Insurance Licensing

AZ-Insurance-Producer-Life

Arizona Examination for Life Insurance Producer Series 13-31

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Question: 1

Regarding the Accumulation at Interest option for their life insurance dividends. The interest earned

A. increases the death benefit.
B. is exempt from taxes.
C. is taxable income.
D. reduces future premiums.

Answer: C

Explanation:
Under the accumulation-at-interest dividend option, dividends generated by a participating life insurance policy are left with the insurer rather than being paid directly to the policyowner. The insurer holds those dividends and credits interest to the accumulated balance. The critical tax distinction is between the dividend itself and the interest earned on that dividend.
Life insurance dividends generally represent a return of excess premium and ordinarily are not treated as taxable income until distributions exceed the policyowner's cost basis. Interest credited by the insurer, however, represents earnings on money being held by the company. That interest is taxable as ordinary income to the policyowner in the year it is credited or otherwise constructively received.
Therefore, leaving dividends with the insurer does not make the interest tax-exempt. The accumulation also does not automatically increase the policy's contractual death benefit or reduce future premiums; those results relate to different dividend options, such as paid-up additions or reduction of premium.
Study Guide Federal Tax Considerations for Life Insurance — taxation of policy dividends; dividend accumulation at interest; treatment of interest earnings.

Question: 2

An insurance policy is a contract of utmost good faith because the insurer relies on the truthfulness of the applicant and the insured relies on the insurer's promise to

A. pay claims.
B. issue a policy.
C. file reports with the insurance department.
D. charge a fair premium.

Answer: A

Explanation:
The doctrine of utmost good faith, traditionally referred to as uberrimae fidei, reflects the expectation that both parties to an insurance contract will deal honestly and disclose material information. During underwriting, the insurer must rely heavily on information supplied by the applicant because many facts affecting insurability—such as medical history, occupation, financial circumstances, and hazardous activities—cannot be independently known without investigation.
The applicant therefore has a duty to provide truthful and complete material representations. In return, the insured must be able to rely on the insurer's contractual commitment to pay covered claims according to the policy terms. That reciprocal reliance explains why answer A is correct.
Issuing a policy is part of contract formation, but it is not the insurer's ultimate promise under the insurance contract. Filing regulatory reports concerns the insurer's obligations to regulators rather than its fundamental contractual obligation to the insured. Similarly, premium determination is governed by underwriting, rating, and applicable law, but the essential performance promised by the insurer is payment of covered benefits when the insured event occurs.
Study Guide General Insurance Concepts — utmost good faith; representations and misrepresentations; contractual obligations of insurer and insured.

Question: 3

Which provides for the continuation of a business if the owner dies prematurely?

A. Key employee life insurance
B. Executive bonuses
C. Deferred compensation
D. Buy-sell funding

Answer: D

Explanation:
A buy-sell agreement funded with life insurance is specifically designed to facilitate an orderly transfer of a deceased business owner's ownership interest and thereby promote business continuity. The owners establish an agreement defining what will happen to an owner's interest following death, and life insurance supplies the liquidity needed to purchase that interest from the deceased owner's estate or beneficiaries.
In a cross-purchase arrangement, individual owners generally insure one another and use the proceeds to purchase the deceased owner's interest. In an entity-purchase arrangement, the business owns the policies and purchases the deceased owner's interest. In either structure, life insurance funding helps prevent ownership from passing unintentionally to heirs who may have no involvement in the business and reduces the need for surviving owners to raise substantial cash immediately after death.

Key employee insurance instead protects the business against economic loss caused by the death of an important employee; it does not itself establish transfer of ownership. Executive bonus and deferred-compensation arrangements are employee-benefit or compensation techniques rather than business-succession mechanisms.
Study Guide Life Insurance Basics — business uses of life insurance; buy-sell agreements; business continuation; key-person insurance.

Question: 4

An insurable interest must exist

A. at the time of the loss.
B. at the time of the application.
C. between all parties to the contract.
D. between the applicant and the producer.

Answer: B

Explanation:
For life insurance, insurable interest must exist when the policy is applied for and issued, rather than necessarily continuing until the insured's death. Insurable interest prevents life insurance from becoming a wagering contract in which the policyowner would financially benefit from the death of someone in whom the owner has no legitimate personal or economic interest.
An individual unquestionably has an insurable interest in his or her own life. Insurable interest may also arise from close family relationships involving love and affection or from substantial economic relationships, such as between business partners, a business and a key employee, or a creditor and debtor within appropriate financial limits.
This differs importantly from property insurance, where insurable interest generally must exist at the time of loss because the claimant must suffer an actual financial loss to recover. In life insurance, a validly established insurable interest at policy inception normally remains sufficient even if the underlying relationship subsequently changes.
There is no requirement that insurable interest exist between every participant in the insurance transaction or between the applicant and the producer.
Study Guide Life Insurance Basics — insurable interest; policy ownership; personal and business uses of life insurance.

Question: 5

Premiums paid on a personal life insurance policy are

A. taxable as ordinary income.
B. not tax deductible.

C. taxable when considered a return of premium.
D. considered to be a capital investment.

Answer: B

Explanation:
Premiums paid by an individual for personally owned life insurance are generally personal expenses and are not deductible for federal income-tax purposes. This treatment is consistent with the general rule that personal living and protection expenses do not create an income-tax deduction merely because the insurance may ultimately provide a tax-favored death benefit.
The premium payment itself is not income to the policyowner, so it is incorrect to describe the premium as taxable ordinary income. Similarly, the premium is not taxed when viewed as a return of premium; rather, premiums generally contribute to the policyowner's cost basis in the life insurance contract. That basis becomes important when determining whether certain withdrawals, surrenders, dividends, or other distributions produce taxable gain.
Life insurance death proceeds paid by reason of the insured's death are generally received income-tax-free by the beneficiary, subject to specific statutory exceptions and special arrangements. That favorable treatment does not convert the premiums themselves into deductible expenditures.
For exam purposes, distinguish clearly between premium deductibility, policy cost basis, cash-value taxation, dividends, loans, and death-benefit taxation.
Study Guide Federal Tax Considerations for Life Insurance — individual life premiums; policy cost basis; taxation of policy proceeds and distributions.

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