

California SB 122 Enacted: What Businesses Need to Know About California's New Software Tax

California has enacted SB 122, creating one of the most significant changes to the state's sales and use tax rules for digital products in recent years. Beginning January 1, 2027, the law expands California sales tax to many forms of prewritten computer software, including software delivered electronically and software accessed remotely through Software-as-a-Service (SaaS) platforms.

Although SB 122 is often described as a tax on downloaded software, the law is much broader. Businesses that sell, license, purchase, or rely on cloud-based software should understand how California's new software tax may affect their operations, pricing, contracts, and compliance obligations.

California SB 122 Expands Sales Tax Beyond Downloaded Software

One of the most important aspects of California SB 122 is its broad definition of a taxable digital product.

Under the new law, prewritten computer software may be taxable whether it is:

- Delivered on physical media
- Downloaded electronically
- Accessed remotely through the internet
- Hosted by a third-party provider, or
- Licensed as a cloud-based application or SaaS platform

This means businesses cannot assume software is exempt simply because customers never download or install the software on their own devices.

Instead, many remote-access software arrangements, including numerous SaaS subscriptions, may now fall within California's sales and use tax rules.

What Is Considered Prewritten Computer Software?

SB 122 focuses specifically on prewritten computer software.

Generally, prewritten software is software developed for general or repeated sale or license, even if it was created for internal use or a specific customer before being commercially marketed.

The law also includes software that customers access remotely through a vendor's servers using login credentials, passwords, access codes, or similar methods.

As a result, many commonly used cloud-based business applications may be subject to California sales tax, including software for:

- Accounting and finance
- Payroll and human resources
- Customer Relationship Management (CRM)
- Project management
- Marketing automation
- Tax compliance
- Data storage and document management
- Business communications
- Enterprise Resource Planning (ERP)

The California budget materials accompanying SB 122 further confirm that the law applies regardless of whether software is delivered through physical media, downloads, local hosting, electronic transmission, or remote internet access.

How California's SaaS Tax May Affect Software Vendors

Businesses that sell software or SaaS to California customers should begin evaluating whether their products are subject to California sales tax under SB 122.

Potential compliance considerations include:

- Updating tax determination systems
- Collecting California sales tax on newly taxable transactions

- Reviewing invoicing and billing procedures
- Updating exemption certificate processes
- Applying proper state, local, and district tax rates
- Reviewing nexus and registration obligations
- Updating ERP and accounting systems

Software companies should also review contracts and product descriptions to ensure they accurately reflect taxable and non-taxable components.

How California SB 122 May Affect Software Purchasers

The new law also affects businesses that purchase software.

Organizations may see higher technology costs if vendors begin collecting California sales tax on SaaS subscriptions and other software licenses.

Businesses with multiple locations, remote employees, multistate operations, shared software licenses, or centralized purchasing functions should review California's sourcing rules to determine how software purchases should be allocated, supported, and documented for sales and use tax purposes.

Sourcing, Allocation, and Documentation for California Software Purchases

SB 122 adds specific sourcing rules for digital products that are transferred electronically or accessed remotely. For an in-person purchase at a seller's permitted California location, the transaction is sourced to that seller's location. For most remote software and SaaS transactions, the place of sale or purchase is the purchaser's known California address shown in the seller's records maintained in good faith in the ordinary course of business. If multiple California addresses are provided, the priority order is shipping or delivery address, billing address, mailing address associated with the payment instrument, and then the purchaser's mailing address.

If the purchaser does not provide an address during the transaction, the seller looks to the purchaser's most recent California addresses in the same order of priority. If no California address is available, the sale is treated as occurring outside California, provided the

retailer can demonstrate that it made a reasonable effort to obtain accurate and complete address information from the purchaser.

For purchasers, allocation should be supported by where the software is actually used. SB 122 provides that the place of use of a digital product is where any right or power over the product is exercised, and remote access is exercised where the person accessing the software is located. For enterprise software, shared seats, remote employees, multistate users, and centralized procurement, businesses should retain records showing the California and non-California use of the software.

Purchases of digital products used solely outside California, or solely in interstate or foreign commerce, may qualify for an exemption if the purchaser provides the required certificate in the form and manner prescribed by the CDTFA. For mixed-use purchases, a purchaser may certify the exempt portion and report and pay use tax on the portion used in California. SB 122 also authorizes the CDTFA to prescribe or require alternative methods that fairly reflect the California sales or use tax due, including for software licenses concurrently available for use in multiple locations.

Until the CDTFA issues additional guidance, businesses should document a reasonable, consistent allocation methodology. Useful support may include executed contracts, order forms, invoices, product descriptions, billing and ship-to records, user seat counts, employee work locations, access or usage reports, cost-center allocations, IP or login-location data where reliable, exemption certificates, direct-pay certificates, and written workpapers explaining how California use was calculated.

Special Rule for Large Enterprise Software Purchases

Enterprise sellers and buyers in California are subject to a \$5 million self-remittance rule. If a single purchaser buys more than \$5 million of taxable digital products from a specific retailer in a calendar year, the retailer is generally relieved of the obligation to collect or remit the tax on the transaction that exceeds the threshold, as well as on related adjustments. Instead, the purchaser must self-assess and pay the applicable California state, local, and district use tax directly to the CDTFA. Beginning January 1, 2028, the threshold may be based on purchases in either the current or preceding calendar year and is scheduled to be adjusted for inflation beginning in 2031.

This is not an exemption from tax. The rule shifts the collection and remittance obligation from the retailer to the purchaser for large software relationships. A purchaser required to self-remit under this rule must obtain a California use tax direct payment permit and issue the appropriate direct payment exemption certificate to the retailer. This mechanism is

unusual; no other state currently uses this specific purchase-threshold self-remittance rule for taxable digital products.

Not Every Digital Product Is Taxable

Although SB 122 significantly expands California's taxation of software, not every digital product is subject to tax.

The law is focused on prewritten computer software and specifically excludes several categories of digital products, including certain:

- Digital books
- Digital audio works
- Digital audiovisual works
- Digital visual works
- Digital assets
- Digital infrastructure
- Digital video game products

Proper product classification remains essential. Businesses should carefully analyze each product or service rather than assuming that all digital offerings, or all SaaS products, receive the same tax treatment.

Additional CDTFA Guidance Is Expected

Although SB 122 has been enacted, businesses should continue monitoring guidance from the California Department of Tax and Fee Administration (CDTFA).

Additional guidance may address important implementation issues, such as:

- Bundled software and professional services
- Mixed software and consulting transactions
- Customer-specific software modifications
- Multistate software use
- Documentation requirements

- Available exemptions
- Sourcing methodologies
- Alternative allocation methods for licenses used in multiple locations
- \$5 million self-remittance procedures and waiver requests

These administrative rules will play an important role in determining how California's software tax is applied in practice.

California SB 122 Compliance Checklist

Businesses should begin preparing now for the new law's January 1, 2027, effective date by:

- Reviewing software and SaaS revenue streams
- Identifying California customers and billing locations
- Evaluating product taxability
- Reviewing contracts and invoices
- Separating software charges from service charges where appropriate
- Evaluating exemptions for custom software or professional services
- Reviewing multistate use documentation
- Updating tax engines, ERP systems, and billing software
- Training finance, sales, and tax personnel on the new rules
- Documenting California address-sourcing data and customer address hierarchy
- Establishing a multistate software-use allocation methodology
- Collecting and retaining exemption certificates for out-of-state or interstate use
- Monitoring purchaser-by-retailer software spend for the \$5 million self-remittance threshold
- Preparing direct payment permit and certificate procedures for qualifying large-buyer transactions

Early planning can help reduce compliance risks and avoid costly system changes as the effective date approaches.

How Thompson Tax Can Help You Prepare For California SB 122 Before It Takes Effect

California's new software tax presents significant compliance challenges for software developers, SaaS providers, technology companies, and businesses that purchase cloud-based software.

Thompson Tax helps businesses understand how California sales and use tax applies to software transactions by reviewing product offerings, contracts, sourcing rules, exemption opportunities, invoicing practices, and compliance procedures.

Whether your company sells SaaS subscriptions, licenses prewritten software, purchases cloud-based technology, or operates across multiple states, our team can help you prepare for California SB 122 and minimize sales tax risk.

Contact Thompson Tax today to discuss how California's new software tax may affect your business prior to the January 1, 2027, effective date.

**RUN,
DON'T WALK!**

**CA SB 122 TAKES EFFECT
JANUARY 1, 2027**

**MAJOR SOFTWARE CHANGES
ARE COMING**

California's new requirements could mean significant changes for businesses dealing with software transactions.

NOW is the time to prepare.

REVIEW | **ASSESS** | **UPDATE** | **PREPARE**

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PREPARE TODAY FOR A SMOOTHER TOMORROW