The 2026-27 Budget: Sales Tax on Prewritten Software

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Background

Custom Software vs. Prewritten Software. When a business designs software for an individual client, it is custom software. Software not customized in this way is known as canned or prewritten software.

Different Ways to Deliver Software. People who buy software can get it in a few different ways:

- They can buy tangible objects that have the software already installed. Although buying software on disks has become less common, many other types of tangible goods—such as vehicles and personal electronics—include pre-installed software.
- They can download the software to devices they already own.
- They can access the software remotely, sometimes called "software as a service."

Sales Tax Applies to Some Sales of Software, But Not Others. Most states' sales and use taxes (hereafter, sales taxes) apply mainly to tangible goods. Different states, however, have interpreted the word "tangible" differently, and they also have made different choices about broadening their sales tax bases beyond tangible goods. California's approach has resulted in a relatively narrow tax base in several areas, including software. The state's sales tax applies to prewritten software transmitted on tangible media. It does not apply to other sales of software, such as custom software, prewritten downloaded software, or prewritten software accessed remotely. Consequently, California's sales tax excludes growing categories of spending while taxing similar transactions differently depending on the delivery method.

Governor's Proposal

Apply Sales Tax to Retail Sales of Digital Prewritten Software. The Governor proposes extending the state's sales tax to sales of prewritten software broadly, no matter how the software is delivered. Custom software would remain exempt. The change would go into effect January 1, 2027. The administration estimates that this would raise General Fund revenue by $450 million and local sales tax revenue by $560 million in 2026-27, when it would be in effect for half a year. The full-year revenue estimates for 2027-28 and ongoing are $900 million General Fund and $1.1 billion in local sales tax revenues.

Assessment

Link Between Tangible Goods and Consumption Has Weakened Over Time. Broad-based taxes work best when they align closely with fundamental parts of the economy, like income or consumption. This can have a variety of benefits for long-run revenue growth, taxpayer fairness, and economic performance. When California introduced its sales tax nearly a century ago, consumers spent most of their money on tangible goods. The state further aligned the sales tax with consumption by excluding sales for resale—including raw materials and component parts—from the tax base.

Over time, however, the economic importance of tangible goods has declined, outpaced by growth in services and digital products. This trend has weakened the link between consumption and California's sales tax base in two ways:

- A growing share of consumption falls outside of the sales tax base. In some cases—such as prewritten software delivered through different means—the distinction between taxed and untaxed sales is very difficult to justify.
- Many of the tangible goods used to produce other goods and services are not eligible for the sales for resale exclusion. The state has taken some steps towards addressing this by creating partial exemptions for certain

items used in production, such as farm equipment and manufacturing equipment.

Recent Analysis Evaluated Options for Addressing This Issue. In March, our office published a report <https://lao.ca.gov/Publications/Detail/5170> evaluating various options for raising and lowering taxes. Three of the options we evaluated would align the sales tax base more closely with consumption:

- Expanding sales tax exemptions for business equipment;
- Extending the sales tax to consumer services;
- Extending the sales tax to digital goods.

The third option overlaps substantially with the Governor's proposal. The report summarizes some of the key trade-offs between this type of policy and other options for raising revenue. Below, we discuss some other issues raised by the proposal.

Proposal Excludes Many Types of Digital Products. By focusing on software alone, the Governor's proposal would address one type of inconsistency between digital and conventional products, but other significant discrepancies would remain. Growth in the digital economy has included not just software, but also other types of digital products, such as text, audio, and video files. Like prewritten software, many of these products have close analogs that already are subject to sales tax, so taxing them would eliminate additional arbitrary distinctions between taxed and untaxed products.

Proposal Includes Substantial Amount of Software Purchased by Businesses. A large share of the newly taxed transactions likely would be business-to-business sales. Extending the sales tax to new business-to-business sales does not align the sales tax more closely with consumption—in fact, it does the opposite. Taxes on business-to-business sales might seem appealing because the resulting costs to consumers are less direct and perhaps less salient. Taxing business purchases, however, can raise costs for consumers even more than a direct tax on consumption. This is because businesses often pass such taxes on to consumers anyway, and additionally, such taxes can create inefficiencies that raise costs even further. Taxes on business-to-business sales favor some types of production—such as more vertically integrated businesses—over others, which can lead to inefficient business operations and higher costs. Since the mid-20th century, many countries have addressed such concerns by implementing value-added taxes, which are designed to avoid taxing business-to-business sales. Value-added taxes have now become the dominant type of consumption tax in high-income countries.

As Usual, Revenues Uncertain. Overall, the administration's revenue estimates for this proposal are reasonable. As is typical for revenue proposals, however, they are subject to substantial uncertainty. The actual amount for 2027-28 plausibly could turn out to be hundreds of millions of dollars higher or lower than projected. For 2026-27, we see a bit more downside risk due to potential acceleration of software purchases to avoid the new tax. For the out-years, we see a bit more upside due to likely growth in the industry.

Recommendation

Consider Modified Version of Proposal. We see merit in the general idea of modernizing the state's sales tax and eliminating some of the arbitrary distinctions between taxed and untaxed sales. If the Legislature wants to address these issues, we recommend that it consider extending the sales tax to a broader set of digital products, not just software. We also recommend that the Legislature consider an approach like the ones taken by Connecticut, Iowa, Maryland, and New Jersey, which have exemptions or reduced rates for software purchased by businesses. In keeping with the spirit of the proposal, such exemptions or reduced rates should not depend on the means through which the vendor delivers the software.

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