Is a QSBS Constitutional Crisis Looming in New Jersey?

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In this article, the authors use an example in California to examine potential constitutional issues concerning recently enacted New Jersey legislation that adds a qualified small business stock provision to the state's tax code.

The following is not legal advice and is for educational purposes only.

Introduction: New Jersey and QSBS

Given the significant tax benefits involved, nearly 90 percent of early-stage equity financing deals include representations related to qualified small business stock (QSBS).[1] Eligible taxpayers who sell QSBS may potentially qualify for a capital gains exclusion equal to the greater of $15 million or 10 times their investment basis.[2] Because QSBS plays a major role in the start-up economy,[3] some states have been debating whether to align their tax codes more closely with the federal QSBS rules.

New Jersey is one of those states, and on June 30, 2025, Gov. Phil Murphy (D) signed QSBS state legislation into law as Chapter 67.[4] New Jersey joins 45 other states that follow the federal QSBS rules.[5] New Jersey had legitimate concerns before adopting this legislation, particularly about losing tax revenue. But ultimately the absence of a state-level QSBS incentive may have put the state at a competitive disadvantage because founders had a larger incentive to launch start-ups or establish funds in nearby states like New York or Maryland that fully conform. As a result, before enactment, New Jersey may have missed out on job creation, long-term tax revenue from successful

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[1] Aumni Blog, "QSBS Representation Inclusion Shows Strong Momentum" (Dec. 12, 2024).

[2] IRC section 1202(b)(1). Note that this law applies to all stock issued after the enactment of the One Big Beautiful Bill Act (P.L. 119-21). Also, the tax benefits of QSBS under federal laws can be even larger. For instance, one strategy involves stacking the benefits of QSBS using trusts. *See, e.g.*, Christopher A. Karachale and Ethan Osheroff, "Stacking Qualified Small Business Stock: New Guidance on Anticipatory Assignment," *Tax Notes Federal*, July 24, 2023, p. 523.

[3] *See, e.g.*, Philip Wolf, "The San Francisco Small Business Expo: A Tax Perspective," *Tax Notes Federal*, Sept. 25, 2023, p. 2349.

[4] Office of the New Jersey Governor release, "Governor Murphy Signs Fiscal Year 2026 Budget Into Law" (June 30, 2025).

[5] *See, e.g.*, "QSBS Rules by State," QSBS Expert (last visited July 10, 2025).

homegrown companies and employees, inflow of investment capital, and ultimately a stronger and more competitive innovative economy. Had New Jersey not adopted state QSBS legislation, these missed opportunities might have become even more pronounced now that the One Big Beautiful Bill Act (P.L. 119-21) expanded the federal QSBS rules.

With New Jersey now conforming to federal QSBS rules, the state may soon face legal challenges like those seen in other states. For example, in 2012 a state court struck down a California QSBS provision as unconstitutional.[6] New Jersey's newest effort to adopt QSBS legislation recalls the constitutional battle in *Cutler*, leading us to ponder if the New Jersey law might face a similar fate.

What Is QSBS and Why Did New Jersey Adopt a State-Level Equivalent?

QSBS refers to stock issued by a qualified small business that meets specific requirements under section 1202 of the Internal Revenue Code. These requirements are complex and outside the scope of this article,[7] but, put simply, eligible holders who later sell their QSBS can receive up to a 100 percent federal capital gains exclusion on qualifying investments in small businesses.[8] Congress enacted the QSBS rules to address the challenges faced by small businesses attempting to raise equity capital.[9] By offering a substantial tax exclusion for gains on QSBS, Congress sought to make investments in small businesses more attractive relative to other investment opportunities and to encourage U.S. innovation.[10]

Because of the QSBS rule's significant tax savings and strong congressional support for the policy, many founders, venture capitalists, investors, and others are drawn to conducting business in states that have conforming QSBS provisions in their tax codes. To understand why, consider the following scenario that would have played out if New Jersey's QSBS law had not passed.

Two founders lead their company to a successful exit after five years, and each realizes a capital gain of $10 million. Founder 1 lives in New York City and Founder 2 lives across the Hudson River in Hoboken, New Jersey. From a federal tax perspective, both founders would be treated the same: Neither would be subject to the 20 percent capital gains tax or the 3.8 percent net investment income tax. But at the state and local tax level, each founder would have been treated differently based on where they lived.

In New York City, Founder 1 will not pay the New York state-level capital gains tax of 8.82 percent or the New York City income tax of 3.8 percent.[11] Because New Jersey did not conform to section 1202, however, Founder 2 would have needed to pay the state's top rate of 10.75 percent on the $10 million in gain (or $1.075 million in tax before adjustments).[12] This disparity might have pushed founders away from New Jersey and disadvantaged local start-ups attempting to attract capital. Investors might have been afraid of becoming subject to New Jersey state tax on their otherwise QSBS-eligible stock and might have avoided that jurisdiction for similar reasons.[13]

6 *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (Cal. Ct. App. 2012).

7 For more about the requirements to qualify for QSBS treatment under section 1202, see "Learn the Basics of QSBS," QSBS Expert (last visited June 20, 2025). See also the articles available at "QSBS Investor's Hub," Hanson Bridgett LLP (last visited July 1, 2025).

8 Section 1202(a)(4).

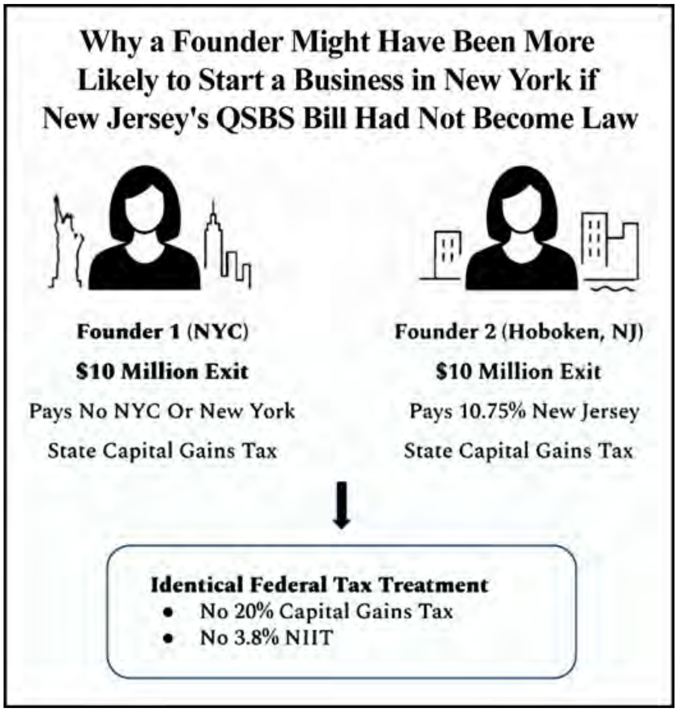
9 *See, e.g.*, H.R. Rep. No. 103-111, at 831 (1993) ("The committee believes that targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies, will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.").

10 *See generally* 139 *Cong. Rec.* 2721-2729 (Feb. 16, 1993), stating that QSBS is "a capital investment tax incentive that challenges Americans to make high-risk, long-term, growth-oriented investments in the enterprises that will lead America into the 21st century." *See also* "History of Section 1202 Qualified Small Business Stock (QSBS)," QSBS Expert (May 31, 2020).

11 *See, e.g.*, N.Y. Tax Law section 612(u)(1); N.Y. Tax Law section 1303.

12 "New Jersey State Income Tax in 2025: A Guide," Intuit TurboTax Blog (Feb. 28, 2025).

13 As described at greater length below, California imposes an even more onerous state personal income tax of 13.3 percent on otherwise federally excludible QSBS gains.



Given this disparity, many members of the New Jersey business community had pushed the state to enact its own QSBS legislation. When advocating for a New Jersey QSBS law, TechUnited, a nonprofit organization dedicated to empowering innovators, entrepreneurs, and professionals in the technology and life sciences sectors throughout New Jersey, noted that the state could realize significant benefits, including attracting "a wave of new residents — venture capitalists, angel investors, and entrepreneurs" who "would bring not only their wealth but also their knowledge, experience, and connections, which could be leveraged to foster local innovation and economic growth."[14]

Brian Smiga, a founding partner at Alpha Partners, wrote that he believed QSBS would be "the best job-creator and ultimate revenue generator for" New Jersey.[15] A founder of six New Jersey companies, Rutgers University professor Richard E. Riman lamented how he had "lost good candidates" for his start-up companies because of New Jersey's previous policy and how New Jersey "is too small to give people reasons to live in" Pennsylvania, Delaware, New York, and Connecticut, so New Jersey "loses a lot of other sources of tax revenue."[16] These comments show why many thought New Jersey had a compelling need and opportunity to adopt QSBS-conforming legislation.

Why Some Opposed QSBS Conformity in New Jersey

Not everyone in the state of New Jersey supported conforming to the federal QSBS laws. Common concerns included the potential loss of state revenue from capital gains taxes, questions about fairness and complexity, and fears of misuse. Others believed that alternative policies might have better aligned with New Jersey's goals. These concerns were legitimate, but they overlooked the broader economic benefits of conformity or otherwise failed to address the true underlying issue causing the criticism.

Concerns That QSBS Conformity Could Lead to Revenue Loss

One common argument against adopting QSBS in New Jersey was the concern that excluding large capital gains could lead to a loss in state tax revenue. There may well be some short-term revenue reductions, but the long-term economic benefits of technology companies moving into New Jersey as a result of QSBS conformity may likely outweigh the initial costs. New York City's tech ecosystem reportedly accounted for more than 291,000 jobs and $124.7 billion in economic output.[17] The tech sector in Washington state contributes $138.7 billion to the state's economy (21.8 percent of it), attracts more than $7.73 billion in annual venture capital investment, and employs nearly 360,000 workers statewide.[18] Tech workers in many states are known to make "anywhere from 20 percent to 85

[14] TechUnited New Jersey, "Why NJ Needs to Recognize QSBS Like 45 Other States in the US" (Sept. 16, 2024). *See also* Lori Campos, "The Ultimate Incentive: TechUnited's Price Feels Adopting Federal QSBS Policy for Startups Will Help State Attract Even More Investments and Entrepreneurs," ROI-NJ (Jan. 15, 2025).

[15] TechUnited New Jersey, "NJ QSBS Response From the Entrepreneur and Investor Community" (Sept. 19, 2024).

[16] *Id.*

[17] New York City International Business, "Technology and Media Industry" (last visited June 20, 2025).

[18] Choose Washington State, "Information & Communications Technology" (last visited June 20, 2025).

percent more than their state's average salary."[19] These high-paying jobs create a positive income shock that can boost state revenues through increased income tax collections, even as capital gains go untaxed.[20]

One counterargument to this point is that California does not have QSBS legislation, but it continues to be a leader in the start-up space.[21] Although this is true, the absence of QSBS conformity may actually be limiting California's full potential. If California were to adopt QSBS legislation, it might see even greater start-up activity, more capital formation, and stronger retention of high-growth companies that might otherwise relocate to more tax-friendly states.[22]

Concerns That QSBS Conformity Would Be Inequitable

Another argument often raised against the New Jersey QSBS law was that the tax incentive is not equitable and primarily benefits wealthy investors. This concern is understandable, but it overlooks the fundamental issue, which is tax awareness. Many entrepreneurs do not learn about QSBS until it is too late for them to set up their businesses in a way that takes advantage of the benefits. Gaps in tax knowledge are particularly acute in minority and underserved communities, where discussions about finance and taxation can be seen as taboo or inaccessible.[23] The solution is not to discard QSBS but to expand education about it. As Congress noted, the purpose of section 1202 is to encourage investors and venture capitalists to take more risks and to support small businesses that may lack access to traditional sources of funding.[24] With greater awareness, QSBS has the potential to promote equality by making it easier for founders from disadvantaged communities to raise early-stage capital.

Concerns QSBS Is Less Effective Than Upfront Subsidies for Small Business

Some critics argued that New Jersey might prefer upfront subsidies over QSBS to support small businesses. Although subsidies can encourage business creation, they provide financial rewards regardless of whether a business succeeds. As we learned from COVID-19 programs like Paycheck Protection Program loans, which were forgivable under certain conditions, direct financial assistance is vulnerable to abuse.[25] QSBS rewards only businesses that succeed, making it a more targeted and potentially cost-effective incentive. By adopting QSBS rules, New Jersey should be able to reduce or even eliminate the need for costly upfront subsidies. Moreover, if states choose to continue prioritizing subsidies, QSBS can complement those efforts, allowing the approaches to work together.

Concerns That QSBS Is Not Aligned With New Jersey's Current Economic Landscape

A final critique of QSBS was that it might not align perfectly with New Jersey's current economic landscape. New Jersey's economy includes major pharmaceuticals, life sciences, financial services, advanced manufacturing, information technology, transportation, and logistics sectors.[26] It also has large agriculture and tourism industries.[27]

Some of these sectors are not traditionally associated with QSBS (for example, IRC section

[19] Trevor Wheelwright, "The Top Tech Salaries in the U.S. in 2021," Business.org (July 12, 2021).

[20] Because of the niche nature of QSBS, the field is understudied. Further analysis would be required to determine the extent to which QSBS plays in the statistics cited. But in practice, many founders shy away from states that do not have QSBS-conforming code sections.

[21] Roseann Cattani, "California Ranks Second in the Nation for New Business Creation," *Palm Springs Desert Sun*, Mar. 22, 2025.

[22] *See, e.g.*, NSKT, "What Is the QSBS Tax Exemption in California?" (Mar. 24, 2025).

[23] *See, e.g.*, Wolf, "A Window Into the Life of an Enrolled Agent and the Black Taxpayer Community," *Tax Notes Federal*, July 15, 2024, p. 541. In this article, Wolf interviews tax practitioner Nayo Carter-Gray about the challenges that African American entrepreneurs face. Carter-Gray explains that one major challenge some African American business owners face is a cultural taboo around discussing taxes and finances.

[24] Benjamin M. Willis and Ryan J. Dobens, "Building Back Biden's American Start-Up," *Tax Notes Federal*, Nov. 29, 2021, p. 1247 (citing H.R. Rep. No. 103-111, at 831 (1993)).

[25] U.S. Small Business Administration, "COVID-19 Pandemic EIDL and PPP Loan Fraud Landscape and Recommendations Update," Report 25-10 (Mar. 31, 2025).

[26] New Jersey Office of Innovation Business Portal, "Frequently Asked Questions (FAQs): What Are New Jersey's Principal Industries?" (last visited July 10, 2025).

[27] Kimberly Redmond, "Garden State's $1.5B Agriculture Industry 'Going Strong' Thanks to Innovation," NJBIZ, Oct. 16, 2023.

1202 excludes financial services or farming businesses from the definition of a "qualified trade or business").[28] But New Jersey's QSBS law may complement and even enhance the ones that do qualify, thereby stimulating innovation. It could encourage the growth of tech start-ups that support and extend the capabilities of established industries like pharmaceuticals and manufacturing. The law could also encourage tourism-related tech start-ups that improve visitor experiences and promote the state as a vacation destination (which is fitting for a place proudly known as the Garden State). Rather than competing with established sectors, the New Jersey QSBS law could encourage a dynamic ecosystem where new businesses drive growth and innovation alongside traditional industries.

Will New Jersey Suffer California's Fate?

New Jersey's QSBS law could still be challenged, just as in California. In *Cutler*,[29] a California court of appeal deemed the state's previous QSBS tax benefit unconstitutional under the interstate commerce clause of the U.S. Constitution. Before *Cutler*, Cal. Rev. & Tax. Code section 18152.5 had granted QSBS exclusion benefits. In addition to imposing the federal QSBS requirements, it had required that at least 80 percent (by value) of the assets of the qualified small business be used in the active conduct of one or more qualified trades or businesses in California. In addition, at least 80 percent of the corporation's total payroll expense had to be attributable to employment located within the state.

In *Cutler*, the taxpayer filed a protest asserting, *inter alia*, that the California QSBS statute unfairly discriminated against investors in companies that conduct a portion of their business outside California. The California Court of Appeal, Second District, agreed.

Applying the U.S. Supreme Court decision in *Fulton Corp.*,[30] the California Court of Appeal found that Rev. & Tax. Code section 18152.5 favored investment in corporations doing business within California and operated as a disincentive to buying stock in corporations doing business outside California. The *Cutler* court ruled that a provision requiring 80 percent of a company's payroll to be in state violated the dormant commerce clause. The taxpayer's win in *Cutler* was Pyrrhic because after the date of the decision, California residents have not received QSBS benefits on their state-level gains.[31]

As in California, previous versions of the New Jersey QSBS legislation contained in-state business activity requirements, such as thresholds for in-state payroll or operations, that could have raised constitutional concerns under the dormant commerce clause. However, the final version of New Jersey's law seems to have attempted to avoid these pitfalls by aligning more closely with the federal QSBS framework and omitting any explicit in-state activity mandates. This more neutral approach may help the law withstand legal scrutiny, but challenges could still arise. Opponents might argue that even indirect effects of the law create incentives favoring in-state over out-of-state businesses. As such, while New Jersey has taken steps to reduce its constitutional exposure, it remains to be seen whether the law will face litigation similar to *Cutler*, and how courts will respond if it does.

Conclusion

By following the current federal QSBS policy, New Jersey is poised to attract greater investment, foster start-up growth, and position itself as a more competitive hub for innovation-driven businesses. The policy promises a competitive, equitable, and legally resilient tax framework. It remains to be seen if the new law will withstand any constitutional challenges that come its way. But by conforming to the federal QSBS policy, New Jersey is encouraging entrepreneurs and investors to build and scale start-ups within the state and fostering a dynamic innovation ecosystem that drives job creation, business growth, and sustainable economic development for years to come. ■

[28] *See, e.g.*, section 1202(e)(3)(A) and section 1202(e)(3)(C). Note that New Jersey's new legislation is based off the language used in section 1202.

[29] *Cutler*, 208 Cal. App. 4th 1247.

[30] *Fulton Corp. v. Faulkner*, 516 U.S. 325, 330 (1996).

[31] *See also* FTB Notice 2012-03 (Dec. 12, 2012).