Permissibility of and Zakāt on 401k plans & other securities

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The 401K Plan

401k refers to an IRS Code that allows employers to set up retirement plans for their employees. This company-sponsored benefit allows employees to invest money from their paychecks into an investment vehicle on a pre-tax basis, meaning no taxes will be charged for investing until the employee decides to make a withdrawal from his or her plan at the age of 59 1/2. The employer can encourage the employee by also contributing to the plan by matching or partially matching the investment of each employee. All of money invested (up to a certain predefined limit), along with any investment or matching from the employer, is put into an account that is invested into funds (i.e. money market, fixed income, or equity), as chosen by the employee from a list of funds offered by the company.

To understand the Islamic ruling regarding of permissibility or impermissibility of a 401K plan, we first need to understand the different rulings regarding the various types of investment instruments that may be associated with a 401K Plan.

Individual Retirement Account (IRA)

An Individual Retirement Account is a retirement plan where individuals can deposit funds into an account that will earn interest with the goal of augmenting an individual's retirement savings. An IRA is different than a 401k because an IRA earns a fixed-rate of interest. It is not an investment so it does not have the ability to earn a higher rate of return in a lucrative market. Conversely, it is safe during periods of market correction.

It is very clear that investing in such an IRA is impermissible since it is not considered an investment (hence no chance of loss on invested capital). It is similar to an interest bearing deposit such as a saving account. However, an IRA in many cases can also be set up with an institution like a broker (called brokerage IRAs) to invest in lawful stocks at one's own discretion. This could be a good lawful investment option if the stocks one invests in meet the criteria highlighted below.

Mutual Funds

A Mutual Fund is an investment entity, usually a corporation that sells shares to investors, usually individuals, in exchange for a portion of the Fund's investment portfolio. Different funds are designed to meet the requirements of various types of investors. For example, fixed income / bond funds are available for investors seeking moderate returns and low risk and equity / stock funds are accessible for those who are willing to accept more risk exchange for potentially higher returns.

Investing in Mutual Funds is permissible if one restricts his or herself to investing only in equity / stock funds whose portfolios consist of lawful companies. Investing into fixed income / bond funds is impermissible since the returns are derived from interest-bearing securities.

Money Market Fund

A Money Market Fund is a mutual fund that invests in short-term interest bearing securities and sometimes allows its investors to have a debit card associated with it and write checks against their accounts. Since the investments are made into short-term securities (which typically mature within one year), these funds are very low-risk. Investing in Money Market Funds is impermissible since the pool of investments consists of interest-bearing assets.

Bonds, Bills and Notes

These are debt obligations under which the borrower, typically a corporation of governmental entity, agrees to make specified payments of interest for the money it borrows (the "face value" or principal). For example, a corporation may issue a bond which will mature in 5 years with a face value of $1,000 and promise to make annual interest payments of 10% per year. In this case, the bondholder will earn $100 a year for five years and after the fifth year will be given back his or her initial investment of $1,000 as long as the corporation does not default. The interest / expected return of each of a bond depends on the degree of risk, which determined by independent ratings agencies. Bonds issued by governmental entities typically have a lower expected return than those issued by corporations since the chances of governmental entities defaulting are smaller.

Investing in Bonds is also impermissible since they are essentially loans that promise to pay back the face value plus interest.

Certificate of Deposit (CD)

A Certificate of Deposit is a savings certificate at various denominations issued primarily by commercial banks where the holder receives interest at a specified rate upon maturity. Investing in Certificates of Deposition is impermissible because the gains of the investment are earned from interest.

Stocks

A Stock, Share, or Equity, is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. There are two main types of stock: common and preferred. Common stock usually gives the shareholder voting rights and allows them to receive dividends declared by the company. Preferred stock generally does not have voting rights, but has a higher claim on assets and earnings than the common shares. For example, owners of preferred stock are given priority over owners of common stock in the event of bankruptcy

It is permissible to invest in common stocks as long as the company one is investing is in compliance with the following conditions (as highlighted below by Justice Mufti Taqi Uthmani, a renowned and respected scholar in the field of finance and economics):

1. The main business of the company is not in violation of Shari'a. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Sharī'a, such as the companies manufacturing, selling or offering liquors, pork, harām meat, or involved in gambling, night club activities, pornography etc.

2. If the main business of the companies is halāl, like automobiles, textile, etc. but they deposit there surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

4. The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, i.e. in the form of money that cannot be purchased or sold, except on par value, because in this case the share represents money only and the money cannot be traded in except at par. [Please visit http://albalagh.net/Islamic_economics/finance.shtml for complete fatwa and explanations]

Now that we understand the independent rulings of the securities mentioned above, we are given a better picture of what types of 401k plans would be lawful and unlawful to invest in. Based on what we have examined it is therefore permissible to invest in a 401K plan as long as the mutual fund selected is in compliance with the Sharī'a.

The problem that arises at this point is that the majority of the funds offered by companies for this plan do not include Islamic funds (such as the Dow Jones Islamic Fund) or even *ethical funds*, (which are not necessarily lawful since they may not meet all the requirements to be in compliance with the Sharī'a). Nevertheless, if a Sharī'a compliant fund is offered then it would be permissible to invest in it as part of one's 401k plan. In this regard any amount matched or contributed by one's employer toward the 401K plan is also permissible.

Existing Investments in non-lawful 401k plans

As for 401K investments already held in an unlawful mutual fund, one should opt to switch his or her holdings out of the existing fund and reallocate the money into a Shari'a compliant

Fund. In the case where one's company does not include any lawful mutual funds then one may be able to make such a request, like including the Dow Jones Islamic Funds as an option. If this is not a possibility then it would be necessary to withdraw the funds from one's plan and either transfer over (roll over) to another lawful plan (such as a brokerage IRA consisting of lawful stocks) or consider other investing venues, even though there will be a penalty for an early withdrawal. Whatever money is received by the person in this case, only the original capital amount invested by the person and that which has been added by one's company will be permissible for one to retain. All excess will have to be disposed off to the poor without intention for reward.

Zakāt on 401k plans

Given that one cannot withdraw from 401K plans until one is 59.5 years old without facing a penalty, the question comes up as to how and when *zakāt* needs to be paid on this.

Since lawful 401K plans are considered business investments, the money invested does not come under the definition of being a debt and thus *zakāt* is necessary each year as long as the total amount (along with any other savings a person has, minus any debts) meets the *zakāt* quantum [*nisāb*] which is approximately $140. One is obliged to pay 2.5 percent on the total value of one's investments (which includes one's own investment, along with any amount added by one's employer that has vested [i.e. the money is now considered the employees since some companies release the amounts contributed by themselves in installments so the employees cannot take the whole amount at once], and any gain or profits that have since been accumulated. In other words the *zakātable* amount will be the amount a person would consider his or hers at that time even if he was to leave his employment.

For instance, if a person's total personal investments in his or her 401K plan are $5,000.00 along with $2,500.00 matched by the employer, then the *zakāt* will be 2.5% of $7,500.00 which is $187.50 for that year.

If he or she has an additional $2,500.00 in other *zakātable* assets like cash in hand or inventory, etc. then the total *zakātable* income is $10,000.00, hence, his *zakāt* will be $250.00 for that year.

Any penalty amount or taxes that one would have to pay if they did a premature withdrawal of their investment are not exempted from the total *zakātable* income each year, unless a person makes such a withdrawal or cancels his or her plan. In this case he or she would only pay *zakāt* on the amount left on the day the *zakāt* becomes due after deducting any penalties or taxes.

And Allah knows best.
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Wassalam
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