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"All Events" Test for Accrual of Deductions: *Morning Star Packing Co. v. Commissioner*

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Under the accrual method of accounting, an expense is considered to have been incurred, such that a deduction may be claimed, only if (i) all the events that establish liability have occurred, (ii) the amount of the expense is ascertainable with reasonable accuracy, and (iii) "economic performance" (as defined in IRC section 461(h)) has occurred.

The Court of Appeals for the Ninth Circuit recently affirmed a decision of the Tax Court (TC Memo 2020-142, affirmed, 134 AFTR 2d 2024-6440) that, under circumstances discussed below, the petitioners failed to establish that all the events had occurred to establish liability for anticipated costs of annual reconditioning of manufacturing equipment during each of the years at issue (2008 through 2011), where the reconditioning did not occur until the following year.

Facts in *Morning Star Packing*

A limited partnership and a limited liability company (collectively referenced in the Court of Appeals opinion and below as Morning Star) processed tomatoes and provided bulk-packaged tomato products using three manufacturing facilities in California. Each of these entities used the accrual method of accounting and filed Form 1065 partnership returns for taxable periods corresponding to the calendar year.

Each manufacturing facility was operated annually for a period of a few months, beginning in June or July and ending by October. To maintain necessary quality and sanitary specifications and reliability, Morning Star incurred reconditioning expenditures annually in the range of $16.7 million to $21 million to restore the operational capability of the facilities.

But for *de minimis* work in the portion of each calendar year following the end of production, the reconditioning was performed in the first six months of each year, shortly before production commenced. However, the anticipated reconditioning costs were included in costs of goods sold (COGS) for the preceding year to the extent of the percentage of the year's production that was sold by December 31. Reconditioning costs not included in COGS were included in ending inventory.

Morning Star had financing agreements with lenders that did not specifically address the reconditioning of equipment but did require that it "conduct its business activities in compliance with all laws and material contractual obligations applicable" to it and "keep all property useful and necessary in its business in good working order and condition, ordinary wear and tear excepted."

The IRS had audited Morning Star in the early 1990s and found its accrual of reconditioning costs in the year before the reconditioning was performed to be acceptable. Following audits for the years at issue, however, the IRS issued notices of final partnership administrative adjustment that reduced COGS for each year by the amount attributable to reconditioning that was to occur in the following year. The IRS asserted that Morning Star failed to establish that all the events had occurred to establish the fact of liability in the year prior to the year in which the reconditioning was performed, and, further, that "economic performance" had not occurred with respect to those costs in the years claimed.

Discussion

Before the Tax Court, Morning Star argued that its financing agreements, which required that its property be kept in good working order, and its multiyear production contracts with customers that included extensive product quality specifications, gave rise to obligations to recondition its equipment that were sufficiently fixed and definite to establish that, by December 31, all the events had occurred that were necessary to cause Morning Star to be liable for the reconditioning to be completed before production commenced in the following year.

None of the financing agreements or production contracts, however, referred specifically to the reconditioning of equipment, or identified standards for determining the scope of reconditioning. Cases discussed in the Tax Court opinion required that, to be deductible, a liability "must be fixed, absolute, and unconditional" (citations omitted). More specifically, cases finding that the all events test was met on the basis of requirements imposed by law or regulation, such as a comprehensive strip-mining reclamation statute applicable to a coal mining company (see *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981)), were found to be distinguishable as involving situations where more specific and detailed requirements were imposed. The Tax Court ultimately agreed with the government's position that neither the financing agreements nor the production contracts were sufficiently specific to establish Morning Star's liability for the reconditioning costs.

Taking into account that liability for the reconditioning costs was not established in the years for which those costs were accrued on Morning Star's returns, the Tax Court concluded that it need not address the separate question of whether the "economic performance" test was met for those years.

Morning Star appealed to the Court of Appeals for the Ninth Circuit and made the same arguments as it did to the Tax Court, relying principally on its financing agreements as the source of the reconditioning obligation. The appellate court ultimately agreed with the Tax Court, however, that no fixed and definite reconditioning obligation arose under those agreements. In particular, the Court of Appeals noted that the agreements did not by their terms attempt to prohibit (or characterize as a default) deterioration of equipment caused by ordinary wear and tear, and that Morning Star did not dispute that the facilities' deterioration over the course of the year was caused by ordinary use.

A strenuous dissent by one judge of the Court of Appeals panel asserted that deterioration resulting from use of the facilities which required in the vicinity of $20 million of reconditioning annually, far exceeded what could reasonably be characterized as ordinary wear and tear.

The dissent also discussed at length two leading cases in this area, *United States v. Hughes Properties, Inc.,* 476 U.S. 593 (1986) and *Gold Coast Hotel & Casino v. United States*, 158 F.3d 484 (9th Cir. 1998), that applied the all events test in the context of casino operators. *Hughes* concluded that amounts required to be paid eventually by reason of use of progressive slot machines could be deducted even though not been paid out by the end of the year. In *Gold Coast*, the Court of Appeals for the 9th Circuit found that the value of redeemable points could be deducted in the year in which casino customers had accumulated the minimum number of points necessary to redeem for a prize because the accumulation of points was sufficient to cause the liability to be fixed and unconditional, notwithstanding the probability that some of the customers would not redeem their points.

The dissent characterized the last production run of the year for Morning Star as closely analogous to the slot machine plays and redeemable points that sufficed to establish a fixed liability in *Hughes* and *Gold Coast.*

Observations

Although the conclusion reached by the Tax Court and by the Court of Appeals majority is not surprising, the circumstances of *Morning Star Packing* (and the Court of Appeals dissent) underscore the potential for uncertainty in specific situations as to whether the all events test have been met. Also implicit in this case is that provisions included or omitted from commercial agreements may influence in surprising ways the appropriate tax accounting for related costs (or revenue).

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