

# The incorporation of Sharia in offshore trusts

**Leah K Scott**

Appleby, Bermuda

In Arabic, Sharia means the clear, well-trodden path to water. In Islam, it is used to refer to the matters of religion that God has legislated for His servants. The linguistic meaning of Sharia reverberates in its technical usage: just as water is vital to human life, so the clarity and uprightness of Sharia is the means of life for souls and minds. It is used to refer both to the Islamic system of law and the totality of the Islamic way of life. At its essence, Sharia law is the attempt on the part of human beings to discern and implement the will of God on earth in all aspects of life.

## I. Where does Sharia come from?

Sharia is derived from the teachings of the Qur'an, which is the Muslim holy book. Muslims believe that the Qur'an is the Word of God, as dictated to the Prophet Muhammad by the angel Gabriel and from Sunna, which is referred to as Islamic custom or practice; particularly that associated with the exemplary life of the Prophet Muhammad. The Sunna is the term used to describe how the Messenger of Allah (*saas*) lived his life. The Messenger's life is an example for all Muslims, or those who accept Islam, to follow and is recorded in the hadith. The hadith is literature which consists of the narrations of the life of the Prophet and the things approved by him.

All the various rulings of the Sharia seek to fulfill the following five aims:

1. Preservation of religion;
2. Preservation of the sanctity of life;

3. Preservation of lineage;
4. Preservation of wealth; and
5. Preservation of intellect.

It is not possible to address each of the five aims in an article this size; thus the focus of this article will primarily be on the preservation and safeguarding of wealth and restrictions on investments.

## II. Islamic rules of inheritance

Everyone should have a will. It is particularly important to stress to your Muslim clients that they have a will, as it is the only way that others will know whether their assets are to be distributed according to Sharia. Further, even if their assets are not going to be distributed according to Sharia, a will is necessary to indicate who is to inherit one's assets/wealth.

Leah K Scott is an Associate in the Trusts Practice Group at Appleby in Bermuda.

Sharia provides specific rules of inheritance that are applied to Muslims. In Islam, the law of inheritance is based upon five main considerations:

- To break up the concentration of wealth in individuals and spread it out in the Muslim society.
- To respect the property right of ownership of an individual earned through honest means.
- To impress upon the consciousness of man the fact that man is not the absolute master of the wealth he produces, but he is a mere trustee and is not, therefore, authorized to pass it on to others as he likes.
- To consolidate the family system which is the social unit of an Islamic society.
- To give incentive to work and encourage economic activity as sanctioned by Islam.

There are precise rules for the division of inheritance set out in the Qur'an. Generally the rules of inheritance are based on the principle of providing specific allocation/shares of the estate of the deceased to certain types of his relatives. Under Islamic law, only a maximum of one-third of one's net assets can be distributed freely. The remainder of one's assets must be distributed in accordance with the rules outlined in the Sharia.

Briefly, the heirs are divided into three classes as follows:

- a. Dhaw-u'l-Fara'id are those people who have a right to definite shares in the deceased's assets. There are 12 categories of person who shall receive a share of inheritance according to their status in the relationship with a deceased Muslim: four males: father, grandfather, uterine brothers and husband. Eight persons out of 12 are females who qualify to be heirs. They are: wife, single daughter, son's daughter, mother, grandmother, full sister, consanguine sister and uterine sister.
- b. The second group of inheritors who receive the residue of the deceased's assets, after the heirs set out in a) above have received their respective shares, are called Asaba. According to Sharia, Asaba implies those relatives in whose line of relationship no female enters.
- c. The Asabat do not receive a fixed share. If the deceased is not survived by any Dhaw-u'l-Fara'id, then the whole of the deceased's property falls to their share. If Dhaw-u'l-Fara'id are there to get their due share, then any residue is taken by the Asabat.
- d. The last category of inheritors are known as Dhaw-u'l Arham. These are relations who are connected through females. It is only in extremely rare cases that they get any share in the inheritance.

It should be noted that if a will that is intended to be Sharia compliant attempts to distribute more than one-third (or 33 percent), under Islamic law, the remaining heirs may elect to ignore the additional bequest or the adult sane heirs may elect to pay the additional bequest out of their portion. For example, if the will distributes 43 percent of the assets as legacies, instead of the allowed one-third, the extra 10 percent will be ignored and the Sharia heirs will still inherit 67 percent of the net estate. However, the adult heirs can elect to pay the extra 10 percent out of their own inheritance. How they elect to do it and whether all the heirs contribute is their choice.

The above is but a brief account of the Sharia rules of inheritance and distribution. Please note that each and every case is different and unique and requires deliberation accordingly.

### III. Preservation of wealth

The preservation of wealth is one of the five universal needs that Islamic law has come to preserve. It does so by providing legislation to define and maintain the existence of wealth as well as laws to prevent its destruction, wastage, or theft.

The following is a hadith that clearly indicates how important the preservation of wealth is in the Muslim community.

The Prophet Muhammad went out of his home one evening and came upon two friends. He asked of them, "What has brought you out of your homes at this hour?" They replied, "Hunger, O Messenger of Allah." The Prophet Muhammad said to them, "I have been brought out of my home for the same reason. Come with me."

The two friends went together with the Prophet Muhammad until they came to the residence of another friend who, when he saw them, exclaimed "Praise be to Allah. No one has a more honourable set of guests today than me." The host then set off and came back with clusters of fresh and dried fruit and said to them, "Eat from this." As he started to set off once again, this time with his knife, the Prophet Muhammad said to him, "Be sure not to slaughter a milk-giving sheep".

The Prophet Muhammad was concerned that the host was going to destroy a source of income that would sustain the livelihood of the host and his family for a long period of time. The Prophet, therefore, forbid the host from slaughtering a milk-bearing sheep in consideration of the man's family, because they would benefit from the milk that the sheep provided, and the meat could easily be obtained by slaughtering a sheep that was not milk-bearing.

The Prophet was bringing to his host's attention the importance of taking care of such a significant source of wealth and, in doing so, showing him what was best for his worldly life. He had instructed his host to slaughter another animal that would fulfill the needs of the occasion, without destroying a source of milk and a future source of young livestock. Slaughtering livestock unnecessarily is considered to be destructive of wealth.

The above referenced hadith applies to any good source of income, real estate and capital as much as it applies to livestock. The preservation of wealth is that Islam forbids certain practices: gambling, usury (the taking and giving of interest), and extravagant spending. In a non-Muslim society such as the United States, extravagance is considered to be something praiseworthy. This type of lifestyle is presented as the ideal, which everyone should seek to emulate. However, this type of extravagance in Islam is forbidden. Islam encourages people to enjoy life and makes a distinction between extravagance and opulence of lifestyle enjoying the pleasures of this world.

#### IV. The offshore trust in Sharia planning

There is increasing interest in the Middle East in structures designed to ensure that family wealth remains available for the benefit of future generations. A trust structure is a useful vehicle for this purpose and, with the long established use of the Islamic waqf, general trust principles are not an alien concept under Islamic law.

A waqf is an inalienable religious endowment in Islam, typically devoting a building or plot of land for Muslim religious or charitable purposes. The Islamic waqf system is conceptually similar to the common law trust, with the idea of someone gifting to a third party specific property to be held for the benefit of others. Muslims may be able to use a trust to achieve many of the same ends, since the flexibility of the trust allows adherence to Islamic law and the holding of property for the benefit of others, including charities.

When drafting a Sharia compliant trust, the Islamic rules of inheritance and the restrictions on investment have to be the primary focus. Islamic inheritance rules provide a formula for the division of property that is regarded as having been divinely revealed, and is designed to prevent the familial strife that may result from mere human calculation.

As far as creating a trust is concerned, there do not appear to be any restrictions under Sharia law in relation to lifetime gifts, but upon the settlor's death, the Qur'an sets out precise rules for the division of inheritance that must be followed. The surviving relatives of the deceased are grouped into an order of preference based on class and degree of strength of blood relationship. Rights accrue to the legal heirs of the deceased by the operation of law.

A settlor who wants to create a trust that is Sharia compliant, will need a trust that provides that on the death of the settlor, the trust fund will be paid to the settlor's heirs under Shari'a law in the proportions set out in the Qur'an. According to the Qur'an, the division of an estate follows a two-step process in which the qualifying "sharers" take their Qur'anic entitlements, and then the closest surviving relative whose kinship is traceable exclusively through the male (agnate) inherits whatever remains.

For example, if a man dies leaving a wife, one son, two daughters, and two brothers, the wife will inherit one-eighth of the estate as a "sharer". The children inherit the remaining seven-eighths of the estate. According to the Qur'anic principle, "the share of a male is equal to that of two females." Therefore, the son inherits seven-sixteenths of the estate while each daughter inherits seven-thirty-seconds of the estate. As the closest surviving agnates, the sons and daughters totally exclude the decedent's brothers from the inheritance.

For the settlor whose primary motive is to preserve assets for the benefit of future generations, while also having regard to the Sharia inheritance proportions, then a fully discretionary trust is likely to be the most useful vehicle.

The settlor may provide the trustees with a non-binding letter of wishes to assist the trustees when exercising their discretions in respect of any distributions. This letter may also, among other things, set out who is to be consulted upon the death

of the settlor, and provide the trustees with some guidance in terms of the proportions in which the settlor intended the beneficiaries to benefit.

With a discretionary trust structure, the funds would remain on discretionary trusts after the settlor's death. However, in considering distributions to the family members, the trustees could take into account the amounts that the various heirs had already received under Sharia law, thereby ensuring that no heir receives more than his/her Sharia entitlement.

The trust is also sufficiently flexible to allow the trust structure to be set up with two trust funds, Fund A and Fund B. Fund A would contain the settlor's assets which are situated in the settlor's home jurisdiction and held on strictly Sharia compliant trusts, while Fund B could be comprised of assets situated in other jurisdictions and held on fully discretionary trusts.

Where trusts are not fully Sharia compliant, care must be taken to ensure that assets are not held with a jurisdiction that is subject to Sharia law because the local courts in that jurisdiction may decide to apply Sharia rules to assets within their jurisdiction, and completely disregard the intended legal effect of the structure in which the assets are held.

#### V. Trust administration and investment policy

It is particularly important that careful attention is paid as to how the trust is to be administered with respect to investment policy. Further discussion regarding investments will follow later in this article. However, particular consideration should be given, when drafting the trust deed, to the following points:

- Specifying a list of non-permitted investments, making it clear in particular that the trustees have no power to invest the assets in the trust fund in interest bearing investments or on deposit,
- A list of permitted investments with the proviso that such investments are not permitted if the industry benefiting from the investment is "sinful".

Such considerations raise the wider issues of ethical investment – the case law in this area makes it clear that express provision in the trust deed is a relevant factor to be considered by being explicit about non-permitted investments from the outset, a well drawn trust deed should ensure the scope for criticism of trustees pursuing such an ethical policy is minimised.

The settlor may require that the investment policies to be followed by the trustees are in accordance with Sharia law, normally by including this requirement in the trust document. The trustees will then need to ensure that any assets held by the trust are Sharia compliant. Where a trust has a large portfolio of investments in stocks and shares, it is unlikely that the trustees will be able to undertake this selection process themselves and therefore, they will normally either employ a specialist investment manager or invest in an Islamic Investment Fund. Generally, the investment manager will be guided by the rulings of a Sharia Supervisory Board with which they will have agreed certain investment criteria.

The criteria that the investment manager will be required to work within can be split into two distinct categories: firstly the qualitative criteria that will con-

sider the actual business activities of the target company such that these activities are:

1. *Halal* (i.e. acceptable under the Sharia); and
2. Certain quantitative measures that will consider certain financial ratios derived from the target company's accounts.

Another important consideration is whether the trust should in principle be revocable. Clearly, it is important to bear in mind that where a trust is revocable, careful consideration will need to be given to the interests of the beneficiaries under the trusts if these could in any circumstances depart from the rules of forced heirship that could apply to the settlor's estate on death.

If your practice includes Muslim clients who wish to ensure that their estate planning is Sharia compliant, it may be feasible to suggest that they obtain a prior clearance that the basic operation of the trust contemplated and its terms comply with Sharia law. This may be achieved by obtaining approval from an appropriate doctor of Islamic law confirming the trust is compliant in principle.

In summary it can be seen that there are a variety of ways in which the framework of the trust can be adapted flexibly to ensure appropriate consultation is undertaken by the trustees and full observance paid to appropriate principles of Islamic law.

## VI. Islamic finance and investment restrictions

In addition to careful drafting of the trust instrument, attention must also be paid to how a Sharia compliant trust is administered in respect of investment policy. The belief that money itself has no intrinsic value is central to Islamic finance. Islamic finance is founded on Sharia principles which express an explicit intention to meet the financial needs of participants with integrity and in a manner that is just, fair, trustworthy and honest, while ensuring a more equitable wealth distribution. Money is simply a medium of exchange. Each unit is 100 percent equal in value to another unit of the same denomination and one is not allowed to make a profit by exchanging cash with another person.

Islam is very clear on a number of financial topics. Trade and investment are encouraged; however, Sharia rules prohibit involvement in alcohol, gambling, pornography, abortion, human cloning, defence, conventional banks or insurers, and most forms of entertainment. Any industries associated with pork are also not permitted investments. The biggest difficulty for devout Muslims and those financial groups which aim to serve them is the principle of *riba*.

*Riba* (which literally means an increase or growth), is prohibited under Islamic law as it is considered usurious and exploitative. In conventional finance, there is a distinction between usury and interest. Regulators in the United States and western jurisdictions regulate and distinguish between interest rates that are considered reasonable and interest rates that are considered usurious. Under Islamic Sharia, any interest, even 0.01 percent, is usurious. There is no distinction between acceptable interest and unacceptable interest.

Islamic law views lending with interest payments as a relationship that favours the lender, who charges interest at the expense of the borrower. Because Islamic law views money as a measuring tool for value and not an "asset" in itself, it requires that one should not be able to receive income from money (for example, interest or anything that has the genus of money) alone. By contrast, Islamic banking exists to further the socio-economic goals of Islam.

Accordingly, Sharia-compliant finance consists of profit banking in which the financial institution shares in the profit and loss of the enterprise that it underwrites. Of equal importance is the concept of *gharar*. Defined as risk or uncertainty, in a financial context *gharar* refers to the sale of items whose existence is not certain. Examples of *gharar* include forms of insurance, such as the purchase of premiums to insure against something that may or may not occur or derivatives used to hedge against possible outcomes.

In addition to the prohibition on the payment and the receipt of interest, any activity that is going to be financed must also be Sharia compliant itself. If real estate is being acquired, the activities undertaken on the property have to be compliant. Any tenants who rent/lease the premises must be Sharia compliant. That means that the tenants who lease the property cannot be, for example, conventional banks, or insurance companies or businesses that trade in, say firearms, or any other immoral activity.

## VII. Basic financing arrangements

Below is a brief overview of permissible financing arrangements often encountered in Islamic finance.

- **Declining-Balance Shared Equity:** This structure is commonly used to finance a home purchase. The declining balance method requires that the financial institution and the investor to purchase the home jointly. The institutional investor gradually transfers its portion of the equity in the home to the individual homeowner, whose payments constitute the homeowner's equity.
- **Lease-to-Own:** This arrangement is similar to the declining balance described in a) above, except that the financial institution puts up most, if not all, of the money for the house and agrees on arrangements with the prospective homeowner to sell the house to him at the end of a fixed term. A portion of every payment made by the prospective homeowner goes toward the lease and the balance toward the purchase price of the home.
- **Instalment (Cost-Plus) Sale (murabaha):** This is a structure where an intermediary investor buys the home with free and clear title to it. The intermediary investor then agrees on a sale price with the prospective buyer, and this price includes some profit. The purchase may be made outright (lump sum) or through a series of deferred (instalment) payments. This credit sale is an acceptable form of financing and is not to be confused with an interest-bearing loan.
- **Equities:** Sharia law allows investment in company shares provided those companies do not engage in lending, gambling or the production of alcohol, tobacco, weaponry or pornography. Investment in

companies may be in shares or by direct investment (private placement). Islamic scholars have made some concessions on permissible companies, as most use debt either to address liquidity shortages (they borrow) or to invest excess cash (interest-bearing instruments).

- **Retirement Investments:** Retirees who want their investments to comply with the tenets of Islam face a dilemma in that fixed-income investments include *riba*, which is forbidden. Therefore, specific types of investment in real estate, either directly or in securitised fashion (a diversified real estate fund), could provide steady retirement income while not running contrary to Sharia law.
- **Traditional insurance:** Traditional insurance is not permitted as a means of risk management in Islamic law because it constitutes the purchase of something with an uncertain outcome, and because insurers use fixed income – a form of *riba* – as part of their portfolio management process to satisfy liabilities.

A possible Sharia-compliant alternative is cooperative (mutual) insurance. This is where subscribers contribute to a pool of funds, which are invested in a Sharia-compliant manner. Funds are withdrawn from the pool to satisfy claims, and unclaimed profits are distributed among policy holders. Such a structure

exists infrequently, so Muslims may avail themselves of existing insurance vehicles if needed or required.

The key to identifying whether an investment is Sharia compliant is the type of profit that the investment generates. Where the investment generates a pre-determined fixed return, then this profit will be regarded as illegitimate under Sharia law.

## VIII. Conclusion

Islamic finance is a centuries-old practice that is gaining recognition throughout the world and whose ethical nature is even drawing the interest of non-Muslims. Given the increased wealth in Muslim nations, expect this field to undergo an even more rapid evolution.

This article attempts to summarise several important principles in respect of estate planning for Muslim settlors. Trust practitioners and service providers who are looking at the Middle East for potential business are now finding themselves being asked whether they can provide Sharia estate planning. Sharia law is a complex area, and clearly special care must be taken in all cases to ensure that all relevant formalities are complied with.

*For further information, please contact the author by email at: [lscott@applebyglobal.com](mailto:lscott@applebyglobal.com)*