age 59 1/2, so the 10% early withdrawal penalty does not apply. However, the earnings portion of the distribution (the amount exceeding the cost basis) is still fully taxable as ordinary income.

24. Which of the following is NOT a primary factor in underwriting a life insurance policy?

✔ A) Marital status
B) Gender
C) Age
D) Health history

Explanation: Key underwriting factors for life insurance include age, gender, health history, occupation, hobbies, and habits (like smoking). Marital status is generally not a primary factor in determining risk or premium.

25. Coordination of Benefits (COB) in group health insurance prevents:

A) Employers from self-funding their group health plan
✔ B) An insured from collecting benefits exceeding 100% of their actual covered medical expenses
C) Dependents from being covered under a parent's plan
D) Employees from having more than one insurer

Explanation: COB rules prevent double recovery — an insured with two group health plans cannot collect more than their actual covered medical expenses combined. COB rules determine which plan is primary (pays first) and which is secondary (pays after the primary, covering remaining eligible expenses up to 100% of cost).

26. A producer who submits a life insurance application without the initial premium is issuing what type of receipt?

A) Premium receipt
✔ B) An application without any receipt
C) Conditional receipt
D) Binding receipt

Explanation: If no initial premium is collected with the application, no receipt is issued and the insurance does not take effect until the policy is delivered AND the first premium is paid in good health. A conditional receipt provides coverage from the date of the application or exam, whichever is later, IF the applicant is found insurable.

27. Susan has a life insurance policy with an Accidental Death Benefit (Double Indemnity) rider for $100,000. Her base policy face amount is $100,000. If Susan dies from a heart attack, how much will her beneficiary receive?

A) $200,000
✔ B) $100,000
C) $0
D) $50,000

Explanation: The Accidental Death Benefit rider only pays the additional benefit if death results from an accident. Because a heart attack is an illness (natural cause), only the base policy face amount of $100,000 is paid.

28. A client is considering replacing their current annuity with a new one. The agent must ensure that the replacement is not a 'churning' transaction, which means:

A) The client is over age 65.
B) The new annuity has a higher interest rate.
✔ C) The replacement is done without considering the client's best interest, often just to generate a new commission.
D) The replacement involves a 1035 exchange.

Explanation: Churning is the unethical practice of repeatedly replacing insurance or annuity policies for the same client primarily to generate new commissions for the agent, often without any demonstrable benefit to the client and potentially causing harm through new surrender charge periods.

29. A 'two-tiered annuity' (or multi-tier annuity) is one that:

A) Requires two separate premium payments before it becomes effective
B) Has two separate accumulation funds with different interest rates
✔ C) Credits a higher interest rate if the contract is annuitized but a lower rate if surrendered
D) Is available in two different risk tiers — aggressive and conservative

Explanation: A two-tiered annuity uses two different interest rates: a higher rate applies to the annuity value if the contract is annuitized (converted to income), and a lower rate (the surrender value) applies if the contract is surrendered for cash. This structure incentivizes annuitization but limits flexibility. They have been controversial and are less common today.

30. A fraternal benefit society differs from a stock or mutual insurer because it:

A) Only provides group life insurance to employers
B) Is regulated by the federal government, not state agencies
✔ C) Is nonprofit and sells insurance only to its own members through a lodge system
D) Sells coverage to the general public without any membership requirement

Explanation: A fraternal benefit society is a nonprofit organization with a lodge or ritualistic structure that provides insurance and social benefits only to its members. Membership is usually based on a common bond such as religion, ethnicity, or profession.

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31. The 'consideration' provided by the insured in a life insurance contract consists of:

A) The insured's agreement to provide evidence of insurability upon request
B) The agent's promise to provide good service
✔ C) The premium payment and truthful completion of the application
D) The insured's good health at the time of application

Explanation: Consideration is something of value exchanged by each party. For the insured, consideration consists of the initial premium payment AND the representations made in the application. The insurer's consideration is the promise to pay the death benefit upon the insured's death.

32. If a policyowner designates a beneficiary as 'irrevocable,' what is required to change the designation?

✔ A) The written consent of the irrevocable beneficiary
B) A court order
C) A notarized letter from the policyowner
D) Approval from the insurance company

Explanation: An irrevocable beneficiary designation gives the named beneficiary a vested interest in the policy. The policyowner cannot change the beneficiary, take a policy loan, or surrender the policy without the written consent of the irrevocable beneficiary.

33. What is the main advantage of tax deferral in an annuity?

A) It makes all withdrawals tax-free.
B) It guarantees a minimum rate of return.
C) It lowers the overall tax rate paid on earnings.
✔ D) It allows the contract's earnings to grow faster by earning interest on money that would otherwise have been paid in taxes.

Explanation: Tax deferral allows for 'triple compounding' - earning interest on principal, interest on interest, and interest on the funds that would have been used to pay taxes. This can lead to significantly faster accumulation of wealth over time compared to a taxable account.

34. Under the 'interest only' settlement option in life insurance:

A) Benefits are paid only as interest — no principal is ever distributed
✔ B) The insurer holds the principal and pays interest to the beneficiary; the principal is later paid to a contingent beneficiary
C) The insured receives interest on the policy while living
D) The insurer invests proceeds and retains all interest earned

Explanation: Under the Interest Only option, the insurer retains the death benefit principal and pays only the interest earned (at a guaranteed minimum rate). When the primary beneficiary dies, the principal is paid to the contingent beneficiary. This option is commonly used to provide income to a surviving spouse while preserving the principal for children.

35. The 'Interest Only' settlement option:

A) Requires the beneficiary to pay income taxes annually on all interest
✔ B) Pays only interest on the proceeds to the beneficiary while preserving the principal for a named successor
C) Terminates all benefits when the beneficiary dies
D) Reduces the death benefit by the amount of interest earned

Explanation: Under the Interest Only option, the insurer holds the principal (death benefit proceeds) and pays only the interest earned to the beneficiary. When the beneficiary dies, the principal is paid to a named successor beneficiary (often used to preserve principal for children while providing income to a surviving spouse).

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36. Group life insurance typically has a 'certificate of coverage' for each employee. This certificate:

A) Must be signed by both the insurer and the employee to be valid
✔ B) Is evidence of coverage summarizing the employee's benefits under the master group policy held by the employer
C) Replaces the need for a beneficiary designation form
D) Is the actual insurance contract that the employee can enforce against the insurer

Explanation: The certificate of coverage (certificate of insurance) is given to each employee and summarizes their benefits, eligibility, and coverage details under the group plan. The certificate is NOT the insurance contract — the master policy held by the employer is the actual contract. However, employees can enforce their rights through the certificate.

37. If an agent knowingly recommends a wildly unsuitable annuity to a senior, this could be considered:

A) Churning
B) Financial abuse of an elder
✔ C) All of the above
D) A deceptive practice

Explanation: Recommending a clearly unsuitable product to a vulnerable senior could be classified as a deceptive or unfair practice under the insurance code. It could also rise to the level of financial abuse of an elder, which carries severe penalties.

38. The purpose of the conditional receipt in life insurance is to:

- ✔ A) Provide coverage from the application date if the applicant is approved as applied for
- B) Allow the insurer to deny coverage without explanation
- C) Prove that the agent collected the first premium
- D) Replace the need for a medical examination

Explanation: The conditional receipt provides temporary coverage from the date of application (or medical exam if required), conditional on the applicant being found insurable as applied for at the standard rate. If the applicant is approved, coverage is retroactive to the application date. If not approved, no coverage existed and premiums are returned.

39. Modified Whole Life and Graded Premium Whole Life are similar in that:

- A) Both have a flexible premium.
- B) Both offer a flexible death benefit.
- C) Both are types of term insurance.
- ✔ D) Both have a lower premium in the early years that increases in later years.

Explanation: Both Modified and Graded Premium Whole Life are designed for individuals who need permanent insurance but cannot afford the level premiums of a traditional whole life policy at the outset. Both have lower initial premiums that increase over time before leveling off for the remainder of the policy.

40. The period of time after a benefit trigger is met but before LTC benefits begin is called the:

- A) Probationary period
- B) Benefit period
- C) Grace period
- ✔ D) Elimination period

Explanation: Similar to a disability policy, an LTC policy has an elimination period (or waiting period). This is the number of days the insured must be receiving care before the policy will start paying benefits. Common periods are 30, 60, or 90 days.

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41. Group underwriting differs from individual underwriting primarily because the underwriter evaluates which of the following?

- A) Each individual member's health history in detail
- B) The financial status of each member's beneficiary
- ✔ C) The characteristics of the group as a whole rather than individual members
- D) Only the youngest members of the group

Explanation: Group underwriting focuses on the characteristics of the group itself, such as size, type of industry, turnover rate, and age distribution, rather than the health of each individual member. This is a fundamental principle of group insurance.

42. A client, age 55, takes a $10,000 withdrawal from his non-qualified annuity. His cost basis is $50,000 and the current value is $70,000. How much of the withdrawal is taxable, and what is the penalty?

- ✔ A) $10,000 is taxable, plus a $1,000 penalty.
- B) The taxable amount is zero, but there is a $1,000 penalty.
- C) The taxable amount is $2,857, plus a $285 penalty.
- D) The entire $10,000 is a tax-free return of basis.

Explanation: Under LIFO rules, the withdrawal comes from the $20,000 of earnings first. So, the entire $10,000 withdrawal is taxable as ordinary income. Because the client is under age 59 1/2, a 10% penalty applies to the taxable amount, which is 10% of $10,000 = $1,000.

43. A physical hazard is best described as:

- A) The cause of the loss itself
- B) A legal restriction that increases risk
- ✔ C) A physical condition that increases the chance of loss
- D) A person's dishonest tendencies

Explanation: A physical hazard is a tangible condition or characteristic that increases the likelihood of a peril occurring, such as a faulty electrical system in a building or a person's high blood pressure.

44. Who is required to be a member of the Washington Life and Disability Insurance Guaranty Association?

- ✔ A) All licensed insurers transacting life, accident, and sickness insurance in Washington as a condition of their license.
- B) Only domestic Washington insurers.
- C) Insurers with over $10 million in assets.
- D) Membership is voluntary.

Explanation: All insurance companies authorized to transact life, accident, and sickness insurance in Washington must be members of the Guaranty Association.

45. Which type of whole life policy is designed to be paid up after a specific number of years, such as 20 years or at age 65?

- ✔ A) Limited-Pay Whole Life
- B) Straight Life
- C) Single Premium Whole Life
- D) Adjustable Life

Explanation: Limited-Pay Whole Life provides permanent protection, but the premiums are paid over a shorter, limited period. After the final premium is paid, the policy is 'paid-up' and remains in force for the insured's lifetime.

46. The waiver of a known legal right or advantage by one party to an insurance contract is called:

A) Contribution
B) Estoppel
✔ C) Waiver
D) Subrogation

Explanation: Waiver is the voluntary relinquishment of a known legal right or advantage. If an insurer waives a policy condition (e.g., late premium payment), it cannot later enforce that condition.

47. A Market Value Adjusted (MVA) annuity is a type of:

A) Variable annuity where the market value is adjusted daily.
✔ B) Fixed annuity where the surrender value is adjusted to reflect changes in interest rates.
C) Indexed annuity where the cap rate is adjusted.
D) Immediate annuity with an inflation adjustment.

Explanation: An MVA is a feature that can be attached to a fixed deferred annuity. If the owner surrenders the contract early when interest rates are higher than when the contract was purchased, the surrender value will be adjusted downward. Conversely, if rates are lower, the surrender value may be adjusted upward.

48. Under the ACA for plan years beginning on or after January 1, 2014, annual and lifetime dollar limits on:

A) All benefits are prohibited
B) All limits were grandfathered and remain in effect
C) Only inpatient hospital benefits are prohibited
✔ D) Essential health benefits are prohibited; lifetime limits on non-essential benefits may still apply

Explanation: The ACA prohibits annual and lifetime dollar limits on essential health benefits (EHBs) in non-grandfathered plans. Insurers cannot cap the annual or lifetime amount they will pay for EHBs. However, annual and lifetime limits may still be applied to benefits that are not EHBs.

49. A resident producer, Arthur, dies suddenly. His widow wants to continue collecting renewal premiums and wind down the business. The Commissioner may issue a temporary license in this situation for a maximum duration of how many days?

A) 90 days
B) 120 days
✔ C) 180 days
D) 360 days

Explanation: A temporary license may be issued to a spouse, next of kin, or administrator for up to 180 days without requiring an examination to wind down an agent's business.

50. Which element is NOT required for a risk to be considered insurable?

A) The loss must be definite and measurable.
✔ B) The loss must pose a minimal financial hardship.
C) The loss must not be catastrophic.
D) The loss must be due to chance.

Explanation: For a risk to be insurable, the potential loss must be significant enough to cause financial hardship. Trivial or minimal risks are generally not insurable because the cost of the policy would outweigh the benefit.