

Adoption of Market-Based Sourcing in Arkansas Highlights Tax Risks for Firms in Other States

By Matt Boch



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The most important tax legislation from the 2025 Arkansas legislative session was changing the way the state income tax applies to multistate businesses that provide services—including legal services—by adopting market-based sourcing. The bottom-line effect on your own taxes will be limited if you are an in-state resident business owner. But other states have similar approaches, and the tax risks from working across state lines are increasing for legal and other professional services.

Market-Based Sourcing Imposes State Tax Based on Where Benefits Are Received

First, some income tax basics: Most states impose an income tax, and they generally tax multistate businesses using formulary apportionment. Instead of trying to track profit and loss within the state by separate accounting, a state takes the total income of a business and then *apportions* a share to tax according to its choice of formula. Two generations ago, that formula was almost always one-third payroll, one-third property, and one-third sales. States since then have changed their apportionment formulas to be more competitive, by shifting the tax burden toward the privilege of selling into the state instead of penalizing job creation and investment.

Arkansas has been a laggard, with most¹ of its apportionment reforms coming in the past decade: The state adopted apportionment for tax partnerships beginning in 2018, instead of requiring separate accounting.² Then Arkansas adopted single sales factor apportionment³ upon recommendation by the Tax Reform and Relief Legislative Task Force.⁴ By eliminating the property and payroll factors, Arkansas income tax was apportioned based only on the sales factor beginning in 2021. The next step was repealing the throwback rule—which turns the sales factor for sellers of goods into a backdoor tax on jobs and investment—under a phase-out resulting in complete repeal by 2030.⁵

While these reforms have improved competitiveness, they left the sales factor

rules for services and intangibles in the old status quo, sourcing based on costs of performance.⁶ The costs of performance of services tend to be where labor and property are located, effectively penalizing job creation and investment. In the old economy of in-person services, that approach made sense, but the contemporary economy involves remote sales of services through the internet and other communications technology. Maintaining costs of performance rules in this environment made Arkansas less competitive for service centers, data centers, and other service businesses, and it allowed out-of-state service businesses to sell into the Arkansas market while paying no or minimal income tax.

Act 719 of 2025 begins fixing this problem, putting Arkansas on market-based sourcing for tax years beginning in 2026 or later. If a business is taxable in multiple states, it generally will calculate the Arkansas sales factor by sourcing sales based on where the services are received instead of where they are performed. So, for example, a firm deciding between hiring a paralegal in its offices in Texas or Arkansas would face no income tax apportionment penalty for hiring in Arkansas.

The direct impact of Arkansas market-based sourcing on a resident law firm owner is limited: Almost all law firms are set up as passthrough entities, and an Arkansas resident is taxed on worldwide income, and with a credit for taxes paid to other states. For an individual resident owner, tax at 3.9% of worldwide income applies regardless of how the passthrough business sources its income. Nonresident partners, on the other hand, may see a benefit if work is being performed in Arkansas for an out-of-state market. The long-term impact of Act 719 should be improved growth and slightly increased tax revenue for the state—which in all likelihood will help pay for additional cuts to the Arkansas income tax.

Of course, there are additional layers of tax complexity. Sales to states where a business is not taxable will be ignored under a “throwout rule,”⁷ which could be repealed to maximize the competitiveness benefits of market-based sourcing and to avoid malapportionment. Some firms may have obtained permission from the Department of Finance and Administration to use separate

accounting instead of apportionment.⁸ And the passthrough entity tax regime that was enacted in 2021 can complicate things further, although it typically is beneficial for Arkansas business owners.

Firms Practicing Across State Lines Face Tax Risks

It is not just Arkansas that has gone to market-based sourcing. Most states have done so already, although our neighbors in Texas and Mississippi have not. The result of most states going to market-based sourcing of services is a more difficult compliance landscape for small- and mid-sized businesses like many law firms. Legal practice often involves travel to appear in court, take depositions, or meet with clients. Such activity, depending on the facts and applicable state rules, may be sufficient to establish nexus. Even fully remote services can trigger economic nexus with a sufficient volume of sales under many state rules—perhaps a \$250,000 or \$500,000 annual threshold.

Increasing data and systems capabilities on the part of state revenue agencies should be expected to increase state audit activity. And legal practice—particularly appearances before courts or other tribunals—creates a trail of data for state auditors to identify out-of-state businesses. Once on audit, invoices and time entries provide ample information for a state tax auditor.⁹

Market-based sourcing as applied to legal practice has thorny issues given the fluid nature of the work.¹⁰ What is the market if you are conducting a deposition in Kansas on behalf of a client in Missouri in connection with litigation before a federal court in Oklahoma?¹¹ State rules vary on sourcing; the most common approach is derived from the Multistate Tax Commission’s model rules for professional services,¹² which generally source based on residence for individual clients and on the place of principal management—the office or headquarters—for business clients. Typically, these will be the billing addresses, and market-based sourcing tends to that approach as a practical matter, but state rules may require a nuanced analysis. Firms with tax obligations in multiple states face difficult practical questions about determining what information to track and identifying appropriate sourcing positions.

Conclusion

As law firms scale and work across jurisdictions, their tax complexity and state tax risks grow. Market-based sourcing is just a part of the compliance puzzle. Arkansas’s new law will require the owners of many out-of-state firms selling into Arkansas to pay income tax, but the mirror image of that is that Arkansas-based law firms have been facing similar risks in other states, and those risks are increasing.

Endnotes:

1. Arkansas did double-weight its sales factor 30 years ago. Act 682 of 1995.
2. Act 482 of 2017, § 1 (amending ARK. CODE ANN. § 26-51-802).
3. For a discussion of single sales factor apportionment, see *Moorman Mfg. Co. v. Blair*, 437 U.S. 267 (1978) (declining to invalidate Iowa single sales factor apportionment under the record before the Court).
4. Act 822 of 2019, § 7.
5. Act 485 of 2023, § 3.
6. See ARK. CODE ANN. § 26-51-717, as in effect for tax years beginning before 2026.
7. See ARK. CODE ANN. § 26-51-717(c), as amended by Act 719.
8. See ARK. CODE ANN. § 26-51-802(c)(3) (A).
9. Tax audits also can create confidentiality issues for law firms. See Boch and Lawrence, *Lawyers Face Confidentiality Ethics Risks in Their Own State Tax Compliance*, 26 JOURNAL OF MULTISTATE TAXATION AND INCENTIVES No. 6, at 40 (Sept. 2016).
10. For a detailed analysis of market-based sourcing as applied to law firms, see Lipin, LoDico, Porcelli, and Vadner, *State Corporate Income Tax Rules for Sourcing of Revenue for Law Firms*, ABA TAX TIMES (Aug. 10, 2017).
11. These market-based sourcing issues may also apply to gross receipts taxes and the handful of sales taxes that apply to legal services.
12. *Model General Allocation and Apportionment Regulations* IV.17(d) (4) (rev. Jul. 25, 2018), MULTISTATE TAX COMMISSION, available at <https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf> (accessed Jul. 16, 2025). ■