Section 1202 and QSBS: A Survey of States That Don't Conform to the Federal Treatment

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Section 1202 of the Internal Revenue Code provides a capital gains exclusion for certain qualified small business stock (QSBS) when a stockholder sells the same. This gain exclusion impacts venture-backed startups, angel investors, and many in private equity looking to reap the benefit of Section 1202. Many of the facets and requirements regarding Section 1202 and QSBS can be found in Frost Brown Todd's QSBS library and on our QSBS & Tax Planning Services page.

Section 1202 received some major updates after the One Big Beautiful Bill Act (OBBBA), signed into law by the president on July 4, 2025, changed up the game![1] These changes included a tiered gain exclusion regime allowing taxpayers to exclude a portion of the gain on QSBS held for at least three or four years—a significant shift from the prior all-or-nothing approach under which no exclusion was available unless the stock was held for the full five-year period. [2]

Additionally, these gains that can now be excluded at the three-year and four-year mark will not be allowed to qualify as alternative minimum tax (AMT) preference items and thus be allowed to avoid additional alternative minimum tax burdens. One of the other big changes is that the OBBBA raises the gross asset threshold from $50 million to $75 million (with inflation adjustments beginning in 2027). For a more detailed breakdown of the OBBBA and its impact on Section 1202, see our previous article, "One Big Beautiful Bill Act Doubles Down on QSBS Benefits for Startup Investors."

While Section 1202 provides a gain exclusion at the *federal level*, states are free to adopt their own rules for how QSBS gains are treated for state income tax purposes. Currently, only a handful of states do not conform to the federal treatment of QSBS. These include California, Pennsylvania, Mississippi, and Alabama. Although New Jersey was previously among this group, recent legislation

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brings the state into conformity beginning in 2026, with certain limitations and timing considerations.

California law, unlike the other three states that provide no QSBS benefit, explicitly provides that it does not recognize any QSBS exclusion under Section 1202, even in partial conformity.[3] Therefore, a taxpayer who qualifies for up to 100% of the QSBS gain exclusion at the federal level is taxed on the full amount of gain. Moreover, this applies to residents and nonresidents with income sourced to California.

In a similar vein, but not as explicit as California law, Pennsylvania, Mississippi, and Alabama do not provide any exclusion for QSBS or conform to Section 1202. Thus, any gain from QSBS will be taxed at the state level. Moreover, these three states make no mention of Section 1202 or QSBS in their respective codes. Investors and business owners in these states should carefully consider the tax implications if planning QSBS-related transactions in any of the four above-mentioned states.

Recent legislation in New Jersey provided a big win for investors and business owners in possession of QSBS. On June 30, 2025, the governor of New Jersey signed Bill A4455/S4503 into law. This bill brought New Jersey into conformity with Section 1202 for tax years beginning on or after January 1, 2026.[4] The legislation not only applies prospectively, but it also opens the door for those who previously held QSBS (and meet the five-year holding requirement as of 2026) or who properly rolled over their gains under Section 1045 into eligible replacement QSBS to now potentially claim the federal exclusion for New Jersey state income tax purposes as well. Taxpayers who rolled QSBS gains using Section 1045 should carefully analyze whether their replacement stock now qualifies for the exclusion under New Jersey law.

Will the last remaining hold-out states follow New Jersey's lead? Only time will tell. For now, it is important that investors know that QSBS transactions in the last remaining four states that do not offer any QSBS gain exclusion could result in capital gain treatment at the state level.

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Please reach out to the authors of this article if you have questions or concerns as it relates to QSBS and the changes enacted under the OBBBA. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state and local tax planning and tax administration.

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[1] One Big Beautiful Bill Act, H.R. 1, 119th Cong. § 70431 (2025).

[2] This tiered system broke away from the required five-year holding period required by § 1202 and put into place exclusion amounts for stock issued on or after July 5, 2025. The tiered system contains: 50% exclusion for stock held for at least three years, 75% for four years, and 100% for five years or more.

[3] *See* Cal. Rev. & Tax. Code § 18152 (providing "Section 1202 of the Internal Revenue Code, relating to the 50-percent exclusion for gain from certain small business stock, does not apply.").

[4] N.J. Sess. Law No. 4455 (2025), *available at* https://legiscan.com/NJ/text/A4455/2024.

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