Text of Proposed California Code of Regulations

Title 18. Public Revenues

Division 2. California Department of Tax and Fee Administration – Business Taxes

Section 1502.2. Custom Computer Software.

(*A new regulation to be added to the California Code of Regulations.*)

Regulation 1502.2. Custom Computer Software.

(a) Definitions. For purposes of this regulation, the definition of the terms "basic operational program," "computer," "computer software," and "custom computer software" have the same meaning as set forth in Revenue and Taxation Code section 6010.9 and "prewritten computer software" has the same meaning as set forth in Revenue and Taxation Code section 6016.1.

(b) Tax does not apply to the sale or lease of custom computer software, other than a basic operational program, regardless of the form in which the computer software is transferred. In addition, tax does not apply to the transfer of custom computer software in connection with the sale or lease of computer equipment, whether or not the charges for the custom computer software are separately stated.

Example 1. Company A is a manufacturing company. Company B is a computer software company. Company A hires Company B to create new computer software that will interface between Company A's warehouse inventory database and its shipment software. The new computer software has been created for use by Company A only and cannot be operated by any other companies. Because the new computer software is sold to a single customer and is designed to meet that customer's unique internal processes, it qualifies as custom computer software.

Example 2. Company X is a computer software vendor that offers an Artificial Intelligence (AI)-powered tax-analysis tool within its prewritten compliance platform. The AI tool automatically generates recommended filing categories based on patterns the model has learned. To improve its predictions, Company X trains the AI tool on California's sales and use tax statutes, regulations, and historical legal opinions. The result is a version of the tool that produces more accurate suggestions for California-based users.

Even though the AI tool produces outputs that appear tailored to California tax rules, these outputs are not the result of computer software prepared to the special order of a single customer. Instead, they are trained, automated outputs produced by a generalized machine-learning system that is sold or licensed to many customers. Therefore, such AI-generated adaptations do not qualify as custom computer software.

(c) Charges for custom modifications to prewritten computer software are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of

the sale of the prewritten computer software. (See Regulation 1600 for the application of tax to digital products.)

Example 3. Company C is a transportation company. Company D is a computer software company that developed scheduling software which is held for general or repeated sale for $10,000. Company C purchases the scheduling software, and also requests that Company D rewrite major components of the software to perform route optimization unique to Company C's business. Company D charges $15,000 for the modified scheduling software, separately stating the charges as $10,000 for software and $5,000 for the modification. Because the additional modification is prepared to the special order of the customer, the scheduling software is custom computer software to the extent of the modification. Since the $5,000 charge for the custom modification is separately stated, that amount is not subject to tax. Tax applies to the $10,000 charge for the prewritten scheduling software.

Example 4. Same as Example 3 but Company D charges a lump-sum price of $15,000. Because the charges for the modification to the prewritten scheduling software are not separately stated, tax applies to the entire $15,000.

(d) When charges for the custom modification of prewritten computer software are not separately stated, tax applies to the entire charge made to the customer for the modified computer software unless the modification is so significant that the new computer software qualifies as custom computer software. If the prewritten computer software was previously marketed, the new computer software will qualify as custom computer software, if the price of the prewritten computer software was 50 percent or less of the price of the new computer software. If the prewritten computer software was not previously marketed, the new computer software will qualify as custom computer software if the charge made to the customer for custom modification, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(e) Charges for any written documentation or manuals designed to facilitate the use of custom computer software by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer software is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(f) Custom computer software includes computer software prepared to the special order of a customer who will use the computer software to produce and sell or lease copies of the computer software, and the charge for such custom computer software is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer software.

(g) Computer software prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is custom computer software even though a different version currently operates in connection with an incompatible basic operating system.

(h) Operative Date. This regulation is operative as of January 1, 2027.

NOTE: Authority cited: Sections 15570.22 and 15570.24, Government Code; Statutes 2026, chapter 23 (Sen. Bill No. 122), Section 34; and Section 7051, Revenue and Taxation Code.

Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016.1, Revenue and Taxation Code.