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Small Businesses Face Big Tax Bills From Research-Deduction Change

A piece of the 2017 tax law is leaving small, research-intensive firms with IRS bills they can't pay

Westminster Tool, which employs 35 full-time workers in Plainfield, Conn., faces a 171% tax rate for 2022 due to a change in the way research expenses are deducted.

By Richard Rubin

Laura Lynn Gonzalez expected a tax refund this year, after her two-employee data-visualization company experienced a $30,000 loss. Instead, she said, she is facing a $100,000 federal tax bill that is about as large as her 2022 salary.

Ms. Gonzalez's predicament stems from a piece of the 2017 tax law that is taking effect now. It requires companies to spread deductions for research costs over five years instead of taking them immediately.

For many biotech companies, contract manufacturers and software firms, the law means losing the ability to deduct the bulk of their expenses on the tax returns they are about to file. That means some businesses that broke even or lost money in 2022 are considered profitable for tax purposes—and are finding they owe money to the Internal Revenue Service.

For large companies, such as Northrop Grumman Corp. and Moderna Inc., the change is a cash-flow challenge, one that gets easier after several years even if Congress doesn't act. It is a much bigger hurdle for small and medium-size firms that can't tap reserves or borrow easily.

Ms. Gonzalez, of Oakland, Calif., first read about the issue in January. The tax code's definition of research expenses is broad and includes software development, and Ms. Gonzalez's company receives federal research grants, which are causing complications for many businesses.

"I emailed my accountant and she was like, 'Oh yeah, this is not great,'" Ms. Gonzalez said. "It's insane, so I think everybody was like, 'This is too insane to be reality.'"

Because of California's weather disasters, she has until October to pay her taxes, and she's hoping that is enough time for Congress to change the law. If not, she thinks the best path forward for Dynamoid LLC is setting up an installment payment plan with the IRS. But that would limit her ability to pay daycare bills for her 18-month-old son.

Congress included the change for research-expense deductions in the 2017 tax law to help pay for cutting the corporate tax rate. The 2022 start date has been on the books for years, but many business owners and accountants assumed Congress would change the law before it took effect.

"You can explain all you want. You can illustrate it all you want. Until you see it in a payment due, that's when the sticker shock is," said William Kuhlman, a partner at accounting firm Marcum LLP in Philadelphia. "I've had a lot of hard-core discussions with clients that just don't have the money to come up with between now and April 15."

In the 2017 legislative calculus, starting the shift in tax year 2022 yielded revenue during the 10-year window for measuring federal budget effects. That is because the provision was projected to accelerate tax payments into that period and push deductions outside of the budget window. The $120 billion in projected revenue was about equal to 1 percentage point on the corporate tax rate.

Lawmakers in both parties now agree on reversing the change, but they are in a stalemate over how to do it. Democrats, noting that Republicans wrote the law that created the issue and enacted it without any Democratic votes, insist that this business tax legislation be paired with an expanded child tax credit.

"We've talked about a balanced kind of approach," said Senate Finance Committee Chairman Ron Wyden (D., Ore.), who said he met with affected businesses from his state this week. "I'm open to ideas. We've got to get this done."

Republicans say the changes Democrats want—particularly benefits for families with little or no income—remove incentives to work.

President Biden's budget is silent on the provision. Instead, he proposes repealing a tax break for exporters and using the proceeds for unspecified research incentives.

While lawmakers debate, businesses are contemplating how to pay the bills by mid-April. Some may borrow. Others may roll the dice by failing to pay now and hoping Congress deals with the problem soon.

"This hit me like a brick this morning," Carmie Mick, president and chief executive of CWMF Corp., said on Thursday. The company, based in Waite Park, Minn., makes customized parts for asphalt plants and is partway through an expansion.

Ms. Mick had expected to pay about $580,000 in federal and state taxes on $3.8 million in income. Instead, she's looking at a $4.4 million bill and isn't sure what she is going to do.

This first year creates the biggest pinch. Under IRS rules and accounting conventions, companies can deduct only 10% of their 2022 domestic-research costs on their 2022 tax returns, spreading the remainder over future years.

Consider a company with $1 million in revenue, $500,000 in research costs and $500,000 in other deductible expenses. Under 2021 tax law, it would have zero profit and its owners would owe no income taxes. For 2022, it could deduct only $50,000 in research costs, and its owners would pay taxes on $450,000 of income. The company could get research tax credits to offset some costs, but it might also face higher state income taxes.

'It's 100% going to prohibit me from growing any more the next three years,' says Westminster Tool's finance chief, Colby Coombs, of the family business's tax bill.

"This is, I think, the worst statute I've ever seen," said Mr. Kuhlman, who has spent more than 20 years working with businesses on research tax incentives. "I mean, there's been a lot of bad ones. This is the worst one because it does exactly the opposite of what you want a statute to do."

For Colby Coombs, chief financial officer of Westminster Tool Inc., the research-expense change is yielding a 171% tax rate for 2022, up from 12% in 2021. He said he is considering difficult choices at his family business, which has 35 full-time workers in Plainfield, Conn. Westminster Tool designs, tests and builds injection-mold systems for the medical, aerospace and consumer-product industries, conducting research as it tries to improve manufacturing processes.

"I'm looking at a tax bill that is astronomical. It's 100% going to prohibit me from growing any more the next three years," he said. "All of my capex planning is immediately thrown out the window."

At Brewer Science, a Rolla, Mo., company that develops materials and processes for chips and other small-scale devices, the law appears at odds with broader government interest in U.S. competitiveness and scientific advances, said Doyle Edwards, director of government programs.

"Our understanding was that Congress was going to find a way to fix it, so we really didn't plan for it. I hate saying that from a strategic-planning standpoint," Mr. Edwards said. "For us to be competitive, we're willing and we want to invest, but it just seems like this is penalizing us to do that."