Tax Insights
from State and Local Tax
Services

California to impose sales and use tax on digital products including prewritten software and SaaS beginning January 1, 2027

July 10, 2026

In brief

What happened?

Legislation (SB 122) signed by California Governor Gavin Newsom (D) on June 29, 2026 implements the Governor's budget revision to apply sales and use tax to transactions involving digital products transferred on tangible media, transferred electronically, or accessed remotely, effective January 1, 2027. Digital products include prewritten computer software, regardless of how the software is delivered or accessed, and software as a service (SaaS). Custom software remains exempt.

Why is it relevant?

The new legislation significantly expands the sales tax base to now tax electronically delivered software and remotely accessed software. Vendors and purchasers of software and SaaS will face new sales tax collection, remittance, and cost considerations. The legislation introduces sourcing hierarchies and, under certain circumstances, shifts the liability for tax remittance from the retailer to the purchaser, particularly for transactions exceeding $5 million in the aggregate.

Actions to consider

Retailers and purchasers of software in California should consider the following steps in anticipation of the 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 whether the digital product, now defined to be tangible personal property, meets the requirements for exemption and/or reduced rate for manufacturing and R&D or electric power generators and distributors.
- Consider whether the software is exempt as custom software, which is defined as a computer program prepared to the special order of the customer even though it may incorporate preexisting program components.
- Consider the potential impact of the tax on pricing, contract terms, and planning for transactions occurring on or after January 1, 2027.
- Monitor subsequent guidance from the California Department of Tax and Fee Administration (CDTFA) that may clarify definitions, sourcing rules, exemptions, resale treatment, bundling rules, documentation requirements, and transition rules. A workshop is scheduled for July 21, 2026.

In detail

Scope of taxable software

Under SB 122, “digital products” are subject to sales tax, regardless of delivery method. Specifically, the tax applies 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. SB 122 extends this tax treatment to digital delivery and remote-access models, including SaaS, that are generally not taxable under current California guidance. Complementary use tax applies based on the location where any right or power is exercised over the software. Digital products purchased outside the state are subject to the use tax if used in-state within 90 days from the date of sale.

The legislation specifically excludes the following from the definition of “digital products”: digital assets, digital audio works, digital books, digital video game products, digital visual works, and digital infrastructure. Custom software continues to be exempt from tax.

Exemptions, allocations, credits

The legislation also:

- Shifts tax liability on large purchases. The legislation relieves retailers from liability to collect and remit sales tax on sales of digital products transferred electronically or accessed remotely where the gross receipts with a purchaser exceed $5 million in the aggregate in the current calendar year, or beginning January 1, 2028, in the current or the preceding calendar year. The purchaser must obtain a direct pay permit (DPP) in order to self-assess and report the use tax. Retailers should obtain the DPP from the purchaser in this instance. The purchaser may request a waiver from the department, along with detailed information on locations of first use. If granted, the retailer would be required to collect the use tax.
- Exempts out-of-state usage. The legislation 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 the purchasers are using or consuming them. This procedure may require a purchaser to obtain a DPP or provide another exemption form.
- Provides an exemption for the sale, use, or consumption of a digital product that represents a service primarily involving the application of human effort, and the human effort originated after the customer requested the service. This exemption does not apply to a separate charge for the right to use the providers' software and does not extend 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.

Sourcing digital product transactions

Detailed sourcing rules are outlined for sellers. Digital products transferred on a tangible medium are sourced where the tangible property is physically located at the time of the sale.

Digital products not transferred on tangible medium are sourced as follows:

- If in-person sale occurs at the seller’s location, transaction is sourced to the seller’s location.
- If not an in-person sale, the transaction is sourced to the purchaser’s known address in California that is maintained in the seller’s books and records.
- If the purchaser provided more than one address during the consummation of the sale, the following hierarchy determines the proper sourcing address (in order of priority):

1. Purchaser’s billing address
2. Purchaser’s shipping or delivery address
3. Purchaser’s mailing address associated with the purchaser’s payment instrument
4. Purchaser’s mailing address.

- If the purchaser does not provide an address during the consummation of the sale, the seller should use an address previously provided by the purchaser, in the following priority order:

1. Purchaser’s most recent billing address
2. Purchaser’s most recent shipping or delivery address
3. Purchaser’s most recent mailing address associated with the purchaser’s payment instrument
4. Purchaser’s most recent mailing address
5. If none of the above applies, then the place of sale would be deemed to be out of state.

- The legislation also provides purchasers with the ability to issue an exemption certificate where the digital products are not provided on tangible medium and are expected to be used outside California, or both inside and outside California. The department may authorize or require methods that fairly reflect the tax due. Future administrative guidance on methodology and forms is expected.

For purposes of the use tax, the place of use of a digital product is the place where any right or power is exercised over the digital product. For remotely accessed digital products, this right or power is exercised at the place where the person accessing the digital product is located.

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: The legislation requires sellers of prewritten software, including downloads, hosted software, and SaaS, to evaluate whether some or all of their sales are taxable beginning January 1, 2027. Retailers will need to track their volume of transactions with specific purchasers to monitor for the $5 million threshold and request DPPs. Retailers should be prepared if the purchaser waives its right to self- assess, which would require collection under these circumstances. Additionally, purchasers need to account for increased tax expense on these transactions and the potential need to report use tax. There is currently no transition language for guidance regarding existing contracts or subscriptions.

Businesses should monitor for further clarifications on implementation and subsequent administrative guidance. The CDTFA has a workshop to discuss and receive input regarding the application of sales and use tax to digital products scheduled for July 21, 2026.

Let's talk

To discuss the potential implications of this legislation, please contact:

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