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Tame the Tax Gross-Up's Impact on Deal Economics

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While tax gross-up clauses are usually considered innocuous provisions intended to make a recipient in a transaction whole, they are a salient component of deal economics, as an improperly negotiated gross-up could expose the paying party to disproportionate risk, Pryor Cashman's Islame Hosny advises.

Parties to transactions in which tax gross-ups are contemplated should pay close attention when negotiating the terms of tax gross-up provisions — similar to how they manage other terms affecting deal economics.

On September 18, 2024, the Federal Open Market Committee [reduced the target range for the federal funds rate](#) by half a percentage point with [more rate cuts expected](#) in the near future. Many investment banks and corporate attorneys view this as a welcome change as it [likely will increase deal-making activity](#) in the mergers and acquisitions (M&A) space by reducing the cost of borrowing.

The expected increase in deal flow comes at a time when many significant tax provisions enacted by the [Tax Cuts and Jobs Act \(TCJA\)](#) are set to [expire at the end of 2025](#). Even though some or all of those provisions may be extended, their scheduled expiration fosters a sense of tax uncertainty in the period ahead. The anticipated uptick in M&A transactions set against a backdrop of an uncertain tax environment highlights the need for buyers and sellers to effectively manage the terms of tax gross-up arrangements early in the negotiation process.

Avoiding Unintended Consequences

While tax gross-up clauses are usually thought of as innocuous provisions intended to make the recipient in a deal whole, the [economics of the gross-up formula should be managed](#) to avoid wholly unintended consequences.

An improperly negotiated tax gross-up provision could expose the paying party to a disproportionate risk relative

to the recipient. On the recipient side, even assuming the highest possible tax rate of 100%, the maximum tax exposure on a payment of \$100 with no gross-up would be \$100. However, as the recipient's tax rate approaches 100%, the grossed-up payment would [theoretically approach infinity](#), exposing the paying party to an inordinate amount of risk.

As a solution, the parties may [consider placing a cap on the gross-up](#), for example, at 200% of the payment subject to the gross-up. So, if the payment being grossed up is \$100, the parties may consider a cap of \$200 on the grossed-up payment. The effect of the cap equates to using a maximum rate for t of 50% in the general gross-up formula: $p/(1 - t)$, where t is the recipient's tax rate applicable to the grossed-up payment and p is the \$100 after-tax payment being grossed up. But even if a gross-up cap is agreed to, parties should still take into consideration any formula-impacting factors, including the TCJA expirations.

TCJA Provisions Scheduled to Expire

The expiration of I.R.C. [§1\(j\)](#), which provides the current 37% maximum federal individual income tax rate, would increase the rate to 39.6% after 2025. It may be only 2.6 percentage points, but that could increase a grossed-up payment that is treated as ordinary income to the recipient by more than 2.6% as a direct result of the [mechanics of the gross-up formula](#). To illustrate, assume a recipient is subject to federal and state income tax rates of 37% and 10%, respectively, on the grossed-up payment. Under current law, a \$100 after-tax payment would result in a \$188.68 grossed-up payment: $\$100/(1 - 0.37 - 0.1) = \$100/0.53 = \$188.68$. However, if the federal rate were to increase by 2.6% to 39.6%, the grossed-up payment would increase by 5.16% to \$198.41: $\$100/(1 - 0.396 - 0.1) = \$100/0.504 = \$198.41$. Thus, a slight increase in the federal tax rate could result in a disproportionately larger increase in the grossed-up payment.

Another expiring tax provision that could have a significant impact on tax gross-up arrangements is the qualified business income (QBI) deduction under [§199A](#). Under certain circumstances, not having that QBI deduction could increase the cost of a gross-up to the

paying party. For example, assume a recipient is subject to a 37% federal income tax rate on ordinary income and is entitled to an after-tax payment of \$17 arising from \$100 of ordinary income triggered by a transaction. The \$17 is the incremental tax cost incurred by the recipient because of the transaction and represents the excess of the 37% ordinary rate over the 20% capital gains rate, multiplied by the \$100. Under the terms of the gross-up provision, the \$17 must be reduced by the value of both the QBI deduction and the deduction for state income taxes resulting from the \$100 of income. Assume further that the recipient qualifies for a 20% QBI deduction on \$90 (\$100 – \$10 state tax deduction), is not subject to any restrictions on deducting state income taxes against their federal taxable income, and is subject to a 20% federal capital gains rate and a 10% state income tax rate on the grossed-up payment.

Under current law, the recipient would be entitled to a grossed-up payment of \$9.49: $(\$17 - \text{value of QBI deduction} - \text{value of state tax deduction}) / (1 - 0.2 - 0.1) = (\$17 - (\$90 \times 0.2 \times 0.37) - (\$100 \times 0.1 \times 0.37)) / 0.7 = \$6.64 / 0.7 = \$9.49$. But if §199A expires and the maximum federal individual income tax rate increases to 39.6%, the recipient's incremental tax cost from the transaction would increase from \$17 to \$19.6. The \$19.6 amount represents the excess of the 39.6% ordinary rate over the 20% capital gains rate, multiplied by the \$100 of ordinary income realized by the recipient as a result of the transaction. Furthermore, the grossed-up payment would increase by 135.5% to \$22.34: $(\$19.6 - \text{value of state tax deduction}) / (1 - 0.2 - 0.1) = (\$19.6 - (\$100 \times 0.1 \times 0.396)) / 0.7 = \$15.64 / 0.7 = \$22.34$. Accordingly, parties to gross-up arrangements should pay particular attention to expiring tax provisions that could impact the economics of the deal vis-à-vis the gross-up.

Managing the Anti-Gross-Up

Yet, the difficulties that parties to tax gross-up arrangements often encounter are not necessarily limited to issues related to the recipient's tax rate or the amount of the payment being grossed up. One common roadblock arises from the complexity in accounting for the recipient's tax benefits generated by the grossed-up payment, or the anti-gross-up. To overcome that obstacle, however, parties may take the [anti-gross-up](#) into account by using the after-tax benefit grossed-up payment formula: $p / (1 - t + s)$, where s is the recipient's tax savings rate applicable to the grossed-up payment.

Nonetheless, tensions may still rise between the parties in determining the appropriate rate to use for s . On the one hand, it is in the paying party's interest to utilize a higher

rate for s because it would increase the denominator and reduce the grossed-up payment. On the other hand, using a smaller rate for s benefits the recipient by decreasing the denominator and increasing the gross-up. As such, the formula for the after-tax benefit grossed-up payment inherently creates adversity of interests among the parties in negotiating the gross-up.

One counterargument in response to using $p / (1 - t + s)$ instead of $p / (1 - t)$ as the gross-up formula is that it is difficult to determine the rate to use for s before the close of the tax period in which the grossed-up payment is received. The argument ostensibly relies on the premise that it is only possible to know the tax consequences of all events occurring during the tax period in which the grossed-up payment is received after the close of the tax period. As a result, it is not possible to determine the rate to use for s at the time of negotiating the gross-up provision, or even at the time the grossed-up payment is received.

However, just as the marginal tax rate can be used to determine t , it can also be used to compute s . A marginal tax rate is simply a taxpayer's tax rate on the next dollar of income. Because the [anti-gross-up may only be relevant in relatively larger deals](#) and assuming that the payment of the purchase price, including the gross-up, would put the recipient in the highest tax bracket, the rate used for t is generally based on the highest marginal tax rate. But, unlike s , a higher rate for t benefits the recipient by increasing the grossed-up payment. It follows, then, that if the highest marginal tax rate is used to determine t , it would be reasonable to also utilize the highest marginal tax rate to compute s . During this period of tax uncertainty when deal activity is expected to increase, it may be prudent to address these and other similar issues affecting the components of the tax gross-up formula early in the negotiation phase to avoid unintended consequences.

Conclusion

Undoubtedly, a unique feature of the tax gross-up formula is its high degree of sensitivity: a slight change in any of the components of the formula could result in a disproportionately larger change in the grossed-up payment. Therefore, both a paying party and a recipient should not only appreciate the mechanics of the gross-up formula, but also be mindful of how potential changes in the tax law may impact their rights and obligations arising from a gross-up arrangement. Parties to a transaction in which a tax gross-up is contemplated should view tax gross-up provisions as a salient component of the transaction having the potential to significantly impact the economics of the deal.

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