



Special Needs Trusts as S-Corporation Shareholders:

Practical and Planning Considerations

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Families with closely held business interests and special needs family members will often want to incorporate special needs planning into their broader estate and business succession planning. When a special needs trust ("SNT") is expected to own S-corporation stock, practitioners must carefully navigate both the S-corporation shareholder eligibility rules and the requirements for eligibility and receipt of means-tested public benefits.

An S-corporation may have only certain permitted shareholders, including individuals, estates, and specific categories of trusts. If S-corporation stock is transferred to an ineligible trust, the corporation's S-election may terminate, potentially resulting in significant adverse tax consequences for all shareholders. Accordingly, drafting attorneys of special needs trusts should consider the S-corporation rules whenever special needs trust planning involves a closely held business that is taxed as an S-corporation.

Third-Party Special Needs Trusts

A third-party SNT is typically established by parents, grandparents, or other family members for the benefit of an individual with disabilities using assets that never belonged to the individual. Because the trust beneficiary has never owned the trust property in the beneficiary's name, third-party SNTs generally provide the greatest planning flexibility.

When a third-party SNT is expected to hold S-corporation stock, practitioners generally look to one of two trust ownership classifications: the Qualified Subchapter S Trust ("QSST") or the Electing Small Business Trust ("ESBT").

Although a QSST can be an eligible S-corporation shareholder, its statutory requirements often conflict with traditional special needs trust planning. To qualify as a QSST, there must be only one current income beneficiary, and all trust income must be distributed currently to that beneficiary. In addition, a timely QSST election must be made by the income beneficiary (or the beneficiary's authorized representative).

These mandatory distribution requirements can create significant challenges in the special needs context. One of the primary purposes of a third-party SNT is to provide the trustee with complete and total discretion over distributions so that public benefits may be preserved to the greatest extent possible. Requiring all trust income to be distributed annually may interfere with that objective and substantially limit the trustee's flexibility. For that reason, many traditional third-party SNTs are poorly suited for QSST treatment.

As a result, the ESBT is often the more practical solution. Unlike a QSST, an ESBT may have multiple beneficiaries and generally permits the discretionary distribution standards generally

required for special needs trusts. The trustee must make a timely ESBT election. Once the election becomes effective, the trust may continue as an eligible S-corporation shareholder while preserving the flexibility necessary for mean-tested public benefits eligibility.

The principal drawback of ESBT treatment is fiduciary income taxation. S-corporation income allocated to an ESBT is taxable at the trust level and, as a result, is subject to the compressed fiduciary income tax brackets even if income is distributed (either outright or in-kind). Unlike traditional non-grantor trust taxation, distributions to or for the benefit of the beneficiary do not necessarily shift the S-corporation income tax burden away from the trust. For a successful family business producing substantial annual income, this can create a significant long-term tax cost that should be carefully evaluated before implementing ESBT planning.

First-Party Special Needs Trusts

The analysis remains complex when dealing with a first-party SNT. These trusts are funded with assets belonging to the individual with disabilities and must contain a Medicaid payback provision. As practitioners are aware, common funding sources include litigation proceeds, direct inheritance, accumulated savings, and other assets owned by the beneficiary.

Many first-party SNTs are structured as grantor trusts for income tax purposes due to application of Internal Revenue Code Sections 673 and 677. In those situations, trust income is treated as owned by the trust creator and "grantor" rather than by the trust itself. Depending upon the trust's structure and administration, ownership of S-corporation stock may be permissible. A grantor trust (most commonly, a revocable trust) is a permissible shareholder of S-corporation stock.

Practitioners should proceed carefully, however. A first-party SNT that qualifies as an eligible S-corporation shareholder today may not necessarily remain an eligible shareholder indefinitely. Changes in trust administration, modifications to trust terms, or changes affecting grantor trust status may require additional analysis to ensure continued compliance with the S-corporation rules.

Practitioners should also be mindful of the special shareholder qualification rules that apply when grantor trust status terminates due to the beneficiary's death. Generally, a trust that was eligible to hold S-corporation stock as a grantor trust may continue to qualify as an

S-corporation shareholder for a limited period following the death of the deemed owner, which is two years. This two-year grace period can provide valuable time for the trustee and advisors to evaluate available options, including shareholder redemption arrangements, stock transfers, or restructuring alternatives necessary to preserve the corporation's S-election.

Ownership of closely held business interests also raises considerations beyond tax qualification. Trustees must consider valuation issues, liquidity concerns, and the responsibilities associated with owning shares in a closely held company. The trustee may be asked to vote shares, review corporate actions, consent to transactions, or otherwise participate in corporate governance matters.

Particular attention should be given to the Medicaid payback obligation. Upon the death of the grantor/beneficiary the trustee must satisfy any Medicaid reimbursement claim before making distributions to remainder beneficiaries. If S-corporation stock represents a significant trust asset, advance planning becomes essential. Practitioners should review shareholder agreements, redemption provisions, buy-sell agreements, and other liquidity arrangements to

help ensure that adequate funds will be available when needed. In many situations, the trustee may be required to become a party to an existing shareholder agreement as a condition of ownership.

Practical Drafting Considerations

Whenever S-corporation ownership is anticipated, shareholder eligibility should be addressed during the drafting stage rather than after stock has been transferred to the trust. Practitioners should determine whether grantor trust treatment, QSST treatment, or ESBT treatment will apply and ensure that any required elections are timely made.

For third-party SNTs, the ESBT frequently provides the best balance between preserving means-tested public benefits and maintaining eligibility as an S-corporation shareholder. While the income tax consequences may be less favorable than those associated with other planning alternatives, the flexibility afforded by ESBT status is often more consistent with the objectives of special needs planning.

For first-party SNTs, drafting attorneys should coordinate closely with tax advisors, corporate counsel, and other professionals to ensure compliance with the S-corporation rules, the trust's Medicaid payback requirements, and post-death ownership considerations.

Conclusion

Special needs trusts can successfully own S-corporation stock, but doing so requires careful planning. For many third-party SNTs, ESBT treatment will provide the most practical solution because it preserves the discretionary distribution standards fundamental to special needs planning. First-party SNTs raise additional considerations, particularly with respect to grantor trust status, the two-year post-death shareholder qualification period, Medicaid payback obligations, ownership planning, and liquidity planning.

By addressing these issues during the creation and drafting process, practitioners can help families preserve public benefits, maintain the corporation's S-election, and successfully integrate business succession planning with the long-term needs of a loved one with disabilities.

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