



The Assembly of Muslim Jurists of America  
16th Annual Imams' Conference  
Houston – United States

# **Contemporary Financial Issues**

## **Retirement Accounts**

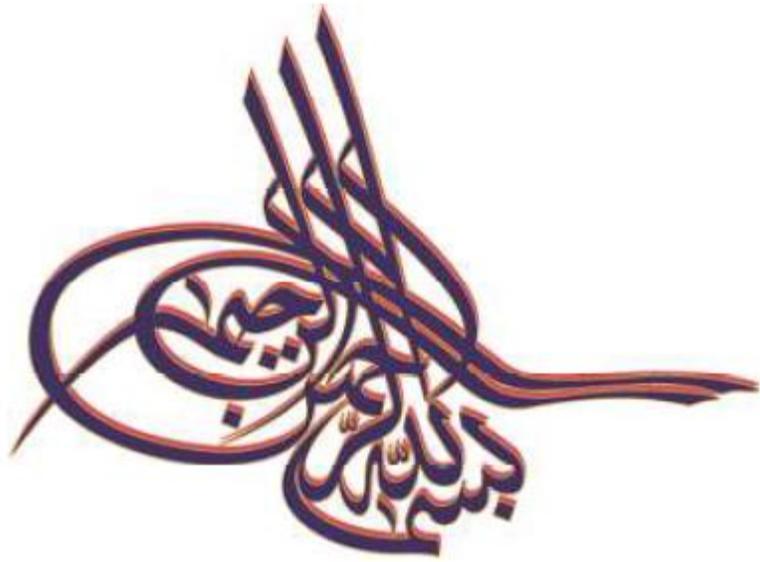
## **Life Insurance**

## **Bankruptcy**

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"الأراء الفقهيية في هذا البحث تعبر عن رأي الباحث و ليس بالضرورة عن رأي أمجا"  
Fiqh opinions in this research is solely those of its author and do not represent AMJA



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*In the name of Allah, the Most Merciful, the Grantor of Mercy*

## **Introduction**

Rulings related to retirement accounts are among the frequently asked questions that AMJA experiences. American Muslims have a lot of questions regarding early withdrawal from their accounts, borrowing from retirement accounts, how to calculate their Zakah, can they basically have an account even if they cannot have a pure Sharia compliant options, how to purify their accounts, what are the Halaal and the Haraam securities or financial instruments to invest in,....etc

Life insurance is another important topic. Most workers and family sponsors in the US are in need for life insurance to secure financial stability for their families after their death, while the mainstream Fatwa is that life insurance is prohibited. Muslims in the US want to know to what extent their need for life insurance can influence the default rule of prohibition and make an exception or dispensation for them.

People have a lot of options for life insurance; some policies might be offered by employers without their employees being required to apply for them, while others are individual policies where people have to apply independently from their employers. Scholars have different rules for each case. Some are term policies while others are whole life insurance policies,....etc.

If there is a way to permit life insurance, then beneficiaries can either limit themselves to only insurance benefit, they can increase their premium to receive (cash advance) on top of the insurance benefit, and they can increase their premium more to receive interest on top of the above. Of course, the question is about the permissibility of each of the aforementioned options.

Bankruptcy is as important subject as the above two. The US legal and the finance systems are different from those in the Muslim World. Bankruptcy rules waive insolvents - after being declared bankrupt - from paying off their debts even if they became solvents in the future. This is because creditors, whether banks or mortgage or credit companies, usually have insurance against bad and unpaid debts, so in most cases, they get their money from their insurance companies once their debtors are declared bankrupt.

The questions that Muslims have are about the ruling of applying for bankruptcy to start with, the waiver from paying off debts in the future, the difference between being indebted to a corporate person versus individuals, the difference between the inward and the outward - or the religious versus the judicial - liability.

It is worth mentioning that this work is not meant to be an academic research that complies with research methodology, rather only the conclusion and the summary of an academic research that has been done already. So, readers should not expect an evidence for each and every ruling the writer adopts. Specialized students of knowledge who want to learn more can enroll in the Master's in Islamic Finance program offered by Al-Huda University [www.GuidanceCollege.org](http://www.GuidanceCollege.org)

Main Alqudah

02-16-2019

## **First: Retirement Accounts**

- **Early Withdrawal from Accounts, like 401(K)**

If an individual decides to make an early withdrawal from his 401(K), he may be subject to taxes and an early withdrawal penalty. In some cases, the account holder may qualify for an exception if it is a disability withdrawal. If the original account holder dies, the beneficiaries may seek distributions of an inherited 401(K).

An employee can make an early withdrawal from his 401(K) by doing one of the following methods:

1. Take an interest-bearing loan from the investment company. The company would give him funds directly from his 401(K) and may impose a penalty with interest on the account. Clearly, this transaction is not really a loan, even if named as such because it is from his own earnings. Hence, this transaction is allowed because meanings and objectives are given the ultimate consideration in transactions, not the word structures. This method will save the withdrawn amount from additional taxes.

2. The employee may directly withdraw from his 401(K), in which case penalties are imposed on the account. This method is also not problematic.

It is noteworthy that companies stipulate these clauses to discourage employees from withdrawing from their 401(K) before retirement or disability. Also, the employee may not exceed the maximum early withdrawal percentage unless they qualify for an exception.

- **Investing Options for Retirement Accounts**

In many cases, an employee can select any of the following investment options:

1. **STABLE VALUE FUND:** Or a saving account that has a fixed interest rate. The client loans his money to the investment company, and in return, the company guarantees the investment by law and the account accrues interest. This option is clearly forbidden because it is interest.
2. **BALANCED FUND:** Usually 50% stocks and 50% bonds. This option is also forbidden because bonds are interest-based loans.
3. **LOCAL STOCK FUND:** This option is allowed as long as the stocks are for companies with Halaal dealings.
4. **INTERNATIONAL STOCK FUND:** This option is also allowed with the same requirements as the previous.
5. **EMPLOYER STOCK FUND:** This is also allowed as long as the company engages in Halaal dealings.

## • **Mutual Fund Options**

This topic is very relevant to the above one since mutual funds are none but vehicles or platforms of investment that contain several securities or financial instruments. However, the main difference between mutual funds and retirement accounts is that the later are employer -based accounts, while mutual funds are individual-based ones.

There are short-term mutual funds that are not commonly used as retirement accounts, while others are long-term ones that are used as individual retirement accounts.

Some accounts are managed by wealth managers and financial advisors, which increases the cost of investment, while others are managed without human involvement because they are programmed to follow established guidelines and restrictions on what to invest in and what to avoid. They abide by certain formulas and algorithm to keep the management cost to the minimum, known as Exchange Traded Funds (ETF).

Regardless of the above technical details, the focus will be on the level of permissibility of all these options, which will be discussed in the following paragraph.

## • **Summary of Requirements for Halaal Investment**

1. The invested capital and the profit cannot be guaranteed. Hence, choosing Stable Value Fund is prohibited. Also, Balanced Fund option is forbidden because a bond is essentially a loan with interest in which the borrower guarantees the money and the interest.
2. One cannot invest in stocks of companies with unlawful dealings, such as banks, credit card companies, wineries, cigarette and tobacco products, gambling, casinos, musical instrument companies, adult film productions, mortgage companies... etc.
3. Within the Halaal core business companies mentioned above, the Haraam investment, Haraam assets, and the debt-equity ratio have to be to the minimum.

Socially responsible investing Companies (SRIC), also known as socially conscious, "green" or ethical investing, is any investment company that follows strategy which seeks to consider both financial return and social good to bring about a social change. Usually, they avoid investing in whatever is harmful for people or environment.

A Muslim may reach out to a socially responsible investing company to evaluate how Sharia compliant his portfolio might be.

If an employee doesn't have a choice in the type of investments, he still may benefit from the 401(K) investment. However, he must make an effort to discover the nature of the investments and the amount of unlawful wealth accrued so that he may discard unlawful earnings from his ownership by giving it to general causes.

Some modern Islamic scholars hold that all forms of 401(K) are allowed, regardless of the nature of the investment. They explain that as being part of the employee package. Along with their income, employees often receive special offers and incentives, such as travel deals, health insurance, 401(K), paid vacations and etc.

They argue that the employee is allowed to benefit from all the above because they are peripherals to the agreement. Peripheral matters are usually not given the same scrutiny as the main contract. Since that is the case, allowing an employee to benefit from his 401(K) should not be an issue because the company offers it as part of the package in the employment agreement and there is clear need for it. Choosing the type of investment is at the company's discretion, and hence, any blame should be directed against it for choosing to invest in something unlawful.

Even though there is some depth and evidence to back this opinion, avoiding it is better and more religiously precautious. Islamic jurists have long championed the principle that avoiding scholarly disagreement is a virtue.

### • **Zakah on Retirement Accounts**

Contemporary scholars have three various approaches in this regard:

1- Zakah is mandatory on the total value of the retirement accounts, whether withdrawable or accessible by the account holder or not. This is because retirement accounts are pure investment, where the investment company acts on behalf of the investors in managing their accounts and make profit.

2- No Zakah mandated on retirement accounts at all because they are not accessible, while one of the stipulations for the Zakatability of any wealth is that it has to be fully accessible to the owner. Upon death or disability or reaching the age of retirement, accounts become Zakatable.

3- Zakah is mandatory on the accessible amounts only. If employees are able to withdraw from their accounts for emergency or humanitarian reasons, then the withdrawable amount is Zakatable after deducting all prescribed taxes, penalty, interest if applicable, and other administration fees.

I adopt the third opinion since it considers both factors; mandating Zakah on investment & stipulating accessibility to accounts.

### • **Zakah Formula and Calculation**

Based on the third opinion adopted above, Zakah should be calculated as follows:

1- Individual retirement accounts like mutual funds and ETFs are Zakatable annually in full after deducting fixed assets as well be explained below, and all other expenses, in case the investment company actively trades in the securities of these accounts, buys and sells throughout the whole year, which is most probably the case.

2- The profit only of the individual retirement accounts like mutual funds and ETFs is Zakatable annually after deducting fixed assets as well be explained below, and all other expenses, in case the investment company does not trade in the securities of these accounts, buys and sells throughout the whole year, which is most probably not the case.

3- The accessible portion only of any employer- based account like 401(K) is Zakatable annually after deducting fixed assets as well be explained below, and all other expenses.

4- The Zakah rate on retirement accounts is 2.5% if paid in Ramadan or based on the lunar calendar. Rate should be 2.575% if paid in December or based on the fiscal year, so to accommodate the 10 days difference between the lunar and the Gregorian year.

5- If the portfolio encompasses Haraam securities like bonds or stocks belong to companies with prohibited core business, then Zakah is to be paid on the principal only, while the profit of these securities is to be disposed in full as it is a prohibited earning.

6- Excluding fixed assets of companies from Zakah calculation is very legitimate since these assets are not for-sale commodities or merchandise, thus, not Zakatable basically.

For example; if the value of the stock is \$100, among which is \$40 fixed assets and \$60 merchandise, and the annual profit is \$10. If this stock is actively tradable, then Zakah should be paid on \$70, the merchandise and the profit, after deducting all other expenses, while only the \$10 profit are Zakatable if the shareholder limits himself to dividend only. However, calculating Zakah on the total market value of the stock is safer and more rewardable.

## Second: Life Insurance

• The semi- consensus amongst Fiqh Councils and contemporary scholars is that commercial insurance is a transaction that involves ambiguity (undue risk taking) , misrepresentation, interest, and gambling. Therefore, transactions that involve these defects are forbidden. Accordingly, sales insurance- or purchased extended warranty- being a type of commercial related insurance is also not allowed.

• Nevertheless, there are two other types of general structures of insurance that are permissible, government sponsored, and cooperative or mutual insurance.

• Arguably, this distinguishing is based on the differentiation between unilateral and bilateral contracts. Many contemporary scholars see commercial insurance as a bilateral contract and transaction, and the other two categories as unilateral.

• Close analysis of this argument leads others to point out the invalidity of this understanding, and its lack of soundness. All insurance, except welfare insurance without premiums, are bilateral contracts and transactions. All policies will be cancelled by the underwriter if a premium is not paid by the insured, hence, the inherent bilateral structure of all insurance products is obvious.

• Recently, the International Islamic Fiqh Academy (IIFA) has acknowledged "Islamic insurance" including government-based and mutual insurance as "cooperative insurance" and not "unilateral agreement or non-profit ones" anymore.

In its conference in Riyadh-Saudi Arabia from 18<sup>th</sup> to 22<sup>nd</sup> of November 2013, the IIFA declared:

" التأمين التعاوني عقد جديد أساسه مبدأ التعاون المنضبط بضوابطه الشرعية المستمدة من القرآن الكريم  
والسنة النبوية "

Which means "Cooperative insurance is a new contract that is based on and abide by the Sharia principles derived from the Quran and Sunnah".

In this regard as well, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has declared the following:

" التأمين الإسلامي هو اتفاق أشخاص يتعرضون لأخطار معينة على تلافي الأضرار الناشئة عن هذه

الأخطار، وذلك بدفع اشتراكات على أساس الالتزام بالتبرع....."

Which means "Islamic insurance is an agreement between people who face certain dangers to avoid the harm resulted from these dangers, by paying subscriptions based on the concept of binding donation..."

It is worth mentioning here that (binding donation) is none but bilateral agreement! Underwriters will immediately cancel any insurance policy that does not generate profits or breakeven at least; another proof of the nature of the bilateral nature of insurance.

• The other argument of the scholars that see the differentiation between insurance types, is all insurance present ambiguity, gambling and *Riba*, therefore, it is only permissible in the case of government sponsored or none for profit cooperatives due to its benevolence goals (where all these deficiencies are overlooked according to the Islamic law); which is also a false argument.

Insurance is not meant for lazy profits by the insured, rather, it is meant to provide protection of lives and properties. The insured is seeking protection as a service and is not entering the transaction to make an easy return on money for money arbitrage transaction. There are

multiple contracts in history allowed by scholars to seek protection for a fee, and even compensation for a "measurable loss".

- Close analysis of the government-based insurance in the US in particular, namely Medicaid and Medicare, show that the government does not provide underwriting services. The government subsidizes and outsources the operation of those two programs to private companies. Therefore, the arguments to draw a distinguishing are flawed.

- Based on the above; insurance in theory is a permissible bilateral transaction based on the Fiqh maxim: "In principle, everything is permissible" i.e. transactions are permissible unless it is clearly proven to be otherwise.

- However, few of the options insurance companies give to their clients in the form of guaranteed returns are not permissible. For example, offers of fixed returns on added premiums for the purpose of building a cash savings position, are considered *Riba*; despite the fact that the policy and its variable investment account maybe permissible. This includes any fixed returns benefits on accumulated premiums paid out on future events, in addition to death or disability benefits; like interests on cash positions.

- In 1992, the Islamic Fiqh Council of India (IFCI) has permitted for Muslims reside in India to have insurance on their properties and their lives as well.

There was unrest and turmoil in the region at that time, where Muslims 'lives and properties were unjustly targeted, either by the government itself or by other deviant religious sects. The Fatwa was based on two Fiqh maxims; "Necessities permit prohibited matters" and "Harm is to be removed".

- Based on the above, my position is that Muslims in the US should be permitted to have life insurance, either because of the default permissibility of life insurance- to my knowledge - or otherwise, because of the necessity involved. As explained before, necessity does not have to be an existing one, rather it is enough to be highly anticipated. A simple assessment of the situation of Muslim families who lost their sponsors show clearly how dire in the need for the vast majority of Muslims in the US to have life insurance.

### **Third: Bankruptcy and the Rights of the Creditors**

- Bankruptcy is a legal status of a person or other entity that cannot repay the debts it owes to creditors. In most jurisdictions, bankruptcy is imposed by a court order, often initiated by the debtor
- After a bankruptcy is discharged the debtor will no longer be legally responsible to pay off the debts. A discharge in bankruptcy refers to a permanent order that releases the debtor from personal liability for certain specified types of debts, thereby releasing the debtor from any legal obligation to pay any discharged debts.
- If the debtor wants to continue paying a particular debt to preserve an asset from being liquidated, such as a house, car or furniture, he may continue to do so, and the contract between the two parties is not affected by the bankruptcy.

#### **Islamic Law Pertinent to Bankruptcy**

- Declaring bankruptcy means that the debtor is claiming that he is unable to pay off his debts. Hence, it is forbidden for a Muslim to make such a decision unless the claim is true and genuine. He must ascertain that all of his current possessions are insufficient to pay off the debts and that most probably, he won't be able to pay them off later on.
- If a court order releases a debtor from personal liability for a debt, while creditors have received their money from a different recourse, he is also released from religious liability, even if he does gain money in the future. It is noteworthy that bankruptcy wipes out only some debts. There are a number of debts that are unaffected by bankruptcy.
- In order for a debt to be removed by bankruptcy, the creditor must be an institution or entity. If it is an individual or a group that gave a personal loan, that debt will not be affected by the bankruptcy.
- Creditors (whether they are banks, mortgage companies or credit card companies) have insurance on their loans. Companies that lose money to a debtor declaring bankruptcy collect the amount from the insurance companies. Since the rights have already reached the creditors via the insurance companies, there is no basis to compel the debtor to pay the debts after his bankruptcy is declared. It would also raise an issue with the company's accounting records if it collected the money from the debtor after receiving the insurance coverage.
- Death takes the ruling of bankruptcy. So, if the debtor passes away and released from legal liability, while creditors have received their money from a different resource, then he is also released from religious liability.
- If the creditor is an individual, neither declaring bankruptcy nor the death of the debtor would wipe out the debt. So, whenever he is able to pay the debt, then he has to, or if he died and left inheritance, then his inheritors are required to do so on his behalf, because the rights of others are not discarded with the passage of time or with death. In other words (statute of limitation) does not apply.

Furthermore, insurance companies do not offer individuals coverage for the debts they are owed. The ruling of a judge doesn't change a religious ruling from being Haraam to being Halaal or vice versa.

- In light of the aforementioned, if a Muslim declares bankruptcy is able to pay some of his debts, he must give priority to the debts owed to individuals over the debts owed to entities.

And that will be the end of the third and final topic in this brief paper. May Allah bless and accept.