Vermont Decouples from Section 1202: What QSBS Investors Need to Know

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Section 1202[1] of the Internal Revenue Code provides a capital gains exclusion for investors and founders who hold qualified small business stock (QSBS). While the federal benefit is well-established and allows eligible taxpayers to exclude up to 100% of gain from the sale of QSBS held for the requisite period, whether that exclusion extends to state income taxes is a separate question that depends entirely on each state's own conformity decisions. A detailed overview of Section 1202's requirements and planning considerations can be found in the QSBS library.

Vermont's Act 164: A Departure from Federal Conformity

Until recently, Vermont followed the federal income tax treatment of QSBS, allowing Vermont resident taxpayers to benefit from Section 1202's gain exclusion at the state level.

But Vermont has now joined California, Pennsylvania, Mississippi, and Alabama in decoupling from Section 1202's tax exclusion on capital gains at the state level. H.933 was introduced in the Vermont House of Representatives, amending the definition of "taxable income," in the case of an individual, to mean federal adjusted gross income *plus* an amount equal to any gain excluded under Section 1202.[2] Put another way, the Section 1202 exclusion is an add-back for purposes of determining Vermont taxable income. This bill passed both houses of the Vermont General Assembly, and Gov. Phil Scott signed it into law on June 18, 2026. Importantly, this change applies retroactively to tax years beginning on or after January 1, 2026.[3]

Among the other states that do not recognize the Section 1202 exclusion, the nature of each state's decoupling differs. California's decoupling is explicit by statute, whereas Pennsylvania, Mississippi, and Alabama make no mention of Section 1202 or QSBS in their respective codes. For a comprehensive look at the full state conformity landscape, including states that have recently moved toward conformity, see our earlier survey, *Section 1202 and QSBS: A Survey of States That Don't Conform to the Federal Treatment and States That Have Recently Conformed to IRC Section 1202*.

What This Means for Vermont Taxpayers

Vermont's decoupling serves as a reminder that QSBS planning must account for the state income tax dimension, not just federal eligibility. As states, which must balance their annual budgets, continue to independently evaluate their conformity to Section 1202, the landscape can shift in either direction. Vermont taxpayers who own QSBS should act promptly to model the state income tax impact of any upcoming sale or exchange.

For Vermont residents who hold QSBS with significant embedded gain, this statutory change represents a meaningful change in the tax calculus. A taxpayer who qualifies for a 100% federal gain exclusion on a substantial QSBS sale, including under the One Big Beautiful Bill Act's new tiered exclusions for QSBS held three or four years, will now owe Vermont state income tax on the entire gain. Investors and business owners in Vermont should carefully consider the state income tax implications when planning QSBS-related transactions.

For additional background on Section 1202 and the federal treatment of qualified small business stock, visit our QSBS & Tax Planning Services page.

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[1] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended. Not all states follow the federal income tax treatment of QSBS.

[2] Vermont H.933, Sec. 55a, *available at* ACT164 As Enacted.pdf.

[3] H.933, Sec. 64(9).