FORTUNE

The federal government is simultaneously investing in my startup–and crippling our business with a little-known tax code provision. Only Congress can save us

A seemingly innocuous provision in the 2017 Tax Cuts and Jobs Act could spell disaster for America's most innovative startups.

By Rayana Marker   January 31, 2024

A provision in the tax code is threatening hundreds of early-stage, research-intensive firms. Fortunately, Congress finally seems prepared to fix the problem. But lawmakers will have to act quickly to save startups like mine.

The dilemma stems from a seemingly innocuous provision in the 2017 Tax Cuts and Jobs Act, which, among many other things, adjusted Section 174 of the tax code. Previously, that section allowed businesses to deduct the full cost of their research and development (R&D) expenses in a single year.

However, starting in 2022, the new tax law changed this longstanding practice and started requiring companies to spread out the deductions over five years. This effectively raised the yearly cost of performing scientific research, since companies could no longer claim the full R&D deduction in the year that they actually spent the money.

For small startups like mine, specifically those that have received research grants from the federal government, the change poses an existential threat to the business. Here's why.

Cellf BIO, the firm I now help lead, was founded in 2014 based on groundbreaking work in regenerative medicine. Since then, we've developed a bioengineered sphincter muscle that can be grown from patients' own cells and then implanted back into their bodies to treat their fecal incontinence. Our treatment could help millions of Americans suffering from this debilitating and quality-of-life-altering condition.

With the assistance of significant federal grant money, we were able to start Phase 1 clinical trials in 2023. We're making great progress and have successfully achieved the major milestone of the first in-human implantation of the BioSphincter. But even in the best-case scenario, it is a long road ahead to win market approval from the FDA and start earning revenue.

To support our research, we have relied on Small Business Innovation Research (SBIR) grants from the Small Business Administration (SBA) and the National Institutes of Health.

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This SBA grant program functions as seed funding for promising startups that haven't yet raised venture capital investment. And it has proven hugely successful. 23andMe, the most recognizable name in genetic testing, initially received SBIR funding.

These federal grant programs, which are earmarked exclusively for research expenses, have always counted as taxable income. Prior to 2022, that wasn't a problem or barrier to research startups since firms could simply deduct the full cost of R&D from the equivalent amount of grant income, leaving them with no net tax liability.

In other words, the previous status quo ensured that promising startups wouldn't be penalized for winning government grants.

But now, because of the change in expensing, they are penalized. And penalized disproportionately. Our small firm, with less than five employees, faces a six-figure tax bill under the new rule. And because we don't yet have an FDA-approved product, we have no sales revenue. Currently, and like many other similarly situated research startup small businesses, our income and funding stream is almost entirely based on grants.

The government's research agencies believe in our vision and are helping ensure we can make it a reality with critical grant funding. But paradoxically, the IRS wants that money back. And new grant money is not allowed to be used to pay these taxes.

So far, we've managed to survive–and our technology is ready for outside investment. Many other startups aren't so fortunate. Some have just weeks of runway left.

Lawmakers have recognized how hard this would hit small, research-intensive companies–and now they finally seem poised to do something about it. House and Senate negotiators recently announced a deal that, among other reforms, would once again allow full expensing for research, as was the standard.

The clock is ticking for Congress to act. The urgency of this issue cannot be overstated. Jobs, small businesses, and tomorrow's life-changing innovations are on the line.

Rayana Marker is the chief operating officer of Cellf BIO LLC.