

# How Chevron, Texaco, and the Indonesian Government Structured Transactions to Avoid Billions in U.S. Income Taxes

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**SYNOPSIS:** This paper explains the transactions, agreements, and accounting that Chevron, Texaco, and the Government of Indonesia used to structure transactions that avoided billions in U.S. income taxes. Although ChevronTexaco became a merged entity on October 9, 2001, for many years Chevron and Texaco operated as separate corporations, with each owning 50 percent of a group of primarily non-U.S. companies collectively known as Caltex. Transactions were structured such that Chevron and Texaco subsidiaries paid Caltex excessive prices for Indonesian crude oil, leading to excessive dividend income (with foreign tax credits) and cost of sales deductions on U.S. income tax returns. When one of the equal shareholders purchased more overpriced oil than the other, Caltex paid monthly “Special Dividends” to the “overlifter” that could be construed as cost rebates, not dividends. To compensate for the extra taxes it received, the Government of Indonesia provided Caltex with oil in excess of the amount called for under the formal production-sharing contract (PSC) with the Government of Indonesia.

We estimate that this arrangement allowed Chevron and Texaco together to annually avoid paying some \$220 million in federal income taxes and \$11.1 million in state income taxes from 1964 to 2002. These estimates produce total federal and state taxes avoided of \$8.6 billion and \$433 million, respectively, for the combined company, ChevronTexaco.

## INTRODUCTION

The purpose of this paper is to explain the transactions, agreements, and accounting methods that Chevron and Texaco employed, and apparently continue to employ, to reduce tax paid in the United States. Our principal objective is to enable students, academics, and policy makers to appreciate the extensive transaction structuring and controversial accounting that can occur when large multinational corporations cooperate with foreign governments to avoid U.S. taxes. Another objective is to encourage federal and state tax officials to reexamine this arrangement.

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Although ChevronTexaco became a merged entity on October 9, 2001, for many years Chevron and Texaco operated as separate corporations, with each owning 50 percent of a group of primarily non-U.S. companies collectively known as Caltex.<sup>1</sup> Transactions were structured such that subsidiaries of Chevron and Texaco paid Caltex above-market prices for Indonesian crude oil, leading to lower U.S. income and higher Indonesian income and related taxes. Without some form of compensation, Chevron and Texaco officials might have violated their responsibilities to shareholders if they deliberately shifted income from the lower U.S. marginal tax rate to the higher Indonesian marginal tax rate. However, further examination indicates that Chevron and Texaco officials were indeed concerned about shareholder wealth, as Caltex received compensation for the excess Indonesian tax from the Indonesian Government's wholly owned oil company, Pertamina.

Caltex sold its Indonesian oil production to only U.S. subsidiaries of Chevron and Texaco, termed *offtakers*, at approximately \$4.55 more than fair market value. *Special Dividends* were paid by Caltex to either Chevron or Texaco, depending on which of the firms' *offtakers* bought more of the overpriced oil. The above-market price created additional dividend income (with foreign tax credits) and cost of sales deductions that were reported on U.S. income tax returns.

**Offtaker:** U.S. subsidiary of either Chevron or Texaco that purchases crude oil produced by Caltex. By paying above-market prices for this oil, an increased cost of goods sold was deducted on U.S. income tax returns of Chevron and presumably Texaco.

We roughly estimate that the arrangement enabled Chevron and Texaco together to avoid some \$8.6 billion in federal income taxes and \$433 million in state income taxes across the 39-year period ending December 31, 2002, excluding potential interest and penalty additions. In 1998 the IRS issued a Technical Advice Memorandum (hereafter, TAM) that permits this arrangement, with the possible result that other companies operating in foreign countries will adopt similar techniques (IRS 1998).<sup>2</sup> We confess to not understanding the logic underlying the decision in the TAM, and wonder whether national-level oil industry influence in U.S. government affairs and/or possible U.S. geopolitical aims to support the Indonesian Government played a role. But such reasons do not justify the use of unwarranted transfer prices, unreported oil receipts, and apparent cost rebates characterized as Special Dividends, all of which are addressed in U.S. laws. The IRS examined but decided not to litigate these issues, choosing instead to settle separately with Chevron and Texaco out of court. However, if a court finds tax fraud, all years involved are opened to recomputation, leading to potentially substantial penalties and interest on any additional taxes due.

## OVERVIEW OF APPLICABLE U.S. TAX RULES

### Foreign Tax Credit

The foreign tax credit is designed to neutralize the effects of having multiple countries' tax authorities apply levies against the same income. When foreign income becomes subject to U.S. tax, the credit allows U.S. taxpayers to reduce their U.S. federal tax liability by the lower of the amount of the foreign income tax paid or deemed paid (IRC Sec. 901) or the U.S. tax on that income (IRC Sec. 904). Thus, the credit is limited to the portion of the U.S. tax that arises from including foreign income on the federal income tax return. In other words, although the Section 901 foreign tax credit seeks to eliminate multiple taxation of the same income, the Section 904 "foreign tax credit limit" is

<sup>1</sup> A website provides readers the opportunity to view the entire source of each noncopyrighted reference plus a large amount of additional relevant data such as SEC filings and legal references: <http://www.usm.maine.edu/~gramlich/caltex/>. Chevron was called Standard Oil of California until December 31, 1983.

<sup>2</sup> The IRS issued the TAM in February 1998, removing the taxpayer's name and the names of its related entities to maintain confidentiality. However, Chevron attorneys Carl A. Nordberg and Michael F. Kelleher, in a January 25, 1999 letter to the editor of *Tax Notes*, acknowledge that the TAM relates to their client (Nordberg and Kelleher 1999).

designed to maintain at least single taxation, so that affected U.S. taxpayers are kept on par with other foreign and domestic taxpayers.

The Treasury Department further clarifies that to be eligible for the Section 901 credit, the payment must meet the definition of a “tax” on income [Reg. Sec. 1.901-2(a)(1)]. Specifically, the Regulations provide that a tax is “a compulsory payment pursuant to the authority of a foreign country to levy taxes” [Reg. Sec. 1.901-2(a)(2)(i)]. Further, to qualify as an *income tax*, the “pre-dominant character of a foreign tax [must be] an income tax in the U.S. sense” [Reg. Sec. 1.901-2(a)(3)]. Moreover, to be eligible to claim the foreign tax credit, Reg. Sec. 1.901-2(e)(5) requires that taxpayers minimize their foreign taxes. In an analysis of the available documents relating to each of these rules (not reported here), we conclude that payments made by Caltex to the Indonesian Government do not satisfy all the tests needed to qualify as a creditable tax.

### **Transfer Prices and Dividends**

IRC Sec. 482 empowers the IRS Commissioner to reallocate income among related taxpayers if the Commissioner believes such reallocation is necessary to clearly reflect income or to prevent tax evasion. Interpretive Reg. Sec. 1.482-1(b)(1) explains:

The purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer ... The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.

Thus, when non-arm’s-length transfer prices are being applied, the IRS has the right, indeed the responsibility, to restate the prices as if the parties are unrelated. In a similar vein, Section 301(a) of the U.S. Internal Revenue Code (IRC) states that only the portion of a distribution made “with respect to stock” is to be taxed as a dividend. If a taxpayer fails to properly determine the correct amount of Section 301 dividends, the IRS and the court system may have to intervene to determine whether the distribution in question is a dividend or a return of capital. This distinction is important in the present case because, in contrast with a dividend, a return of capital does not generate foreign tax credits. In this case, an amount found to be a return of capital could be substantial.

### **Consolidation and Dividends for Tax and Financial Reporting Purposes**

Prior to their 2001 merger, neither Chevron nor Texaco consolidated Caltex financial statements into its financial reports. Both Chevron and Texaco reported their 50 percent ownership of Caltex as an affiliated company and accounted for their investments using the equity method. Under the equity method, either Chevron or Texaco, as the investor, recognizes its 50 percent share of Caltex income. The equity method increases the investment account by the income share and reduces the investment account by dividends received.

Once elected, Chevron and Texaco must continue to file U.S. federal consolidated tax returns that include results from subsidiaries, except that foreign subsidiaries or those owned less than 80 percent, such as Caltex, are excluded from the consolidated group. For those equity investments excluded from the consolidated tax return, income is usually recognized when dividends are received, as the U.S. tax code does not recognize the equity method. For federal tax purposes, distributions received are (1) dividend income to the extent that the distributing corporation has positive “earnings and profits” (E&P), (2) nontaxable return of invested capital to the extent of the investor’s basis in the equity investment, and (3) capital gain for any distribution in excess of basis. E&P is a tax concept of dividend-paying ability that somewhat mirrors the financial accounting term “retained earnings” (IRC Sec. 312), although E&P usually differs from retained earnings. The accuracy of the E&P computation is impacted when related-party transactions are not recorded at arm’s length

values. IRC Section 482 provides for correcting adjustments that could affect Chevron and Texaco's tax bases in their Caltex investments.<sup>3</sup>

When a U.S. investor like Chevron or Texaco receives dividend income from an unconsolidated foreign investee (like Caltex), the investor also receives a foreign tax credit to the extent that foreign taxes are deemed to have been paid on that income (IRC Sec. 902), subject to the foreign tax credit limit.<sup>4</sup> Since the Tax Reform Act of 1986, the foreign tax credit limit has been separately applied to each of many different types or "baskets" of income, without regard to the country in which the foreign taxes were paid [IRC Sec. 904(d)].<sup>5</sup> Thus, the foreign tax credit limit is separately applied to the oil and gas extraction income "basket" (IRC Sec. 907), such that foreign tax credits generated in a high-tax country can become available to offset the additional U.S. tax liability that arises when oil and gas income is generated in a low-tax country.

## THE TRANSACTIONS AND THEIR ACCOUNTING

### Contract Terms

A simple contract underlies the Chevron/Texaco/Indonesian Government transactions. The Indonesian Government brings oil to the bargaining table and Caltex brings the capabilities of extracting and selling it. The parties agree that oil is split between the Indonesian Government's wholly owned company, Pertamina, and Caltex in sharecropping style, after allowing Caltex to recover its operating costs and providing Pertamina with sufficient oil to satisfy domestic oil obligations (Hom 1994, para. 14). In other words, proceeds from sales of oil are first dedicated to covering Caltex expenses and then the profit, or "profit oil," is split in defined percentages between Pertamina and Caltex (Hom 1994; IRS 1998). Over the years of the arrangement, the after-tax split changed from the original ratio of 60 percent for the Government of Indonesia and 40 percent for Caltex to 70/30 and eventually to 88/12, as Indonesia ultimately claimed 88 percent of the oil output. Caltex sold its portion of the extracted oil to Chevron's and Texaco's wholly owned domestic subsidiaries—"offtakers"—in relation to their respective needs for oil.

The 1963 Contract of Work (COW) between Caltex and Indonesia was stated in after-tax terms, thus merging Indonesia's share of "profit oil" with the revenue it receives as a tax collector (Hom 1994, para. 13; IRS 1998, under "Facts"). Although it is difficult to ascertain when and at whose initiative the use of the non-market-value Government Sales Price (GSP) began, we do know that the COW employed the overpriced GSP (Hom 1994, para. 16). A Production Sharing Contract (PSC) was negotiated in 1971 to replace the COW at its scheduled expiration date in 1983 (Hom 1994, para. 19; IRS 1998, under "Facts"). In 1978, before the PSC became effective, the IRS changed the foreign tax credit rules. Revenue Ruling 78-222 eliminated the creditability of taxes under the 1971 PSC primarily because the PSC called for the Indonesian Government to receive the Caltex taxes from Pertamina and not from Caltex (Hom 1994, para. 22; IRS 1998, under "Renegotiation of the COW and the PSC").

The 1971 PSC was replaced by a new PSC that did not affect the after-tax split of oil profits between the Government of Indonesia and Caltex. Without changing the underlying agreement, the revised PSC rephrased the terms to a before-tax basis by clearly dividing Indonesia's portion between profit oil and taxes. To retain the creditability of the Indonesian taxes, the revised PSC required that Caltex pay its Indonesian taxes directly to the Indonesian Government; this revised the

<sup>3</sup> Similar adjustments would be necessary to the Caltex investment values reported on the SEC-filed balance sheets of Chevron and Texaco.

<sup>4</sup> The dividends-received deduction applies only to dividends received from domestic corporations and certain foreign corporations with U.S. source income (IRC Sections 243 and 245).

<sup>5</sup> Until 1976 taxpayers could choose either a per-country limitation or an overall limitation approach. From 1976 until the passage of the Tax Reform Act of 1986, taxpayers were required to use an overall limitation approach that was applied separately to five categories of income.

prior practice of having Pertamina “pay” the Caltex taxes from its share of the oil split (Hom 1994, paras. 47–51 and 54; IRS 1998, under “Renegotiation of the COW and PSC”). As a result, Caltex’s before-tax profit share under the new PSC was adjusted to become 27.27 percent, equal to the prior 12 percent divided by the net of 1 minus the Indonesian 56 percent tax rate [ $.12/(1 - .56) = .2727$ ].

### Accounting Based on Fair Market Value Prices

The following scenario applies actual Indonesia-Caltex contract terms but assumes the production of only 3.667 barrels of “profit oil” that have a fair market value of \$20 per barrel. The purpose of the scenario is to explain how the arrangement should have been recognized for tax and financial accounting purposes, given that \$20 fair market value. Simplification to a single barrel of profit oil allocated to Caltex ( $3.667 * 0.2727 = 1$ ) allows the implications of the computations to remain intact, since both the actual number of barrels and the fair market value of oil at different points in time can be determined retrospectively. Further, the amount of the overpricing reported in court documents, combined with the fair market value of the oil, the actual number of barrels, and the “dividend” payments (repatriation), determines the annual amount of U.S. income taxes avoided. As reflected in Table 1, the identity of the purchaser is irrelevant if the transaction is recorded at fair market value. We assume initially that Chevron buys 60 percent of the Caltex oil, Texaco buys the remaining 40 percent, and both parties pay Caltex the \$20.00 fair value rate on a per-barrel basis.

As described above, the revised PSC that became effective in 1983 gives Indonesia a 72.73 percent share of the profit oil and allows Caltex to keep the remaining 27.27 percent prior to paying its Indonesian tax. Since costs were already considered in determining the 3.667 “profit” barrels, the Caltex pre-tax Indonesian profit was \$20.00 ( $0.2727 * 3.667 * \$20.00$ ), and Caltex has \$8.80 remaining after paying the 56 percent Indonesian income tax of \$11.20. As 50 percent shareholders, Chevron and Texaco should each receive one-half of the distributed portion of after-Indonesian-tax profits.

Across the 31-year period from 1970–2000 for which financial statements have been collected, Caltex distributed an annual average of 86.1 percent of its profits as dividends. Applying this 86.1 percent ratio to the \$8.80 after-Indonesian-tax profit in this example, each shareholder should, on average, receive a \$3.79 dividend ( $\$8.80 * .861 * .50$ ). Since the dividends are repatriated to the U.S., both Chevron and Texaco are eligible to receive dollar-for-dollar U.S. foreign tax credits,

**TABLE 1**  
**Division of Caltex Dividends and Foreign Tax Credits between Chevron and Texaco**  
**Assuming One Caltex Barrel Is Sold at Its \$20 Fair Market Value**

	<b>Total</b>	<b>Chevron (60% buyer, 50% owner)</b>	<b>Texaco (40% buyer, 50% owner)</b>
(1) Caltex’s Share of the Pretax Profit ( $0.2727 * 3.667 * \$20.00$ )	\$20.00		
Less: (2) 56% Indonesian Tax = (1) $\times .56$	\$11.20		
Equals: (3) Caltex Profit after Indonesian Tax = (1) – (2), split 50/50	\$8.80	\$4.40	\$4.40
(4) Distributed Dividends = 86.1% $\times$ (3)	\$7.58	\$3.79	\$3.79
(5) Taxable Dividends = (4)/(1 – .56)	\$17.22	\$8.61	\$8.61
(6) Federal Tax on Dividends = (5) $\times .35$	\$6.02	\$3.01	\$3.01
(7) Foreign Tax Credit Before the \$904 Limit = (5) $\times .56$	\$9.64	\$4.82	\$4.82
(8) Total Benefit to Shareholders = (4) – (6) + (7)	\$11.20	\$5.60	\$5.60

Tables 1–3 and Figure 2 assume that there are 3.667 barrels of profit oil with a fair market value of \$20 per barrel. These profit barrels are split between Pertamina and Caltex according to the terms of the PSC.

subject to limitation, equal to each shareholder's portion of the Indonesian income taxes deemed to have been paid on the dividend income received. We assume that the foreign tax credit limitation is either ineffective or only partially effective, since Chevron reports no foreign tax credit carryforwards in financial statement tax footnotes between 1977 and 2000. In contrast, beginning in 1979 Texaco consistently reports such carryforwards.<sup>6</sup> Deemed paid taxes are calculated as follows: (1) gross up the dividends to their pretax amount by dividing the dividends by 1 minus the foreign country tax rate [ $\$3.79/(1 - .56) = \$8.61$ ], and (2) multiply this result by the foreign country tax rate [ $\$8.61 * .56 = \$4.82$ ]. The \$8.61 pretax dividend must be included in the recipient corporation's U.S. federal gross income and the \$4.82 foreign tax credit reduces its U.S. tax liability (IRC §78).

In sum, as described above, Chevron and Texaco each receive \$5.60 from their involvement in the business:<sup>7</sup> \$3.79 as dividends and \$4.82 as foreign tax credits from the U.S. government, less \$3.01 U.S. income tax on the grossed-up value of the dividends ( $0.35 * \$8.61$ ).<sup>8</sup> Together, Chevron and Texaco receive \$11.20 ( $2 * \$5.60$ ). They also have dividends and related foreign tax credits that will become available when the remaining 13.9 percent (100 percent – 86.1 percent) of undistributed earnings are distributed.

### **Caltex and Chevron Accounting as Described by the IRS**

To contrast the accounting using fair market value transfer prices that is described above, this subsection explains how Caltex, Chevron, and Texaco accounted for these transactions, depicted in Figure 1. Pursuant to an in-depth Chevron (1984) document, *The Economics of Lifting Sumatran Crude*, Caltex and Indonesia agreed that Caltex would sell oil to subsidiary offtakers of its parent companies at above-market, Indonesia-prescribed "government sales prices" (GSP) (Chevron 1984; IRS 1998, under "Renegotiation of the COW and PSC"). In particular, Caltex recorded its oil sales to Chevron and Texaco at approximately \$4.55 per barrel above fair market value.<sup>9</sup>

**GSP:** Indonesian-established Government Sales Price that exceeds the fair market value. Oil was sold by Caltex to Chevron and Texaco offtakers at GSP, leading to higher Indonesian income and lower U.S. income.

### **Western Hemisphere Allowance (WHA)**

For each barrel that Caltex sells to offtakers at \$4.55 above the market price, Caltex pays an extra \$2.55 ( $\$4.55 * 0.56$ ) to the Indonesian Government as tax and retains \$2.00. Without some form of compensation, a taxpayer has no reason to move income from a 35 percent tax jurisdiction to a 56 percent jurisdiction. To facilitate this, the Government of Indonesia reimburses Caltex the \$2.55 tax in the form of additional oil, characterized as *Western Hemisphere Allowance* (WHA) oil (IRS 1998, under "Renegotiation of the COW and the PSC"; Chevron 1984, 19 para. 7). However, since this oil will itself be subject to tax when sold to offtakers, the Indonesian Government provides

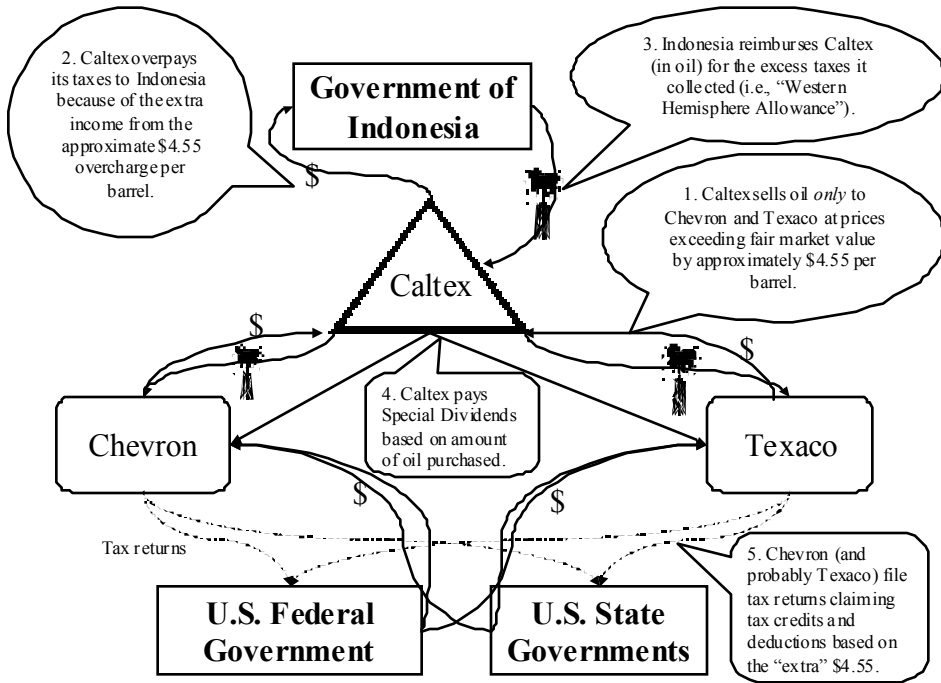
<sup>6</sup> The existence of foreign tax credit carryforwards does not necessarily mean that foreign tax credits go unused, only that the credits are deferred for at least one year prior to utilization.

<sup>7</sup> This value is overstated to the extent that the limitation precludes use of all available foreign tax credits. If the foreign tax credit limit is not reached, as is apparently the case for Chevron, the increase in the after-tax value of the oil occurs immediately, as Chevron generally has not reported foreign tax credit carryforwards. If the foreign tax credit limit is exceeded, as is generally the case for Texaco, the after-tax value of the oil is reduced by the implicit interest lost on the credits until subsequent years when the credit carryforward can be used.

<sup>8</sup> We assume a constant U.S. federal corporate income tax rate of 35 percent and a 56 percent rate for Indonesia. However, the U.S. rate across the 31-year period ending in 2000 varied from as high as 48 percent to as low as 34 percent. We also assume that all of the distributions from Caltex qualify as dividends, although this is highly unlikely if Section 482 is applied and reduces E&P. Any deficit created by these adjustments further increases Chevron and Texaco U.S. federal income tax liability since the foreign tax credit would no longer be available.

<sup>9</sup> The amount of the price overstatement is determined by reference to a Chevron memorandum in Hom (1996, para. 35(c)). In the memorandum that concerns Chevron's 1985–1987 tax years, the amount is \$2.00 per after-tax barrel, or \$4.55 in (rounded) pre-tax terms [ $\$2.00/(1 - .56)$ ]. For tax years outside of the 1985–1987 period, we extrapolate based on the \$2.00 rate since the amount of the deviation from the correct price has not been publicly disclosed.

**FIGURE 1**  
**Diagram of the Controversial Transactions**



Caltex sufficient oil so that Caltex realizes \$2.55 after tax, thereby making Caltex whole (IRS 1998, under “Renegotiation of the COW and the PSC; Hom 1994, paras. 56 and 60). Thus, with the 56 percent tax rate, the Indonesian Government provides Caltex \$5.80 of oil [ $\$2.55 / (1 - 0.56)$ ] for each barrel that Caltex sells to offtakers at the \$4.55 GSP excess. The \$5.80 consists of \$3.25 to cover the 56 percent tax on the \$5.80 sale of WHA oil to the offtakers and \$2.55 to reimburse Caltex for the additional tax it paid because of the initial \$4.55 GSP excess. These matters are depicted in Figure 2.

**WHA oil:** Oil provided to Caltex by Pertamina in excess of the amount prescribed by the production sharing contract. This oil returns all Indonesian income tax resulting from the use of above-market transfer prices, including the income tax on the WHA itself.

The WHA was large at times. One way to get a sense of the magnitude of the WHA is to consider a June 1983 memorandum estimating that Chevron’s share of the WHA amounted to \$520,000 per day, or \$189.8 million per year (Hom 1996, Exhibit N). That memorandum determined that a \$15 million charge against Chevron’s book income was a worthy trade-off for \$189.8 million worth of oil. In January 1986, when the size of the WHA had increased because of a growing differential between falling market prices of oil and a steady GSP, Caltex informed Chevron and Texaco officials that there was not enough oil production to fund the WHA “compensation” requirement (Hom 1996, Exhibit L).

Beyond the benefit Caltex receives from the WHA rebate, the GSP sales prices produced two tax-mitigating effects for Caltex and its parent companies: (1) an increase in Caltex’s Indonesian

income and related tax that produced more U.S. foreign tax credits, and (2) a decrease in U.S. income to the relevant Chevron or Texaco offtakers. We explore each of these effects in turn, continuing the example above as a basis for discussion.

**Use of GSP Pricing**

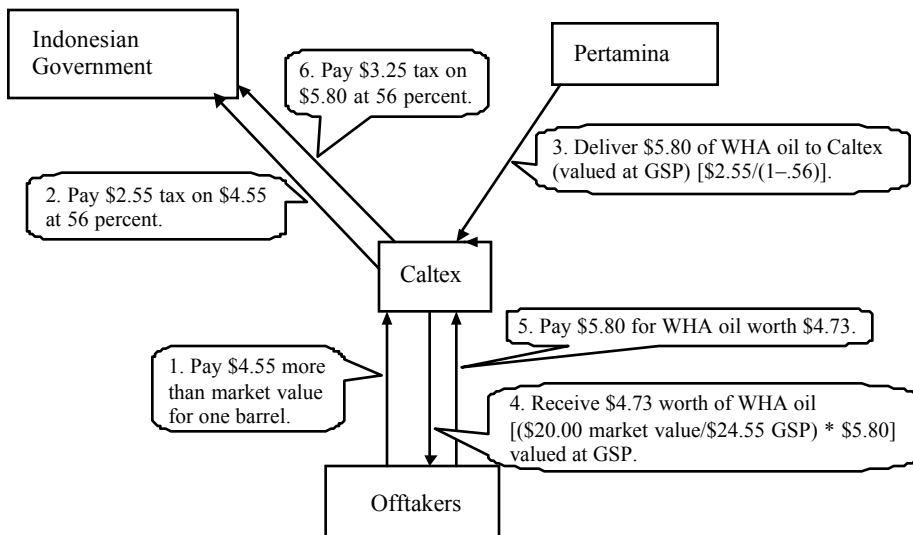
Assume again that Caltex produces 3.667 barrels of profit oil that are distributed 0.7273 to the Indonesian Government (2.667 barrels) and 0.2727 to Caltex (1 barrel), in accordance with the PSC. As described in the TAM and in declarations by Hom (1994, 1996), Caltex sells its entire 0.2727 portion to offtakers at the GSP, which is on average \$4.55 higher than fair market value. If Chevron offtakers purchase 60 percent of the Caltex profit oil and Texaco offtakers purchase 40 percent, Chevron overpays Caltex \$2.73 ( $\$4.55 \times 0.6$ ) and Texaco overpays Caltex \$1.82 ( $\$4.55 \times 0.4$ ). The combined \$4.55 overpayment increases Caltex Indonesian taxes by \$2.55 ( $\$4.55 \times 0.56$ ) and thereby increases Caltex after-tax profits by the remaining \$2.00 ( $\$4.55 - \$2.55$ ).

It is possible that elements of Indonesian law might have compelled or influenced how Caltex priced its transactions with Chevron and Texaco offtakers and with the Indonesian Government. However, if the pricing approach required by Indonesian law conflicts with filing appropriate financial information with the IRS or the SEC, such adjustments must be made prior to filing with these American authorities. That monthly Special Dividends were calculated and paid is evidence that correction for excess GSP pricing is possible. The calculation of these Special Dividends is discussed next.

**Special Dividends**

A major equity problem occurs if Caltex after-tax profit is distributed evenly to the 50/50 shareholders, since in the example Chevron purchases 60 percent of the overpriced oil and Texaco

**FIGURE 2**  
**How Caltex Is Impacted by the \$4.55 GSP Excess and WHA “Compensation”**



In steps 1 and 2, Caltex receives \$4.55 from offtakers and pays \$2.55 in tax, thus retaining \$2.00. Steps 3 and 4 show that Pertamina delivers WHA oil to Caltex and Caltex sells it to offtakers at the GSP. In steps 5 and 6 Caltex receives \$5.80 from offtakers and pays \$3.25 in tax, retaining \$2.55. Overall, Caltex retains \$4.55 (\$2.00 plus \$2.55) and pays \$5.80 in tax to Indonesia (\$2.55 plus \$3.25).

purchases only 40 percent. To adjust for the overstated price on unequal purchase volumes, Chevron and Texaco directed Caltex to pay monthly “Special Dividends” only to the overliker (IRS 1998, under the heading “Dividends;” Hom 1994, para. 69).<sup>10</sup> To calculate the Special Dividend, Caltex first subtracts the 56 percent Indonesian tax from its share of pretax profit based on the \$24.55 GSP (= \$20.00 fair market value plus \$4.55). In the example involving one barrel of profit oil summarized in Table 2, this leaves Caltex with \$10.80 of current profits [ $\$24.55 * (1 - 0.56)$ ].

**Special Dividends:** Dollar amounts computed and paid monthly by Caltex to either Chevron or Texaco, based on which company’s off-takers purchased more above-market-priced oil than the other’s.

**TABLE 2**  
**Calculation of Special Dividend and Regular Dividends**

	(a) Caltex	(b) Chevron (60% buyer, 50% owner)	(c) Texaco (40% buyer, 50% owner)
(1) Chevron and Texaco Contributions to Caltex Profits (based on buyer percentages)	\$24.55	\$14.73	\$9.82
Less: (2) Indonesian Tax = (1) × .56	\$13.75	\$8.25	\$5.50
(3) Caltex Profit After Indonesian Tax = (1) – (2) (based on buyer percentages)	\$10.80	\$6.48	\$4.32
Multiplied by: (4) Caltex Average Distribution Pct.	86.1%		
Equals: (5) Total Distribution = (3) × (4)	\$9.30		
(6) Special Dividend = (3b) – (3c)	\$2.16	\$2.16	\$0.00
(7) Regular Dividends = (5) – (6), allocated 50/50	\$7.14	\$3.57	\$3.57
(8) Total Dividends = (6) + (7)	\$9.30	\$5.73	\$3.57

On average, over the years 1970–2000 Caltex distributed 86.1 percent of its current profits each year. Assuming this distribution percentage, Caltex distributes \$9.30 ( $\$10.80 * 0.861$ ). In order to compensate Chevron for the additional overpriced oil that it purchases relative to Texaco, Caltex first pays Chevron a Special Dividend equal to the excess of the Caltex after-Indonesian-tax profit contributed by Chevron over that portion contributed by Texaco. In the current example, since Chevron contributed \$6.48 (60 percent of \$10.80) and Texaco contributed only \$4.32 (40 percent of \$10.80), Chevron receives a \$2.16 Special Dividend ( $\$10.80$  minus the product of 2 times the equivalent dividend, \$4.32).<sup>11</sup> After subtracting the \$2.16 Special Dividend from the \$9.30 total distribution, the remaining \$7.14 is split evenly between Chevron and Texaco as regular dividends.

Note that a portion of the \$7.14 regular dividend is also due to pricing the equivalent barrels sold to Chevron and Texaco at the GSP. Specifically, \$0.66 of each shareowner’s \$3.57 regular dividend arises from pricing at the GSP ( $\$4.55/\$24.55 * \$3.57$ ). To summarize, based on its historical average, Caltex distributes only 86.1 percent, or \$9.30, of the \$10.80 after-tax earnings, and, in the example of Chevron purchasing 60 percent of the oil and Texaco purchasing 40 percent, Chevron

<sup>10</sup> Calculations of the excess dividends received by one 50 percent shareholder over the other 50 percent shareholder are based on information in Chevron and Texaco annual reports between 1976 and 1988. Insufficient disclosures make the calculation impossible for the other years. During 1976–1988, Chevron received greater dividends in eight of these years and Chevron received \$187 million net more in dividends from Caltex than Texaco received.

<sup>11</sup> On a per-barrel basis, the Special Dividend is calculated as 100 percent (not 50 percent as indicated in the TAM) of the after-Indonesian-tax profit on barrels that the overliker purchases from Caltex in excess of purchases by the underliker. If Chevron purchases 60 percent and Texaco purchases 40 percent of a barrel, the Special Dividend, \$2.16, can be calculated as Chevron’s excess oil purchase, 0.2 (0.6 minus 0.4) multiplied by the product of the \$24.55 GSP times the net of 1 minus the 56 percent Indonesian tax rate  $\{\$2.16 = 0.2 * [\$24.55 * (1 - 0.56)]\}$ .

receives \$5.73 of dividends (\$2.16 + \$3.57) and Texaco receives \$3.57. Thus, the effect of the inflated GSP is also imbedded in the undistributed earnings.

The effects of the pricing at the \$24.55 GSP instead of the \$20.00 fair market value are demonstrated by comparing the results in Table 3 with those presented in Table 1. From each barrel of profit oil received by Caltex, Chevron now receives \$8.46 from its involvement in the business: \$5.73 as dividends (from Table 2) and \$7.29 as foreign tax credits from the U.S. government [ $\$5.73 / (1 - 0.56) * 0.56$ ], less \$4.56 U.S. income tax on the grossed-up value of the dividends [ $\$5.73 / (1 - .56) * .35$ ]. Thus, from the additional foreign tax credit alone, the use of the GSP transfer price provides Chevron with a net after-tax benefit of \$2.86 per barrel (\$8.46 minus \$5.60, determined in the discussion of Table 1). Similarly, Texaco now benefits only by \$5.27 from the sum of \$3.57 in dividends and \$4.54 in foreign tax credits [ $\$3.57 / (1 - 0.56) * 0.56$ ], less \$2.84 in federal income tax [ $\$3.57 / (1 - .56) * .35$ ]. Interestingly, because of the Special Dividend, this produces a net reduction of \$0.33 compared with the \$5.60 benefit Texaco received under the accounting discussed and illustrated in Table 1. Together, assuming that neither company is constrained by the foreign tax credit limit, Chevron and Texaco now receive \$13.73 (\$8.46 + \$5.27), \$2.53 more than the \$11.20 they netted in the Table 1 accounting. Next we consider two additional aspects of these transactions: (1) the additional cost of sales deductions on domestic tax returns, and (2) the WHA "compensation" from the Indonesian Government for the additional tax Caltex paid.

**TABLE 3**  
**Chevron and Texaco Foreign Tax Credits Using GSP Pricing, WHA, and Special Dividends**

	<u>Total</u>	<u>Chevron (60% buyer, 50% owner)</u>	<u>Texaco (40% buyer, 50% owner)</u>
(1) Dividends Received per Table 2	\$9.30	\$5.73	\$3.57
(2) Taxable Dividends to U.S. Parents = (1)/(1 - .56)	\$21.13	\$13.02	\$8.11
(3) U.S. Federal Tax on Taxable Dividends = (2) × .35	\$7.40	\$4.56	\$2.84
(4) Foreign Tax Credit Before §904 Limit = (2) × .56	\$11.83	\$7.29	\$4.54
(5) Total Benefit to Shareholders = (1) - (3) + (4)	\$13.73	\$8.46	\$5.27

### ***Additional Cost of Sales Deduction***

Beyond the additional foreign tax credit, the second tax benefit arises from using the GSP as the oil's transfer price: the resulting larger cost of sales deduction that appears on the consolidated federal and state income tax returns of Chevron and Texaco. For federal tax return purposes, this larger deduction is partially offset, but not corrected, by the increased dividend income discussed above that occurs if all Caltex earnings are distributed currently as dividends.<sup>12</sup> Since Caltex distributes, on average, only 86.1 percent of its earnings as dividends, approximately 13.9 percent of earnings remain undistributed, thus producing additional federal tax savings from the increased cost of sales deduction. To estimate this effect, we multiply an average 35 percent federal corporate income tax rate by the product of the \$4.55 excess of GSP over fair market value and the average proportion of earnings not distributed, 13.9 percent. On average, Chevron and Texaco reduce their federal income tax burden through an increased cost of sales deduction by \$0.22 ( $\$4.55 * 0.139 * 0.35$ ) per barrel of oil purchased from Caltex at the GSP.

<sup>12</sup> Note that the IRS can question the earnings and profits of each separate legal entity. In particular, if the distributions from Caltex to the parent companies exceed the correct amounts of Caltex earnings and profits, these distributions would be deemed returns of capital that do not qualify for foreign tax credit.

For state tax return purposes, the offtakers report their cost of sales deductions in states where income is allocated. However, dividend income may be reported only in the state of the parent company's domicile or apportioned across the states in which the companies operate, depending on state rules and taxpayer elections. Continuing the example above, and assuming that the average state corporate tax rate is 6 percent, Chevron and Texaco reduce their state income taxes by \$.27 per barrel sold to the offtakers (\$4.55 overprice \* .06 state income tax rate).

### Summary

By extracting oil in Indonesia, Caltex earns income in Indonesia that the Government of Indonesia can rightfully tax. However, the correct amounts of this income and Indonesian tax depend on the fair pricing of oil between Caltex and the related Chevron and Texaco subsidiary "offtakers" that purchase oil. In this case, according to a sworn declaration by an IRS Branch Chief, the TAM, and numerous Caltex and Chevron documents, Caltex sold its oil to each of its 50/50 shareholders' offtakers at prices set at approximately \$4.55 per barrel higher than market value. Of course, the actual extent that the GSP differed from market value is presently known only to certain tax authorities and the parties involved in the transaction—Caltex, Chevron, Texaco, and the Indonesian Government.

## AUDIT HISTORY AND ESTIMATES OF TAXES AVOIDED

### Audit Adjustments, Initial Settlement, and the TAM

The IRS began an audit of Chevron's 1985–1987 tax years in early 1991. After a lengthy audit, Chevron entered into a settlement with the IRS in 1994 covering the years 1979 through 1987 by paying \$675 million (Chevron 1995, FS-4). The settlement specifically covers the *amounts* of Chevron's dividends from Caltex, the *amounts* of Chevron's cost of goods sold deduction for oil purchased from Caltex, and changes in the *amount* of foreign tax credit to correspond with the revised dividend and cost of sales amounts (IRS 1998, under "Dividends"). Chevron had anticipated and recorded a tax audit pad of at least \$1.019 billion, of which \$675 million was paid to the IRS and \$344 million was taken back into reported income with this explanation:

In 1994, prior-year tax adjustments increased earnings \$344 million, including the net reversal of \$301 million of tax and related interest reserves resulting from the company's global settlement with the Internal Revenue Service for issues relating to the years 1979 through 1987. (Chevron 1995, FS-4)<sup>13</sup>

Thus, by Chevron's own estimates, the \$344 million reduction in tax expense indicates that significant amounts of tax, penalty, and/or interest were left on the table in the 1994 settlement.

Several of the key issues were "settled" in 1994 for Chevron for the years 1979 through 1987, but the IRS still questioned whether Chevron deserved to receive *any* foreign tax credits from its dealings with Caltex in Indonesia. In October 1994 the District IRS office handling the case requested a Technical Advice Memorandum from the National Office. The District Office wanted to know whether Chevron's Caltex-related tax credits should be disallowed because the Office believed that, together, the GSP pricing, the WHA, and the Special Dividends constituted sham transactions:

Briefly stated for the purpose of this discussion, we believe that the records sought by our summons will show that the *foreign tax credits claimed by Chevron were nothing but a sham*, and that the alleged Indonesian "taxes" were never intended to be anything but window dressing for the IRS and therefore not creditable taxes under IRC §§ 901, 902, 903, and 904. (Hom 1994, para. 7) (emphasis added)

<sup>13</sup> Texaco also indicated a settlement with the IRS but did not disclose the amount of the payment nor the years covered; Texaco did, however, report taking \$488 million back into income (Texaco 1998, Exhibit 13, p. 28).

On March 29, 1994, the IRS District Office issued a designated summons to obtain certain key documents from Chevron that were believed to support the allegation that the foreign tax credits were not justified. Chevron withheld the documents, arguing that they were protected by attorney-client privilege. Eventually, the IRS sought judicial enforcement of its document request. On January 25, 1996, Judge Magistrate F. Steele Langford held that although most of the documents that the IRS requested were privileged, 129 of the 648 contested documents contained evidence of “crimes or frauds.” Specifically, he writes:

The IRS would like to see additional documents which would elucidate the deals struck by CPI [Caltex] and PN [Pertamina] to deceive the IRS, and evade U.S. taxes, e.g.,

- 1) GOI’s [Government of Indonesia’s] overpricing its crude ...
- 2) Chevron and Texaco always lifting CPI’s [Caltex’s] crude ...

This court has thoroughly and carefully reviewed both the Government’s proffer in support of probable cause and the documents themselves, submitted for in camera review.

The court concludes that the proffer, along with the documents themselves, adequately supports a finding of probable cause to believe that one or more crimes or frauds have been committed or attempted and that the attorney-client communications at issue were created in furtherance of those crimes or frauds, *including a showing of the client’s* [Chevron’s] *intent*. (U.S. District Court 1996a) (emphasis added)

Both the IRS and Chevron appealed Judge Magistrate Langford’s decision. In response, on March 13, 1996, District Court Judge Sandra Brown Armstrong determined that none of the remaining 519 documents were privileged, overruling Langford and saying that he had not applied the correct legal standard (U.S. District Court 1996b). Further, on May 30, 1996, Judge Armstrong clarified that privilege extends only to “discrete and segregable portions” of each document that contains communications that are for “the primary purpose of seeking legal advice” (U.S. District Court 1996c). Judge Armstrong also held that privilege does not extend to any documents that are “prepared for simultaneous review by both legal and nonlegal personnel.”

In February 1998, after Chevron produced most of the controversial documents to the IRS but before the District Office of the IRS brought its case to court, the National IRS Chief Counsel issued the TAM (IRS 1998). In the TAM it became apparent that National Office Chief Counsel personnel either ignored or missed the District Office’s point regarding the controversial transactions (Guttman 1998). The Chief Counsel chose not to address the issues resulting from the multiple side agreements and transactions that do not correspond to *any* contract. Instead, the TAM simply noted that the contract between Caltex and the Government of Indonesia would have had real economic consequences if the terms of the agreement had been followed. To reiterate a point made early in the paper, we do not understand the reasoning behind that assertion.

Because a TAM issued by the National Office of the IRS is final, it became the basis for a closing agreement between the IRS and Chevron [Reg. §601.105(b)(5)(vii)(a)]. Such closing agreements cannot be reopened to make an adjustment unfavorable to the taxpayer unless: (1) “there is evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact,” (2) the closing agreement involved a “clearly defined substantial error,” or (3) failure to reopen the case would be “a serious administrative omission” [Reg. §601.105(b)(5)(vii)(j)(1)]. The analysis presented above suggests that at least one of these exceptions applies. If so, the issue becomes one of benefit versus cost: Would the benefit of the taxes, penalty, and interest outweigh the cost of pursuing the issue in the court system? To begin to address this, we next estimate the amount of taxes involved, excluding potential penalties and interest.

### Estimated Taxes at Issue

Caltex officials report that daily oil production in Indonesia was fairly consistent at about 700,000 barrels per day throughout most of the 1970s and early 1980s (Hom 1996, Exhibit P). Chevron (1984, 4) indicates that costs represent about 5 percent of the value of oil production. Thus, on average, Caltex produces 665,000 barrels of profit oil ( $0.95 * 700,000$ ). According to the PSC, Caltex retains 181,346 barrels (27.27 percent) and distributes the remaining 483,654 barrels to Pertamina. Using the data in Table 4, we estimate the combined federal and state income tax Chevron and Texaco avoided each day to be \$633,194. Of this, the estimated state income tax portion is \$30,375, as follows:<sup>14</sup>

Higher cost of sales deduction [(216,346 cost and profit barrels + 51,058 WHA barrels) * \$4.55 GSP excess * 0.06 state tax rate]	\$73,001
Less the effect of greater dividends (181,346 profit barrels * \$4.55 GSP excess * 0.06 state tax rate * 0.861 dividend payout ratio)	<u>42,626</u>
Equals: Estimated state income taxes saved daily	<u><u>\$30,375</u></u>

The daily estimated federal income tax avoided is the remainder of the total estimate in Table 4, or \$602,819 (\$633,194 minus \$30,375). Assuming a 365-day operating year, Chevron and Texaco's combined estimated annual federal and state income tax shortfalls are \$220.0 million and \$11.1 million, respectively.

It appears that this tax avoidance activity persisted at least from November 28, 1963 (Hom 1994, para. 37) through 2002, thus producing rough total estimates of \$8.6 billion and \$433 million in federal and state tax savings, respectively, exclusive of potential interest and penalty.<sup>15</sup> These estimates assume that Caltex has sufficient earnings and profits to support the existence of Section 301 dividends, and related foreign tax credits, for the distributions that do not relate to the GSP pricing effects. To the extent that such distributions do not correspond to positive Caltex earnings and profits after applying Section 482, they should be treated as nontaxable returns of capital not eligible for foreign tax credits. If the distributions are not eligible for foreign tax credits, the amount of federal income tax at issue could increase very substantially.

### Tax Recoverability Issues

Generally speaking, tax returns remain open to IRS examination for only three years after filing (IRC Sec. 6501). However, once an investigation into a tax year has begun a tax return remains "open" until the investigation is closed. Since most large U.S. corporations' tax returns undergo some form of IRS audit, several tax years prior to the three-year window usually remain open at any point in time. Gradually, as these corporations resolve differences with the IRS, older tax years are

<sup>14</sup> This estimate assumes that Chevron and Texaco allocate dividend income from Caltex to each of the states in which they do business, rather than recognize all of the dividend income only in the state of domicile.

<sup>15</sup> We deduce that the overpayment activity extended through 2002 because ChevronTexaco (2003) states that Indonesian oil production fell by 50,000 barrels per day "due to the effect of higher [world] prices on the company's share of net production sharing agreements." This production drop is consistent with a decreased WHA that would occur with a decline in the excess of GSP over market price resulting from the recent run-up in oil market prices. The production drop is also inconsistent with the increased production that is expected during periods of higher oil prices.

**TABLE 4**  
**Estimated Tax Savings from the Accounting Methods Used by Chevron and Texaco**

	<u>Initial Oil</u>	<u>WHA Oil</u>	<u>Total</u>
Barrels of Oil Purchased by Offtaker	1	0.236 <sup>a</sup>	1.236
<i>Effects on Cost of Sales Deductions:</i>			
(1) Tax Benefit of Increased Federal Cost of Sales Deduction = (\$4.55 * 0.35) = [\$5.80 – (0.236 * \$20.00)] * .35 <sup>b</sup>	\$1.59	\$0.38	
(2) Tax Benefit of Increased State Cost of Sales Deduction = (\$4.55 * .06) = [\$5.80 – (0.2363 * \$20.00)] * .06	\$0.27	\$0.06	
(3) Total benefit of increased Cost of Sales Deduction = (1) + (2)	\$1.86	\$0.44	
(4) Multiplied by: Profit Barrels (181,346) Plus Cost Barrels (700,000 * 0.05 = 35,000) WHA Barrels (181,346 * 0.236)	216,346	51,058	
(5) Daily Value of Increased Cost of Sales Deduction = (3) × (4)	\$402,404	\$22,466	\$424,870
<i>Effects on Dividend-Related Taxes and Tax Credits:</i>			
(6) Increased U.S. Foreign Tax Credit = (\$4.55 * 0.56 * 0.861) (\$5.80 * 0.56 * 0.861)	\$2.19	\$2.80	
(7) Federal Tax on Increased Dividends Received = (\$4.55 * 0.861 * .35) [\$5.80 – (0.236 * \$20.00)] * 0.861 * .35	(\$1.37)	(\$0.33)	
(8) State Tax on Increased Dividends Received <sup>c</sup> = (\$4.55 * 0.861 * .06) [\$5.80 – (0.236 * \$20.00)] * 0.861 * .06	(\$0.24)	(0.06)	
(9) Total Value of the Accounting Method for Each Profit Barrel = (6) + (7) + (8)	\$0.58	\$2.41	
(10) Multiplied by: Daily Profit Barrels to Caltex = (700,000 * 95% profit * 27.27 profit percent) (181,346 * 0.236)	181,346	42,798	
(11) = Daily Effect on Dividend Taxes and Credits = (9) × (10)	\$105,181	\$103,143	\$208,324
(12) Total Daily Value of Accounting Method = (5) + (11)	\$507,585	\$125,609	\$633,194

<sup>a</sup> Each barrel of oil priced at the \$4.55 higher GSP generates 0.236 of a barrel of additional oil from the Indonesian Government (i.e., Pertamina) that is not stipulated in the PSC. Valued at the GSP, the amount of this oil is computed by dividing the extra tax paid on the initial barrel by 1 minus the 56 percent Indonesian tax rate and is stated in per barrel terms by dividing this result by the assumed GSP; i.e., [(\$2.55/(1 – .56))/\$24.55 = 0.236 of a barrel].

<sup>b</sup> The \$5.80 of WHA oil is computed as \$2.55/(1 – .56). Alternatively, the WHA oil is the sum of the \$2.55 tax (at 56%) on the initial \$4.55 GSP excess barrel plus the tax on the WHA oil, \$3.25 (\$5.80 \* .56).

<sup>c</sup> This assumes that each state taxes dividends received from unconsolidated subsidiaries. This assumption is not valid in some states, such as Arizona and Florida, thereby underestimating the total state income taxes saved.

closed to further IRS examination and this closure prevents the IRS from assessing additional taxes, interest, and penalty with regard to these years. However, the existence of tax fraud nullifies the statute of limitations and opens these closed tax years to investigation [IRC Sec. 6501(c)(1)]. In other words, this is an application of a very important principle, “the sun never sets on fraud.”<sup>16</sup>

For tax authorities interested in pursuing any potentially underpaid taxes associated with these transactions, the issue is whether tax fraud exists. Although this is a question of fact to be determined in court, our research uncovered the following three items potentially relevant to such a finding:

- 1) District Court Judge Magistrate Langford found evidence of “crimes or frauds” in the documents that are presently in the custody of the IRS.
- 2) The analysis presented in this paper linking the GSP transfer prices, Special Dividends, and WHA accommodations to substantial tax savings suggests tax fraud, and
- 3) Chevron incurred extensive effort and expense to avoid the release of the documents that Judge Langford and the IRS believed to contain evidence of fraud (Guttman 1998).

Even so, these items only raise questions to be investigated, and do not preempt the presumption of innocence until proven guilty.

### CONCLUSION

This paper describes how Chevron, Texaco, Caltex, and the Government of Indonesia structured transactions to avoid large amounts of U.S. federal and state income taxes. We explained the key transfer pricing, Special Dividend, and WHA transactions involved and their accounting. For these transactions, we contrast the accounting approach that should have been used given the available information with the accounting approach that apparently was applied. For the combined Chevron and Texaco companies that are now ChevronTexaco, based on a rough estimate using only publicly available information, it appears that federal and state taxes avoided annually amount to \$220 million and \$11.1 million, respectively, before potential interest and penalties. The tax savings appear to exist at least for the years 1964 through 2002, amounting to an approximate total of \$8.6 billion in federal taxes, and \$433 million in state taxes, across the 39-year period.

Many situations are of interest because of the effects created by using different accounting methods for book and tax purposes. One particularly vivid example of this phenomenon involving General Dynamics Corporation is discussed in Wheeler and Outslay (1986). However, in the Chevron/Texaco/Caltex case, book and tax results relating to the oil transactions recounted here appear to be congruent. But this case is of interest because of the payoffs in tax savings apparently created by the particular congruent accounting methods employed.

As noted earlier, this case is presently closed at the federal level with regard to the years 1979 through 1987. Whether the case is reopened for further investigation depends on the authorities' cost/benefit calculus, as Congress provides for such reexaminations under the proper circumstances. In contrast with the document shredding that occurred in the Enron debacle, it appears that the key documents needed in this case are already in the hands of the IRS and the activity appears to be continuing. Conversely, if U.S. tax officials do not reexamine Caltex/Chevron/Texaco, other U.S. companies contracting with foreign governments may want to consider structuring their transactions and accounting following this model.

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<sup>16</sup> This quote arises in part from a Georgia civil medical malpractice case in which a doctor was held accountable 18 years after lying to a patient's parents (*Bynum v. Gregory* 1994). Not only can fraud open previously closed tax years but it can also be used to nullify an IRS ruling such as the TAM [Reg. Sec. 601.105(b)(5)(vii)(j)(1)].

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