BDO UNITED STATES

EMPOWERING GOVERNMENT CONTRACTORS THROUGH EMPLOYEE OWNERSHIP: REVISITING ESOP BENEFITS

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Employee Stock Ownership Plans (ESOPs) are the most common and successful employee ownership model in the U.S. and have become a popular alternative to traditional M&A transactions for business owners looking to exit – either partially or completely – in a tax-advantaged structure that transitions ownership to employees over time. Among businesses that are classified as government contractors, providing some level of employee ownership has been accepted by both large and small players in the space. In fact, the U.S. Government Accountability Office found that between 2014 and 2017, the Department of Defense issued almost half of its obligations (on contracts with annual obligations greater than $150,000) to companies that had ESOPs in place.

Like many industries, the government contracting space is experiencing increased competition and pressures from a change in administration and changes to regulatory priorities. The industry is also seeing a shrinking pool of clearance, or clearance-eligible, employees. Further, as government contractors face challenges common to many businesses (higher prevailing wages, competition and regulation, downward pressure to margins), they are also confronted with a question: growth reinvestment or shareholder return? This article attempts to address these issues.

How an ESOP Provides for Growth Reinvestment

Tax savings leads to increased cash flow

An ESOP is a qualified retirement plan and is exempt from federal (and most state) income tax under Internal Revenue Code (IRC) section 501(a); as a result, income passed through to an ESOP is not taxed. Companies can be fully or partially owned by an ESOP, as the founders/shareholders decide what percentage of stock they want to sell to the ESOP. Full ESOP ownership of an S Corporation will eliminate all federal (and most state) income tax burdens. Reducing or eliminating a company's taxable income is still possible even if the ESOP does not own 100% of a company. Contributions to a qualified retirement plan are tax deductible up to 25% of eligible compensation, which can be especially beneficial to service-based government contractors where the preponderance of operating costs is labor- or compensation-related.

Providing ownership leads to higher employee morale

Offering current and prospective employees equity ownership of a company via an ESOP is a powerful incentive. Government contractors across various specialties are facing a highly competitive and, at times, scarce skilled labor market at a time when they are proactively trying to attract top talent. This phenomenon has led to upward pressure on labor costs as government contractors compete for the most highly skilled individuals to increase their likelihood of winning new contracts or successfully recompeting. According to the Small Business Administration (SBA), there are over 30 million small businesses in the U.S., and only approximately 6,500 active ESOPs as partial or full owners, according to the National Center of Employee Ownership (NCEO). While ESOPs are continuing to gain popularity on main street and Capitol Hill, this statistic implies that a large majority of small businesses have yet to adopt employee ownership, and as employees weigh their employer options, offering beneficial ownership could make the difference. A survey by NCEO indicated that the average ESOP contribution as a percent of base salary ranges from 6% to 10%, double the average employer 401(k) match (e.g., 3% to 5%). It is important to note that ESOP stock allocations come at **no cost** to the participant, and many companies continue to provide a 401(k) program for diversification.

Another study, which looked at employees' economic circumstances over time, compared individuals aged 28 to 34 who have ESOP benefits to their peers that do not have such benefits. The study found that the ESOP employees enjoyed 92% higher median household wealth and 53% longer median job tenure. Typically, ESOPs benefit employees with the longest tenure, and plan design features such as vesting and payment can be structured in a manner that disincentivizes employee participants from leaving the company.

Recouping contributions to fund ESOP share allocations

ESOP contributions, which fund the annual ESOP stock release to employees, are an allowable cost that contractors can claim in their indirect rates used for pricing and billing, subject to the requirements outlined in the cost principle under FAR Part 31.205-6, *Compensation for Personal Services*. This cost principle invokes the requirements of Cost Accounting Standard (CAS) 415 – Accounting for the Cost of Deferred Compensation regardless of the contractor's small business status that otherwise exempts it from CAS applicability. These regulatory requirements outline how government contractors should measure the amount of an ESOP contribution and the cost accounting period to which the costs should be assigned given the circumstances and the substance of the contributions.

How an ESOP Provides Shareholders with Fair Market Returns

M&A transactions with government contractors present a unique set of considerations that affect the deal at large, notably the negotiated equity value, structured payouts and confidence to close. One important point a buyer will need to assess is if the target is defined as a small business under government regulations. If so, and if any of the target's contracts are "set aside" for small businesses only, the buyer will need to analyze how the contemplated transaction will impact those set-aside contracts, including recompete eligibility and probability. Since this analysis calls into question the firm's ability to generate future cash flows, it has a theoretical impact to equity value and structure (e.g., potential deferrals or earnouts). Another hurdle is the buyer's appetite for any perceived risks associated with customer concentration of the target. Government contractors deploy highly sophisticated – and often mission critical – services and products, sometimes to only a few government agencies. Those relationships could be affected for several reasons in an outright sale scenario, which could also impact deal value.

However, with a sale to an ESOP, many of these unique considerations are moot. In the context of a sale to an ESOP, the buyer is a trust (the Employer Stock Ownership Trust or "ESOT") that is represented by an independent trustee. If properly structured, a sale to an ESOP does not preclude the sponsor's 8(a) small business certification. This allows the owner to sell at fair market value based on cash flows from all contracts, including set-asides.

Further, predictable cash flows generated from longstanding customer relationships bode favorably to the firm's creditworthiness. Many banking institutions have dedicated government contracting specialists that understand industry norms, regulations and the contractual nature to cash flows and many banks also have dedicated ESOP lenders that leverage the retirement plan's tax advantages to maximize liquidity to the exiting owners.

ESOP Success Story: Cybersecurity Government Contractor

Founded in 2007, a thought-leading technology firm offering a robust suite of cybersecurity, software development, systems engineering, and test and evaluation solutions to premier government and civilian agencies had grown to approximately 150 employees at the time the founders' stock was acquired by an ESOP.

Having been a BDO client for many years, the company developed a trusted relationship and engaged the BDO ESOP Advisory Services team to explore exit strategies, including ESOPs, in a Phase I Review of Strategic Alternatives. This Phase I process addresses each aspect of a sale and compares the pros and cons of an outright sale to an ESOP, including: a detailed valuation, achievable liquidity, timing and tax analysis to the exiting owner, as well as post-deal board governance considerations. In the context of an ESOP sale, modeling the projected benefits to employees is key to those considering the best exit strategy. As part of the Phase I assignment, the shareholders looked to BDO for advice on the choice of tax entity

(e.g., S Corporation or C Corporation), under which the company would complete the transaction. IRC section 1042 provides for the deferral (and possible elimination) of capital gains to the shareholders in a C Corporation ESOP sale scenario. However, in some cases, converting to a C Corporation comes with a five-year period of corporate taxes, and, as described earlier, a S Corporation ESOP may provide for a corporate income tax exemption, especially in the case of a 100% S Corporation ESOP.

There were many factors driving the decision to sell via an ESOP. Most notably, the company was embarking on its next-generation growth strategy and one of the pillars of this strategy called to share the financial success with all employees via equity ownership. Shortly after delivering the Phase I feasibility study, the company made the decision to sell 100% to an ESOP and engaged the BDO ESOP Advisory team as its sell-side advisor. Maintaining its qualified preferred status was desired, and the BDO ESOP team consulted closely with the firm's deep arsenal of tax and government contracting professionals to ensure the company's qualified status was maintained and regulatory compliance was maintained in the post-transaction ESOP structure.

Through BDO's deep and extensive history as advisor to many complex M&A transactions (both third-party sales and ESOP sales), BDO was able to confidently structure an exit that achieved the founders' goals of receiving fair market value and further empowering the company through employee ownership.

Conclusion

The growing interest in employee ownership among government contractors has created the need for a sophisticated level of expertise among ESOP advisors. While ESOPs are common in the government contracting space, there is no one common structure that achieves all stakeholders' goals. Engaging the right financial advisor is critical in such a complex and highly-regulated industry.