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EXECS SUE OVER TAX SHELTER

THEY BLAME ACCOUNTING FIRM FOR SELLING THEM DEAL RULED ILLEGITIMATE BY IRS

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Five Silicon Valley executives -- including four with ties to Cisco Systems -- are suing Ernst & Young, claiming the Big 4 accounting firm peddled them a tax shelter that left them owing millions of dollars in taxes, penalties and damages.

The five men invested more than $50 million total, a sum that the Internal Revenue Service estimates would generate $150 million in tax losses. The plaintiffs in the lawsuit filed in Santa Clara County Superior Court are:

- Alexandre Balkanski, a noted venture capitalist for Benchmark Capital who once headed C-Cube Microsystems, invested nearly $7 million.
- Robert L. Puette, a former CEO for two valley companies, a onetime Apple Computer president and a former Cisco director, invested nearly $7 million.
- Thomas Fallon, a former Cisco vice president, invested $8 million.
- Carl Redfield, a senior vice president at Cisco, invested $10 million.
- Richard ''Rick'' Timmins, Cisco's vice president of worldwide sales and service finance, invested $20 million.

The five also filed suit in federal court in 2004 against the noted Dallas-based law firm Locke, Liddell & Sapp, which provided a legal opinion that the shelter was likely to pass muster with the IRS.

Four of the five plaintiffs either declined comment or did not return phone messages and e-mails from the Mercury News. Fallon could not be reached for comment.

Ernst & Young spokesman Charles Perkins also declined to comment, saying the firm had not yet seen the lawsuit, which was filed Jan. 30.

The lawsuit harks back to the late 1990s, when national accounting firms joined with elite law firms and international financial giants to market tax shelters to wealthy investors so they could avoid taxes.

Silicon Valley was a prime hunting ground because it was teeming with executives eager to find ways to slash their tax bills after cashing in stock options during the tech boom.

The explosion of tax shelters triggered congressional investigations into the practices, plus crackdowns by the Internal Revenue Service and the California Franchise Tax Board.

In 2004, the state offered an unusual tax-amnesty program targeting participants in what authorities called ''abusive'' tax shelters. The state originally hoped the amnesty would snare $90 million, but instead it collected a national record $1.4 billion from 1,202 taxpayers. Nearly $1 billion of that came from 860 individuals.

The five plaintiffs' saga began when Ernst & Young pitched them with a complex tax shelter known as a ''contingent deferred swap,'' or CDS. In 1999 and 2000, they were among about 125 people nationwide who paid Ernst & Young nearly $28 million in fees -- an average of $224,000 -- to participate in the program, according to the lawsuit.

Though there is always a risk that the IRS will audit cutting-edge tax shelters, the plaintiffs say they were won over in part because the accounting firm had obtained an opinion letter from Locke, Liddell & Sapp that said the shelter would probably survive IRS scrutiny. The plaintiffs each paid $50,000 for the letters, the federal lawsuit says.

But in May 2002, the IRS announced it would challenge such shelters.

The men claim they were never advised about the downside if the IRS challenged the plan. Some of the five valley plaintiffs were pitched the tax shelter on the condition that they couldn't consult with outside attorneys or advisers, said Anthony B. Gordon, a Woodland Hills attorney who is handling the suit.

''If you are dealing with firms like that, if you can't get satisfaction and rely on the advice from firms of that size, stature and prestige, it means you could never accept anyone's word,'' Gordon said Tuesday. ''You've got to pay them a lot of money, rely on their advice and shouldn't have to get second opinions.''

The five plaintiffs now allege the opinion letter was not from an independent third party because Ernst & Young and the law firm were acting ''in concert'' to develop the shelter.

The complex shelter, which the IRS analyzed in a 63-page document in 2006, begins with the premise that the client would qualify as a ''trader'' rather than a regular investor. Gaining that status theoretically would entitle each client to claim millions of dollars of investment losses in the first year -- and offset gains from stock options or other income. In the second year, each client would claim long-term capital gains.

In essence, the lawsuit says, the five men thought they had a chance to transform ordinary income and turn it into investment losses or defer it to a later year, when it would be taxed at a lower rate as a capital gain.

The IRS said the shelter was illegitimate because its principal purpose was to avoid taxes by creating the illusion of investment losses and had ''no reasonable prospect for profit'' before taxes.

The shelters were quite potent, however, after the tax write-offs. The IRS says investors in the top tax bracket were ''guaranteed to be profitable on an after-tax basis in every situation.'' Indeed, the shelter was so predictable, the IRS says, that promoters usually figured the shelter would trigger a loss that was three times the investment -- for example, a $6,666,667 investment would generate a $20 million loss.

Two of the plaintiffs, according to the lawsuit, invested precisely that amount.

TAX SHELTER PLAINTIFFS

Here are the five plaintiffs who have sued Ernst & Young over multimillion-dollar investment they made in a tax shelter the accounting firm marketed in 1999 and 2000.

Alexandre Balkanski $6,666,667
General partner with Benchmark Capital. He founded and served as CEO and president of C-Cube Microsystems. He also has served as chairman of PMC-Sierra and as a director for C-Cube, CKS Group and Sierra Semiconductor. He is currently a director of Infinera.

Robert L. Puette $6,666,667
Former CEO and president of Centigram Communications and NetFrame Systems. Former director of Cisco Systems, Centigram Communications, NetFrame Systems and Quality Semiconductor. Centigram was acquired by ADC Telecommunications in July 2000 for nearly $198 million in cash. Previously in his career, he was president of Apple USA from 1990-93, following a 24-year stint with Hewlett-Packard, where he led the worldwide personal computer business.

Thomas Fallon $8 million
Former Cisco Systems vice president.

Carl Redfield $10 million
Senior vice president at Cisco Systems, which he joined in 1993. He is currently a director of Infinera. Previously, he has served on boards of Cincinnati Bell and VA Software, and worked for Digital Equipment and Texas Instruments.

Richard ''Rick'' Timmins $20 million
Vice president of worldwide sales and service finance for Cisco Systems, which he joined in 1996. He is a director for Ultratech and Transmeta.

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