

UKRAINE



FALLEN AND FLED: Ex-President Viktor Yanukovich, seen shortly before he was toppled in February, stands accused of skimming billions of dollars by centralizing a host of tax and extortion schemes. **REUTERS/KONSTANTIN CHERNICHKIN**

# How scams and shakedowns brought Ukraine to its knees

A Reuters examination finds that rampant tax frauds and business extortion nearly bankrupted Kiev, leaving it at the mercy of foreign powers

BY STEVE STECKLOW, ELIZABETH PIPER AND OLEKSANDR AKYMENKO

# UKRAINE HOW SCAMS AND SHAKEDOWNS BROUGHT KIEV TO ITS KNEES

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**L**ate last year, Ukraine's consumer protection agency began filing lawsuits against Foxtrot, the country's largest electronics retailer. By early March, Foxtrot faced at least 231 separate suits that demanded fines totaling more than \$150 million.

Many of the suits accused the company of minor violations of Ukraine's labeling law – such as not placing a “quality seal” on tiny memory cards and wafer-thin batteries inside mobile phones. Foxtrot said it placed the seals on the external packaging, which the law also allows.

Viacheslav Povroznick, Foxtrot's CEO, said agency officials proposed a deal – pay \$1 million in cash and the lawsuits would disappear. “We said no,” he said. “It was like a kind of extortion.” Today, the company still faces a mountain of litigation.

Six months after a popular uprising toppled President Viktor Yanukovich, Ukraine's new leaders are fighting wars on two fronts. One struggle is against Russian-backed insurgents in the east. The other is against staggering corruption that top officials say infected every level of government – and continues to this day.

“It is hard to name an agency that was not involved in any of the scams,” said Vitaliy Kasko, a deputy prosecutor general who is trying to recover billions of dollars in assets allegedly stolen and stashed overseas. Prosecutors say they believe that Yanukovich and a circle of associates stole vast sums of government money and profited from illicit schemes. Last week the prosecutor's office detained a deputy head of the central bank on suspicion of involvement in the theft of more than \$170 million in state funds.

Corruption has plagued Ukraine since the country gained independence from the Soviet Union in 1991. But under Yanukovich, it grew far worse. The sheer scale of the graft – involving tax evasion, fraudulent value-added tax claims, bribery



**CLEAN-UP JOB:** New tax agency chief Igor Bilous says the government lost at least \$6 billion last year through a vast “tax minimization” racket. “I don't think much can be recovered.”

REUTERS/KONSTANTIN CHERNICHKIN

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**Vitaliy Kasko**

deputy prosecutor general

and extortion – helped set off the chain of events that has embroiled Ukraine in a separatist war.

A Reuters examination of the rampant tax and extortion rackets finds that the toll on the Ukrainian treasury was so great that the state was mortally weakened, leaving it at the mercy of outside powers. Top government officials told Reuters that by the time Yanukovich fled to Russia in February after four years in power, Ukraine was bankrupt. That is why the country sought and took a \$17 billion bailout this year from the International Monetary Fund.

Igor Bilous, a former investment banker who now heads Ukraine's tax agency, said in an interview that the government lost between \$6 billion and \$9 billion last year through just one scheme – a complex “tax

minimization” racket that had the tax office's blessing.

Where did the money go? “In pockets, obviously,” Bilous said. “I don't think much can be recovered. A lot was taken out of the country ... in dollars and gold.”

The looting ultimately backfired on Yanukovich, helping to set in motion his downfall.

## AN IMPROVED FORM OF GRAFT

Last year, desperately needing billions of dollars in assistance to replenish the treasury, his government first looked to the European Union for help.

Yanukovich initially supported an association agreement with the EU that would have opened a path to European aid and closer ties to the West. Instead, the pro-Russian politician decided to abandon the agreement and sign a treaty with Moscow to provide monetary aid. That about-face sparked the popular revolt led by pro-Western protesters who occupied the capital's Independence Square, known locally as the Maidan, culminating in deadly clashes that

ultimately led Yanukovich to flee to Russia.

The reverberations are still being felt: Russian President Vladimir Putin annexed Ukraine's Crimean peninsula, and pro-Russian separatists are fighting to hold territory they've seized in eastern Ukraine. On Wednesday, NATO warned that Moscow had massed 20,000 troops on the border and could be poised to send them across.

Yanukovich did not pioneer Ukrainian graft. Prior presidents, too, have been accused of corruption. Instead, according to business executives, government officials and independent watchdog groups, his administration and associates took control of, systematized and expanded various schemes that had existed on a smaller scale for years.

"The current situation with corruption is rooted in Soviet times," said Andrei Marusov, chairman of the board of Transparency International Ukraine, an anti-corruption organization. "What happened under Yanukovich was the centralization of corruption.... Everything went through this centralized hierarchy of state governance, by steps, by layers, from town, to municipality, then regional, then the ministry and then up to the president."

Yanukovich – who entered office vowing to fight corruption – could not be reached for comment.

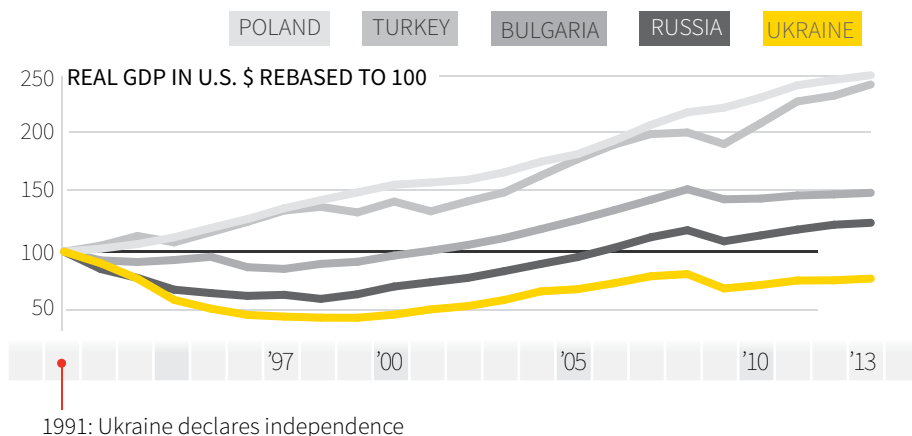
Oleksandr Klymenko, who was head of the tax authority under Yanukovich, said in a statement to Reuters: "It is shameful and just plain wrong that some of my country's new crowd of bureaucrats are so desperate to distract the public from the alarming economic conditions which they should be working hard to solve (as I did my best to do), that they duplicitously try to explain their own failures by casting blame on my popular successes by fabricating groundless charges."

Tomas Fiala, president of the 900-member European Business Association, said many companies were targeted by corrupt officials and had little choice but to participate in tax avoidance and other illicit

## A failed state in the heart of Europe

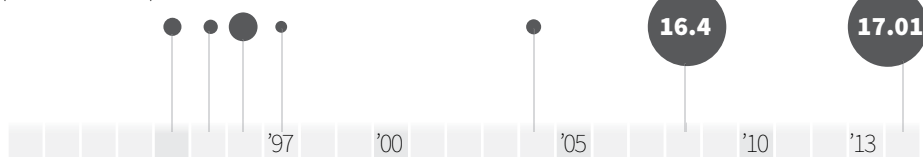
Ukraine's growth rate has badly lagged those of other developing economies as graft drained state coffers and sapped the nation's independence.

### Ukraine's economic evolution since 1991



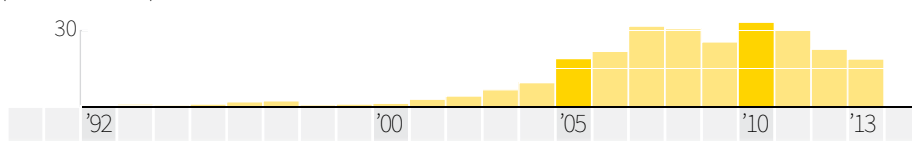
### IMF loans

(in billion U.S. \$)



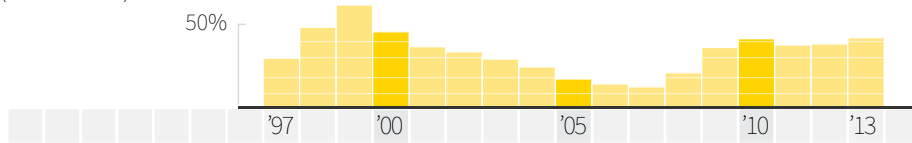
### Foreign reserves

(in billion U.S. \$)



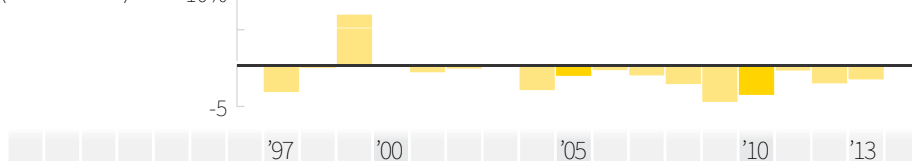
### Debt

(as % of GDP)



### Government budget surplus/deficit

(as % of GDP)



Source: International Monetary Fund

M. Ulmanu/Reuters Graphics



FEEDING FRENZY: Multinationals were squeezed by officials seeking payoffs. French dairy giant Danone SA said it was hit with extra taxes; Swiss food conglomerate Nestle SA said one of its products was banned after officials sought a bribe. **REUTERS/REGIS DUVIGNAU AND DENIS BALIBOUSE**

schemes just to conduct ordinary business. “Definitely more than half of the companies working in Ukraine overall were forced to pay bribes,” he said.

About 100 of the EBA’s members currently face criminal cases against executives alleging tax evasion, according to its executive director, Anna Derevyanko.

## “THEY USE THAT AS BLACKMAIL”

For French food group Danone SA, troubles began with Ukraine’s tax authorities in 2011, the year after Yanukovich took office. Dario Marchetti, Danone Dairy Ukraine’s general manager at the time, said the subsidiary had agreed to pay a local tax on royalties it was paying the parent company to license its dairy products.

But after paying the tax to the tax office, Danone Ukraine was audited by Ukraine’s customs office. According to Marchetti, customs authorities determined the tax was owed to customs, not the tax office, and the company was required to pay the tax again – plus a penalty for non-compliance. The amount demanded by customs came to about \$725,000, he said. Worse, the tax office refused to refund Danone’s previous payment of more than \$500,000.

“I personally went to the guys investigating us, and they said, ‘Look, we have a

# \$145

Average monthly salary of a Ukrainian tax inspector.

Ukraine’s tax agency

target, and you have two options. You can pay us either 20 or 30 percent of what is owed, or we will go after you.”

Marchetti said Danone rejected the demand – which it considered a bribe. He said Ukrainian authorities then filed a criminal complaint against Danone Ukraine’s chief accountant, a single mother with two children, accusing her of participating in tax evasion. “They use that as blackmail,” he said.

“In the end, we ended up paying customs, we ended up paying twice just to save our employee,” said Marchetti, who is now general manager at Danone Dairy Brazil. “For a business that went through the 2009 crisis and had low margins, this was a huge hit.”

Mikhailo Noniak, deputy minister for revenue and duties at Ukraine’s tax agency, said of Danone’s past problems: “This doesn’t happen now, but it happened very often before. Tax police, tax inspectors

would start checks, investigations, they would go after firms like Danone, they would try to find something, and say something they had done did not correspond to the law.

“To be honest,” Noniak said, “at most firms they could find something that did not meet the legal requirements, and they would do the checks and they would either demand a fine, or open a criminal case, and then they would say, ‘We will not launch a case if you pay.’”

Businesses such as electronics retailer Foxtrot say Ukraine’s consumer protection agency employed similar tactics.

Nestle SA’s local subsidiary, Nestle Ukraine LLC, had a run-in about three years ago with the consumer protection agency. Gennadiy Radchenko, local head of corporate communication and corporate affairs for the Swiss food titan, said the agency halted the sale of 50-gram packages of Nescafé in southern Ukraine. It claimed the product had a bad smell.

He said the allegation made no sense, since the agency found no problem with 100-gram packages of Nescafé, even though the coffee came from the same factory in Brazil. “How could one package be bad and another good?” Radchenko asked. “It’s clear they wanted a bribe.”

Nestle declined to enter discussions and filed a lawsuit against the agency, he said. The company initially lost the case but eventually won on appeal, a process that lasted two to three months, he said.

Radchenko said Nestle's experience was not at all unusual in Ukraine. "This is routine," he said.

In a statement to Reuters, Olha Sokolova, the consumer agency's recently appointed acting head and previously its deputy chief, said she had no information on Radchenko's allegations. Separately, she defended the agency's legal actions against Foxtrot, and said she had no information about the retailer's charge that officials tried to extort bribes.

## BLACK SALARIES

According to the tax agency and interviews with business people, officials from other government offices frequently shook down companies. The government has 70 different bodies with licensing authority, including 40 with the power to shut down a business, the tax agency said.

Said Danone's Marchetti: "It was so hard to get an export license without paying bribes that I had to give up exporting."

Government officials partly attribute the widespread bribery in Ukraine to the low salaries paid to civil servants. The average pay for tax inspectors, for example, is about \$145 a month, according to the tax agency. The head of a regional state tax office earns about \$350 a month.

"Bribes are how you make your ends meet," said Jorge Zukoski, who headed the American Chamber of Commerce in Ukraine for 15 years until stepping down in January. "Your government paycheck does not put food on the table. It's not a living wage."

In the private sector, many Ukrainian businesses pay their employees partly in cash – known as "black" salaries – to avoid social-security contributions that average about 38 percent. The government loses



WAVES OF GRAFT: Wheat grows in southern Ukraine. The head of the country's grain lobby says officials sought a huge cut of any tax refunds. **REUTERS/VINCENT MUNDY**

additional revenue because employees typically do not pay income tax on the secret cash portion of their salary.

"Many analysts single out the payroll tax as being exceptionally high and the main reason why shadow wage payments remain common in Ukraine," the Office of the U.S. Trade Representative stated in a 2012 report. The social-security tax for employers in Ukraine is more than 2.5 times the average paid by companies in the 34-nation Organization for Economic Co-operation and Development.

The practice of paying "black salaries" continues today. "I know our local competitors are paying in cash in envelopes," Nestle Ukraine's Radchenko said. "I know from people in interviews who want to be employed by Nestle."

Tax authorities estimate that cash payments for salaries total about \$17 billion a year, resulting in at least two million workers not appearing on tax rolls. Another five million employees report earning salaries that are below minimum wage, which authorities say is a sign they are paid partly in cash. In all, more than a third of Ukrainian workers are believed to receive "black" salaries.

To run this dodge, many businesses used

so-called cashing services, which offered – for a fee of about 8 percent to 12 percent – to provide banknotes to pay "black" salaries and bribes, according to the tax agency.

Tax officials say that during Yanukovich's administration, there were between six and nine "certified" cashing services that received the agency's blessing. There were also another 100 to 120 "transit companies" used in the fraud to disguise transactions.

The officials declined to name any of the companies or the people involved, but said more than 100 tax agency employees were directly involved in the schemes.

## PHONY PAPERWORK

In exchange for fees, the cashing services provided businesses not just with bank notes, but also phony invoices showing purchases of goods that never took place. Businesses used these fake expenses to reduce their reportable profits and save on corporate income tax, tax officials say.

Many companies also used the fake purchases to reduce the value-added taxes they owed to the government by falsely claiming that they had paid VAT on goods they never really bought.

For years, hundreds of firms offered such illicit services. But tax agency officials say that in 2012 and 2013, Yanukovich officials began pressuring companies to use the half-dozen or so "certified" or "state program" firms. Tens of billions of dollars passed through these firms, tax authorities say.

The biggest loss to the government was VAT revenue, a 20% tax on goods and services that normally provides more than half the funding of Ukraine's budget, according to tax agency officials. They estimate the treasury last year lost a quarter of its expected VAT revenue through government-sponsored fraudulent schemes.

Ukraine's treasury was so depleted that in recent years, companies with legitimate claims for VAT refunds often couldn't receive them.

Volodymyr Klymenko, president of the



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Ukrainian Grain Association, whose 40 members account for about 90 percent of the country's grain exports, said that about 15 years ago, officials typically would ask for a cut of one or two percent of VAT refunds. The kickback demands later rose dramatically, he said.

In December, a Ukrainian subsidiary of U.S.-based agribusiness group Archer Daniels Midland Co pleaded guilty in U.S. District Court in Illinois to charges that between 2002 and 2008, it paid about \$22 million in bribes to Ukrainian officials through vendors to obtain more than \$100 million in legitimate VAT refunds.

The improper payments, falsely recorded as insurance premiums or other business expenses, "were generally 18 percent to 20 percent of the corresponding VAT refunds," according to a lawsuit by the Securities and Exchange Commission.

ADM and its subsidiary agreed to pay criminal fines and other penalties of about \$54 million. Calling the conduct "regrettable," chief executive Patricia Woertz said ADM had enhanced its internal controls and terminated some employees.

A spokeswoman for ADM added: "While we owned 80% of the corporate parent of the Ukrainian company, we did not control it at that time."

Grain lobby chief Klymenko said the business of paying kickbacks to receive VAT refunds "reached its height" after Yanukovich became president in 2010. "You had to give up 40 to 50 percent of it," he said. "They told you where to put it, in which bank to open a bank account, where to transfer the money."

## POLYGRAPH TESTS

In his statement, Oleksandr Klymenko, the previous head of the tax authority and no relation of the grain lobby chief, said that the amount of VAT refunds increased in 2013 under his leadership and that he "radically"



**CASH GRAB:** Ukrainian banknotes. To curb graft, the new government is trying to purge corrupt officials – and raise salaries for those who survive the cull. **REUTERS/GLEB GARANICH**

dealt with "VAT swindlers." His statement didn't address the issue of kickbacks.

Officials in the new government of President Petro Poroshenko have taken steps to try to deter corruption. These include a plan announced this week to slash the size of government and increase the salaries of civil servants, although it isn't clear whether the measure will pass Ukraine's parliament.

In the meantime, at the ministry of economic development and trade, new chief Pavlo Sheremeta said graft is "a cancer that's eating the country from inside." Some of his reform efforts have met resistance.

Sheremeta tried to cancel some of the huge fines leveled by the consumer protection agency against retailers like Foxtrot. The agency – which falls under his own ministry – responded by filing a lawsuit against Sheremeta, arguing that the fines were legal. The suit was dismissed.

The tax ministry, meanwhile, is trying to clean up the VAT rackets.

Noniak, the tax deputy, said the agency has opened 166 inquiries involving allegedly fraudulent requests for VAT refunds totaling about \$76 million and another \$4

million in illegal refunds. It also has started a criminal case against state officials involved in the suspect refunds.

The agency, Noniak said, plans to give polygraph tests to state officials. It has opened 256 criminal cases against tax inspectors, tax police and customs officials, including 18 cases of alleged bribery. Another focus is hiring.

"We need to appoint new managers as soon as possible," said Noniak. "We need normal, honest, reliable people who are ready to work for the state, not for themselves."

Asked if he believed some tax agency employees are still on the take, tax chief Bilous replied: "Of course. That's our main problem."

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