CALIFORNIA EXPANDS SALES AND USE TAX TO SAAS AND CERTAIN DIGITAL PRODUCTS STARTING 1 JANUARY 2027

CDTFA PROPOSES EMERGENCY REGULATIONS TO IMPLEMENT THE NEW LAW

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US Corporate Alert

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California is making a major change to how it taxes software and digital commerce. Beginning 1 January 2027, software-as-a-service (SaaS), other remotely accessed software, and digital products will become subject to California sales and use tax under Senate Bill No. 122 (Stats. 2026, ch. 23) (SB 122), a law signed by the governor on 29 June 2026. The California Department of Tax and Fee Administration (CDTFA) has proposed emergency regulations to implement the new law, summarized below along with their broader implications for businesses that sell, license, or purchase software and digital products in California.

BACKGROUND: CALIFORNIA'S NEW SAAS AND DIGITAL PRODUCTS TAX

SB 122 amends the Revenue and Taxation Code (RTC) to redefine “tangible personal property” to include a “digital product” and associated copyright or patent interests, for purposes of California sales and use tax, effective 1 January 2027. A “digital product” is defined as prewritten computer software transferred on tangible storage media, transferred electronically, or accessed remotely. The definition excludes seven categories: digital assets (e.g., cryptocurrency and other blockchain-recorded value), digital audio works, digital audiovisual works, digital books, digital infrastructure (i.e., IaaS/PaaS), digital video game products, and digital visual works.

CDTFA has released a discussion paper proposing amendments to existing regulations, along with new regulations, intended to implement the new law. CDTFA intends to adopt the regulations through the emergency rulemaking process that SB 122 expressly authorizes, which allows immediate effectiveness upon approval by the Office of Administrative Law (for up to two years, subject to readoption), bypassing the standard 45-day notice-and-comment period.

KEY STATUTORY CHANGES EFFECTIVE 1 JANUARY 2027

Expanded Definition of “Sale” and “Purchase”

Amended RTC sections 6006 and 6010 define “sale” and “purchase” to include any permanent or temporary transfer, for consideration, of the right to open, view, access, download, copy, update, possess, store, manipulate,

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or otherwise use a digital product transferred electronically or accessed remotely—broad enough to capture typical SaaS subscription and software licensing arrangements.

Sourcing Rules

New RTC section 6010.5.1 and amended section 6010.5 establish a sourcing hierarchy: first, an in-person sale at a California location of the seller is sourced there; second, absent an in-person sale, sourcing follows the purchaser's known address in priority order—billing address, shipping/delivery address, payment-instrument mailing address, or general mailing address; and finally, if the purchaser's address cannot be determined, the sale is deemed to occur outside California. A rebuttable presumption treats a digital product purchased outside California and used in California within 90 days of the sale or purchase date as sourced to California.

US$5 Million Threshold Shifting Liability Between Retailer and Purchaser

New RTC sections 6052 and 6201.55 relieve a retailer of liability to collect tax from a single purchaser on electronically transferred or remotely accessed digital products once its gross receipts from sales of such products to that single purchaser exceed US$5,000,000 in the aggregate in the current calendar year (or, beginning in 2028, the current or preceding year). The purchaser's direct-payment obligation begins with the transaction that causes the threshold to be exceeded, not only subsequent transactions. A purchaser required to self-assess and pay use tax must obtain a use tax direct payment permit. A purchaser may instead request a CDTFA waiver. If CDTFA grants it, the relevant sales-tax liability or use-tax collection obligation is returned to the retailer. The sales-tax relief provision does not apply where the purchaser is an insurer as specified in RTC section 6052. CDTFA must calculate a CPI-based threshold adjustment on or before 1 October 2031, and every five years thereafter, with the adjusted amount applying from 1 January of the succeeding year. This is a significant departure from ordinary retailer-collects-tax practice and effectively requires large enterprise purchasers to track aggregate purchases from each vendor and register for direct payment permits once the threshold is reached.

Key Exemptions

SB 122 provides some important exemptions. First, RTC section 6362.4 provides that tax does not apply to the right to reproduce or copy a digital product for distribution to third parties for consideration, even where a copy is transferred concurrently with that right. Second, RTC section 6372 provides that digital products purchased solely for use outside California or in interstate or foreign commerce are exempt if the seller obtains a valid exemption certificate in good faith, although this exception is unavailable for products on tangible storage media. Third, RTC section 6372.1 provides that a digital product representing a service provided in electronic form is exempt where the service primarily involves the application of human effort by the service provider, originating after the customer requested the service.

OVERVIEW OF CDTFA'S PROPOSED IMPLEMENTING REGULATIONS

Regulation 1502.2, Custom Computer Software

This section consolidates the custom software rules. Tax does not apply to custom computer software (other than a “basic operational program”) regardless of transfer form, and separately stated charges for custom modifications to prewritten software remain nontaxable. Examples include one concluding that outputs from a

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generalized, artificial intelligence (AI)-powered tax-analysis tool within a prewritten compliance platform do not qualify as custom software because they are not prepared to the special order of a single customer.

Regulation 1600, Application of Sales and Use Tax to Digital Products

This section is the centerpiece of the regulations. It defines key terms (digital product, accessed remotely, prewritten computer software, tangible storage media, transferred electronically, and the seven statutory exclusions) and clarifies that sales tax applies only where the place of sale occurs in California through genuine in-person participation by a California place of business of the retailer; otherwise use tax applies. It restates the sourcing hierarchy and 90-day presumption and addresses timing. Importantly, for subscriptions spanning the 1 January 2027 effective date, sales tax applies to payments for periods on or after that date, regardless of when the contract was signed or invoiced.

Regulation 1600.1, Sales and Use Tax Liability Threshold

This section implements the US$5,000,000 threshold mechanics, including the proposed process and required certifications for a purchaser to request a CDTFA waiver to shift tax-collection responsibility back to the retailer.

Regulation 1600.2, Multiple Points of Use

This section authorizes a “multiple points of use” (MPU) certificate mechanism allowing a purchaser whose digital product is used concurrently inside and outside California to apportion tax on a reasonable, consistent method (e.g., headcount or device count). For this purpose, using an apportionment method based on server location is expressly deemed unreasonable. It prescribes the certificate's required elements and recordkeeping.

Regulation 1600.3, Use Solely Outside California or in Interstate/Foreign Commerce

This section implements the RTC section 6372 exemption for digital products transferred electronically or accessed remotely (which exemption is unavailable for products on tangible storage media), prescribing certificate mechanics, the good-faith reliance standard, and recordkeeping, mirroring the existing tangible personal property framework.

IMPLICATIONS AND KEY TAKEAWAYS

SB 122 represents a fundamental shift in how California taxes software and digital commerce. Until now, California has generally not imposed sales tax on SaaS, cloud-based services, or electronically delivered software, consistent with its longstanding treatment of such transactions as nontaxable services or intangible property. Effective 1 January 2027, SaaS subscriptions, remotely accessed software, and other digital products will be subject to California sales and use tax, subject to specific exclusions and exemptions.

Because the CDTFA regulations remain proposed and subject to the emergency rulemaking process, implementation details remain subject to change. Businesses should not wait for final regulations before preparing, since the statutory tax obligation itself takes effect 1 January 2027 regardless of whether the regulations are finalized by then.

- The law is broader than it may first appear. Any business that sells, licenses, or purchases SaaS, cloud-based software, or other digital products with California nexus or customers should assess whether the new regime applies, not just traditional software vendors.

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- Pricing and contracts should be reviewed now, including whether multiyear subscription agreements spanning the 1 January 2027 effective date require amendment or updated billing treatment.
- Systems and tax engines need configuration time to recognize SaaS and digital products as taxable in California, source transactions correctly, and apply available exemptions.
- Exemption and threshold planning is a two-sided obligation: sellers should identify applicable exemptions (reproduction-for-resale, use-outside-California, human-effort services), while large purchasers should track cumulative annual purchases from each vendor against the US$5,000,000 threshold to prepare for self-assessment if collection responsibility shifts to them.
- The proposed regulatory text is the best current indication of how the statute will be administered, but it is not final. The official comment deadline was 24 September 2026, but informal input may still be possible; businesses with material exposure should monitor the rulemaking process.
- Businesses with multistate or multijurisdictional software deployments should evaluate whether the proposed MPU certificate regime under Regulation 1600.2 offers a more favorable apportionment method than allocating the full purchase price to California.
- Companies providing consulting, AI-enabled, or hybrid software/service offerings should review the human-effort services exemption and the custom software rules carefully.

This alert is a general summary of SB 122 and CDTFA's proposed implementing regulations, not tax or legal advice. The proposed regulations may change before adoption.

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