

## Michigan SALT Workaround Update: Accrual Taxpayers

Article By:

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As a follow up to our tax advisory issued December 23, 2021, pertaining to Michigan's new SALT workaround ([Michigan Tops the Growing List of States with a SALT Cap Workaround for Pass-Through Entities](#)), we are providing this update to alert accrual-basis taxpayers regarding the Michigan SALT workaround and the deductibility of taxes under section 164.

Section 164(a) of the Internal Revenue Code provides a deduction for state and local income taxes "paid or accrued". Under normal accrual method accounting rules, taxes may be deducted if both of the following apply:

1. The all events test has been met (i.e. all events have occurred that fix the fact of liability, and the liability can be determined with reasonable accuracy); and
2. Economic performance has occurred.

With respect to taxes, economic performance generally occurs when taxes are paid. However, there is an exception to this for recurring items that meet four requirements:

1. The all-events test is met.
2. Economic performance occurs by the earlier of:
  - 8½ months after the close of the year, or
  - The date you file a timely tax return (including extensions) for the year.
3. The item is recurring in nature and the taxpayer consistently treats similar items as incurred in the tax year in which the all-events test is met, and
4. Either:
  - The item is not material, or

- Accruing the item in the year in which the all-events test is met results in a better match against income from accruing the item in the year of economic performance.

Thus, under normal instances, if payment of tax is made by an accrual-basis taxpayer with a timely filed tax return in the following year and the rest of the elements above are met, state income taxes can be deducted on an entity's federal return. Applying the normal accrual rules to the Michigan SALT cap workaround without additional authority, a partnership/S corporation that makes an election to be taxed at the passthrough entity level but does not pay such taxes until it files a timely return may still deduct Michigan income taxes if the elements above are met.

There is substantial concern, however, that the IRS may challenge this deduction based on authority issued. In Notice 2020-75, the IRS provided a limited blessing of certain SALT workarounds but focuses on where "specified income tax payments" are made. The notice does not specifically address accrual taxpayers, or whether accrual accounting rules would still apply to such taxes allowing payment in the following year. There are also concerns that the IRS may view passthrough entity taxes paid by accrual taxpayers as not satisfying the accrual accounting rules because of the elective nature of the tax.

Given the lack of certainty in this area, the conservative position for accrual-basis taxpayers should be to pay the passthrough entity tax by December 31, 2021. Payments can be made today on the Michigan Treasury Online system, which also triggers the election for the passthrough entity tax. From communications with the State of Michigan, we expect additional guidance to be issued in January of 2022 for the Michigan SALT workaround, including the release of the election form.

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