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Illinois Opts Out of QSBS Treatment

August 4, 2026

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Overview

Illinois has enacted a significant change to its income tax treatment of Qualified Small Business Stock ("QSBS") under Section 1202 of the Internal Revenue Code. Beginning with sales occurring in the 2026 tax year, Illinois will no longer recognize the federal exclusion from gain available for QSBS. Although the federal Section 1202 exclusion remains unchanged, Illinois taxpayers will be required to add back federally excluded QSBS gain in computing Illinois income tax. This development is likely to be of particular importance to founders, early-stage investors, key equity holders, and families using trust structures to hold QSBS, especially where a sale or other liquidity event may be on the horizon.

Background

Section 1202 of the Internal Revenue Code permits eligible taxpayers to exclude some or all gain from the sale of QSBS, subject to applicable statutory requirements and limitations. Historically, state treatment of that exclusion has varied. With this change, Illinois joins several jurisdictions that have chosen not to conform fully to the federal regime.

Key Takeaways

- **Effective Date.** The new Illinois rule applies to sales of QSBS beginning in the 2026 tax year.
- **Federal Treatment Unchanged.** The federal exclusion under Section 1202 is unaffected.
- **Illinois Addback Required.** Illinois taxpayers will nevertheless be required to add back federally excluded QSBS gain for purposes of calculating Illinois income tax.
- **Illinois Joins Other Nonconforming States.** Illinois now joins other states that have decoupled from the federal QSBS exclusion, including California, Maine, Oregon, Vermont, Pennsylvania, Alabama, and Mississippi.
- **Residency Planning May Become More Important.** The change may increase the relevance of residency planning for founders and other QSBS holders, particularly where substantial built-in gain exists and a future exit is anticipated.
- **Trust-Owned QSBS Raises Additional Complexity.** Residency planning may be less flexible where QSBS is held through irrevocable trusts, especially where "QSBS stacking" has been implemented using non-grantor trusts originally established in Illinois.

Planning Considerations

This change is more than a technical state tax conformity issue. For affected taxpayers, it may materially reduce after-tax proceeds from a sale that otherwise would have been expected to benefit from favorable Section 1202 treatment. In particular, the new rule may warrant renewed attention to the following issues:

- **Individual Residency.** Founders and other individual QSBS holders may wish to evaluate whether a change in state residency before a sale is feasible and advisable.
- **Trust Situs and Administration.** Taxpayers holding QSBS through irrevocable trusts should consider whether trust situs, administration, and governing structure create Illinois tax exposure that cannot easily be mitigated.
- **Exit Timing.** Taxpayers anticipating a sale after 2025 should review whether timing considerations affect the overall state tax analysis.
- **Existing QSBS Planning Structures.** Structures designed to maximize Section 1202 benefits, including non-grantor trust planning, should be revisited in light of Illinois's new nonconformity.

Conclusion

Illinois's decision to opt out of federal QSBS treatment has meaningful implications for taxpayers expecting to rely on Section 1202 in a future liquidity event. Illinois residents, Illinois-based trusts, and taxpayers with significant QSBS positions should evaluate promptly whether existing residency, trust, and transaction planning remains efficient under the new regime. Early review may be particularly important where substantial appreciation is involved, because once a sale process is underway, opportunities to improve state tax treatment may be significantly more limited.

If you have questions or would like additional information, please contact Kilpatrick's Private Client Practice.

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