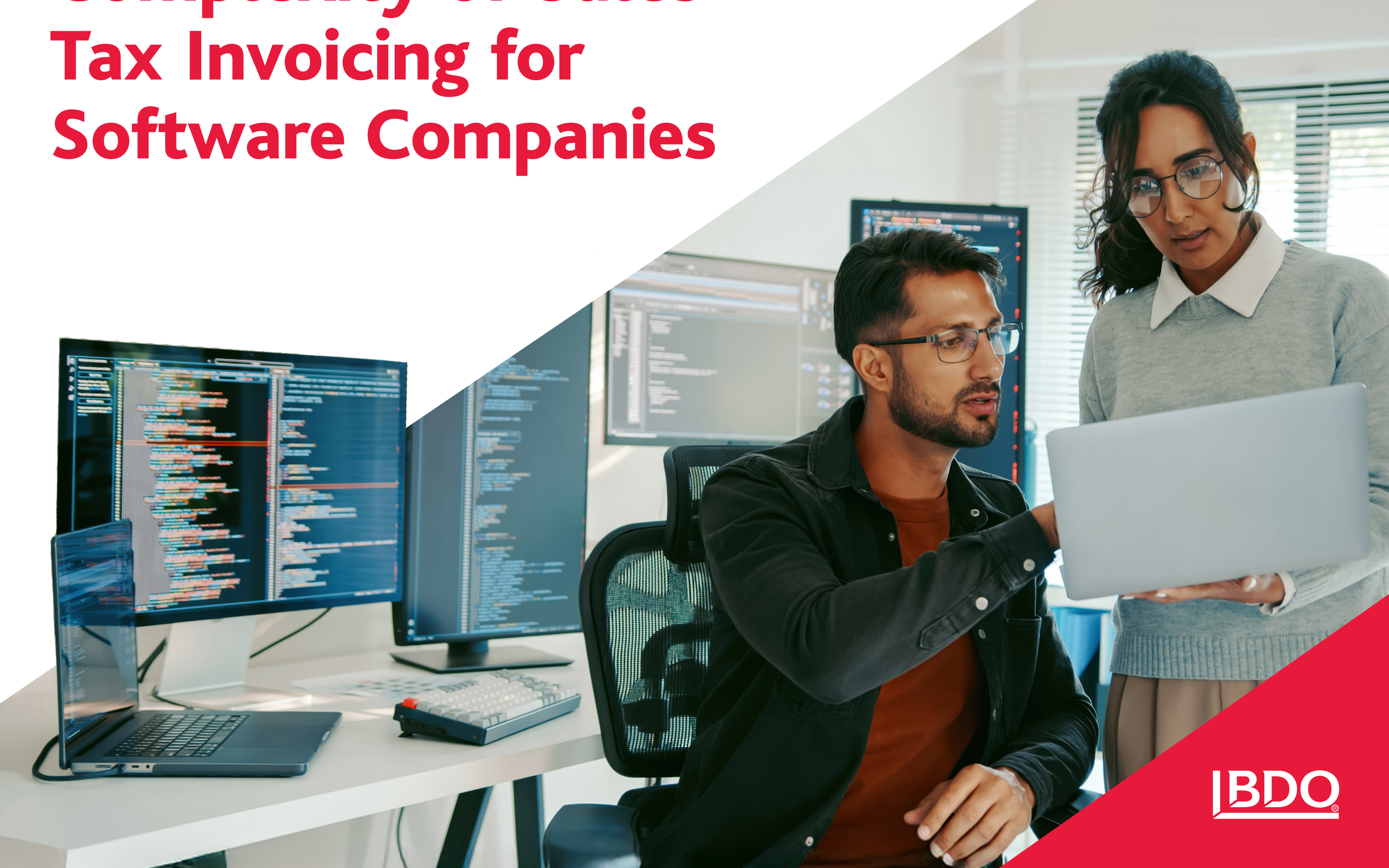
Addressing the Complexity of Sales Tax Invoicing for Software Companies



The digital economy is growing at a remarkable rate. In the U.S. alone, it has doubled in size since 2020, reaching an estimated $4.9 trillion in value and accounting for [18% of U.S. GDP](), according to an April 2025 report from the Interactive Advertising Bureau (IAB).

At the same time, the taxation of tech-enabled offerings continues to evolve, resulting in substantial complexity involving the treatment of sales tax.

To maintain compliance with shifting taxation requirements across all jurisdictions, tech companies must continuously evolve their sales processes and tax strategies. For software companies, that means improving transparency into the taxability of their individual products and services.

However, many software companies often bundle their charges on invoices, which makes it difficult to achieve the necessary level of transparency. A lack of transparency could create confusion regarding the sales tax classification of the offering, which in turn could result in unintended exposure. According to **BDO's *2025 Software Report***, in response to increased taxation of the digital economy, just 41% of software companies are unbundling invoices to break out taxable and nontaxable items for indirect tax purposes.

By unbundling invoices, software companies can help mitigate their tax exposure, avoid double taxation, and maintain compliance as tax requirements continue to evolve.

Understanding Bundled and Unbundled Invoices

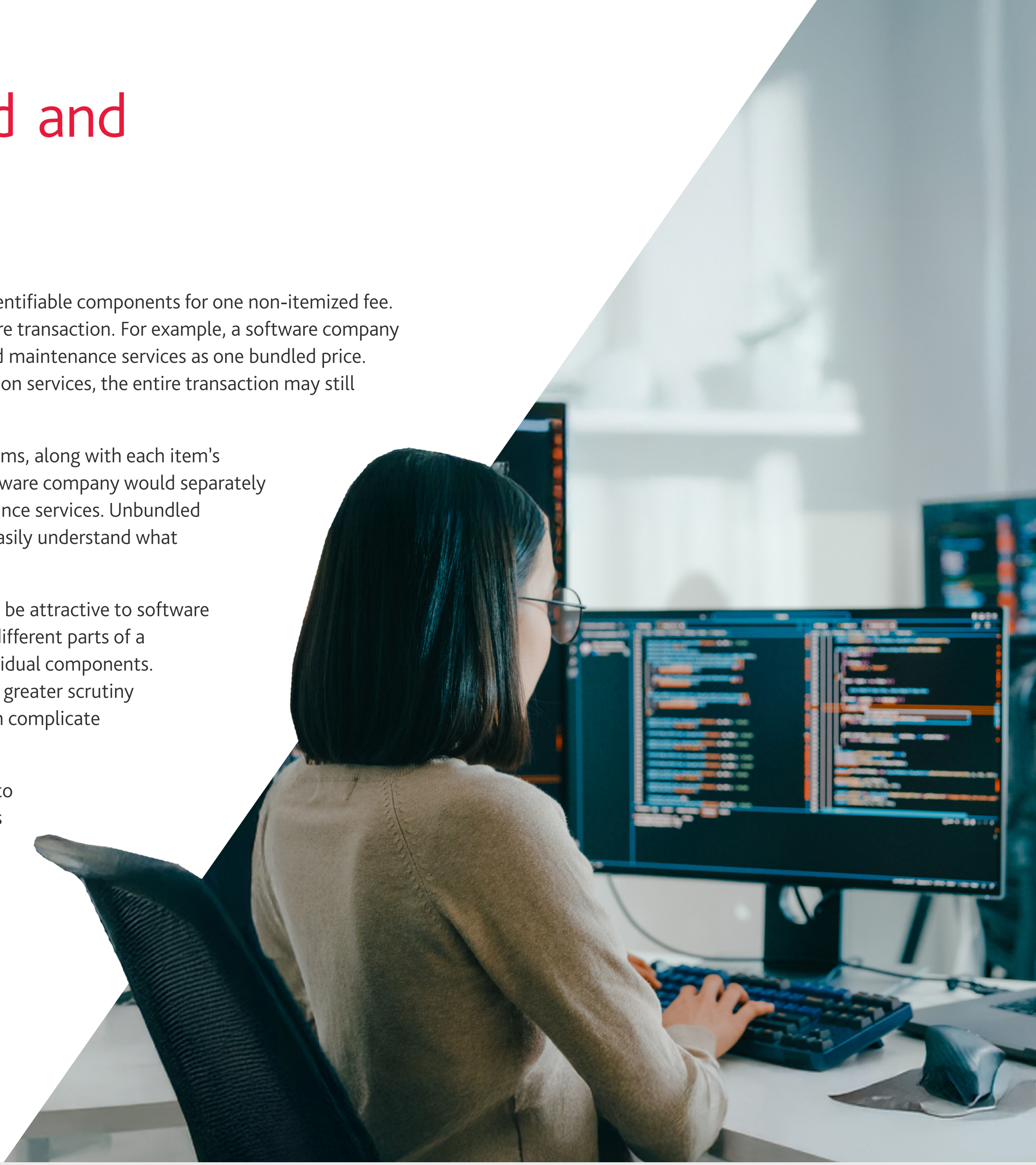
A bundled transaction generally consists of the sale of separately identifiable components for one non-itemized fee. If any component is subject to sales tax, the state could tax the entire transaction. For example, a software company invoices a product license, installation/implementation services, and maintenance services as one bundled price. Even if a state taxes just software, and not the related implementation services, the entire transaction may still be subject to tax.

Unbundled invoices list each product and service as separate line items, along with each item's corresponding price and sales tax treatment. Thus, our example software company would separately itemize the prices for the product license, installation, and maintenance services. Unbundled invoices provide the most transparency, allowing the purchaser to easily understand what charges were taxed.

Despite the advantages of unbundled invoices, bundled invoices can be attractive to software companies for several reasons. First, it is generally easier to bundle different parts of a transaction under one selling price rather than assign values to individual components. Second, listing the price of each component on an invoice can invite greater scrutiny from customers when comparing prices with competitors, which can complicate the sale process.

In some cases, bundled invoicing could result in less sales tax owed to the applicable state. If the taxable product component is de minimis in value compared to the exempt service component, some jurisdictions might consider the entire bundled charge exempt from sales tax. But this approach is not without risk. Many states are aggressive in taxing bundled transactions in their entirety irrespective of whether the taxable component is de minimis.

It is therefore understandable why companies frequently choose to bundle their invoices despite the possible sales tax complexities that doing so can create.



The Status of Software Taxation

To understand how unbundling invoices could affect a transaction, software companies must first understand the U.S. software taxation landscape.

State treatment of software, such as software as a service (SaaS), for sales and use tax purposes varies considerably. For example, Texas classifies SaaS as a taxable data processing service. By contrast, in California, SaaS is not taxable because it does not involve the transfer of tangible personal property. States like New Jersey tax electronically downloaded software, but because SaaS does not involve a transfer or download of software, it is not subject to sales tax.

The taxability of software can depend on many factors, such as whether the software is used for personal or business matters or if it is used in- or out-of-state. For instance, New York determines taxability based on where users are located, not where the software is hosted. In other states, SaaS is exempt if used in a business context.

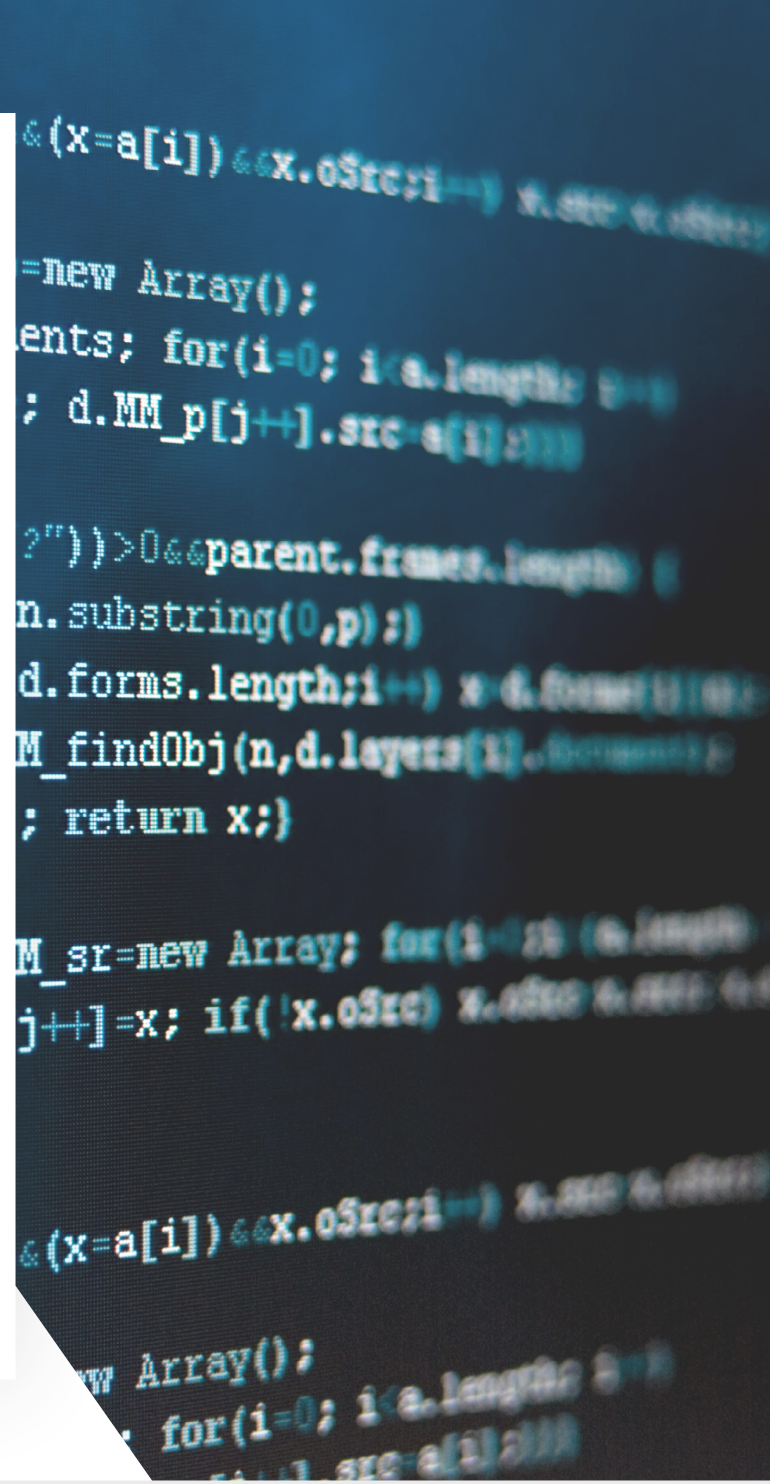
Home-rule local jurisdictions also have different tax requirements than the states where they are located, meaning taxes can also vary on a local or city level. Local taxes are applied on top of state taxes and can add yet another level of complexity. Chicago, for instance, taxes SaaS under its personal property lease transaction tax, while SaaS remains nontaxable at the state level in Illinois.

As a result, software companies typically have to conduct many different sales and use tax calculations at both the state and local levels to maintain compliance across all relevant jurisdictions.

For bundled transactions, some states apply the true (or primary) object test, de minimis test, or essence of the transaction test to determine taxability by identifying the transaction's primary purpose.

Under the true object test, if the intent of the transaction is to acquire a taxable good or service, the entire bundle will generally be deemed taxable. If the objective is to acquire a nontaxable service and the bundle includes a taxable good or service that is incidental, the entire bundle may be deemed nontaxable, depending on the state. For example, if an online advertising company offers a service to place ads online, it might also have software to enable those placements. But if the overall intent of the transaction is to purchase ad placement services, the bundle may be deemed nontaxable under the true object test.

By contrast, if a company purchases a software license, it might also purchase implementation and maintenance services for one nonitemized price. Because the intent of the transaction is to provide a software license, the entire bundle may be deemed taxable under the true object test.



Issues in Bundling Invoices

Given the complexities of software taxation, bundling invoices can lead to several critical issues for software companies to consider.

Consider over or under-taxation.

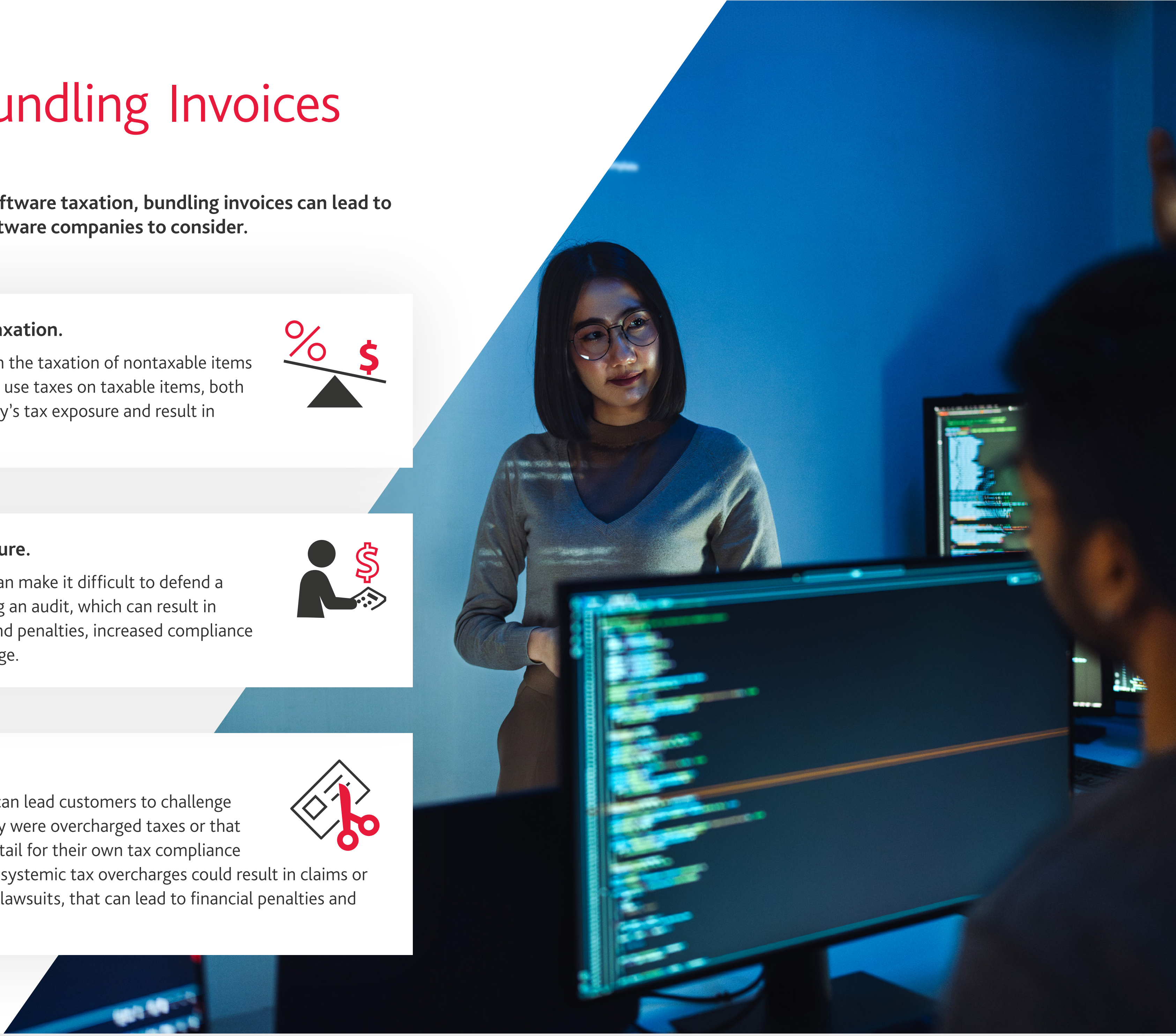
Bundling invoices can result in the taxation of nontaxable items or the failure to pay sales and use taxes on taxable items, both of which can affect a company's tax exposure and result in assessments on audit.

Manage your audit exposure.

Inadequate documentation can make it difficult to defend a company's tax position during an audit, which can result in additional tax assessments and penalties, increased compliance costs, and reputational damage.

Avoid customer disputes.

Choosing to bundle invoices can lead customers to challenge invoices on the basis that they were overcharged taxes or that the invoices lack sufficient detail for their own tax compliance requirements. In some cases, systemic tax overcharges could result in claims or disputes, such as class action lawsuits, that can lead to financial penalties and reputational damage.



Considerations for Unbundling Invoices

If you are considering shifting to unbundled invoices, the steps below can facilitate a smooth transition.

Understand the tax classifications of your offerings.

Analyze your products and services to better understand the substance of your offerings and how tax authorities will classify them for tax purposes. For example, while many technology companies use SaaS terminology in their marketing and branding materials, some might offer services that, from a tax perspective, fall under professional services. Accurate tax classification depends on the specific nature of the services provided, not the definitions companies create.

Involve your tax team in drafting contracts and designing invoices.

Companies often fail to bring their tax functions into decisions on invoicing or contracting until a problem arises. If sales tax professionals are brought in early, they can help verify the contract accurately represents what is provided and what will show up on the invoice, which could reduce sales and use tax exposure. Sales tax professionals can also help you maintain accurate documentation in case of an audit or other type of regulatory action.

Make sure your teams track all relevant data.

Sales and use tax compliance requires tracking not just where a product or service is sold but also where it is used or consumed. Your professionals, including salespeople, need to understand what data must be tracked from a tax perspective and why doing so is important. Educating and training your teams on the importance of data tracking will help verify they are capturing the necessary data and creating adequate documentation to support your tax positioning.

Adapt to changes in your products.

Changes to your products and services or the underlying technology could affect your tax compliance requirements. For example, if you are an online advertising company, you may eventually add generative artificial intelligence capabilities to produce insights about an ad's performance. That evolution could shift the tax classification from a service offering to a mixed transaction that includes both services (ad distribution) and products (performance reports), potentially changing your overall tax treatment.

Stay up to date on tax regulations.

As the digital economy continues to evolve, tax regulatory frameworks will adapt accordingly. Consistently monitor regulatory changes in all jurisdictions where you have operations or customers. Staying informed is crucial to correctly updating your tax positioning and maintaining compliance as the regulatory landscape changes.

Looking for support in understanding your sales and use tax compliance requirements?

Reach out to our state and local tax professionals to get the guidance you need. Contact Us Today. ▶

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