



Tax Insights
from State and Local Tax
Services

California budget proposal would tax digital prewritten software, permanently limit business tax credits

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In brief

What happened?

Governor Gavin Newsom's [May Revision to California's 2026-2027](#) budget proposes to apply sales and use tax to transactions involving digital products transferred on tangible media, transferred electronically, or accessed remotely, including prewritten computer software and software as a service (SaaS), effective January 1, 2027. Under the proposal, sales and use tax would apply regardless of how the software is delivered or accessed.

The proposal also includes a permanent income and franchise tax credit utilization limitation of the greater of 50% of the combined tax liability or \$5 million for tax years beginning on or after January 1, 2027. This permanent limitation would come on the heels of the temporary credit limitation (\$5 million for each tax year beginning on or after January 1, 2024 and before January 1, 2027) and NOL suspension (for tax years beginning on or after January 1, 2024 and before January 1, 2027) under current law.

Why is it relevant?

The proposal would permanently limit business tax credit utilization and significantly expand the sales tax base to include electronically delivered software and remotely accessed software. Vendors and purchasers of SaaS would face new sales tax collection, remittance, and cost considerations if the proposal is enacted under the statutory framework. The proposal introduces sourcing hierarchies and,

under certain circumstances, shifts the liability for tax payment from the retailer to the purchaser for large-scale transactions. Taken together, the credit limitation and sales and use tax base expansion is projected to generate state and local revenues of approximately \$1.3 billion for 2026-2027, rising to \$2.9 billion by 2029-2030.

Actions to consider

California's budget must be adopted by the legislature no later than midnight on June 15. Details may still be subject to change for a period of time after that deadline. Businesses should model the potential impact of the permanent credit limitation, NOL suspension sunset, prior elections, and potential future elections that could enhance credit benefits.

Purchasers and sellers of software in California should consider the following steps in consideration of the proposed January 1, 2027 effective date:

- Identify offerings that constitute digital products, including prewritten computer software, SaaS, and other electronically transmitted solutions, and assess how those offerings are currently treated for sales tax purposes.
- Evaluate systems and billing processes to determine whether they can distinguish taxable software transactions (across all delivery methods) and apply sales tax appropriately.
- Evaluate accrual processes to determine whether they can identify taxable software purchases and self-assess use tax where needed. Consider whether any exemptions are available for interstate or other use outside California.
- Consider the potential impact of the tax on pricing, contract terms, and planning for transactions occurring on or after January 1, 2027.
- Monitor the budget process, any implementing legislation, and subsequent guidance from the California Department of Tax and Fee Administration (CDTFA) that could clarify definitions, sourcing rules, exemptions, resale treatment, bundling rules, documentation requirements, and transition rules.

In detail

Scope of taxable software

Under the May Revision proposal "digital products" would be subject to sales tax, regardless of delivery. Specifically, the tax would apply to prewritten software:

- provided on discs or other physical media;
- delivered via electronic transmission and local hosting (download); and
- accessed remotely through the internet, including SaaS, where the customer accesses the software that resides on a vendor's server or the server of a third party but never takes possession of it.

California currently imposes sales tax on prewritten software furnished on tangible storage media. The proposed budget would extend this tax treatment to digital delivery and remote-access models, including SaaS, that are generally not taxable under current California guidance. Complementary use tax would apply based on the location where any right or power is exercised over the software. Digital products

purchased outside the state would be subject to the use tax if used in-state within 90 days from the date of sale.

The new imposition specifically excludes digital assets, audio works, audiovisual works, books, video games, and visual works, as well as “digital infrastructure” provided remotely on a rental or subscription basis enabling the user to run its own software.

Exemptions, allocations, credits

The May Revision proposal also:

- Relieves retailers exceeding certain levels of gross receipts (\$5 million single transaction or aggregate transactions exceeding \$2.5 million in previous and current year) from liability to pay the sales tax on sales or purchase of digital products transferred electronically or accessed remotely. The purchaser remains liable for the use tax and must self-assess.
- Provides an exemption for digital products transferred electronically or accessed remotely that are purchased solely for use outside of California or in interstate commerce. The exemption does not apply to digital products transferred on tangible storage media.
- Provides a mechanism that allows purchasers to allocate the tax base of their electronically delivered or SaaS purchases based on the locations where they are using or consuming them.
- Provides an exemption for digital products that represent a personal or professional service. This exemption does not apply to SaaS.
- Contemplates a credit for retail sales tax imposed with respect to the digital product by any other state or jurisdiction at the time of sale.
- Describes situations where credits related to lease transactions may be limited.

Local sourcing agreements

Retailers of electronically delivered software and SaaS would not be able to enter into agreements with local California jurisdictions to shift or otherwise allocate tax monies to other local jurisdictions.

Observation: If enacted as described in the May Revision, the proposal would require sellers of prewritten software, including downloads, hosted software, and SaaS, to evaluate whether affected sales are taxable beginning January 1, 2027. Additionally, purchasers would need to account for increased tax on affected transactions. There is currently no transition language for guidance regarding existing contracts or subscriptions.

Business tax credit background

California in 2024 suspended NOL deductions and limited credit utilization for 2024-2026 ([S.B. 167](#)) and provided for the elective recovery of credits limited by the provision ([S.B. 175](#)).

Specifically, S.B. 167 suspended NOL deductions for tax years beginning on or after January 1, 2024 and before January 1, 2027 for taxpayers with net business income or modified adjusted gross income of at least \$1 million for the tax year.

Further, the legislation limited the aggregate use of otherwise allowable business credits to \$5 million for each tax year beginning on or after January 1, 2024 and before January 1, 2027 (except for certain credits not subject to the limitation). For combined reports, the \$5 million credit limitation is applied to the aggregate amount of “tax,” as defined in Cal. Rev. and Tax. Code Section 23036, of all combined group members. The carryover period for any credit that is not allowed due to the application of the \$5 million limitation is increased by the number of tax years that the credit or any portion thereof was not allowed.

S.B. 175 allowed taxpayers to make an irrevocable election on an original timely filed return for each tax year beginning on or after January 1, 2024, and before January 1, 2027. The election provides taxpayers with an annual refundable credit during the five-year refundable period equal to 20% per year of the credit that otherwise would have been available to reduce net tax in the tax year of the election but for the limitations established by S.B. 167.

The “refundable period” is the first five consecutive tax years beginning the third tax year after the tax year for which the taxpayer makes the election. In each tax year of the refundable period, the annual refundable credit amount will be allowed as a credit against the tax computed for the tax year, and the excess, if any, will be credited against any other amounts due. Any remaining balance will be paid to the taxpayer. The legislation provides that “no portion of the annual refundable credit amount can be assigned to another taxpayer.”

Observation: The 20% annual refundable credit amount is only refunded to taxpayers to the extent that the annual refundable credit and other credits exceed the amount of tax due for that tax year.

Permanent credit limitation in May Revision proposal

The proposed May Revision includes a permanent credit limitation effective for tax years beginning on or after January 1, 2027. This permanent provision is described in the Revised Budget Summary as a “more modest permanent business tax credit limitation that protects small businesses while ensuring that larger corporations pay a minimum level of tax....Unlike the current temporary credit limitation and net operating loss suspension that is in effect from 2024 through 2026, net operating losses can be fully utilized and are not impacted.”

Specifically, the proposal provides:

- For each tax year beginning on or after January 1, 2027, the total of all business credits otherwise allowable (with certain exceptions), including carryovers, for the tax year may not reduce the “net tax” (or “tax” for combined filers) by more than 50% or \$5 million, whichever is greater.
- The amount of the refundable credit allowed under the S.B. 175 election noted above is excluded from this limitation and appears to be allowed as directed to lower tax below the 50% threshold in the applicable years.
- The limited amount for any otherwise allowable credit will be treated as a credit carryover. The legislation does not appear to provide an extension of the allowable carryover period for limited credits.

Let's talk

To discuss the potential impact of these proposed California tax legislative changes on your business, please contact:

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