SALT Alert! 2026-06: California: Governor Newsom signs bill to expand taxation of prewritten software

Governor Newsom on June 29 signed a budget trailer bill (S.B. 122) to help finance the recently approved FY 2027 California state budget. The new law substantially expands the sales taxation of prewritten software to include electronically delivered and remotely accessed prewritten software.

Under current law in the Golden State, the sales and use taxation of prewritten computer software is generally limited to prewritten software that is transferred to the purchaser via tangible media. S.B. 122, effective January 1, 2027, will modify the definition of "tangible personal property" subject to sales and use tax to include the term "digital product and any copyright or patent interests therein;" it then defines "digital product" as prewritten computer software transferred on tangible media, transferred electronically, or accessed remotely. While the new law will likely subject most software-as-a-service (SaaS) products to taxation, it does exclude "digital infrastructure" from taxation. Digital infrastructure is defined as a cloud-based service accessed remotely on which a user may deploy their own software on the provider's digital platform.

The term "digital product" is also defined *to exclude* digital assets, digital music, books, movies, and games from the purview of taxation; custom software produced for only a single user also remains nontaxable.

Sales of digitally delivered software will be sourced primarily based on the billing or other address of the purchaser known to the seller; for use tax purposes, remotely accessed software will be sourced based on the physical location of the software user. Finally, the new law will require that if a purchaser exceeds $5 million in electronically delivered or remotely accessed software purchases from a retailer annually, the purchaser will become liable for payment of use tax directly to the state, and the retailer is absolved from collection responsibility.

S.B. 122 provides several other exemptions for certain types of transactions, including: (a) for the right to reproduce or copy a digital product in order for copies of the digital product to be distributed for consideration to third parties; (b) for digital products purchased solely for use outside California or in interstate or foreign commerce, noting that the Department may authorize or require alternative methods to calculate the sales or use tax due on any digital product sold or purchased for use in this state, including on licenses of digital products concurrently available for use in multiple locations; and (c) for the sale, storage, use or consumption of a digital product that represents a service provided in electronic form in which the service primarily involves the application of human effort by the service provider.

The California Department of Tax and Fee Administration is responsible for implementation of the new provisions. The Department has scheduled a special workshop for July 21, 2026, in Sacramento as part of that process. There is also an option to participate in the meeting remotely. Further information on the meeting and an agenda are available in the Business Taxes Committee Section of the Department website.

KPMG Observations

While the California approach of defining electronically delivered and remotely accessed software as a digital product differs from that taken in most other states, the outcome as far as what is taxable will likely be similar to other states. The provisions of S.B. 122 that may present the most challenges and questions for taxpayers without further guidance are those concerning the application of the $5 million threshold that relieves the retailer from the requirement to collect tax for sales of digital products. (See sections 12 and 14 of S.B. 122.)

The $5 million threshold appears to apply to purchases by a single purchaser from a retailer that in the aggregate exceed $5 million. Once the threshold is exceeded, the retailer is relieved of the obligation to collect sales tax, and the purchaser becomes liable to pay use tax for its purchase of digital products from that retailer with the tax being based on the locations at which the software is used. There is no requirement that the retailer notify the purchaser that the retailer has exceeded the threshold, so purchasers may need to monitor their purchase amounts from individual retailers to determine whether a retailer's threshold has been exceeded, thereby creating a use tax obligation for the purchaser. A purchaser that is required to pay use taxes to the Department must apply for and obtain a use tax direct payment permit.

Alternatively, the bill provides a mechanism for purchasers to request that retailers with whom it has exceeded the $5 million threshold continue to collect sales tax. Purchasers may submit a waiver request to the Department that includes all the places of business that the applicant expects to be places of first use for its purchases of digital products. The request will be granted if the Department deems it necessary for the efficient administration of the tax code.

Contact

For any questions about the bill, please contact Jim Kuhl or another member of the California indirect tax team.
