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The Importance of Actively Monitoring S Corporation Compliance

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Many banks have elected to be “S Corporations” for tax purposes. This status can provide significant tax benefits to the bank’s shareholders, but it also comes with several ongoing technical requirements. Failure to satisfy any one of these rules *at any point in time* can result in automatic termination of the bank’s S Corporation status. This terrible result could happen without the bank even knowing, such as upon the death of a beneficiary of a trust that owns bank shares. Although it is possible to fix an accidental termination by asking the IRS for relief, in many cases the process can be both time-consuming and costly. All S Corporations should therefore have a plan in place to actively monitor their compliance with these rules.

Below, we address some of the key rules applicable to S Corporations and provide suggestions for monitoring compliance.

S Corporation Eligibility Requirements

1. Only certain types of shareholders can hold S Corporation stock.

Ownership in an S Corporation generally is limited to individuals that are U.S. citizens or residents, estates, certain tax-exempt entities (such as charities and qualified retirement plans), and the following types of domestic trusts:

Grantor Trusts. A “grantor trust” established by an individual U.S. citizen or resident grantor may hold S Corporation stock. However, the trust usually stops qualifying as a grantor trust when that individual dies. In that case the trust may continue holding the stock for *two years*, but after that, it must make a QSST or ESBT election (see below).

Testamentary Trusts. If a shareholder dies and a trust receives S Corporation stock from their estate pursuant to a will, the trust may hold the stock for only *two years*.

Qualified Subchapter S Trusts (QSSTs). A trust that *timely elects* to be a QSST, and that meets certain other requirements, may hold S Corporation stock. A QSST must have only one current income

beneficiary (an individual U.S. citizen or resident) and must distribute *all of* its income to the beneficiary at least annually. If the beneficiary dies, the trust may hold the stock for two more years before it must make a new QSST (or ESBT) election.

Electing Small Business Trusts (ESBTs). A trust that *timely elects* to be treated as an ESBT, and that meets certain other requirements, may hold S Corporation stock. ESBT beneficiaries generally are limited to individuals, estates, and charitable entities. The status of an ESBT does not change when a beneficiary dies (unlike QSSTs).

Voting Trusts. Certain trusts created by shareholders primarily to exercise the voting power of the stock transferred to the trust may hold S Corporation stock.

2. S Corporations cannot have more than 100 shareholders. For this purpose, certain family members are treated as a single shareholder.

3. S Corporations can have only one class of stock. Instruments, obligations and other arrangements may be treated as a second class of stock even though not designated as such. For example, certain non-traditional borrowing arrangements may be treated as a second class of stock. Different voting rights are allowed, so long as the economic rights are identical.

Monitoring “S Corporation” Requirements

Banks that are S Corporations should have a plan to monitor compliance. The plan should focus on S Corporation compliance in connection with certain bank actions, such as approving share transfers, issuing new shares, or amending its governing documents.

When a trust becomes a shareholder, the bank should obtain information about the trust’s status and any election that it has made. The death of an individual shareholder, or the “grantor” or beneficiary of a trust shareholder, can result in an ineligible shareholder. If this occurs, the bank should obtain information about existing and future stock ownership and stay updated on any share transfer or trust status and election. Banks that are S Corporations also should reach out to their trust shareholders periodically to determine whether any changes have occurred that could impact trust eligibility to hold S Corporation stock.

When a bank that is an S Corporation amends its governing documents, it should consider including provisions that will assist it in complying with S Corporation rules. A good compliance plan can help avoid serious issues. If an eligibility issue exists, it generally will be easier and less costly to correct if it is discovered sooner, rather than later.

Conclusion

Maintaining compliance with S Corporation limitations is complex and critical for banks treated as S Corporations. Such banks should work closely with their tax counsel to develop a robust compliance monitoring plan.