'This is so crazy.' Tax spike pushes researchers to the brink of bankruptcy

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Going into 2022, Zehra Parlak received a warning from her accountant: A looming change to the federal tax code threatened to torpedo the future of Qatch Technologies, the biomedical company she had founded six years earlier based on her postdoctoral research at Duke University.

There was little she could do to avoid an exponentially higher tax burden

that year, the accountant explained. "Brace for impact," was his advice, meaning Parlak should save as much money as possible before the bill came due this October.

But there wasn't much to save.

Like many biotech startups, Qatch is financed predominantly by government grants, which it spends annually on staff and supplies in accordance with its grant agreement. The company doesn't turn a profit and has generated less than $50,000 in revenue.

Qatch directs the vast majority of its grant money toward its primary objective: a tool that can determine, with less than a droplet, whether drugs under development can be administered via injectable shots or IV transfusions. Pinpointing best delivery methods early in the process can save drugmakers significant time and money.

"This way, pharma can make better decisions and end up with a better drug," Parlak said.

Investors often shy away from research-intensive health care startups. Any returns could be years away, and many of these companies pursue niche, if vital, products that address unique diseases and conditions. These companies expect to one day be profitable, but their missions don't always attract venture funds—especially at first.

Instead, federal agencies step in with grant funding. Since launching, Qatch has received roughly $4.8 million in small business innovation and technology grants between the National Institutes of Health, Department of Commerce, and National Science Foundation.

But last year, these grants became a veritable poison pill to Qatch and many other health tech startups. The reason is a new tax rule, passed

during the Trump administration and effective as of Jan 1, 2022, that requires the amortization of research and development expenses. This means the grant money these companies receive is now taxed as income.

For 2022, Qatch's taxable income was about eight times what it had been the previous year. Parlak dipped into her own savings to pay the bill, which was $61,000 higher.

The deadline to file last year's taxes was Oct. 16.

"I can't cover it personally again," she noted, thinking ahead to this year's filing. "This is so crazy. We all thought surely the tax law would be fixed. But it stayed that way."

"It will leave everything up to companies ... that focus on areas that will generate money."

The News & Observer spoke with seven founders of startups in North Carolina's Research Triangle who described how the amortization requirement has left them scrambling to stay afloat.

"I could tell you I know how I will pay this tax, but it would be a fiction," said Taub Swartz, cofounder of Karamedica in Raleigh, which is developing a device to control bleeding during surgeries.

Others said they were able to absorb the higher cost, at least for this first year.

"It really wiped out all of our reserve funding for 2022 into 2023," said Ed Burgard, president and CEO of Dignify Therapeutics in Research Triangle Park.

Under the previous tax policy, which had been in effect since 1954,

companies could deduct their research and development (R&D) spending upfront. If businesses used their grants to pay staff and obtain supplies in a given year, then these dollars spent would erase the dollars received, leaving no tax liability.

But under the new rule, included within the federal tax code's Section 174, companies may only deduct 10% of their R&D expenses in the first year. A $1 million direct research grant has become $900,000 in taxable income in Year 1. Overall, the law mandates businesses amortize their domestic R&D expenses over five years and overseas R&D expenses over 15 years.

This accounting structure allows the government to raise more revenue in the short run, but critics argue it ultimately curbs tax-generating growth as businesses face steep initial bills, possible tax penalties, and lost opportunities for their money to appreciate.

Launched in 2013, Dignify works to improve bladder and bowel control for people with spinal cord injuries, multiple sclerosis, and other brain conditions. The company has survived entirely on government grants for the past five years, Burgard says.

"If it's not for companies like ours that will address these unmet medical needs, (the care) would just go by the wayside," he said. "It will leave everything up to the large companies that focus on major areas that will generate money."

The change to Section 174 meant Dignify's largest investors faced what Burgard called "phantom income" of $100,000 to $200,000. The company's active partners assumed the personal tax burdens of those who couldn't pay.

"As partners, we may have realized $7,000 or $10,000 that all of a

sudden were tacked on to our normal income tax," he said.

Without an adjustment, local founders invariably predicted they will slash spending on research and development, diverting from their original development goals.

"As a company, we are pivoting away from doing innovative R&D, which is an unfathomable situation to be in," said Melissa DeRozier, founder of the behavioral health software firm 3C Institute in Durham. "This innovation tax is making it where we honestly can't do innovative development anymore. I think that would be horrendous for this country."

Democrats and Republicans seek reversal

At least two small businesses (one in North Carolina, another in South Carolina) have already filed for bankruptcy as a result of the Section 174 requirement, says Aron Josefsberg, an accountant in Raleigh.

Josefsberg, who works for Eva Garland Consulting, put his startup clients on filing extensions this year in the hopes that officials would amend the rule over the summer. The extension deadline passed with no adjustment.

"My sense is that it's just a loophole," he said. "I think it was just overlooked, the impact this is having on (grant) funded companies."

Others blame former President Donald Trump, suggesting his administration put a burden on R&D-intensive startups to balance out other tax relief in his 2017 Tax Cuts and Jobs Act.

"All Trump did was borrow money from small business owners to pay for his tax cuts," said Hafeez Dhalla, CEO of Theia Imaging, which

develops eye imaging products in Durham.

There is now a bipartisan effort to rescind the Section 174 requirement.

Adam Webb, a spokesperson for North Carolina Sen. Thom Tillis, a Republican, wrote in an email that "restoring full expensing under Section 174 is one of Senator Tillis' top priorities."

Both Tillis and fellow Republican N.C. Sen. Ted Budd are among 41 cosponsors of the American Innovation and Jobs Act, a Senate bill filed in March that would return R&D deductions to the pre-2022 format. A House bill to reverse the policy currently has 191 cosponsors, including four North Carolina Democrats (Deborah Ross, Jeff Jackson, Donald Davis and Kathy Manning) as well as Republican Gregory Murphy.

In an statement to the N&O, a spokesperson for N.C. Democratic Rep. Valerie Foushee said "local businesses and innovators who have earned and receive support through government funding and federally funded research grants should not be subjected to crippling tax bills that are based on the grants awarded to them."

In a Nov. 27 letter to North Carolina's 16-member congressional delegation, state Commerce Secretary Machelle Baker Sanders implored the delegation to block the Section 174 change.

"Failure to act would result in a 'tax on innovation' that would stifle entrepreneurship and growth across the state," she said.

In the Triangle, business consultant Eva Garland has galvanized support among founders to raise awareness.

On Nov. 7, she sent ranking members of two congressional committees a letter signed by dozens of North Carolina CEOs, including Parlak,

Burgard and Dhalla. "This matter requires your prompt attention before the end of 2023," the letter stated, "as it directly jeopardizes the survival of numerous small businesses—the lifeblood of our innovation ecosystem."

Many area researchers were able to weather the first high tax bill. But they say another next year could be fatal.

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