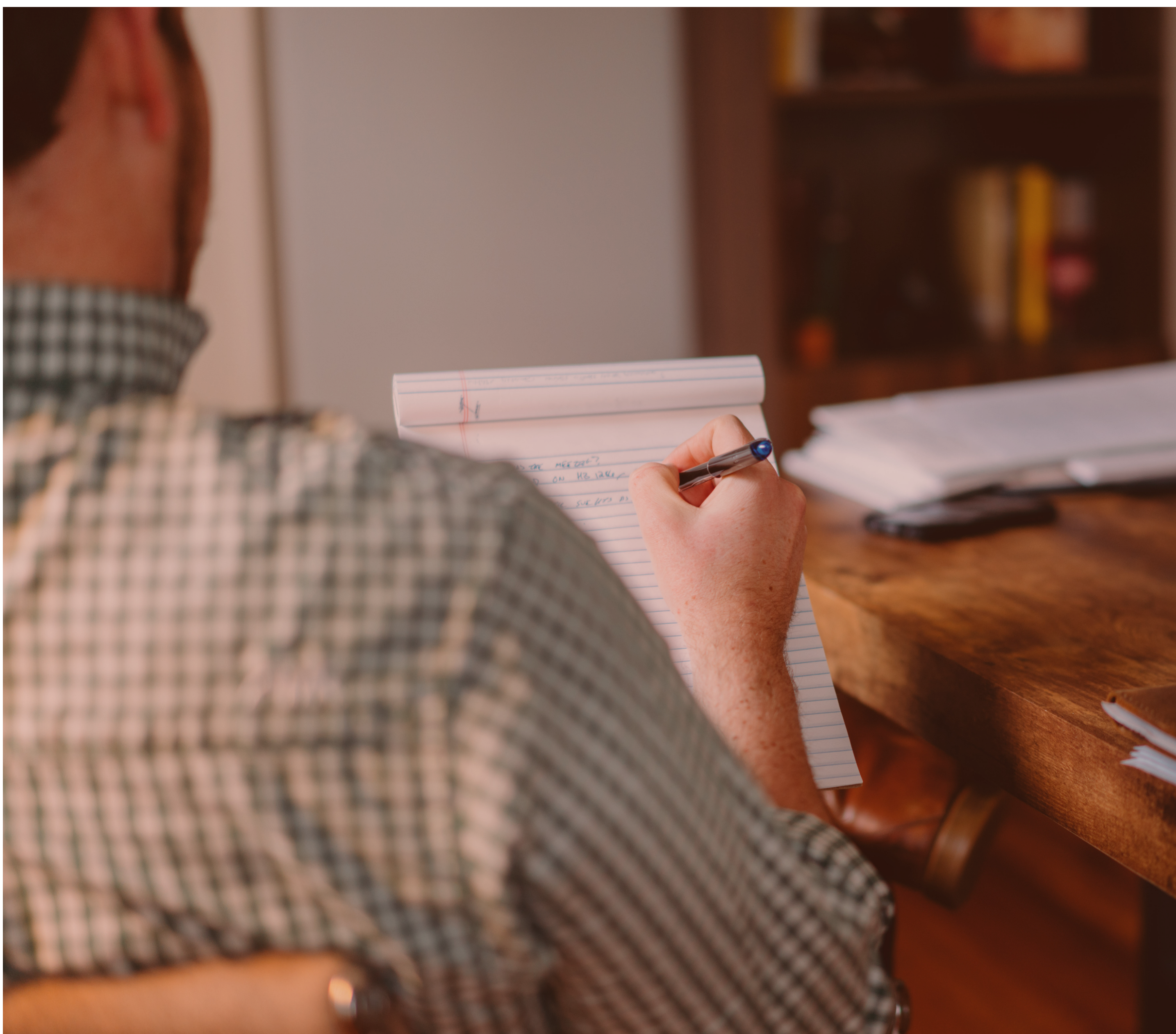
CHOICE OF ENTITY FACTORS

The two most common business entities are corporations and limited liability companies ("LLC"). And while corporations and LLCs have a number of similarities, there are also key differences that may lead a founder to choose one form over the other. For purposes of this discussion, we will assume the corporation is a Subchapter-C corporation.



LIABILITY PROTECTION

One of the most important characteristics for any business entity is the ability to protect its owners from liability for the debts of the company. To that end, a corporation and an LLC each offer limited liability for the owners so long as the formalities of the organization are respected. Therefore, the investors only risk the money or property contributed to or pledged as collateral for the company.

CAPITAL STRUCTURE

The capital structure of the entity is also an important factor to consider in organizing a company. Both the requirements upon formation and the expected capital structure in the future should be considered in making this decision. A corporation and an LLC each can have multiple classes of ownership interests with different rights and responsibilities. Further, they can each have an unlimited number of owners. The owners of these entities may also loan money to the company and the debt will not affect the equity investment as long as it is bona fide debt.

FLEXIBILITY OF CONTROL

A corporation offers limited flexibility of control of the company since control is tied to ownership percentages of stock and corporations are governed by boards of directors. Alternatively, an LLC offers great flexibility on the allocation of control of the company. The statutes governing these entities are generally subject to the terms of the operating agreement of the company, thus allowing the owners to divide control in any manner they see fit.

MARKET PERCEPTION

Corporations and LLCs are both generally accepted in the market. However, certain industries may have a tradition of a certain type of entity and hence drive the founder towards one entity type over the other. For example, scalable technology ventures that may pursue venture backing will almost always organize as a corporation as opposed to an LLC.

LEVELS OF TAX

One of the most important tax issues in choosing an entity is the levels of tax imposed on the organization and its owners. A corporation incurs two levels of tax on its profits, one at the corporate level and one at the shareholder level upon distribution of dividends. Conversely, an LLC only incurs one level of tax.

Profits and losses of LLCs pass through to the owners and are included on the owner's individual returns. The entity itself pays no income tax. This pass-through treatment occurs regardless of whether there is a distribution of cash or other company property to the owners. Therefore, there is a potential that the owners of an LLC could incur a tax liability without having received any funds with which to pay the tax, although the owners may agree to distribute a minimum amount of cash needed to pay their tax liabilities.

CAPITAL GAINS RATES

Although a corporation may have long term capital gains, it does not receive the favorable long-term capital gains tax rate that individuals receive. Since the tax attributes of the income and losses pass through to the owners of LLCs, any long-term capital gain of these entities retains that status in the owner's hands and therefore is subject to the favorable tax rate. This offers significant tax savings where the company has a significant amount of long-term capital gain.

USE OF COMPANY LOSSES

LLCs also offer the possibility of owners deducting losses against other income on their returns. Losses generated by an LLC pass through to the owners and may be deducted against other income, subject to certain limitations such as basis, at-risk amounts, and passive loss rules. Under the corporate structure, losses cannot be offset against anyone's income other than its own (unless in a consolidated corporate group).

DISTRIBUTIONS

Distributions from a corporation are taxed as dividends to the shareholders, while distributions from an LLC are generally not taxable events, subject to certain basis limitations. In addition, distributions of appreciated property by an LLC usually do not trigger the inherent gain in the property; whereas, distributions of appreciated property from a corporation will cause recognition of the gain on the property.

Another consideration in making distributions is the ability to make disproportionate distributions. Corporations usually must make distributions in proportion to stock ownership, although this restriction can be mitigated in the corporation context through the use of multiple classes of stock. However, LLCs generally can make disproportionate distributions without any adverse tax consequences.

SELF-EMPLOYMENT TAX

Where the owners of a business will perform services on behalf of the company, it is important to consider the applicability of the self-employment tax. Shareholders of a corporation who are employees of the corporation are not subject to self-employment taxes, but the compensation received for services performed will be subject to standard employment and payroll taxes. Conversely, a member's distributive share of earnings of an LLC is subject to the self-employment tax unless that member or partner is considered a "limited partner" under the applicable Treasury regulations.

SALE OF OWNERSHIP INTEREST

If the owner's sell their stock in a corporation, generally the shareholders will receive capital gain treatment from the sale. If the stock has been held for more than a year, this will result in a favorable long-term capital gains tax rate. If the stock is bought in return for a promissory note, the sale qualifies for installment sale treatment allowing the shareholder to defer gain over the term of the note.

Selling an LLC interest also generates capital gains, except to the extent of gain attributable to unrealized receivables and substantially appreciated inventory, which are taxed as ordinary income. Sales of LLC interests also qualify for installment sale treatment, except for amounts attributable to unrealized receivables and substantially appreciated inventory.

SALE OF ASSETS

A sale of a corporation's assets followed by a liquidation results in gain recognition by the corporation, and capital gains treatment to the shareholders upon liquidation since they are treated as if they sold their shares of stock. Therefore, unless the sale is pursuant to a tax-free reorganization, there are two levels of tax, although the shareholder level tax may qualify for the long-term capital gains rate.

For an LLC, the sale of assets triggers gain to the entity, but the gain passes through to the owners. This increases the owner's basis in their ownership interests and therefore the liquidation of the proceeds from the company does not result in any additional tax to the owners. As a result, a sale of the assets and liquidation of an LLC will result in a lower effective tax rate than a sale of assets and liquidation of a corporation. Since many buyers prefer to purchase the assets of a company in order to limit the assumption of potential liabilities, this is an important consideration.