July 9, 2026

California Expands Sales and Use Tax to SaaS and Electronically Delivered Software Beginning January 1, 2027

by Samantha K. Breslow , Kylan S. Memminger

Beginning on January 1, 2027, California will apply sales and use tax to digital prewritten software, including software as a service ("SaaS"), regardless of how the software is delivered. S.B. 122, introduced as part of the 2026-2027 budget, significantly broadens California's taxation of software and cloud-based technology transactions by expanding the definition of tangible personal property to include a "digital product and any copyright or patent interests associated therewith."

This is a notable change for California taxpayers because California only historically taxed (and defined as "tangible personal property") items that could be physically seen or touched, therefore excluding electronically delivered software or cloud computing transactions from taxation. Under the new law, California joins the 35 states that tax digital prewritten software and the 24 states that tax SaaS in some form. For companies that develop, license, purchase, resell, or often utilize cloud software, the new law will require close attention to product classification, sourcing, contract terms, billing systems, and compliance responsibilities.

Scope of "Digital Product" and Key Exclusions

Like many states that tax software, the law does not explicitly identify or define SaaS; rather, the bill broadly expands the tax base to include the transfer of rights to "access, use, download, or manipulate" a digital product.[1] A "digital product" is defined as "prewritten computer software transferred on tangible storage media, transferred electronically, or accessed remotely." This broad definition is intended to capture the license of SaaS.

The new law also expressly excludes several other categories of digital assets and products from the definition of digital product, including:

- Cryptocurrency and other digital assets
- Digital audio works
- Digital visual and audiovisual works
- Digital books
- Digital video games

- Digital infrastructure.

Therefore, the meaning of a digital product may be different than what most taxpayers are familiar with in the sales tax context, as it breaks from the Streamlined Sales and Use Tax Agreement's definition of a "digital product." California will therefore tax a "digital product," but then ironically specifically carve out what is commonly understood as a digital product under the Streamlined Sales and Use Tax Agreement.

Additionally, the new law does not extend to custom software or to all technology-related services. Certain services connected to SaaS may remain exempt if they primarily involve "human effort" by the service provider that originates after the customer requests the service. This means that consulting services are likely to remain nontaxable, but the state may seek to tax electronic services like data processing services if there is not a human-enough effort.

Although these exclusions help define the boundary of the new law, they leave unresolved questions as to what constitutes "human effort" and taxability questions for technology offerings that do not fit neatly into the definition of a "digital product." For example, because these services and digital works are not taxable, how will California treat hybrid technology offerings or bundled transactions?

Sourcing Hierarchy and "Place of Use"

As a licensor, sourcing software licenses is generally tricky because these cloud-based transactions rarely occur in-person and the delivery location is usually debatable or unclear. Under the new law, an electronically transferred or remotely accessed digital product is considered sold at the location of the purchaser's known address in the seller's books and records. However, if the purchaser provides more than one address, then the following hierarchy decides the sale location: (1) purchaser's billing address; (2) purchaser's shipping or delivery address; (3) mailing address on purchaser's payment instrument; or (4) purchaser's mailing address. If none of these apply and the seller does not have any reliable address data, the sale is sourced outside of California. This hierarchy opens the door to potential tax planning, as the availability of purchaser data will directly impact situsing.

In contrast, a licensee of software must determine whether California use tax applies based on the "place of use," which is defined as the "place where any right or power is exercised over the digital product. The right or power to remotely access a digital product is exercised at the place where the person accessing the digital product is located." This definition is circular and seems to present more questions than answers.

Also, California anticipates the interstate nature of software licenses by including a presumption of use provision for out-of-state licenses. If a digital product is purchased outside of California but then used within California within 90 days of the date of sale or purchase, then California presumes it is used within California and subject to use tax. This disregard of "first use," a commonly applied situsing concept in sales tax, is ripe for constitutional challenge as internally inconsistent.

Shifting the Tax Remittance Obligation to the Purchaser

The legislation also includes a unique operational rule that shifts tax collection responsibility from the licensor to the purchaser or licensee once certain sales levels are reached.

In short, a retailer is relieved from the liability to collect and remit sales tax on remotely accessed or electronically delivered digital products once the aggregate sales price of those products exceeds $5 million in the current calendar year (or preceding calendar year beginning in 2028). Once the obligation shifts, the purchaser is instead responsible for self-reporting and remitting use tax on the digital products directly to the California Department of Tax and Fee Administration ("CDTFA"). If not already difficult enough to implement, the purchaser can shift the liability back to the licensor if they submit a request for waiver form to the CDTFA.

This burden-shifting provision is guaranteed to create compliance hiccups for both licensors and licensees of software, as it requires purchasers to track their spend on software and be prepared to remit use tax on the first dollar spent on software over the $5 million threshold. Because of these tracking burdens, the new law seems to encourage software licensees to preemptively provide a direct pay permit to licensors and assume the remittance responsibility before they are forced into the self-remittance role.

Practical Steps to Consider Now

Although the effective date is several months away, businesses with California customers, California users, or significant software expenditures should begin evaluating the law now to avoid unexpected tax exposure, billing disruptions, and compliance issues when the new rules take effect. Because the new law grants the CDTFA emergency regulatory authority, we expect to see proposed regulations before January. Until then, taxpayers must add California to the list of states that will likely aggressively tax cloud-based software in 2027.

[1] Unlike the full member states of the Streamlined Sales and Use Tax Agreement, which are specifically prohibited from expanding the definition of tangible personal property to include computer software, California's new law does exactly this, defining tangible personal property as "a digital product."