

Subject Net investment income tax applied to business income from an S corporation in which the taxpayer materially participated

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Summary

Under current law, Minnesota imposes a net investment income tax (NIIT) on individuals, estates, and trusts. The tax is one percent of “net investment income” in excess of \$1,000,000.

“Net investment income” is defined in federal law, which imposes a 3.8 percent tax on such income in excess of \$250,000. Net investment income is defined in federal law to include interest, dividends, annuities, royalties, rents, capital gains, business income from a “passive activity” in which the taxpayer did not materially participate, and trade or business income from trading in financial instruments and commodities. The state NIIT excludes from the definition of “net investment income” any capital gains on the sale of class 2a agricultural property.

H.F. 4123 expands the definition of “net investment income” to cover all income from a trade or business that is not subject to federal Social Security and Medicare taxes on self-employment income. In practice, this mostly expands the state definition of net investment income to include business income from an S corporation in which the taxpayer materially participated.

Background on material participation

Treasury Department regulations include a seven-part test to determine if a taxpayer materially participated in a trade or business, which determines if the business income is active or passive. The determination of whether the income is passive or active will determine if business income is subject to the federal and state NIIT under current law (most business income from activities in which the taxpayer materially participated is exempt from the NIIT).

An individual is considered to materially participate in a business activity if: (1) the individual worked more than 500 hours for the business; (2) the individual’s participation represented 85 percent of all participation in the business; (3) the individual worked more than 100 hours for the business and nobody worked more than the individual; (4) the individual worked for several businesses for more than 100 hours and the total number of hours is greater than 500; (5) the individual materially participated in the business for five of the ten preceding taxable years; (6) the business is a “personal service activity” (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or any business in which capital is not a material income-producing factor) and the individual materially participated in any three preceding taxable years; and (7) based on the overall “facts and circumstances” the individual

participated in the business in a regular, continuous, and substantial basis during the year. No individual who participated for less than 100 hours may qualify under clause (7).



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