

Empowering Government Contractors
through Employee Ownership:
Revisiting ESOP Benefits

Employee stock ownership plans (ESOPs) are the most common and successful employee ownership models in the U.S. They have become a popular alternative to traditional mergers and acquisitions (M&A) for business owners looking to exit – either partially or completely – in a tax-advantaged structure that transitions ownership to employees over time. Among businesses classified as government contractors, providing some level of employee ownership has been accepted by both large and small organizations.

The long-term ownership structure of ESOP-owned government contractors can foster execution discipline, workforce stability, and reinvestment in technical capabilities, aligning well with the priorities of government agencies. Supporting that view, a first-of-its-kind research report published in June 2024, “Outperform and Outlast: [100% Employee Owned Contractors Top the Charts](#),” leveraged data from the contractor performance assessment rating system (CPARS) and found that 100% ESOP-owned federal contractors on average received higher performance ratings than their non-ESOP peers.



Department of Defense ESOP Pilot Program

Congress has materially advanced the role of employee ownership in defense contracting through Section 874 of the National Defense Authorization Act for Fiscal Year 2022 (NDAA FY 2022), which authorized the Department of Defense (DoD) to establish a pilot program that incentivizes contracts with businesses wholly owned through an ESOP.

The pilot grants contracting officers' authority to award a one time, sole-source follow-on contract to qualifying 100% ESOP-owned S corporations, reflecting congressional recognition that ESOP contractors can deliver strong performance while preserving continuity in the defense industrial base. Early implementation of the program revealed areas for refinement, prompting Congress to enact targeted improvements in Section 872 of the NDAA FY2024, including clarification of subcontracting limitations, confirmation that the authority can be used once per contract, authorization for use by the General Services Administration on the DoD's behalf, and an extension of the pilot from five to eight years.

The DoD formalized those statutory changes through final rulemaking published in October 2024, with the amended DFARS provisions becoming effective in November 2024 and authorizing use of the pilot through December 2029.

Beyond improving contracting efficiency at a time of reduced acquisition staffing, Congress has emphasized that the pilot is intended to promote competition over the long term by supporting ESOP-owned firms that are more resistant to acquisition and consolidation. Legislative activity in 2024 and 2025, including proposals to replicate the ESOP pilot authority on a government wide basis, suggests growing policy interest in employee ownership as a long-term ownership model.



Revisiting ESOP Benefits

TAX SAVINGS CAN LEAD TO INCREASED CASH FLOW

An ESOP is a tax-qualified retirement plan in which assets are held in a trust that is exempt from federal and most state income tax under Internal Revenue Code Section 501(a). As a result, S Corporation income passed through to an ESOP is not taxed to the company (but participants pay ordinary income tax on distributions they receive from the ESOP, just like from any other tax-qualified retirement plan). Companies can be fully or partially owned by an ESOP, with the founders or shareholders deciding what percentage of stock they want to sell to the ESOP. Full ESOP ownership of an S corporation will eliminate federal income tax and, in most states, state income tax obligations for the company.

Reducing or eliminating a company's taxable income might also be 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 the company's eligible compensation, which can be especially beneficial to service-based government contractors, most of whose operating costs are labor-related.

PROVIDING OWNERSHIP CAN SUPPORT EMPLOYEE MORALE

Offering current and prospective employees equity ownership of a company through an ESOP might be a powerful incentive. Government contractors across various specialties that are seeking to attract top talent face a highly competitive labor market that at times, also has a scarcity of skilled workers. That trend 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 most recent [data](#) of the National Center for Employee Ownership (NCEO), as of 2023, there were 6,609 ESOPs covering 15 million employee-owners. While ESOPs continue to gain popularity on Main Street and Capitol Hill, the NCEO statistics suggest a large percentage of firms have yet to adopt employee ownership. 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 of 3% to 5%. Further, ESOP stock allocations come at no cost to the participant, and many companies continue to provide a 401(k) program for diversification.

Another NCEO [study](#) examined employees' economic circumstances over time and compared individuals aged 28 to 34 who received ESOP benefits to their peers who did not. The study found that employees with ESOP benefits had 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 discourages employee participants from leaving the company.





RECOUPING CONTRIBUTIONS USED TO FUND ESOP SHARE ALLOCATIONS

ESOP costs are generally allowable under Federal Acquisition Regulation (FAR) 31.205 6(q) when treated as compensation, provided they are measured, assigned, and allocated in accordance with CAS 415 and remain within IRS deductibility limits. Contributions may be made in cash or stock, but allowable amounts are limited to the fair market value of the stock at the time it is transferred to the ESOP trust. Any portion of contributions or stock purchase prices that exceed fair market value or tax deductibility limits is unallowable and must be credited back to the appropriate indirect cost pools. When fair market value is not readily determinable, valuations must follow IRS guidelines and are evaluated case by case.

Chapter 6 of [the Defense Contract Audit Agency's manual](#) directs auditors to review the ESOP's terms to assess whether plan design provides unreasonable compensation to some employees or groups. It also directs auditors to check the reasonableness of the stock distributed to an employee's ESOP account relative to total compensation.

Professional fees incurred to execute the ESOP transaction primarily consist of professional, legal, trustee, valuation, and insurance services. Those costs are generally allowable under FAR 31.205-33 when reasonable, allocable, and adequately supported.

BDO Insight

For government contractors, some ESOP-related transactions and ongoing administration costs might be allowable under FAR 31.205, depending on the nature of the expense, the supporting documentation, and the applicable cost principles. Costs such as those for professional services, legal support, trustee services, valuation work, some insurance expenses, and plan administration services might qualify for allowability treatment under specific FAR provisions.

The key takeaway for contractors is that those costs should be evaluated individually rather than treated as uniformly allowable because the analysis can vary based on the facts and circumstances.

How an ESOP Can Provide Shareholders With Fair Market Value

M&A transactions with government contractors present unique considerations that affect the deal overall — notably, the negotiated equity value, structured payouts, and confidence to close. One important point a buyer will need to assess is whether 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 affect those set-aside contracts, including recompute eligibility and probability. Because that analysis calls into question the firm's ability to generate future cash flows, it has a theoretical impact on equity value and structure, including 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 those unique considerations may be less significant. The buyer is an employer stock ownership trust (ESOT) that is represented by an independent trustee. If properly structured, a sale to an ESOP does not preclude the sponsor's standard small business set asides. That allows the owner to sell at fair market value based on cash flows from all contracts, including general small business set asides.

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

- ▶ See BDO's article: [Financing Considerations in an ESOP Sale](#)
- ▶ See BDO's article: [Unlocking Employee Ownership: How SBA 7\(a\) Loans Can Empower ESOP Transactions](#)



ESOP Success Story: Cybersecurity Government Contractor

Founded in 2007, a technology company offering a broad suite of cybersecurity, software development, systems engineering, and test and evaluation solutions to government and civilian agencies had grown to over 150 employees when an ESOP acquired the founders' stock.

Having been a BDO client for many years, the company developed a trusted relationship and engaged the BDO Capital Advisor's ESOP Advisory team to explore exit strategies, including ESOPs, in a Phase I Review of Strategic Alternatives. That 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 for the exiting owner (in conjunction with the owner's CPA), as well as post-deal board governance considerations (in conjunction with the company's counsel).

In an ESOP sale, modeling the projected benefits to employees is key for the shareholders considering the best exit strategy. As part of the Phase I assignment, the shareholders looked to BDO Capital for advice on the choice of tax entity (e.g., S 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, under the tax rules, if an S election is revoked or terminated, the corporation generally cannot make another S election for five tax years without IRS permission, and, as

noted above, an 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, a pillar of which called for sharing financial success with all employees via equity ownership. Shortly after delivering the Phase I feasibility study, the company decided to sell 100% to an ESOP and engaged BDO Capital as its sell-side advisor. Maintaining its federal government contractor qualified preferred status was desired, and the BDO Capital ESOP team consulted closely with BDO USA's tax and government contracting professionals to help ensure the company's qualified status and regulatory compliance were maintained post-ESOP.

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



HOW BDO CAPITAL ADVISORS CAN HELP

Employee ownership continues to gain interest among government contractors, but ESOP transactions in that industry often involve complex tax, regulatory, valuation, and structuring considerations. Because there is no one-size-fits-all ESOP approach, evaluating whether an ESOP aligns with shareholder objectives, company culture, and government contracting requirements is an important part of the decision-making process. BDO Capital Advisors works with business owners to assess strategic alternatives, navigate transaction complexity, and evaluate whether an ESOP may be the right fit for their goals. Learn what makes a company a strong [ESOP candidate](#) and connect with a [BDO Capital Advisors](#) professional to discuss your situation.

BDO Capital Advisors, LLC, a wholly owned affiliate of BDO USA, P.C., is a leading middle market investment bank that focuses on sell-side advisory, acquisition advisory, ESOP advisory, capital raising, special situations and board advisory services with offices located throughout the United States. The firm has deep industry knowledge, extensive cross-border transaction experience and is dedicated to providing superior execution services. The firm has broad industry experience and contacts having closed transactions within the Manufacturing & Distribution; Consumer, Food & Retail; Healthcare & Life Sciences; Business Services; Energy & Natural Resources; Technology, Media & Telecom; Architecture, Engineering & Construction; and Government Contracting sectors. Our seasoned investment bankers have collectively advised on hundreds of transactions for a variety of clients including family-owned businesses, entrepreneur-led companies, public corporations and leading private equity firms. Our professionals also draw upon the full depth and breadth of BDO USA's national resources which include 77 offices and more than 12,000 professionals located throughout the United States.

The firm has worldwide access to buyers, sellers and offshore investors via the Corporate Finance practices of BDO International Limited's network of independent member firms. BDO Global Corporate Finance firms operate in approximately 120 countries with more than 2,500 professionals who can meet the investment banking needs of clients across the globe.

BDO Capital Advisors, LLC, a FINRA/SIPC member firm, is a separate legal entity and is an affiliated company of BDO USA, P.C., a Virginia professional corporation. For more information please visit: www.bdocap.com.