# FARMING INTO AN UPSTREAM CONCESSION: A TAX PERSPECTIVE

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**Mineral Concessions in Kazakhstan**

A mineral concession in Kazakhstan refers either to a contract with the designated governmental agency or, more recently, to a state license granting an investor the right to explore and exploit the subsurface, onshore or offshore. For the purposes of this article, an entity that technically holds the concession rights is further referred to as the 'concession holder,' and its immediate shareholder / owner referred to as the 'existing investor.'

As regards the already existing concessions, the current legislative framework envisages several pathways for a new investor to acquire mineral rights under such a concession. Often the new investor would consider, as the base scenario, buying shares or an ownership interest in the concession holder, because this share deal only changes the concession holder's ownership structure, but does not require renewal or reissuance of the existing operating licenses and permits, and thus saves time and effort. From a tax perspective, though, selling ownership interest (or a part of the interest) in the concession holder could trigger additional tax leakage for the seller (i.e. the existing investor), if the seller realizes taxable gain on the sale.

An alternative, yet less popular, structure envisages the new investor acquiring part of the current concession holder's rights to explore / exploit the subsurface. However, tax-wise it delivers similar tax exposure for the existing investor: because the concession holder's mineral rights are technically treated as property, any gain the concession holder realizes is likely to represent taxable income.

**Tax-efficient Farm-Ins**

As long as the above transactional tax costs are born solely by the existing investor, the new investor would have little incentive to make the transaction more tax-efficient and would probably choose one of the two structures discussed above. However, if the existing investor is able to shift these tax costs (or any part of them) to the new investor, the latter could probably consider structuring the transaction differently: not as an acquisition of an existing interest or mineral right, but as a farm-in.

Farming into an existing upstream concession generally refers to the joining investor's commitment to bear full or part of the concession's future exploration and / or development costs (such as drilling costs) in return for a specified interest in the concession rights. In other words, instead of structuring the transaction as either a share- or a mineral right-type acquisition, the existing investor agrees to exchange a part of its interest in the concession for the new investor's commitment to cover a certain portion of the future exploration / development costs. The logic behind this structure finds its ground in several keystones in Kazakhstan's civil, mineral and tax laws, including the following:

- As a general principle, the legislation that governs mineral concessions empowers the contracting parties to expand the number of participants in the concession. Adding new participants to an existing concession is, in principle, allowed only with the mutual written consent of the pre-existing participants and, in some cases, with the government's corresponding written permission for a transfer of rights and duties under a mineral contract or a license.

- The concept of a consortium (or a simple partnership) allows the joining partners to unite resources for the joint development of a prospect or a concession. The participants' contributions to such joint activity, as well as the assets created or acquired as a result of such joint activity, are their common shared property, owned according to the participants' defined participation interests. In our example, the new investor and the concession holder could create a simple partnership by entering into a joint operating agreement in order to jointly develop the concession.

- Because a simple partnership does not possess a legal personality and is not regarded as a separate entity, there is no corporation profit tax on the simple partnership's profits. Instead, the joint income and expenses are allocated to the partnerships' participants in proportion to their participation interests.

- Neither the tax law nor the civil law stipulate how revenues and expenses in a simple partnership are to be allocated among the participants, which means the participants could elect to allocate joint revenues and / or expense disproportionately to their corresponding participation interests in the partnership. By the same logic, this means that a participant paying all of the expenses of a joint activity is not deemed to have created taxable income for the other participants on whose behalf it pays these expenses.

Therefore, when a new investor farms into a joint activity, it is possible for the new investor to pay upfront only a minimal amount of cash for the per se purchase of an interest in the concession and simultaneously commit to pay a specified portion of the concession's future exploration / development costs. As committing to pay future work program costs (and subsequently paying them) by the joining new participant does not represent income to the existing participant, farm-ins can be structured to reduce or, in some instances, avoid the tax leakage that the share- or mineral right acquisition structures that we discussed earlier trigger.

From the existing concession holder's perspective, this farm-in structure reduces the immediate cash requirements for the development of the concession and envisages the concept of a carried working interest or a 'carry.' It means that the newly joining investor will 'carry' the existing concession holder by paying the existing concession holder's portion of the costs to develop the prospect.

Altogether, this type of farm-in structure reduces the amount of cash the joining investor needs in order to obtain an interest in the concession by preventing the above upfront tax leakage.

**Conclusion**

The current mineral legislation requires a private investor to explore greenfield offshore prospects jointly with KazMunaiGas and, consequently, carry KazMunaiGas until the commercial discovery has been made. Apart from these legislatively required instances, farm-ins and the corresponding carry arrangements have arguably been used to date only infrequently in Kazakhstan's upstream sector. This is probably the reason why the tax legislature's response to farm-ins has also been somewhat random and failed to address certain tax aspects of these arrangements – for instance, the tax treatment of interest that the new investor may be charging on the carry financing being provided to the existing concession holder. Therefore, we believe there is room for lawmakers to adopt a more comprehensive approach to farm-ins and to make the relevant tax rules more explicit and specific.