

California Proposal to Tax Prewritten Software

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Background

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Budget Woes

- Like many states, California has faced budget deficits over the last few years.
- There are many states with a sales/use tax that impose that tax on electronically transferred prewritten software and/or digital goods. Currently, California's sales/use tax does not apply to electronically transferred prewritten software or digital goods.
- In an effort to stabilize the budget for the current and future years, Governor Newsom has proposed expanding the sales tax to electronically transferred or remotely accessed prewritten computer software.

Background

Current Status and Next Steps

- The Governor's Office circulated a draft budget trailer bill that includes language on the proposed tax on prewritten computer software – no bill has been introduced in the Legislature.
- Legislative committees reconvene on Monday, June 1, and the gubernatorial primary is on Tuesday, June 2, so we will have a better sense of status next week.
- Legislative sponsors(s), bill introduction, then assignment to Budget Committees.
- Constitutional deadline of June 15, with enactment subject to a 2/3 supermajority vote.

Tax Base

Tax Base

- Beginning January 1, 2027, California would impose the sales/use tax on “[a]ny permanent or temporary transfer of the right, in any manner or by any means whatsoever, to open, view, access, download, copy, update, possess, store, manipulate, or otherwise use a digital product transferred electronically or accessed remotely[.]” Section 2.
- Defines a digital product to mean “prewritten computer software transferred electronically or accessed remotely.”
 - *“Accessed remotely” means to have accessed by use of a digital code, password, or other means prewritten computer software that resides on the vendor’s server or the server of a third party for consideration.*
 - *“Transferred electronically” means obtained by the purchaser, by means other than tangible storage media, in a manner that allows the purchaser to open, view, access, download, copy, possess, store, manipulate, update, or otherwise use the digital product.*

Tax Base

- The definition of “digital product” explicitly excludes the following:
 - Digital asset
 - Digital audio work
 - Digital audiovisual work
 - Digital book
 - Digital infrastructure
 - Digital video game product
 - Digital visual work (Section 9)
- Custom software still exempt, as would modified prewritten software *but only to the extent of the modifications.*

Questions under Current Draft?

- Why would California tax “digital products” but explicitly exclude everything except software (i.e., why not just tax software)?
 - It could be so that the legislature could easily add new additional taxable categories in the future by just removing the exclusion and revising the digital products definition instead of creating a separate provision to tax digital goods.
- What constitutes taxable prewritten computer software?
 - SaaS?
 - PaaS?
 - IaaS?
 - AI/AI tokens?

Sourcing Provisions

Sourcing Provisions (Section 5)

- If the digital product is on tangible storage media, then the place of sale/purchase is the place where the tangible storage is physically located at the time the act constituting the sale/purchase takes place.
- If the digital product is not transferred on tangible storage media, but it is an in-person sale/purchase, then the place of sale/purchase is the seller's place of business in CA where the in-person sale/purchase occurred.
- If the digital product is not transferred on tangible storage media and was not an in-person sale/purchase, then the place of sale/purchase is deemed to be the purchaser's known address in CA shown in the seller's records maintained in good faith in the ordinary course of business.

Sourcing Provisions (Section 5)

- If the purchaser provided more than 1 address during the sale/purchase consummation, then the purchaser's known address is determined from those addresses in CA in the following order of priority:
 - Purchaser's billing address
 - Purchaser's shipping/delivery address
 - Mailing address associated with the purchaser's payment instrument
 - Purchaser's mailing address
- If the purchaser does not provide an address during the sale/purchase consummation, then the purchaser's known address in CA is determined from the addresses in CA the purchaser previously provided to the seller in the following order of priority:
 - Purchaser's most recent billing address
 - Purchaser's most recent shipping/delivery address
 - The most recent mailing address associated with the purchaser's payment instrument
 - Purchaser's most recent mailing address

Sourcing Provisions

- If none of the aforementioned provisions apply to the sale, then the place of sale/purchase is deemed to be outside of California. Section 5.
- The bill also provides that a digital product's place of use (i.e., for purposes of the use tax) is the place where any right or power is exercised over such product. Section 6.
- These sourcing rules are also applied to the local sales/use tax sections, in lieu of the local sourcing rules under Bradley-Burns. Sections 19, 20.

Multijurisdictional Use Provisions

Seller “Relief” and Purchaser Use Tax Accrual (Sections 11 & 13)

- The retailer is relieved from liability to pay the sales tax on the sale/purchase of a digital product if either of the following applies:
 - The gross receipts from digital products exceeds \$5M in the aggregate in a single transaction.
 - The \$5M is increased based on the California Consumer Price Index beginning in 2031 and then again, every 5 years thereafter.
 - The cumulative gross receipts from the sale of DPs from a single vendor transferred electronically or accessed remotely exceed \$2.5M in the aggregate in the preceding calendar year, and the gross receipts from the sale of DPs from a single vendor transferred electronically or accessed remotely exceed \$2.5M in the current calendar year (viewed from purchaser perspective).

Seller “Relief” and Purchaser Use Tax Accrual (Sections 11 & 13)

- If a retailer is relieved from liability to pay the sales tax under provisions described on the previous slide, then the purchaser is liable for the use tax and shall self-assess and pay directly to the department the taxes due using the direct payment permit.
- Additionally, the same relief from the previous slide applies to the retailer’s obligation to collect the use tax.

“Waiver” Applications (Sections 11 & 13)

- If the department determines that it is necessary for the efficient administration of this part, the department may waive the requirement for the purchaser to self-assess and pay taxes due directly to the department under the previous slide, and the retailer shall be liable to pay the sales tax if the purchaser submits to the department a request for waiver in a form and manner prescribed by the department that includes all the places of business where the applicant expects to be a place of first use for purchases of digital products.
 - A purchaser that submits a request for a waiver shall also submit to the retailer all places of business where the purchaser expects to be a place of first use.

Interstate Exemption (Section 15)

- There is also an exemption for gross receipts from a digital product purchased solely for use outside of California or in interstate or foreign commerce. Section 15.
 - A purchaser that purchases a digital product solely for use outside of this state or in interstate or foreign commerce in the same transaction may issue an exemption certificate for the purchase of any of those digital products eligible for the exemption and report and pay use tax on any of those digital products used in this state.
 - A purchaser that issues a certificate shall report and pay use tax in a manner that reflects the use tax due on any of those digital products used in California.
- The CDTFA may authorize or require an alternative method to calculate the use tax due in this state, supported by the taxpayer's records, that fairly reflects the use tax due on any digital product used in this state.

“90-Day” Presumption (Section 6)

- Section 6 creates a presumption that a digital product purchased outside the state, per the sourcing rules, and used in this state within 90 days from the date of sale or purchase was purchased for storage, use, or other consumption in this state.
- Based on Regulation 1620(3), Section 6 also ought to apply to the first “functional” use of the software.
- See also Section 4, where “storage” and “use” do not include the exercise of any right over a digital product “*without action by the purchaser to use the digital product to perform a task for which it was designed.*”

Business Inputs and Other Exemptions

Business Inputs – Resale, Component Parts, etc.

- The trailer bill would impose tax on business purchases of digital products (prewritten computer software) and, in fact, is intended to do so.
- Because “digital product” is incorporated into “tangible personal property,” the trailer bill contemplates that resale and component part exemptions would apply to digital products in a manner similar to tangible personal property.
- In addition, partial exemptions applicable to qualified tangible personal property may also apply, e.g., manufacturing and R&D.

Other Exemptions

- “Gold Master” Exemption – Intellectual Property Rights
 - Exemption of gross receipts from 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, even if a copy of the digital product is transferred concurrently with the granting of that right. Any tangible storage media used to transmit the digital product is merely incidental.” Section 14.

- “Human Effort” Exemption
 - Exemption of gross receipts from a digital product that represents a personal or professional service provided in electronic form in which both of the following apply (i) the service primarily involves the application of human effort by the service provider, and (ii) the human effort originated after the customer requested the service. Section 16.



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