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## TRANSACTIONS

## The Anti-Gross-Up: Reducing the Tax Gross-Up by the Recipient's Tax Benefits

Islame Hosny

In many tax gross-up arrangements, the recipient may receive an incremental tax benefit from the gross-up. Yet, reducing the gross-up by the value of that benefit can become a contentious topic in many transactions because of the difficulty in computing the amount of the benefit. On the one hand, the incremental tax benefit would ostensibly reduce the recipient's tax cost, and thus the gross-up. On the other hand, however, the reduced gross-up reduces the incremental tax benefit – creating a seemingly endless chain of adjustments to the tax gross-up. This article presents an approach for determining the proper downward adjustment to the gross-up in situations where the gross-up provides a tax benefit to the recipient.

### A PRELIMINARY FRAMEWORK: COMPUTING REDUCTIONS TO PAYMENTS NOT SUBJECT TO GROSS-UP WHERE THE RECIPIENT RECEIVES A TAX BENEFIT FROM THE PAYMENT

In searching for the proper model to articulate a possible formula, it may be helpful to first consider a situation that involves no gross-up. For example, assume A promises to pay B \$100 but that amount is subject to reduction for any tax benefit realized by B from the \$100 payment. Assume further that B is subject to a 10% state income tax rate and a 37% federal income tax rate.<sup>1</sup> Our goal is to find the proper reduction to the \$100 payment to B such that after such reduction, the tax benefit that B receives from the remaining payment is equal to the reduction. This can be modelled by the following equation:  $(p - r) \times s = r$ , where  $p$  is the unadjusted payment,  $r$  is the reduction to the unadjusted payment on

account of the tax benefit arising from the payment, and  $s$  is the tax rate used to determine the tax savings or benefit derived from the payment. Solving for  $r$  (see *Exhibit 1*) yields Formula a:  $r = ps / (1 + s)$ .

Substituting the values from the above example for the variables in Formula a would result in the following:  $r = ((\$100 \times (0.1 \times 0.37))) / (1 + (0.1 \times 0.37)) = ((\$100 \times 0.037)) / 1.037 = \$3.70 / 1.037 = \$3.57$ , which means that the \$100 payment should be reduced by \$3.57.

To confirm that this is correct, the net payment would be  $\$100 - \$3.57 = \$96.43$  and would generate a federal tax deduction to B in the amount of  $\$96.43 \times 10\% = \$9.64$  and which would have a value of  $\$9.64 \times 37\% = \$3.57$ . Thus, the reduction to the unadjusted payment is equal to the value of the tax benefit from the adjusted payment. Another way of looking at

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## The Anti-Gross-Up: Reducing the Tax Gross-Up by the Recipient's Tax Benefits

CONTINUED FROM PAGE 1

### Exhibit 1: Formula a

$$\begin{aligned}
 (p-r) \times s &= r \\
 \frac{(p-r) \times s}{s} &= \frac{r}{s} \\
 p-r &= \frac{r}{s} \\
 p-r+r &= \frac{r}{s}+r \\
 p &= \frac{r}{s}+r \\
 p &= \frac{r}{s}+\frac{rs}{s} \\
 p &= \frac{r+rs}{s} \\
 p &= r \times \left(\frac{1+s}{s}\right) \\
 p \times \left(\frac{s}{1+s}\right) &= r \times \left(\frac{1+s}{s}\right) \times \left(\frac{s}{1+s}\right) \\
 p \times \left(\frac{s}{1+s}\right) &= r \\
 r &= p \times \left(\frac{s}{1+s}\right)
 \end{aligned}$$

**Formula a:** Reduction for tax benefits =  $r = \frac{ps}{1+s}$

this is that the unadjusted payment equals the reduction to the unadjusted payment plus the adjusted payment,<sup>2</sup> which results in Formula b: unadjusted payment =  $p = r + q$ , where  $q$  is the after-tax-benefit payment. Inputting the amounts from the above example into Formula b would render the following:  $\$100 = \$3.57 + \$96.43$ .

Thus, B would effectively receive a total of \$100: \$96.43 would be paid by A and \$3.57 would be the value of B's tax deduction generated by the \$96.43 payment made by A. By manipulating Formula a and Formula b, we can find  $q$  in terms of  $p$  and  $s$  (see Exhibit 2), which produces Formula c:  $q = p/(1+s)$ .

To summarize the above, to find the reduction for tax benefits to the unadjusted payment we would use Formula a: reduction for tax benefits =  $r = ps/(1+s) = ((\$100 \times 0.037))/1.037 = \$3.70/1.037 = \$3.57$ . To find the after-tax-benefit payment, we would use Formula c: after-tax-benefit payment =  $q = p/(1+s) = \$100/1.037 = \$96.43$ .

However, the above analysis does not answer the question of how to compute the reduction for tax benefits or the after-tax-benefit payment in the event the payment is subject to a gross-up.

### THE ANTI-GROSS-UP: ENHANCING THE PRELIMINARY FRAMEWORK TO TAKE INTO ACCOUNT THE GROSS-UP

Even though Formula a, Formula b, and Formula c do not consider the effects of any tax gross-ups, they do offer a helpful framework for computing the after-tax-benefit payment in a tax gross-up context. For example, assume C promises to pay D \$100, subject to a gross-up, D's federal and state income tax rates<sup>3</sup> applicable to the grossed-up payment are 20% and 10%, respectively, and D's tax rate on ordinary income is 37%. The unadjusted grossed-up payment would be:  $p/(1-t)$ , where  $p$  is the after-tax payment (\$100) subject to gross-up and  $t$  is D's combined federal and state income tax rate applicable to the grossed-up payment. Replacing the variables in the above formula with the values from this example would provide the following: unadjusted grossed-up payment =  $p/(1-t) = \$100/((1-(0.2+0.1))) = \$142.86$ .

But, if D receives a \$142.86 payment from C, D might be overcompensated if D also receives a tax benefit from the \$142.86 payment, for example, a federal income tax deduction with respect to the state income taxes imposed on the \$142.86 payment. One possible remedy to this problem would be to adjust the

### Exhibit 2: Formula c

$$\begin{aligned}
 p &= r + q \text{ (Formula b)} \\
 r &= \frac{ps}{1+s} \text{ (Formula a)} \\
 p &= \left(\frac{ps}{1+s}\right) + q \\
 p - \left(\frac{ps}{1+s}\right) &= \left(\frac{ps}{1+s}\right) - \left(\frac{ps}{1+s}\right) + q \\
 p - \left(\frac{ps}{1+s}\right) &= q \\
 p \times \left(\frac{1+s}{1+s}\right) - \left(\frac{ps}{1+s}\right) &= q \\
 \left(\frac{p+ps}{1+s}\right) - \left(\frac{ps}{1+s}\right) &= q \\
 \frac{p+ps-ps}{1+s} &= q \\
 \frac{p}{1+s} &= q
 \end{aligned}$$

**Formula c:** After-tax-benefit payment =  $q = \frac{p}{1+s}$

### Exhibit 3: Formula d

After-tax-benefit grossed-up payment =

$$\begin{aligned}
 &\frac{\sum_{n=0}^{\infty} p \times t^n}{1 + \left(\sum_{n=0}^{\infty} s \times t^n\right)} \\
 &\text{which can be simplified as} \\
 &\frac{\left(\frac{p}{1-t}\right)}{1 + \left(\frac{s}{1-t}\right)} \\
 &= \frac{\left(\frac{p}{1-t}\right)}{\left(\frac{1-t}{1-t}\right) + \left(\frac{s}{1-t}\right)} \\
 &= \frac{\left(\frac{p}{1-t}\right)}{\left(\frac{1-t+s}{1-t}\right)} \\
 &= \frac{p}{1-t+s}
 \end{aligned}$$

**Formula d:** After-tax-benefit grossed-up payment =  $\frac{p}{1-t+s}$

unadjusted grossed-up payment to take into consideration D's tax benefit.

### The After-Tax-Benefit Grossed-Up Payment

While Formula c (after-tax-benefit payment =  $q = p/(1+s)$ ) provides a starting point for computing the after-tax-benefit grossed-up payment, it must be modified to consider the effects of the gross-up. As shown in Exhibit 3,<sup>4</sup> the grossed-up payment reduced by the tax benefits it generates can be represented as follows in Formula d: after-tax-benefit grossed-up payment =  $p/(1-t+s)$ .

By inputting the figures from the above example in place of the variables in Formula d, we can see that the after-tax-benefit grossed-up payment to D would be:  $\$100/((1-(0.2+0.1) + (0.1 \times 0.37))) = \$135.69$ .<sup>5</sup>

Thus, while the general gross-up formula,  $p/(1-t)$ , furnishes a mechanism that permits the grossing up of a payment, that formula fails to take into consideration the recipient's tax benefit from the grossed-up payment. Formula d, on the other hand, addresses that precise issue and not only effectuates the grossing up of a payment but also adjusts the grossed-up payment on account of the tax benefits of the recipient that are produced by the grossed-up payment. However, in addition to computing the after-tax-benefit grossed-up payment, it may also be helpful to be able to compute the amount of the reduction to the grossed-up payment, or the anti-gross-up.

#### Exhibit 4: Formula e

Anti-gross-up =

$$\frac{(\sum_{n=0}^{\infty} p \times t^n) \times (\sum_{n=0}^{\infty} s \times t^n)}{1 + (\sum_{n=0}^{\infty} s \times t^n)}$$

which can be simplified<sup>1</sup> as

$$\frac{(\frac{p}{1-t}) \times (\frac{s}{1-t})}{1 + (\frac{s}{1-t})}$$

$$= (\frac{s}{1-t}) \times (\frac{(\frac{p}{1-t})}{1 + (\frac{s}{1-t})})$$

$$= (\frac{s}{1-t}) \times (\frac{(\frac{p}{1-t})}{(\frac{1-t}{1-t}) + (\frac{s}{1-t})})$$

$$= (\frac{s}{1-t}) \times (\frac{(\frac{p}{1-t})}{\frac{1-t+s}{1-t}})$$

$$= (\frac{s}{1-t}) \times (\frac{p}{1-t+s})$$

**Formula e:** Anti-gross-up =  $(\frac{s}{1-t}) \times (\frac{p}{1-t+s})$

#### The Anti-Gross-Up

Like the after-tax-benefit grossed-up payment, the formula for the anti-gross-up can also be represented in terms of p, s, and t. Just as Formula d, the formula for the after-tax-benefit grossed-up payment, is derived from Formula c, the formula for the anti-gross-up can be derived from Formula a, reduction for tax benefits =  $r = ps/(1 + s)$ , which must be modified to account for the effect of the gross-up (see Exhibit 4), resulting in Formula e: the anti-gross-up =  $(s/(1-t)) \times (p/(1-t+s))$ .

Substituting the figures from the above example in Formula e would yield the following:  $((0.1 \times 0.37)/(1 - (0.2 + 0.1))) \times (\$100/((1 - (0.2 + 0.1)) + (0.1 \times 0.37))) = \$7.17$ .

Conceptually, just as the grossed-up payment can be expressed as a series of infinite payments that become increasingly small as the number of payments increases (see Exhibit 5)<sup>6</sup>, the anti-gross-up can also be viewed as the grossed-up portion of the tax benefit component of the infinite series of payments that constitute the unadjusted grossed-up payment. In other words,

#### Exhibit 5: Unadjusted grossed-up payment expressed as an infinite series

$$\sum_{n=0}^{\infty} p \times t^n = \sum_{n=0}^{\infty} 100 \times 0.3^n$$

$$= (100 \times 0.3^0) + (100 \times 0.3^1) + (100 \times 0.3^2) + (100 \times 0.3^3) + (100 \times 0.3^4) + \dots (100 \times 0.3^n)$$

$$= 100 + 30 + 9 + 2.7 + 0.81 + \dots = \$142.86$$

since the unadjusted grossed-up payment includes a gross-up of the tax benefit stemming from the unadjusted grossed-up payment, when removing the tax benefit from the unadjusted grossed-up payment, the portion being removed must be grossed up – since it was grossed up when included in the unadjusted grossed-up payment, it must be grossed up when removed to arrive at the after-tax-benefit grossed-up payment.

Another way of looking at the anti-gross-up of \$7.17 is as the amount that would result if the tax benefit, arising from the after-tax-benefit grossed-up payment of \$135.69, was grossed up. This can be shown as follows: anti-gross-up =  $(s/(1-t)) \times (p/(1-t+s)) = (s/(1-t)) \times (\text{after-tax-benefit grossed-up payment})/(1-t) = ((0.037 \times \$135.69)/(1 - 0.3)) = (\$5.019353/0.7) = \$7.17$ .

Alternatively, the anti-gross-up can be computed as the excess of the unadjusted grossed-up payment over the after-tax-benefit grossed-up payment. From a logical point of view, this makes sense because the unadjusted grossed-up payment is not reduced by the anti-gross-up while the after-tax-benefit grossed-up payment is reduced by the anti-gross-up. Consequently, the difference between these two amounts is the anti-gross-up, which can be expressed as follows in Formula f: anti-gross-up =  $(p/(1-t)) - (p/(1-t+s))$ .

Exhibit 6 demonstrates the equivalency of Formula e and the alternative method for computing the anti-gross-up represented by Formula f.

To confirm that Formula e and Formula f are interchangeable, we can substitute the figures from the above example into Formula f:  $(p/(1-t)) - (p/(1-t+s)) = (\$100/(1-0.3)) - (\$100/(1-0.3+0.037)) = \$142.86 - \$135.69 = \$7.17$ , which is the same as the anti-gross-up obtained vis-a-vis Formula e.

As an additional check, we can see that the unadjusted grossed-up payment (\$142.86) equals the anti-gross-up (\$7.17) plus the after-tax-benefit grossed-up payment (\$135.69). Also, the after-tax-benefit grossed-up payment of \$135.69 should trigger a tax liability to D of exactly \$35.69, leaving D with a net payment of exactly \$100 (see Exhibit 7).

Thus, D is neither over- nor under-compensated by C. Accordingly, the after-tax-benefit grossed-up payment of

#### Exhibit 6: Equivalence of Formula e and Formula f

$$(\frac{s}{1-t}) \times (\frac{p}{1-t+s})$$

$$= \frac{ps}{(1-t)(1-t+s)}$$

$$= \frac{p - pt + ps - p + pt}{(1-t)(1-t+s)}$$

$$= \frac{p(1-t+s) - p(1-t)}{(1-t)(1-t+s)}$$

$$= (\frac{p(1-t+s)}{(1-t)(1-t+s)}) - (\frac{p(1-t)}{(1-t)(1-t+s)})$$

$$= (\frac{p}{1-t}) - (\frac{p}{1-t+s})$$

Thus,  $(\frac{s}{1-t}) \times (\frac{p}{1-t+s}) = (\frac{p}{1-t}) - (\frac{p}{1-t+s})$

Formula e = Formula f

\$135.69 properly takes into account the incremental tax benefit inuring to D from the receipt of the after-tax-benefit grossed-up payment.

Nevertheless, before an anti-gross-up is calculated, a cost-benefit analysis should be performed to determine whether the cost of computing and negotiating the anti-gross-up would exceed any potential tax benefit the recipient may realize from the gross-up. For example, computing the anti-gross-up may not be necessary in the case of an individual recipient who is not subject to state income taxation because they reside in a state which does not impose an income tax and the individual has no income sourced to any other state. Such a recipient would not deduct any state income taxes against their federal taxable income and, therefore, would not receive a tax benefit from the gross-up payment. Similarly, determining the anti-gross-up may not be necessary in a situation where the amount of the gross-up is not significant.

#### Exhibit 7: Summary computation of net payment from C to D

Unadjusted grossed-up payment: \$142.86
Anti-gross-up: \$7.17
After-tax-benefit grossed-up payment: \$135.69
State tax liability: \$13.57
Value of tax benefit: $0.37 \times \$13.57 = \$5.02$
Federal tax liability: $(\$135.69 \times 0.2) - \$5.02 = \$22.12$
Net payment: $\$135.69 - \$13.57 - \$22.12 = \$100$

## CONCLUSION

In sum, although the general gross-up formula  $p/(1 - t)$  provides a helpful apparatus to gross up a payment for taxes, it does not take into account the recipient's tax benefit from the payment. However, Formula d,  $p/(1 - t + s)$ , offers a potential solution: it not only grosses up a payment but also simultaneously reduces the payment by the anti-gross-up, which does take into consideration the tax benefit realized by the recipient. Ultimately, determining the amount of the anti-gross-up may assist parties to a gross-up arrangement determine whether a downward adjustment

to the grossed-up payment is necessary. If properly computed, the anti-gross-up could help reduce the risk that a recipient is either over- or under-compensated because of the gross-up. As the magnitude of the gross-up and the recipient's potential tax benefit from the gross-up increase, it may be prudent for parties to a gross-up arrangement to consider computing and negotiating the quantum of the anti-gross-up.

### End Notes

<sup>1</sup> Assume for simplicity that B is not subject to any limitation on deducting state taxes in computing B's federal taxable income.

<sup>2</sup> The adjusted payment is hereinafter referred to as the after-tax-benefit payment.

<sup>3</sup> Assume for simplicity that D is not subject to any limitation on deducting state taxes in computing D's federal taxable income.

<sup>4</sup> See Islame Hosny, 182 Tax Notes Federal, 283, 283-84, Jan. 8, 2024.

<sup>5</sup> Assume for simplicity that D has ordinary income against which D can deduct the state taxes triggered by the grossed-up payment.

<sup>6</sup> See Hosny, *supra* note 4, at 284.



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