

States recognizing the S corporation election generally follow the federal practice of not imposing a corporate-level tax on the corporation (except for the built-in gains and passive investment income taxes). There are exceptions, however, to this adherence to federal rules. For example, a state may impose an income tax on an S corporation's earnings attributable to nonresident shareholders. Other taxes applicable to C corporations at the state level, such as license fees and franchise taxes may likewise be imposed on S corporations.

A corporation may do business in one or more states other than the state in which it was formed. If such a "foreign" corporation has sufficient contact with residents or businesses of another state (that is, has a "nexus" with the state), that second state usually has jurisdiction to impose a tax on the corporation or, more typically in the case of S corporations, to require the corporation to file an informational return. A number of states go further. They require an S corporation to file a return if it has a shareholder residing in the state, even if the corporation otherwise conducts no business activity in the state.

The states generally use one of three methods to divide the income of multi-jurisdictional corporations:

- separate accounting;
- specific allocation; or
- formula apportionment.

These methods generally apply to apportion the income of S corporations in the same manner as they apply to apportion the income of C corporations.

When is each of these methods used? Where formulaic apportionment causes extra-territorial values to be taxed, or the resulting tax is exceedingly unfair in relation to the business conducted in the state, some states accept tax returns based on separate accounting. Under the separate accounting method, a corporation's activities within a state are considered separate and distinct from those outside the state. The corporation "sources" each item of revenue and expense to the state in which it was generated.

The specific allocation method focuses on the geographic source of a particular item of income, such as the location of the property generating the income or the taxpayer's commercial domicile. Specific allocation is used for certain types of non-business income in states that have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) or similar provisions.

The formula apportionment method is most commonly required by the states to divide a corporation's income among the states in which it does business. The UDITPA adopts the formulaic apportionment method to attribute business income to the various states. This method generally assumes that payroll, property, and sales contribute equally to income earned throughout the country. Thus, states using a three-factor apportionment formula typically average the ratios of payroll, property, and sales within the state to their respective total amounts outside the state. This formula determines a corporation's tax liability.