



Getting Started Automatically—IRS Modifies Rules for Start Up and Organization Expenditures
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New Rules Under §§195, 248 and 709

This week the IRS issued temporary regulations under §§195, 248 and 709, provisions that were modified by the American Jobs Creation Act of 2004. However, the major change we find in each of these new proposed regulations is not related to the law change, but rather a significant change that eliminates what was previously a trap for the unwary related to these provisions.

These new rules are officially effective September 8, 2008, but taxpayers can elect to use these new rules for any period after the effective date of the 2004 Act that is still open for assessment of tax.

Getting a Business Started

These provisions of the tax law generally impact new enterprises or new ventures. IRC

195 governs start up expenditures, §248 governs corporate organizations costs and §709 governs partnership organization costs. The general rule is that such expenses are, by default (at least per the Code) capitalized and not available for amortization. But with the proper election, each of these items can be expensed or amortized under the following general rules applied independently for each type of cost:

- Taxpayers may expense up to \$5,000 of such expenses (though we can lose that ability—we'll see that later)
- Any expenses after \$5,000 must be capitalized and then amortized over 180 months
- If the expenses exceed \$50,000, the \$5,000 expensing amount must be reduced dollar for dollar for each dollar in excess of \$50,000. Thus, expensing is entirely eliminated if more than \$55,000 of each cost is incurred.

We'll first consider the Code provisions standing alone, and then we'll look at the new regulations.

Start-Up Costs

Start up costs for a new enterprise are governed by Section 195. That provision starts out with the following:

(a) Capitalization of expenditures

Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

This establishes the general rule that the amounts must be capitalized except as allowed under the IRC. However, the provision goes on to define an alternative:

(b) Election to deduct

(1) Allowance of deduction

If a taxpayer elects the application of this subsection with respect to any start-up expenditures--

(A) the taxpayer shall be allowed a deduction for the taxable year in which the active trade or business begins in an amount equal to the lesser of--

(i) the amount of start-up expenditures with respect to the active trade or business, or

(ii) \$5,000, reduced (but not below zero) by the amount by which such startup expenditures exceed \$50,000, and

(B) the remainder of such start-up expenditures shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the active trade or business begins.

(2) Dispositions before close of amortization period

In any case in which a trade or business is completely disposed of by the taxpayer before the end of the period to which paragraph (1) applies, any deferred expenses attributable to such trade or business which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

This defines our method of recovering the start-up expenses under the “alternative” method.

A key question then becomes—just what are start up expenses. And, for that, we turn to §195(c):

(c) Definitions

For purposes of this section--

(1) Start-up expenditures

The term "start-up expenditure" means any amount--

(A) paid or incurred in connection with--

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an

existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

(2) Beginning of trade or business

(A) In general

Except as provided in subparagraph (B), the determination of when an active trade or business begins shall be made in accordance with such regulations as the Secretary may prescribe.

(B) Acquired trade or business

An acquired active trade or business shall be treated as beginning when the taxpayer acquires it.

This provision deals with both what type of expenses we have to worry about, and then what date counts as start of the trade or business. The "excluded" expenses include interest (§163(a)), taxes (§164) and research and development (§174).

Finally, we look at the issue of how the election is to be made:

(d) Election

(1) Time for making election

An election under subsection (b) shall be made not later than the time prescribed by law for filing the return for the taxable year in which the trade or business begins (including extensions thereof).

(2) Scope of election

The period selected under subsection (b) shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

The election has to be made with the original return for the year in which the trade or business begins, and binds for all future years. This created a trap for the unwary, since if the election is not made then the default treatment is §195(a). As we'll discover, the IRS

has written regulations that effectively reverse the default, but there are still issues that remain.

Corporation Organization Costs

IRC §248 deals with corporation organizations costs. The provision is structured slightly differently than the §195 provision, and the default treatment is implied rather than explicitly mentioned in the provision. It starts out with §248(a):

(a) Election to deduct

If a corporation elects the application of this subsection (in accordance with regulations prescribed by the Secretary) with respect to any organizational expenditures--

(1) the corporation shall be allowed a deduction for the taxable year in which the corporation begins business in an amount equal to the lesser of--

(A) the amount of organizational expenditures with respect to the taxpayer, or

(B) \$5,000, reduced (but not below zero) by the amount by which such organizational expenditures exceed \$50,000, and

(2) the remainder of such organizational expenditures shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the corporation begins business.

Organization expenses are defined at §248(b), which provides:

(b) Organizational expenditures defined

The term "organizational expenditures" means any expenditure which--

(1) is incident to the creation of the corporation;

(2) is chargeable to capital account; and

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.

And, as with §195, the Code provides a description of the election, and again places a hard date that the election must be made by—the extended due date for the return in question.

(c) Time for and scope of election

The election provided by subsection (a) may be made for any taxable year beginning after December 31, 1953, but only if made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof). The period so elected shall be adhered to in computing the taxable income of the corporation for the taxable year for which the election is made and all subsequent taxable years. The election shall apply only with respect to expenditures paid or incurred on or after August 16, 1954.

Again, the IRS's Temporary Regulations will impact the nature of this election.

Partnership Organization Fees

The §709 provision governs both organization and syndication fees—but only the organization fees are potentially deductible/amortizable. This provision is structured more like §195, beginning with an explicit statement of the requirement to capitalize:

(a) General rule

Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

One key difference in this provision and §§195 and 248 is that only some of the expenses are eligible for expensing or amortization:

(b) Deduction of organization fees

(1) Allowance of deduction

If a partnership elects the application of this subsection (in accordance with regulations prescribed by the Secretary) with respect to any organizational expenses--

(A) the partnership shall be allowed a deduction for the taxable year in which the partnership begins business in an amount equal to the lesser of--

(i) the amount of organizational expenses with respect to the partnership, or

(ii) \$5,000, reduced (but not below zero) by the amount by which

such organizational expenses exceed \$50,000, and

(B) the remainder of such organizational expenses shall be allowed as a deduction ratably over the 180-month period beginning with the month in which the partnership begins business.

(2) Dispositions before close of amortization period

In any case in which a partnership is liquidated before the end of the period to which paragraph (1)(B) applies, any deferred expenses attributable to the partnership which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

Syndication fees get “stuck” with being capitalized under this provision, but organization costs are still eligible to be amortized.

The definition of partnership organization expenses are found in §709(b)(3):

(3) Organizational expenses defined

The organizational expenses to which paragraph (1) applies, are expenditures which--

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Syndication costs relate to the selling of the partnership, and will not be deductible or amortizable.

New Regulations

The new regulations give us a default election to amortize/expense in each case—but errors still create issues for taxpayers, just same the same disastrous ones that existed before.

§195 Temporary Regulation

Temporary Regulation §1.195-1T starts out with a general provision that explains the expensing/amortization options:

(a) In general. Under section 195(b), a taxpayer may elect to amortize start-up expenditures as defined in section 195(c)(1). In the taxable year in which a taxpayer begins an active trade or business, an electing taxpayer may deduct an amount equal to the lesser of the amount of the start-up expenditures that relate to the active trade or business, or \$5,000 (reduced (but not below zero) by the amount by which the start-up expenditures exceed \$50,000). The remainder of the start-up expenditures is deductible ratably over the 180-month period beginning with the month in which the active trade or business begins. All start-up expenditures that relate to the active trade or business are considered in determining whether the start-up expenditures exceed \$50,000, including expenditures incurred on or before October 22, 2004.

Temporary Regulation §1.195-1T(b) is what gives us a new default, which is a presumption that the election is made unless taxpayers go out of their way to indicate they do want to make this election. That provision begins as follows:

(b) Time and manner of making election. A taxpayer is deemed to have made an election under section 195(b) to amortize start-up expenditures as defined in section 195(c)(1) for the taxable year in which the active trade or business to which the expenditures relates begins. A taxpayer may choose to forgo the deemed election by clearly electing to capitalize its start-up expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the active trade or business to which the expenditures relates begins. The election either to amortize start-up expenditures under section 195(b) or to capitalize start-up expenditures is irrevocable and applies to all start-up expenditures that are related to the active trade or business.

However, the IRS goes on to apply the concepts of accounting methods to deal with taxpayers who may foul up and either start amortizing in the wrong year (normally too early) or fail to identify all start-up expenses. Previously either error was, in the IRS view, fatal—a taxpayer had not elected at all in the first case, and in the second those expenses were not covered by the election and lost forever. Now the IRS views this matter as follows:

A change in the characterization of an item as a start-up expenditure is a change in method of accounting to which sections 446 and 481(a) apply if the taxpayer treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the active trade or business begins also is treated as a change in method of accounting if the taxpayer amortized start-up expenditures for two or more taxable years.

Example 3 goes through the issue of having mischaracterized an item.

Example 3. Subsequent change in the characterization of an item. The facts are the same as in Example 2 except that Corporation X determines in 2011 that Corporation X

incurred \$10,000 for an additional start-up expenditure erroneously deducted in 2009 under section 162 as a business expense. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2009, including the additional \$10,000 of start-up expenditures. Corporation X is using an impermissible method of accounting for the additional \$10,000 of start-up expenditures and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

Remember that a taxpayer needs IRS permission to change a method of accounting, so if this issue is noticed later a taxpayer is not allowed to just quietly switch methods. However, with permission a §481(a) adjustment goes into the process to “fix” past differences, including those in closed years. And, as well, an IRS agent in an examination can require the taxpayer to change to the proper method in the earliest open year.

Example 4 goes through the similar result if the wrong start year is selected by the taxpayer.

Example 4. Subsequent redetermination of year in which business begins. The facts are the same as in Example 2 except that, in 2010, Corporation X deducted the start-up expenditures allocable to January through December of 2010 ($\$36,000/180 \times 12 = \$2,400$). In addition, in 2011 it is determined that Corporation X actually began business in 2010. Under paragraph (b) of this section, Corporation X is deemed to have elected to deduct start-up expenditures under section 195(b) in 2010. Corporation X impermissibly deducted start-up expenditures in 2009, and incorrectly determined the amount of start-up expenditures deducted in 2010. Therefore, Corporation X is using an impermissible method of accounting for the start-up expenditures and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

Again, the accounting method treatment is what applies.

The effective date provision of the regulations, reproduced below, gives us the option to retroactively use these regulations and requires their use for expenses paid or incurred after September 8, 2008:

(d) Effective/applicability date. This section applies to start-up expenditures paid or incurred after September 8, 2008. However, taxpayers may apply all the provisions of this section to start-up expenditures paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under paragraph (b) of this section is deemed made has not expired. Otherwise, for start-up expenditures paid or incurred prior to September 8, 2008, see § 1.195-1 in effect prior to that date (§ 1.195-1 as contained in 26 CFR part 1 edition revised as of April 1, 2008).

§248 Temporary Regulation

Like the §195 Temporary Regulation, we find the same automatic election/accounting method rulings in these new temporary regulations. Temporary Regulation §1.248-1T provides:

(c) Time and manner of making election. A corporation is deemed to have made an election under section 248(a) to amortize organizational expenditures as defined in section 248(b) and § 1.248-1(b) for the taxable year in which the corporation begins business. A corporation may choose to forgo the deemed election by clearly electing to capitalize its organizational expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the corporation begins business. The election either to amortize organizational expenditures under section 248(a) or to capitalize organizational expenditures is irrevocable and applies to all organizational expenditures of the corporation. A change in the characterization of an item as an organizational expenditure is a change in method of accounting to which sections 446 and 481(a) apply if the corporation treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the corporation begins business also is treated as a change in method of accounting if the corporation amortized organizational expenditures for two or more taxable years.

We also find similar examples applying the “accounting method” ruling for problems found down the line. First, for a change in the characterization of an item, Example 3 provides:

Example 3. Subsequent change in the characterization of an item. The facts are the same as in Example 2 except that Corporation X determines in 2011 that Corporation X incurred \$10,000 for an additional organizational expenditure erroneously deducted in 2009 under section 162 as a business expense. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2009, including the additional \$10,000 of organizational expenditures. Corporation X is using an impermissible method of accounting for the additional \$10,000 of organizational expenditures and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

While Example 4, in a similar manner to the related example under Temporary Regulation §1.195-1T, provides:

Example 4. Subsequent redetermination of year in which business begins. The facts are the same as in Example 2 except that, in 2010, Corporation X deducted the organizational expenditures allocable to January through December of 2010 ($\$36,000/180 \times 12 = \$2,400$). In addition, in 2011 it is determined that Corporation X actually began business in 2010. Under paragraph (c) of this section, Corporation X is

deemed to have elected to deduct organizational expenditures under section 248(a) in 2010. Corporation X impermissibly deducted organizational expenditures in 2009, and incorrectly determined the amount of organizational expenditures deducted in 2010. Therefore, Corporation X is using an impermissible method of accounting for the organizational expenditures and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

The effective date provision also gives us similar options to the one for start up expenses:

(f) Effective/applicability date. This section applies to organizational expenditures paid or incurred after September 8, 2008. However, taxpayers may apply all the provisions of this section to organizational expenditures paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under paragraph (c) of this section is deemed made has not expired. Otherwise, for organizational expenditures paid or incurred prior to September 8, 2008, see § 1.248-1 in effect prior to that date (§ 1.248-1 as contained in 26 CFR part 1 edition revised as of April 1, 2008).

§709 Temporary Regulations

Finally we go to the third Code Section impacted by the new temporary regulations, that of §709 that impacts partnership organizational expenses. The election provision is found in Temporary Regulation §1.709-1T(b)(2) which provides:

(2) Time and manner of making election. A partnership is deemed to have made an election under section 709(b) to amortize organizational expenses as defined in section 709(b)(3) and § 1.709-2(a) for the taxable year in which the partnership begins business. A partnership may choose to forgo the deemed election by clearly electing to capitalize its organizational expenses on a timely filed Federal income tax return (including extensions) for the taxable year in which the partnership begins business. The election either to amortize organizational expenses under section 709(b) or to capitalize organizational expenses is irrevocable and applies to all organizational expenses of the partnership. A change in the characterization of an item as an organizational expense is a change in method of accounting to which sections 446 and 481(a) apply if the partnership treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the partnership begins business also is treated as a change in method of accounting if the partnership amortized organizational expenses for two or more taxable years.

Since this IRC Section covers more than just organization costs, Temporary Regulation §1.709-1T(b)(3) reminds us that while we can write off remaining unamortized organization costs on liquidation of the partnership, syndication costs get a different treatment:

(3) *Liquidation of partnership.* If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

The expected set of paired examples that illustrate accounting method changes also exist in this temporary regulation, beginning with the change in characterization of an item example in Example 3:

Example 3. Subsequent change in the characterization of an item. The facts are the same as in Example 2 except that Partnership X realizes in 2011 that Partnership X incurred \$10,000 for an additional organizational expense erroneously deducted in 2009 under section 162 as a business expense. Under paragraph (b)(2) of this section, Partnership X is deemed to have elected to amortize organizational expenses under section 709(b) in 2009, including the additional \$10,000 of organizational expenses. Partnership X is using an impermissible method of accounting for the additional \$10,000 of organizational expenses and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

We continue with the issue of the redetermination of year in which the business began in Example 4:

Example 4. Subsequent redetermination of year in which business begins. The facts are the same as in Example 2 except that, in 2010, Partnership X deducted the organizational expenses allocable to January through December of 2010 ($\$36,000/180 \times 12 = \$2,400$). In addition, in 2011 it is determined that Partnership X actually began business in 2010. Under paragraph (b)(2) of this section, Partnership X is deemed to have elected to deduct organizational expenses under section 709(b) in 2010. Partnership X impermissibly deducted organizational expenses in 2009, and incorrectly determined the amount of organizational expenses deducted in 2010. Therefore, Partnership X is using an impermissible method of accounting for the organizational expenses and must change its method under § 1.446-1(e) and the applicable general administrative procedures in effect in 2011.

And, as well, we get a similar elective effective date:

(5) *Effective/applicability date.* This section applies to organizational expenses paid or incurred after September 8, 2008. However, taxpayers may apply all the provisions of this section to organizational expenses paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under paragraph (b)(2) of this section is deemed made has not expired. Otherwise, for organizational expenses paid or incurred prior to September 8, 2008, see § 1.709-1 in

effect prior to that date (§ 1.709-1 as contained in 26 CFR part 1 edition revised as of April 1, 2008).

Conclusions

Overall these changes are taxpayer friendly, even if introducing the matter of an accounting method. Previously the IRS viewed these items as requiring item by item specification and election to be able to amortize expenses, thus any item found to be misclassified simply became a permanently capitalized fixture. Similarly, if it was determined the election was made in the wrong year there simply was no election. By changing to a situation where there is an automatic election unless the taxpayer specifically elects out, the IRS has made the provisions much more forgiving.

Why did the IRS do this? In the preamble to the temporary regulations, the IRS gives the following justification for this action:

This Treasury decision revises the regulations under sections 195, 248, and 709 to reflect the amendments made by section 902 of the Act. This Treasury decision also updates the manner in which taxpayers elect to deduct costs under sections 195, 248, and 709. Under these regulations, taxpayers are no longer required to file a separate election statement to deduct costs under sections 195, 248, and 709. The manner of filing these elections is changed because of various electronic return filing initiatives and in acknowledgment that the vast majority of taxpayers that incur costs that may be deducted under sections 195, 248, and 709 elect to deduct those costs. The change also reduces the administrative burden of making the elections.

The reference to electronic filing issues is an interesting one, since many regulatory elections create problems in the electronic filing systems, especially for return types not yet on the modernized efile system. It will be interesting to watch and see if the IRS begins to eliminate the need to file paperwork in cases where there appears to be little gained by the required paperwork that is attached to the return.

Scheduled Courses

Below is the list of live courses I'll be presenting for the various state societies of CPAs. If you wish to attend one of these presentations, contact the specific state society of CPAs listed for registration costs and information:

Arizona Society of CPAs

Run Windows XP and Vista on the Same Computer
July 16, 2008, Phoenix, Arizona, 2 hours

Arizona Federal Tax Institute Annual Tax Conference
November 6-7, 2008 (Conference spans two days, I present my session on day one in the afternoon on preparer penalty changes), Phoenix, Arizona, 16 hours total conference credit

California CPA Education Foundation

S Corporations: A Complete Guide to Planning and Compliance
October 20, 2008, Sacramento, California, 8 hours

Partnership and LLC Taxation: Advanced Issues, Including Transfers of Interest and Liquidations
October 21, 2008, Sacramento, California, 8 hours

Partnership and LLC Taxation: Advanced Issues, Including Transfers of Interest and Liquidations
October 22, 2008, San Francisco, California, 8 hours

S Corporations: A Complete Guide to Planning and Compliance
October 23, 2008, Los Angeles (Airport), California, 8 hours

Partnership and LLC Taxation: Advanced Issues, Including Transfers of Interest and Liquidations
October 24, 2008, Pasadena, California, 8 hours

Maryland Association of CPAs

Fringe Benefits: 2007-2008
September 24, 2008, Towson, Maryland, 8 hours

Minnesota Society of CPAs

Partnerships and LLC Taxation: Advanced Issues, Including Transfers of Interest and Liquidations
September 30, 2008, Bloomington, Minnesota, 8 hours

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Missouri Society of CPAs

IRS Practice And Procedure: Audits, Appeals, Assessment, Settlement, and Collection
August 13, 2008, St. Louis, Missouri, 8 hours

Partnership and LLC Taxation: Advanced Issues, Including Transfers Of Interests And Liquidations
August 14, 2008, St. Louis, Missouri, 8 hours

North Carolina Society of CPAs

Family and Succession Planning for the Business Owner
December 17, 2008 (morning), Browns Summit, North Carolina, 4 hours

Fringe Benefits—2007–2008
December 17, 2008 (afternoon), Browns Summit, North Carolina, 4 hours

Ohio Society of CPAs

Fringe Benefits: 2007-2008
September 19, 2008, Independence, Ohio, 8 hours

Construction Contractors: Special Tax and Accounting Considerations
November 18, 2008, Elyria, Ohio, 8 hours

Construction Contractors: Special Tax and Accounting Considerations
December 1, 2008, Fairfield, Ohio, 8 hours

Fringe Benefits: 2007-2008
December 2, 2008, Dayton, Ohio, 8 hours

Fringe Benefits: 2007-2008
December 3, 2008, Dublin, Ohio, 8 hours

Oregon Society of CPAs

Current Federal Tax Developments
December 9, 2008, Bend, Oregon, 8 hours

Estate and Gift Taxation
December 10, 2008, Bend, Oregon, 8 hours

Virginia Society of CPAs

38th Annual Virginia Accounting & Auditing Conference
September 22-23, 2008, (Technology Update Presentation), Roanoke, Virginia, 16 hours
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38th Annual Virginia Accounting & Auditing Conference

November 20-21, 2008, (Technology Update Presentation), Virginia Beach, Virginia, 16 hours total conference credit

Wyoming Society of CPAs

Current Federal Tax Developments

October 17, 2008, Casper, Wyoming, 8 hours