



Market Segment Specialization Program



Placer Mining Industry

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Forward

Placer mining is a special opencut method for exploiting deposits of sand or gravel containing workable amounts of valuable minerals. Native gold is the most important placer mineral, but platinum and tin are also found in gravels. Minerals also include zircon, diamond, ruby, and other gems.

The Market Segment Specialization Program (MSSP) presents this manual as a guideline for the examinations of taxpayers in the Placer Mining Industry. This guide focuses on small mining operations represented as sole proprietorships on Schedule C, but it can be adapted for partnership and corporate returns.

This text is supplemental to the Audit Technique Guide previously published and which contains in-depth discussions of issues associated with the mining industry.

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Chapter 1

Introduction

Overview

Major operators produce the bulk of gold recovered and refined, but small-scale, independent miners make up the majority of the returns filed. Mining has historically been a cash-based activity. Often the miner will have little, if any, documentation to support the activity. If there are records, they are often disorganized. Hand-written receipts are common. This guide addresses some specific problem areas encountered in the examination of the smaller mining operations, with emphasis on the placer miner.

Under current tax law, exploration and development expenses can be deducted in full in the year they are paid or incurred. The expenses must be recaptured in the year that the mine goes into the producing stage or upon disposition of the property. In reality, few miners ever claim to be in the producing stage, disposals are seldom reported, and it is unlikely that proper accounting for the recapture of expenses will be found. In the past, taxpayers have deducted large mining losses with little or no recourse by the Government. IRC section 183 has strengthened the position of the Service in holding that a miner must be in a trade or business or engaged in an activity for the production of income with the objective of making a profit in order to claim mining related expenses such as those for exploration and development.

The small placer miner usually claims a Schedule C loss created by deducting exploration and development expenses with little or no mining income. The miner claims to be in the exploration or development stage when, in fact, gold is being produced and sold. The examiner will generally find that the expenses are related to the extraction of gold while the sales of gold are not reported.

The miner may be required to maintain a mineral inventory and claim cost-of-goods sold, including the costs necessary to clearly reflect income following the matching of income and expenses principal. Examiners should verify the mining stage, search for unreported income, and confirm the existence of an inventory. Most expenses will be found to be either direct or indirect mining costs which should be included as part of cost-of-goods sold. As a result, mining losses can be reduced by either the increases to income or the decreases in deductible expenses or both.

Key Definitions

There is no one inclusive definition of "**mining**" for federal income tax purposes. The key definitions needed for a quality examination of mining operations are defined below. The glossary includes more definitions of mining terminology.

The term "**mine**" as defined in Treas. Reg. section 1.617-3(c)(1) states:

The term "mine" includes all quarries, pits, shafts, and wells, and any other excavations or workings for the purpose of extracting any known deposit of ore or other mineral.

The term "**mining property**" defined in Treas. Reg. section 1.617-3(c)(3) states:

The term "mining property" means any property (as the term is defined in IRC section 614(a) after the application of subsection (c) and (e) thereof) with respect to which any expenditures allowed as deductions under IRC section 617(a) are properly chargeable.

The term "**property**" as defined in IRC section 614(a) states:

For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

The term "**mining**" as defined in IRC section 613(c)(2) states in part:

The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not common carrier) from the point of extraction from the ground to the plant or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

The life of mining property is generally classified into three separate stages: **Exploration, Development, and Producing**. The term "**exploration expenditures**" as defined in IRC section 617(a)(1) provides in part:

* * * At the election of the taxpayer, expenditures paid or incurred during the taxable year for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, and paid or incurred before the beginning of the development stage of the mine, shall be allowed as a deduction in computing taxable income. * * * In no case shall this subsection apply with respect to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under IRC section 613.

The term "**development expenditures**" as defined in IRC section 616(a) provides in part:

* * * there shall be allowed as a deduction in computing taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ores or minerals in commercially marketable quantities has been disclosed.

The term "**producing stage**" as defined in Treas. Reg. section 1.616-2(b) states:

The mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

The term "**Producing Stage**" is defined in Treas. Reg. section 1.617-3(c)(2) as follows:

A mine will be considered to have reached the producing stage when:

- (i) the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or
- (ii) the principal activity of the mine is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

The term "**Economic Interest**" as used in Treas. Reg. section 1.611-1(b)(1) is defined as follows:

Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from extraction of the mineral or severance of the timber, to which he must look for a return of his capital.

Exploration, Development, and Production

One of the first determinations to be made in an examination of small mining operations is the **type** and current **stage** of the mining activity.

Exploration

Exploration expenditures include amounts paid or incurred during the taxable year, prior to the development stage, for ascertaining the existence, location, extent, or quality of the mineral deposit. Some activities associated with placer mining exploration include staking the claim, removal of property line obstructions, limited removal of overburden (the removal of large amounts of overburden would indicate that a deposit may have already been found and the mine may be in a different stage), and limited sluicing.

Rev. Rul. 70-287, 1970-1 C.B. 146, holds that exploration expenditures include geological and geophysical investigations, reconnaissance, surveying, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of work. However, the physical means or method by which the work is performed does not distinguish exploration from development. For example, core drilling expenditures incurred in a mineralized outcrop after minerals are found to exist in commercially marketable quantities are not exploration expenses.

Exploration expenditures constitute capital expenditures which increase the basis of the mineral property unless the taxpayer makes an election to currently deduct the expenses. The election is made for the first year the taxpayer wishes to deduct the expenditures. The expenditure deductions are subject to recapture when the mine reaches the production stage. The recapture may be accomplished by either the disallowance of depletion deductions until the disallowed amounts equal the previously deducted exploration expenses or the inclusion in non-depletable gross income in an amount equal to the previously deducted expenditures.

The majority of Schedule C returns may appear to be in the exploration stage, but this should be verified. Since reporting requirements for the various stages of the operation differ, it is important to establish, preferably in the initial interview, the stage of mine operation.

The exploration stage encompasses prospecting, which does not necessarily require a state filing and actual exploration. If prospecting is conducted on public lands, a minimum requirement is the filing of Affidavits of Annual Labor. Due to the inclusion of prospecting under IRC section 617, an examination cannot be based on the sole fact that the taxpayer did or did not file the required forms with the state. Filings are not required if the land is privately held.

It is helpful, at the initial interview, to determine the approximate amount of time that was spent at the mine during the tax year since the mining season varies and can be relatively short. Only larger operators will have the equipment and resources to work through the winter. Once this information is obtained, it can be verified with the Affidavit of Annual Labor. However, remember that the Affidavits of Annual Labor are NOT verified by the Department of Natural Resources so they should only be used as a comparison tool.

It may be necessary to explain the various stages of mining to the taxpayer. If this situation arises, examiners should allow taxpayers to describe their activities before determining which stage the taxpayer is in or explaining the tax ramifications.

Development

Taxpayers generally have difficulty distinguishing between the exploration and development stages. If the development stage is claimed, examiners should verify with the taxpayers that they have discovered commercially marketable quantities of ore. In following *Paul R. Schouten and Mary Kay Schouten v. Commissioner*, T.C. Memo., 1991-155, CCH 47,277(M), development expenses can be disallowed when a taxpayer cannot present evidence as to the existence of minerals in commercially marketable quantities.

There should be very little, if any, income during this period. Activities associated with development are building roads, clearing the land, and other activities to prepare a site for the production stage.

Development expenditures must be for preparing a mineral deposit for extraction of the mineral and not for equipment or facilities which relate solely to the extraction of the mineral from the deposit.

Pre-stripping is a process found in open pit and strip mines. The process involves the removal of top soil or earth to expose a coal or ore deposit for later mining. The actual ore may not be removed until the next year after the covering layer of earth is removed or stripped away.

Where the removal of the overburden is related to the extraction of the mineral in the day-to-day mining cycle, and the removal of overburden makes it possible to extract only a small portion of the ore directly beneath the overburden, the costs of overburden removal are operating expenses of mining to be taken into account as costs-of-goods sold under the provisions of Treas. Reg. section 1.61-3. See Rev. Ruls. 67-169, 1967-1 C.B. 159 and 77-308, 1977-2 C.B. 208.

Where a portion of the coal seam is exposed in excess of what is needed to maintain a desired level of coal production, these expenses are developmental expenses under IRC section 616. See Rev. Rul. 86-83, 1986-1 C.B. 251. Accordingly, where expenditures incurred for removing overburden serve both to expose ore for mining and make possible the future mining of additional ore, the costs are developmental expenditures under IRC section 616 because they are incurred for the purpose of making the ore accessible for sustained extraction over a relatively long period.

The time involved with development can be for a short or relatively long period, depending on the location of the mine, the taxpayer's resources, and the amount of work needed to ready the ore body for production. Taxpayers should be questioned on their plan for development of the property. Have the required permits been submitted to the Department of Natural Resources, the Department of the Interior, the Department of Environmental Conservation, etc.? Ask and determine if they are familiar with the filing requirements concerning the property being worked. If they are unaware of the requirements or activity, this may be an indication that the claim owner is not working the mine and possibly making it a passive activity or an activity not engaged in for profit pursuant to IRC section 183.

Production

If the taxpayer is claiming to be in the production stage, the issues of recapture and depletion should be considered. In all instances, regardless of the mining status, expenditures should be reviewed for possible examination issues. Consider if the alternative minimum tax applies or if a passive activity exists.

Recapture of previous expenditures is an important issue when the taxpayer is claiming to have always been in production. If taxpayers state they have always been in production, ask to see returns as far back as possible to derive some type of history of the operation. There should at least be some income in each year, although taxpayers can legitimately state they are in production while having no income shown on the return. If a taxpayer claims to be in production,

yet a history of the operation shows continual losses, then the "not for profit" issue under IRC section 183 can be raised and pursued.

Public Records

The Alaska Department of Natural Resources office contains information on all mining claims in Alaska, on both state and federal lands. Examiners should identify similar regulatory agencies within their state.

Records should be available to identify the claim holder by name and location of the claim. Records may also list the type of activity, the discovery date, the legal description, the years annual labor reports were filed, and any transactions pertaining to the property. They will also indicate if a claim has been abandoned.

The files may contain copies of all recorded documents pertaining to the property, such as quitclaim deeds, warranty deeds, affidavits of annual labor, and any other documents which have been officially recorded.

These documents are public record and easily researched. When a claim is established, on either state or federal land, the proper documentation is submitted to the Bureau of Land Management (BLM) for federal land and Department of Natural Resources (DNR) for state land. A number is assigned to the claim and remains with the claim indefinitely.

Chapter 2

Mining Income

Gold refiners are generally the primary market for miners. Raw gold is usually delivered to the refiner where it is purchased from the miner, processed, and refined. At the point of sale, funds received are considered income to the miner. Examination of a refiner's cost-of-goods sold is a source of information to identify the refiner's suppliers.

IRC section 6045 establishes information reporting requirements for brokers to file information returns showing the gross proceeds from sales of property. This information is reported on Form 1099-B. IRC section 6045 establishes information reporting requirements for brokers relating to gross proceeds including the reporting on sales of property that can be delivered to satisfy a contract approved for trading by the Commodity Futures Trading Commission (CFTC). This applies to both Gold Coins and Bulk Bullion. CFTC contracts for gold coins call for a minimum delivery of 25 coins in the form of South African Krugerrands, Canadian Maple Leafs, Mexican one-ounce coins, or any other type of gold coin.

Rev. Proc. 92-103, 1992-2 C.B. 583, has effectively limited the IRS's ability to verify income to a miner by examining the refiner's records. This Revenue Procedure has retroactively raised the limits required to have a reporting document issued to the limits set by the Commodities Futures Trading Commission rules and regulations concerning futures contracts. Due to this increase, a individual selling bulk gold to a refiner will generally not meet the limit requirements and thus a Form 1099 would not be issued to reflect the income received. Due to this revision of the reporting requirements, the refiners will be required to issue fewer Forms 1099 unless the weight or number requirements are met.

There are two types of contracts for bulk gold as outlined by the Chicago Board of Trade (CBOT): Kilo Gold and 100 Ounce Gold. CBOT Rules and Regulations section A1536.01 covering Kilo Gold contracts states the contract grade for delivery on futures contracts made under the Regulations

* * * shall be 1 (one) bar of refined gold cast in a gross weight of one kilogram minimum (for the purpose of this contract, a kilogram is a weight equal to 32.150 troy ounces), assaying not less than 995 fineness and bearing brands and markings officially approved by the Exchange.

Settlement shall be on the basis of the fine troy ounces of gold delivered. (09/01/94)

CBOT Rules and Regulations section B1536.01 covering 100 Ounce Gold contracts states that each futures contract made under the regulations—

* * * shall be for 100 fine troy ounces of gold, although variation in the quantity of the delivery unit not in excess of five percent of 100 fine troy ounces shall be permitted. Delivery shall be by no more than three cast bars of refined gold, no less than 995 fine, and bearing brands and markings officially approved by the Exchange; and no bar which contains less than 31 fine troy ounces of gold may be delivered in fulfillment of a contract.

Settlement shall be the basis of the fine ounces of gold delivered. Refined gold of fineness above 999.9 shall be considered to be 999.9 pure for the purpose of calculating the fine gold content. (09/01/94)

The Chicago Board of Trade rules and regulations are based on the rules and regulations of the Commodities Futures Trading Commission.

When examining individual returns without the aid of refiner-obtained information, an indirect method will likely be used to determine income or if it is properly reported. Initially, a bank deposit analysis should be conducted with examination of any large or unusual items. If the taxpayer is a wage earner and has other sources of regular income, look for deposits which are out of the norm. The cleanup of the placer usually takes place at the end of the mining season, generally fall or early winter, and particular attention should be given to this time period for an indication of mining activity.

It is not uncommon for miners to deal strictly in cash. If there are indications that the taxpayer is hoarding gold and selling it only as needed, it becomes difficult to determine income through the analysis of bank records. If this appears to be the case, the Cash-T or Net Worth indirect methods should be pursued. The excess of income over expenses or assets over resources should be thoroughly examined. If expenditures prove to be in excess of the taxpayer's resources, the income issue should be raised. CTR's should always be checked as it is not uncommon for the miner to deal in cash as much as possible. Determine if any bartering activity or the trading of services are present in the operation.

Another area indicating unreported income is the acquisition of depreciable assets. If there are purchases of equipment or other items pertaining to the activity, determine and verify what resources were used to obtain the asset. Third-party contacts with the sellers may be necessary to determine the amount paid and when assets were acquired. If it is determined that the individual purchased the asset with a loan, verify the lender, what relationship they had with the purchaser, and what type of collateral was used to obtain financing. If gold was used as collateral, verify the value placed upon it by the bank or other lender. If the gold is used as collateral for a loan, it becomes income to the taxpayer and should be reported. A summons of bank records may be required to obtain this information.

Income information may be obtained in examination of the Affidavits of Annual Labor. The affidavit will list the names and addresses of those individuals who performed labor on the claim. It is often the case that an owner will pay for labor in gold. Verification of the amount of payment for labor performed may also indicate income to the miner.

Discuss the issue of cash hoards with the taxpayer at the initial interview. This information can be useful if an income question arises later in the examination. Question the taxpayer about any accumulations of gold or other precious metals. If the taxpayer is in the production stage, with income but no cost-of-goods sold, the issue of inventory should be raised. Determine how much gold was on hand at the beginning of the year, how much was produced and sold, and the amount left at the end of the year.

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Chapter 3

Prospecting Activities

Of the stages involved in the creation of a profitable mining operation, the prospecting or discovery stage is generally the first activity. A discovery need not be of commercial quantity. However, it should be of a character where an ordinary and prudent person would be justified in further expense with a reasonable expectation of success and profit potential.

Prospecting activities are generally considered a form of exploration so the associated expenses may be allowable under IRC section 617. Normally, state or federal reporting is not completed for general prospecting. The contention that there can be no exploration expenses because there are no documents filed cannot be used as a reason to disallow the expenses. Generally, a taxpayer only needs to show that there is an intent to be in an active trade or business for profit. However, all factors must be considered in determining if a "not for profit" issue (IRC section 183) can be raised. See Chapter 4.

Exploration expenditures as defined by IRC section 617 include amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of a mineral deposit, and paid or incurred prior to the development stage of the mining operation. Prospecting expenditures constitute capital expenditures which increase the basis of the mineral property to the same extent as exploration expenditures. However, Treas. Reg. section 1.617-1(c)(1) grants the taxpayer a right to make an election to currently deduct the expenditures.

By definition, the type of expenditures qualifying as prospecting or exploration expenses are very limited for the placer miner. Expenses should be analyzed to determine if they relate to the types allowable by IRC section 617.

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Chapter 4

Economic Substance, Sham Transactions, and the Hobby Activity

Losses incurred by an individual miner should be reviewed to determine if the activity was engaged in for profit or if it had no economic feasibility for profit. The facts of each case should be considered to determine if the mining activity had economic substance, if it was a sham transaction, or if it involved a hobby activity. An activity "not for profit" is considered a hobby, with expenses limited to the extent of income produced from the activity (except for deductions allowable regardless of whether a "not for profit" issue exists, such as interest and taxes).

IRC section 183(a) provides that if an activity is not engaged in for profit, no deduction attributable to such activity shall be allowed. IRC section 183(c) defines an activity not engaged in for profit as "any activity other than one with respect to which deductions are allowable for the taxable year under IRC section 162 or under paragraph (1) or (2) of IRC section 212".

The following list from Treas. Reg. section 1.183-2(b) sets forth nine non-exclusive objective factors to determine whether an activity is engaged in for profit.

1. The manner in which the taxpayer carries on the activity.
2. The expertise of the taxpayer or his advisors.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the asset used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer's history of income or losses with respect to the activity.
7. The amount of occasional profits, if any.
8. The financial status of the taxpayer.
9. The elements of personal pleasure or recreation involved in the activity.

The regulation factors should not merely be counted to determine the number of items "for" and "against" the taxpayer. All the facts and circumstances must be considered and more weight may be given to some of the factors. Not all factors may be applicable in every case and no one factor is considered controlling.

The following is a list of mining cases dealing mainly with gold mining. They provide insight into mining activity and set forth principles used by the courts in determining economic substance and the objective or reasonable prospect of a profit.

1. *David E. Wasserstrom and Sandra R. Wasserstrom v. Commissioner*, T.C. Memo., 1986-417, CCH 43,328(M)

2. *Ronald Z. Krivitsky and Shirley A. Krivitsky v. Commissioner*, T.C. Memo., 1987-460, CCH 44,189(M)
3. *Carla Gates Cannon v. Commissioner*, 91-2 U.S.T.C. 50,559; (CA-10), *aff'g.* T.C. Memo., 1990-148, CCH 46,474(M)
4. *William Norman and Phyllis Jane Milner v. Commissioner*, T.C. Memo., 1993-91, CCH 48,904; T.C. Memo., 1991-464, CCH 47,634(M)
5. *James P. Thomas and Mary Lou Thomas v. Commissioner*, 86-1 U.S.T.C. 9465, (CA-4), *aff'g.* 84 T.C. 1244 (1985)
6. *Robert G. Davis and Jobee Davis v. Commissioner*, T.C. Memo., 1989-635, CCH 46,179(M)
7. *Kenneth J. Horn and Vickie L. Horn v. Commissioner*, 90 T.C. 908 (1988)

Generally, in order for expenses to be allowable, they must be supported by the taxpayer's actual motive to make a profit. If the profit motive is absent, tax deductions relating to the investment are limited under IRC section 183 to the income generated from the activity. *Maurice C. Dreicer v. Commissioner*, 78 T.C. 642 (1982).

It is important to remember that while a reasonable expectation of profit is not required, the taxpayer's profit motive must be bona fide. Refer to the decisions reached in *Henry N. and Marilyn Hulter v. Commissioner*, 91 T.C. 371 (1988) and *Truett E. Allen and Barbara Allen v. Commissioner*, 72 T.C. 28 (1979). Whether a taxpayer has an actual profit motive is a question of fact and is to be resolved from all the relevant facts and circumstances. The burden of proving the motive is on the taxpayer.

The economic substance of the transaction is one of the factors that is relevant in analyzing a taxpayer's profit motive. Transactions entered into solely for the purpose of obtaining a tax benefit and without economic substance will not be allowed. If the taxpayer is using the mining activity to create a loss to offset income or deduct personal expenses under the guise of a mining activity, they should be not be respected for tax purposes. The cases of *Frank Lyon Company v. United States*, 78-1 U.S.T.C. Para 9370; and *James L. Hudson v. Commissioner*, 103 T.C. 90 (1994), support this position.

Chapter 5

Passive Activities

A passive activity is defined as a trade or business, or activity conducted in anticipation of becoming a trade or business, in which the taxpayer does not materially participate. Passive activities are controlled by IRC section 469; those rules apply to individuals and estates, trusts, personal service corporations, and closely held C-Corporations with five or fewer individuals owning more than 50 percent in value of its outstanding stock anytime during the last half of the taxable year. A passive activity is a Schedule C or F activity with no material participation, a limited partner interest without more stringent material participation, and a rental (regardless of the level of participation).

Most of the returns examined will be for miners who are actually working a claim, and the basic concepts of passive activities should be addressed when interviewing the taxpayer to obtain information regarding the taxpayer's participation in the activity. Determine the approximate number of hours worked by the taxpayer. This figure can then be compared with that on the Affidavit of Annual Labor. If there is a substantial variance, it may be worthwhile to probe the issue in more depth.

Generally, the owner of the claim is the main person working the claim. However, check to see if the claim is leased. If this is the case, the lessee has the same rights as the owner. While most mining claims are worked by individuals, there will be times when a partnership or S-Corporation may be involved with the running of the operation. It is important to determine who actually handles the day-to-day operations, or who is actually materially participating in the activity. It is not uncommon for partners or shareholders to live out of state (lending credence to the fact that the activity may be passive to that individual). Be sure and check the EIN and compare it to the state in which the taxpayer resides. Limited partners are by Code presumed passive unless they pass the exception tests outlined in Treas. Reg. 1.469-5T(e)(2). If this type of return is examined, copies of the Forms K-1 should be obtained and examined. If it appears that the issue of material participation may be applicable, obtain an RTVUE and review the individual's return for possible examination. The glossary contains definitions of certain terms used in this section.

There are seven tests which can be applied to determine material participation. The taxpayer need only meet **ONE** of these tests to qualify. Pay particular attention to items 1 through 3. The seven tests are outlined below.

Material Participation

A trade or business activity is not a passive activity if the taxpayer materially participates in the activity. One materially participates in a trade or business activity for a tax year by satisfying one of the following tests.

1. The taxpayer participates for more than 500 hours during the taxable year. In counting hours of participation, spouses' hours are added together. An individual's participation in an activity may be established by any reasonable means. Time reports and logs are not required. Treas. Reg. section 1.469-5T(f)(4).
2. The taxpayer's participation is substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.
3. The taxpayer participated in the activity for more than 100 hours during the tax year, and he/she participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.
4. The activity is a Significant Participation Activity, (SPA) and the taxpayer's aggregate participation in all SPA's for the taxable year exceeds 500 hours. A significant participation activity is any trade or business activity in which the taxpayer participated for more than 100 hours during the year and in which the taxpayer did not materially participate under any of the material participation tests, other than this test.
5. The taxpayer materially participated in the activity for any 5 (whether or not consecutive) of the 10 preceding years. When determining whether the taxpayer materially participated in tax years beginning before 1987 (other than a tax year of a partnership, S-Corporation, estate, or trust ending after 1986), the taxpayer materially participated only if he/she participated for more than 500 hours during the tax year.
6. The activity is a personal service activity in which the taxpayer materially participated for any 3 (whether or not consecutive) preceding tax years. To determine material participation in tax years beginning before 1987 (other than a tax year of a partnership, S-Corporation, estate, or trust ending after 1986), the taxpayer materially participated only if he/she participated for more than 500 hours during the tax year.
 - a. For the passive activity rules, a corporation is a personal service corporation if it meets all of the following requirements.
 - 1) It is a corporation (other than an S-Corporation).
 - 2) Its principal activity during the "testing period" is performing personal services. The testing period for any tax year is the previous tax year. If the corporation has just been formed, the testing period begins on the first day of its tax year and ends on the earlier of:
 - a) the last day of its tax year, or
 - b) the last day of the calendar year in which its tax year begins.
 - c) The services in (2) must be substantially performed by employee-owners. This is met if more than 20 percent of the corporation's compensation cost for its activities of performing personal services during the tax year are for services performed by employee-owners, and
 - d) Its employee-owners own more than 10 percent of the fair market value of its outstanding stock on the last day of the testing period.
 - b. Personal services are those performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

- c. A person is an employee-owner of a personal service corporation if both of the following apply.
 - 1) He or she is an employee, or performs personal services for or on behalf of the corporation as an independent contractor, during any day of the testing period, and
 - 2) He or she owns directly or indirectly any stock in the corporation at any time during the testing period.
7. The taxpayer's participation is regular, continuous, and substantial. The participation must be more than 100 hours per year and then it is a facts and circumstances determination. Treas. Reg. section 1.469-4(b)(1) defines trade or business activities as:

* * * activities, other than rental activities [as defined in Treas. Reg. section 1.469-1T(e)(3)] or activities that are treated under Treas. Reg. section 1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that—

1. Involve the conduct of a trade or business (within the meaning of [IRC] section 162);
2. Are conducted in anticipation of the commencement of a trade or business; or
3. Involve research or experimental expenditures that are deductible under [IRC] section 174 (or would be deductible if the taxpayer adopted the method described in [IRC] section 174(a)).

Determination of material participation is crucial in determining whether the mining activity is passive or not. IRC section 469(h)(1) states: "* * * A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is: (A) regular, (B) continuous, and (C) substantial." See the seven tests for material participation discussed above.

Exploration and development expenditures for any given claim can only be deducted by the owner of the claim or by another when there has been an arrangement, such as a contract with a renter/lessee. Ownership or control can be verified by examining the documents pertaining to the claim in the Department of Natural Resources files. If the claim is leased or rented to another, the contract should be examined to determine the terms of the agreement. If there is a verbal contract, both parties should be queried to determine the facts.

If the claim is leased and the lessee has control of the operations, this would convert the claim to a rental activity for the owner and generally convert it to a passive activity. IRC section 469(c)(2) defines a passive activity as including any rental activity. Treas. Reg. section 1.469-1T(e)(3) further defines the concept of "rental activity". The owner/lessor would thus not be entitled to any expenses which would fall under IRC sections 616 or 617. The activity would not be allowed to be claimed on the Schedule C but would have to be filed on Schedule E and the appropriate passive loss schedules completed.

To determine if the mining activity for the individual is passive, begin with the ownership documents to verify the taxpayer's position. After ownership is established, examination of the Affidavits of Annual Labor should be pursued, if the taxpayer is required to file them. They describe how much work was done in terms of man-days, the dollar amounts, who actually did the work, and what type of work was done. The reports also give the dates the work was performed.

The reporting period runs from September 1 thru September 1 of the following year, requiring the need to review 2 years of affidavits.

Often, the reports will reveal that the owner of the claim did not actually do the physical labor of working the claim. This standing alone would not immediately make the activity passive to the owner. Management of the activities, hiring the laborers, and filing the necessary documentation pertaining to the claim all must be considered in the determination of the participation by the owner. (Note: Treas. Reg. sections 1.469-5T(b)(2)(ii) and (f)(2) exclude certain types of participation from consideration.) This may be difficult to ascertain as there are no strict record-keeping requirements. Thus, obtaining information at the initial interview is critical. Third-party contacts with those individuals identified on the labor reports may also be helpful in determining the amount of participation on the part of the owner.

Remember, the Affidavits of Annual Labor are NOT verified by the Department of Natural Resources. This information must be used only as reference information. Audit comments should be made regarding the extent of reliance on the information.

The mining season for the small scale miner can be a short period during the spring and summer. This is due to the extreme weather conditions and the need for heavy duty equipment to work in the winter months. Larger operations have more resources and are better able to extend the period of operations. However, for the individual, this relatively shorter working season should be considered when making an analysis of the numbers of hours worked.

Chapter 6

Non-Filers

Through examination of DNR documentation and research of the information available through internal resources, the identity and filing status of an individual can be ascertained. Investigation of these records will allow for determination of compliance by this population.

Affidavits of Annual Labor on file with DNR are a good place to start. The documents will reveal the owner of a claim and the current address. It is the owner's responsibility that the Division of Mining have a current address. The Affidavit further reports the names and current addresses of the persons who actually performed the work.

When examining the DNR documents, the names and addresses of the individuals on the report should be noted and subsequently verified through IDRS for their filing status. If research reveals that an individual has failed to file a return, contact should be made and they should be encouraged to come into compliance.

An IRP document should be obtained and checked for information regarding wages or non-employee compensation. Employers can then be contacted for copies of documents or any other information concerning the individual which would be helpful in supporting an income issue. The DNR files can also be examined for activity regarding this individual. This includes any property transfers, production reports, etc.

The Affidavit of Annual Labor gives the names of individuals who actually worked the claim in any given year. It does not detail the capacity of the laborer, that is, as an employee or an independent contractor. If the SSN or the EIN can be ascertained for the owner, a PMFOLS (summary) can be run to determine if Forms W-2 or 1099 have been filed. If it is found that information documents have been filed, a PMFOLD (detail) can then be run to further define what has been filed.

If it is found that an individual laborer has not filed an income tax return but information reports were filed, the information should be obtained to properly document the file. Initially, this information should be sought from the individual who actually filed the form. If the documents are not obtainable, an explanation as to why and what procedures were taken to procure a copy should be included in the file.

Upon confirmation of an individual's non-filer status, an IRP document should be ordered. An IRP document will be considered evidence of income, as it is an internal IRS document whose source and authenticity is within the Service's ability to confirm. However, copies of actual documents are preferable over internal documentation.

The Bureau of Labor Statistics (BLS) for non-filers should be considered when a taxpayer can be located but is uncooperative. The BLS statistics can be used, if it appears that a taxpayer is gainfully employed or self-employed, based upon the individual's standard of living.

Chapter 7

Employee versus Independent Contractor Status

If individuals work a claim as employees or independent contractors, they are performing a service for the owner and not conducting exploration or development for themselves. Thus, they are not entitled to deduct expenses with regards to that claim.

However, an employee or independent contractor would be allowed to deduct unreimbursed expenses under IRC section 162. It is advisable to find out what the individual's status is in relationship to the owner or lessee of the claim. This information can be obtained through interviewing the individual, the claim owner, or from the information available at the Department of Natural Resources.

If the individual is working as an employee, there should be a Form W-4 filed with the employer and Forms W-2 & W-3 filed by the employer, as well as the appropriate employment tax returns. The documents should be examined for possible employment tax issues when completing the Required Filing Checks as part of an examination of the employer's income tax return. Employee returns should include Form 2106 to claim expenses in connection with the employment. Since the employee is working for the owner, no Schedule C should be filed.

If the individual is working as an independent contractor, a Form 1099 should be issued by the owner. The income and associated expenses of the contractor should be reported on Schedule C. In most cases, the independent contractor does not have an interest in the claim or mine. Thus, the contractor cannot deduct exploration or development expenses for the particular claim. If there are expenses, determine the type and if the taxpayer is deducting them under IRC section 162 as ordinary and necessary business expenses or as exploration or development expenses. In the case of the independent contractor, an IRC section 183 issue can be considered.

In either case, whether an employee or independent contractor, a determination of employment tax issues should be considered. Consult the employment tax coordinator if there are any questions or issues regarding the classification of workers or employment taxes.

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Chapter 8

Depletion

Depletion, like depreciation, is a form of cost recovery. Just as the owner of a business asset is allowed to recover the cost of an asset over its useful life, a miner is allowed to recover the cost of mineral property. Depletion is taken over the period of time that mineral is being extracted. Two forms of depletion are allowed: cost depletion and percentage depletion. The taxpayer is required to use the method which will result in the greatest deduction.

Cost Depletion

The general method used for the calculation of depletion is the cost method. The first step of this method is to determine the number of units which comprise the deposit. The units can be tons of ore, barrels of oil, board feet of timber, etc. The taxpayer must be consistent from year to year in the type of unit being calculated to insure uniformity. The second step takes the cost or adjusted basis of the property which pertains to the deposit and divides this basis by the total number of units to obtain the depletion cost per unit. Once the total number of units extracted is determined for the tax year, it is multiplied by the cost per unit to obtain the amount of depletion available.

It is possible that during the course of the operation or from examination, the estimate of the number of units which comprise the deposit may change. If this happens, the calculation can change. While the number of units can be recalculated, the basis cannot be adjusted. It is advisable to discuss with the taxpayer as early as possible how they estimated the number of units used in the depletion calculation. It is also helpful to determine if the taxpayer has adjusted this estimate over the course of production. Check to see if the taxpayer is being consistent with the measure of units and what method was used to develop the new estimate.

The following example covers depletion using constant estimates.

The taxpayer purchases a claim for \$50,000, with known mineral reserves in mineable quantities. He states that he is in the production phase and is selling product. The taxpayer estimates that there is 100,000 tons of ore to be extracted. For purposes of the computation for depletion, the basis of the mine is \$50,000. During the tax year, the taxpayer mines and sells 3,500 tons of ore. The first year depletion would be calculated as follows:

Rate of Depletion per ton (\$50,000/100,000)	\$.50
Depletion for year (3,500 x \$.50)	\$	1,750.00
 Purchase price	\$	50,000
First year depletion		<u>1,750</u>
First year basis of the property	\$	48,250

If estimates of the amount of reserves were never adjusted, the above calculation for depletion would remain constant. The basis would be reduced each year by the amount of depletion until it is totally consumed and the taxpayer has no basis left in the property. At this time, cost depletion is no longer allowed. While this scenario would certainly not be out of the ordinary, a revision in the estimate of reserves will affect the depletion calculation, and should be thoroughly examined. The following example covers depletion using revised estimates.

In tax year 2, the miner sells 7,000 tons. At the end of the year, the estimate of the ore changes to 130,000 tons. The calculation for depletion for year 2 would be as follows:

Revised estimate of unextracted ore	130,000	
Ore sold during the year	<u>7,000</u>	
Total tonnage used to compute new rate	137,000	
Remaining Adjusted Basis of property	\$48,250	
 Rate of Depletion per ton (\$48,250 / 137,000)	\$.35
Depletion for year 2 (7,000 x .35)	\$	2,450
 First year basis of the property	\$48,250	
Second year depletion	<u>-2,450</u>	
Second year basis of the property	\$45,800	

Percentage Depletion

Under the percentage depletion method, a flat percentage of gross income from the activity is used to calculate the depletion allowance. The deduction for depletion cannot exceed 50 percent of the taxable income from the activity. This limitation is computed without regard to the depletion allowance. Depletion percentages are found in IRC section 613(b) and Treas. Reg. section 1.613-2. The amount of the deduction allowable under percentage depletion is not limited by the basis of the property. Thus, even though the basis of the property is reduced by the amount of depletion taken, if the basis becomes zero, the depletion based on the percentage of gross income may continue. However, if cost depletion will yield a higher deduction, it must be used to calculate the amount deducted.

In using percentage depletion the concepts of gross income, taxable income, and different percentages based on the type of material extracted all come into play in the computation. The Code and Regulations are specific regarding the percentages to be used for the various types of materials which can be mined. Particular attention should be paid to the type of arrangement the taxpayer is involved in, that is, is the property being leased, are there royalties involved, are there prepayments of any kind, etc. This information should be discussed in the initial interview in order to clearly establish the nature of the mining activity.

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Chapter 9

Sale of Claims

Information on sales and other transfers of mining claims can be obtained from the files maintained at the Department of Natural Resources. All transfers must be recorded and a copy of the recorded document supplied to the state. These documents include quitclaim deeds, warranty deeds, and contracts of sale. They provide the names of the seller, buyer, which property is transferred, and the terms of the transfer.

The documents may not contain the true sales price. Usually the documents indicate that the property was transferred for \$10.00 and/or other good and valuable consideration. After the information derived from these documents is obtained, an RTVUE of the sellers return can be requested and examined to verify if the sale has been reported. If there is no sale apparent on the return, further research is warranted. This can be achieved by a third-party contact with the buyer. However, it may be advisable to probe further to guarantee that there is no collusion between the buyer and seller or to verify that the transaction was at arms length.

Since the purchase price or fair market value establishes the basis for the buyer in the majority of transactions, there is some incentive for the buyer to give correct information. Research of sales of property may also reveal a non-filer, so it is advisable to review both the seller's and the buyer's returns.

IRC section 617(d)(1) states:

Except as otherwise provided in this subsection, if mining property is disposed of, the lower of—

- A. the adjusted exploration expenditures with respect to such property, or
- B. the excess of
 - (i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value (in the case of any other disposition), over
 - (ii) the adjusted basis of such property,

shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

Treas. Reg. section 1.617-4(a)(2) states:

In the case of a sale, exchange, or involuntary conversion of mining property, the gain to which [IRC] section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a disposition of mining property other than by a manner described in the preceding sentence, the gain to which [IRC] section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property * * * on the date of disposition over the adjusted basis of the property.

IRC section 617(f)(1) states:

- * * * The term "adjusted exploration expenditures" means, with respect to any property or mine—
- A. the amount of the expenditures allowed for the taxable year and all preceding taxable years as deductions under subsection (a) to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under subsection (a)) would be reflected in the adjusted basis of such property or mine, reduced by
 - B. for the taxable year and for each preceding taxable year, the amount (if any) by which
 - (i) the amount which would have been allowable for percentage depletion under [IRC] section 613 but for the deduction of such expenditures, exceeds
 - (ii) the amount allowable for depletion under [IRC] section 611, properly adjusted for any amounts included in gross income under subsection (b) or (c) and for any amounts of gain to which subsection (d) applied.

Because a large percentage of Schedule C gold mines never claim to reach the production stage, depletion is rarely claimed. It is unlikely that there will be any recapture of exploration and development expenses. The computation described by IRC section 617(f)(1), regarding adjusted exploration expenditures, will generally not be a consideration when determining the gain on the sale of a particular claim; however, it must be considered.

It is important to determine the amount of exploration and development expenditures previously deducted pertaining to a particular claim or group of claims. The taxpayer is required to supply copies of all returns which include exploration or development expenditures pertaining to the claim or claims sold and be able to segregate the expenses by claim. This information can then be used to determine if a gain exists.

The basis of the claim must also be determined in order to ascertain if there is any excess basis. Once determined, the formula per IRC section 617(d)(1) can be applied. Also see IRC section 1254 for property placed in service after 1986.

Chapter 10

Alternative Minimum Tax

For purposes of determining Alternative Minimum Taxable Income (AMTI), mining development and exploration costs paid or incurred after December 31, 1986, which were allowable as a current deduction under IRC section 616(a) or 617(a), must be capitalized and amortized ratably over the 10-year period beginning with the taxable year in which the expenditures were made. This amount is shown as an Alternative Minimum Tax adjustment item and is the difference between the recomputed Alternative Minimum Tax expense and the expense claimed on the return. This adjustment is subject to an election under IRC section 59(e) which could eliminate the adjustment for AMTI purposes.

A taxpayer pays or incurs expenditures of \$50,000 in the current taxable year for mining exploration and development costs. This amount was deducted on the Schedule C. Had the taxpayer elected to amortize the expenses over a 10-year period, the deduction in the current year would have been \$5,000. The Alternative Minimum Tax adjustment would be calculated as follows:

Current Year Deduction	\$50,000
Amortized Deduction	<u>-5,000</u>
Total Adjustment to AMT	\$45,000

In years 2 through 10, the unamortized amount becomes a negative adjustment in computing AMTI. That is, the unamortized amount reduces AMTI in years 2 through 10 as shown below:

Current Year Deduction	\$70,000
Current Year Amortized Deduction	-7,000
Prior Year Amortized Deduction	<u>-5,000</u>
Total Adjustment to AMT	\$58,000

Exploration and development expenditures can effect the Alternative Minimum Tax calculation. Consider also the calculation for Depreciation and Depletion. Most miners tend to have some heavy equipment with sizable basis. The recalculation of the depreciation or depletion and subsequent changes can have an effect on the Alternative Minimum Tax.

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Chapter 11

Corporate Exploration and Development Costs

Per IRC section 291(b), the amount allowable as a deduction for exploration expenses (IRC section 617(a)) and development expenses (IRC section 616(a)) must be reduced by 30 percent. The unallowed expenses are deducted ratably over a 60-month period beginning with the month the costs are paid or incurred. Thus the corporation must prorate the expenses in the first year. The expenses are not taken into account for purposes of determining depletion under IRC section 611. If a corporation subsequently abandons or declares the property worthless and is still carrying unamortized expenses, they may be deducted in full in the tax year the properties are deemed worthless. If there are indications that a corporation is deducting exploration or development expenses, there should be an amount for amortization somewhere on the return. If there is not, it may indicate the corporation is deducting the exploration or development expenses in full.

Per IRC section 617(h), exploration expenses incurred outside of the United States may not be deducted in full in the year paid or incurred. These expenses must either be included in the adjusted basis of the property and recovered through depletion or be deducted ratably over a 10-year period beginning in the year the expenses were paid or incurred. The same rules pertain to development expenditures per IRC section 616(d).

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Chapter 12

Fuel Excise Tax

Taxpayers may be eligible to claim a credit or refund of excise tax included in the price of fuel if it was for off-highway use. Publication 378 defines off-highway business use as any use of fuel in a trade or business other than as a fuel in a registered highway vehicle. A highway vehicle is "any self-propelled vehicle designed to carry a load over public highways, whether or not also designed to perform other functions."

These are vehicles not considered highway vehicles:

1. Specially designed mobile machinery for non-transportation functions. A self-propelled vehicle is not a highway vehicle if it consists of a chassis that:
 - a. has permanently mounted to it machinery or equipment used to perform certain operations if the operation of the machinery or equipment is unrelated to transportation on or off the public highways;
 - b. has been specially designed to serve only as a mobile carriage and mount for the machinery or equipment, whether or not the machinery or equipment is in operation; and
 - c. could not be used, because of its special design, as part of a vehicle designed to carry any other load without substantial structural modification.
2. Vehicles designed for off-highway transportation. A self-propelled vehicle is not a highway vehicle if:
 - a. the vehicle is designed primarily to carry a specific kind of load other than over the public highway for certain operations; and
 - b. the vehicle's use of carrying this load over public highways is substantially limited or impaired because of its design.

Fuels used in off-highway business use include fuels for stationary machines such as generators, compressors, power saws, and similar equipment; for cleaning purposes; forklift trucks and bulldozers; and cars and trucks operating off the highway in construction, mining, or timbering activities, if the vehicles are neither registered nor required to be registered.

A credit or refund is allowable only if tax has been imposed on the fuel. All gasoline and undyed (clear) diesel fuel have been taxed by the time these fuels are used at the mine. Dyed diesel fuels generally do not qualify for a credit or refund. Other types of fuel (such as propane) generally are bought tax free and are not eligible for a credit or refund.

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Chapter 13

Inventories and Uniform Capitalization

It is the Government's position that, under IRC section 471(a), in order to achieve the matching of income to expenses, the taxpayer is required to maintain in inventory the gold extracted from the mining operation. This is necessary in order to determine the income of the taxpayer. The matching of expense to income follows the generally accepted accounting principal. A matching principal issue generally arises when the taxpayer is in the production stage deducting expenses related to the production phase of mining with little or no income. It is not uncommon to examine a return where the taxpayer claims to be in production yet keeps no inventory. Since the gold recovered must eventually be recognized as income, inventories must be maintained.

The initial interview should establish when the taxpayer first went into production and if any gold was on hand, either obtained with the claim or produced in the exploration or development stages. The general rules of inventory apply here, that is, how much gold was on hand at the beginning of the year, how much was produced during the year, how much was sold, and how much was on hand at the end of the year. This will provide the physical amounts used in computing the cost-of-goods sold.

IRC section 471 establishes that an inventory must be kept. Treas. Reg. section 1.446-1(a)(4)(i) recognizes the need for inventories and makes reference to IRC sections 263A and 471. Treas. Reg. section 1.471-7 establishes the need for inventories of miners and manufacturers and is supported by Treas. Reg. section 1.61-3 which provides that in a manufacturing, merchandising, or mining business, gross income means total sales less cost-of-goods sold. Cost-of-goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer.

Treas. Reg. section 1.471-11(a) states that:

* * * In order to conform as nearly as possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing.

The Uniform Capitalization rules require the capitalization of the costs of producing real and tangible personal property. See IRC section 263A(b)(1). Mining operations involve the production of both real and tangible personal property. Until the gold is extracted from the land, the taxpayer is engaged in the production of tangible personal property. The gold is inventory in the hands of the taxpayer.

The costs that must be capitalized are: (1) the direct costs, and (2) a properly allocable share of the indirect costs that benefit or are incurred by reason of the production of the mineral property.

See IRC section 263A(2) and Treas. Reg. section 1.263A-1(e)(3)(i). Treas. Reg. section 1.263A-1(e)(ii) provides an illustrative list of indirect costs required to be capitalized. In addition, IRC section 263A(f) requires the capitalization of interest incurred with respect to the production of real property.

IRC section 263A(c)(3) provides that the general rules of IRC section 263A do not require the capitalization of any cost that is allowable as a deduction under IRC sections 263(c), 263(i), 291(b)(2), 616, or 617.

The direct and indirect costs that benefit or that are incurred by reason of the production of the mineral property must be capitalized to that property. See IRC section 263A(a)(1)(B). The direct and indirect costs that directly benefit or are incurred by reason of the gold must be included in the inventoriable cost of the gold. See IRC section 263A(a)(1)(A).

Appendix A

References

Applicable Code Sections

43 CFR Ch.11 Treas. Reg. section 1865.0-5(c)	Patents and Conveyance of Land
IRC section 263A	Capitalization and inclusion in inventory costs of certain expenses
IRC section 291	Special rules relating to corporate preference items
IRC section 611	Allowance for deduction of depletion
IRC section 612	Basis for cost depletion
IRC section 613	Percentage Depletion
IRC section 614	Definition of property
IRC section 616	Development expenditures
IRC section 617	Deduction and recapture of certain mining exploration expenditures.

Revenue Rulings by Code and Treasury Regulation Sections

<u>Revenue Ruling Number and Description</u>	<u>IRC Sections</u>	<u>Treasury Regulations</u>
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70-287, 1970-1 C.B. 146

617

1.617-1

Expenditures paid or incurred by a mining company in connection with core drilling to ascertain the existence of commercially marketable ore are "exploration expenditures" within the meaning of IRC section 617.

70-288, 1970-1 C.B. 146

616

1.616-1

Expenditures paid or incurred by a mining company in connection with core drilling to further delineate the extent and location of existing commercially marketable ore to facilitate its development are "development expenditures" within the meaning of IRC section 616.

70-289, 1970-1 C.B. 147

617

1.617-1

Expenditures paid or incurred by a mining company in connection with core drilling from within an existing mine to ascertain the existence of a new ore deposit are "exploration expenditures" within the meaning of IRC section 617.

74-282, 1974-1 C.B. 150

**167
616**

**1.167(a)-1
1.616-1**

Strip mining; land purchased as dumping area for overburden. The cost of a tract of land containing an exhausted open pit mine, purchased for use as a dumping area for overburden removed from an adjacent strip mine at a price greater than the going price of similar tracts containing no open pit mine, is not deductible as a development expenditure. The entire cost must be capitalized, but the portion attributable to the exhausted open pit mine is an expenditure for an asset that is depreciable over its useful life based on the capacity of the open pit and the rate of dumping overburden into it.

74-67, 1974-1 C.B. 63

**174
617**

**1.174-1
1.617-1**

Research and experiments; mining exploration; core and non-core drill holes. Expenditures paid or incurred before January 1, 1970, by a domestic corporation under a mining lease agreement involving the drilling of core and non-core holes in connection with the production of minerals are mining exploration expenditures subject to the provisions of IRC section 617. Additional expenditures required to use the drill holes for designing and testing a new mining method are research and experimental expenditures and are subject to the provisions of IRC section 174.

75-122, 1975-1 C.B. 87

**174
616
617**

**1.174-2
1.616-1
1.617-1**

Mining; research and experimental expenditures. A domestic mining corporation's expenditures incurred directly in the development of prototype mining equipment and in perfecting a new metallurgical process, including the cost of shipping mineral samples to the research laboratory, are research and experimental expenditures deductible under IRC section 174(a). However, the expenses for driving shafts, drifts, cross-cuts, and for other production facilities that are not limited to the research activities are mine development expenses within the meaning of IRC section 616.

77-188, 1977-1 C.B. 76

**165
263
614
617**

**1.165-1
1.263(a)-1
1.614-1
1.617-1**

Geological and geophysical exploration expenditures. The tax treatment of geological and geophysical expenditures, for the purpose of obtaining data that will serve as a basis for the acquisition or retention of a mineral property by a taxpayer engaged in exploring for minerals is discussed; I.T. 4006 superseded.

90-20, 1990-1 C.B. 117

**616
617**

**1.616-1
1.617-1**

Carrying party's costs to explore, develop, and operate a mineral property; deductibility. The taxpayer may deduct all amounts it paid or incurred prior to payout that qualify as exploration expenditures under IRC section 617(a) if it has made a proper election under that section. The taxpayer may also deduct all amounts it paid or incurred prior to payout that qualify as development expenditures under IRC section 616(a).

Government Agencies

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U.S. Department of the Interior
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Arctic Office
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Bureau of Mines
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Mine Safety and Health Administration
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Northern Regional Office
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Department of Environmental Conservation
South Central Regional Office
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Non-Governmental Groups and Associations

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Miners Advocacy Council
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Appendix B

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Selected Significant Mineral Deposits in Alaska

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Surface Mining

American Institute of Mining, Metallurgical,
and Petroleum Engineers, Inc.
Eugene P. Pfeleider, Editor
The Maple Press Co., 1968

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Appendix C

Examination Checklist for Mining

An examination checklist covering mining activity is included as part of this audit technique guide for Placer Mining to assist the user with pre-examination planning, the initial interview, and with the recognition of potential issues. This checklist is not intended to be all inclusive but only to serve as a guide.

EXAMINATION CHECKLIST - MINING

- _____ Location of Mine
- _____ Ownership of Mine
- _____ Years of Operation
- _____ Status of Mining Activity
- _____ Type of Minerals Mined
- _____ Type of Mining / Placer
- _____ History of Activity and Operations
- _____ History of Income and/or Losses
- _____ RTVUE of Prior and Subsequent Years
- _____ Other Mines or Miners in Area
- _____ Permits Required and Obtained
- _____ Governmental Agencies Regulating the Activity
- _____ Mining Forms Filed
- _____ State or Federal Claim Number
- _____ Affidavits of Annual Labor
- _____ Mining Activity on Privately Owned Property
- _____ CTR's
- _____ Review IRP Documents
- _____ Inspect Mining Agencies' Files
- _____ Sources of Mining Income
- _____ Types of Sales
- _____ Sales of Minerals
- _____ Amount of Gold Sold and Dates of Sales
- _____ Sales of Raw or Refined Gold
- _____ Sales of Nuggets

EXAMINATION CHECKLIST - MINING

- _____ Records Kept
- _____ Mining Partners/employees
- _____ Mining Stage for Years under Exam
- _____ Type of Mining Activity
- _____ Plan of Development for the Mine
- _____ Mining Season
- _____ Mining Equipment Used
- _____ Assets
- _____ Mining Assets
- _____ Acquisition of Assets
- _____ Bank Accounts
- _____ Source of Funds for Purchases
- _____ Loans and Collateral for Loans
- _____ Name and Location of Buyers of Inventory
- _____ Cash Transactions
- _____ Cash Hoard
- _____ Cash Expenditures
- _____ Bartering
- _____ Inventory of Gold or Other Minerals Maintained
- _____ Beginning and Ending Inventories
- _____ Payments of Labor or Expenses in Kind
- _____ Prospecting Activity
- _____ Exploration Stage and Expenses
- _____ Development Stage and Expenses
- _____ Producing Stage

EXAMINATION CHECKLIST - MINING

- _____ Mineral Discoveries
- _____ Recapture of Exploration or Development Expenses
- _____ Claims Sold
- _____ Trade or Business versus Hobby
- _____ Activity Not for Profit Factors - IRC section 183
- _____ Economic Feasibility of the Operation
- _____ Passive Activity
- _____ Material Participation
- _____ Mining Lease or Royalty Income
- _____ Who Runs Day-to-Day Operations
- _____ Location of Residence of Owners
- _____ Hours Worked
- _____ Employees
- _____ Forms W-4, W-3, W-2, and 1099
- _____ Employment and Excise Tax Returns Filed
- _____ Employee versus Independent Contractor
- _____ Method of Depletion
- _____ Basis or Adjusted Basis of the Mineral Property
- _____ Estimated Reserves in Units
- _____ Fuel Costs and Type of Use
- _____ Environmental Permits and Restrictions

Appendix D

Glossary of Mining Definitions

ABANDONED Given up with the intent of never again claiming a right or interest in the mineral interest.

ACRE A measure of land, 160 square rods (4,840 square yards, 43,560 square feet).

ACTIVE PARTICIPATION Involvement in a rental real estate activity making management decisions. Requires no specific number of hours.

ACTIVITY A trade or business. Two or more operations within a trade or business could be deemed separate activities.

ADIT A nearly horizontal gallery or passage driven from the surface of the ground to the ore body. The term "tunnel" is frequently used in place of adit, but technically a tunnel is open to the surface on both ends.

ADJUSTED GROSS INCOME For purposes of IRC section 469(i)(3)(E), adjusted gross income shall be determined without regard to:

- social security and tier 1 railroad benefits included in income;
- the amount of income from savings bonds used for higher education fees excluded from income;
- the deduction allowed for qualified retirement contributions, and
- any passive activity loss or any loss from rental real estate activities allowed under IRC section 469(c)(7).

AGGREGATE Natural particles, crushed and broken rock, and man-made materials that are graded by size into categories to meet specifications for particular construction uses.

AGGREGATION Combining two or more passive activities in which the taxpayer works 100 to 500 hours.

ALLUVIAL Adjective used to identify particular types of, or minerals found associated with, deposits made by flowing water as, alluvial fan, alluvial terrace, alluvial told, alluvial tin.

ALLUVIAL DEPOSIT Generally pertains to loose gravel, soil, or mud which have been transported and deposited by flowing water.

ALLUVIUM Clay silt, sand, gravel, or other rock materials transported by flowing water and deposited in comparatively recent geologic time as sorted or semi-sorted sediments in river beds,

estuaries, and floor plains, in lakes, on shores and in fans at the base of mountain slopes. The term is not applied to subaqueous sediments deposited in seas or lakes or to non-sorted sediments carried or deposited by glaciers.

ANALYSIS A separation of compound substances by chemical means.

ANGLE OF REST The maximum slope at which a heap of any loose or fragmented solid material will stand without sliding or will come to rest when poured or dumped in a pile or on a slope.

ANGLE OF SLIDE The slope, measured in degrees of deviation from the horizontal, on which loose or fragmented solid materials will start to slide; it is a slightly greater angle than the angle of rest.

ARMOR ROCK Stone resulting from blasting, cutting, or other methods to obtain pieces heavy enough (generally 1 to 3 tons) to require handling two individual pieces by mechanical means. Used to protect beds, bank, shores, and embankments against intense erosion and scour by running water, tidal currents, and wave action.

ASPHALT SAND AND GRAVEL Sized and broken sand and gravel mixed with asphalt in batch plants to form asphalt concrete and road pavements. Dry, clean, fractured particle faces adhere well to bitumen and pack (interlock) efficiently to provide increased concrete and pavement strength.

ASSAY The determination of the valuable minerals in a sample. A wet assay is determined by the use of chemicals. A fire assay is determined by both chemicals and fire. Gold and silver are usually assayed by fire.

AVULSION Removal of land from one owner to another when a stream suddenly changes its channel.

BANK A steeply sloping mass of any earthy or rock material rising above the digging level from which the soil or rock is to be dug from its natural or blasted position in an open pit mine or quarry.

BANK HEIGHT The vertical height of a bank as measured between its highest point or crest and its toe at the digging level or bench.

BANK SLOPE The angle, measured in degrees of deviation from the horizontal, at which the earthy or rock material will stand in an excavated cut in an open-pit mine or quarry.

BARITE Barium sulfate, which has a specific gravity of 4.3 to 4.6.

BEDROCK Any solid rock underlying gold-bearing gravels.

BENCH A former wave-cut shore of a sea or lake or flood plain of a river.

BLACK SAND Grains of heavy, dark minerals such as magnetite, limonite, chromite, etc., found in streams which commonly collect in sluice boxes and which may carry gold and platinum.

BULK Not divided into parts.

BY-PRODUCTS Placer metals, garnet, limonite, chromite, rare-earth elements, zircon, cassiterite, and other minerals concentrated during the mechanical processing of natural aggregates.

CHUTE An opening in the ground where ore is allowed to pass from one level to another. It is the structure built to load cars from a stope.

CLAIM A land area claimed by a prospector and marked out by stakes.

CLOSELY HELD CORPORATION A corporation with five or fewer shareholders owning more than 50 percent in value of the stock at any time during the last half of the taxable year.

COLOR A term referring to small grains or flakes of gold.

COMMODITIES Economic goods, for example, products of agriculture or mining.

CONTRACTOR One that contracts to perform work or provide supplies on a large scale.

CONTOUR Lines connecting points of equal elevation on a contour map.

CRUSHER A machine used to squeeze or force by pressure so as to alter or destroy structure.

DEMARCATÉ To mark the limits of.

DEPLETION The process by which the cost or other basis of a natural resource is recovered upon extraction and sale of the resource. For tax purposes, the two ways to determine the depletion allowance are the cost and percentage methods.

DEPOSIT Something laid down; such as matter deposited by a natural process.

DIP The maximum angle of inclination downward that a vein or bed makes with a horizontal plane.

DYNAMITE An explosive mixture of glycerin, sodium or ammonium nitrate, and a filler of combustible pulp such as a wood meal.

ELECTRIC CAP A small metallic cap containing fulminating powder which is detonated by an electric current.

EMPLOYEE One employed by another usually for wages or salary and in a position below the executive level.

ENTITY Any corporation, partnership, trust, association, or estate formed for carrying on a business activity.

EXCAVATION A cavity formed by cutting, digging, or scooping.

EXPOSURE Any part of a vein or rock outcrop that can easily be seen.

FAULT A fracture in the earth's crust accompanied by a displacement of one side of the fracture with respect to the other and in a direction parallel to the fracture.

FISSURE An opening or crack in the rock. A fissure vein is a fissure filled with mineral matter.

FLOAT The loose and scattered pieces of ore which have been broken off from an outcrop.

FOOTWALL The bottom or lower enclosing wall of a vein.

FUSE A tube or cord filled or impregnated with combustible matter for igniting an explosive charge after a predetermined interval, as in blasting.

GRANTEE A person to whom real estate is conveyed; the buyer.

GRANTOR A person who conveys real estate by deed; the seller.

HANGING WALL The down thrown side of fault block in normal faulting.

HEAD FRAME A structure erected over a shaft to support the sheave wheel for hoisting purposes.

HEADING Any part of a mine where work is under way. Usually confined to development workings only.

HECTARE A metric measure of surface area (2.471 acres).

HEDGING Entering into the purchase of commodity futures contracts to reduce the risk of an unfavorable price fluctuation.

HIGH GRADING Stealing of high grade ore or nuggets from workings of a hard rock or placer mine by employees or others.

HORIZONTAL Parallel to, in the plane of, or operating in a plane parallel to the horizon or to a base line.

IGNEOUS ROCK Rock formed from molten lava.

K-1 The form attached to Forms 1065, 1120-S, and 1041 returns which reports the flow-through of income and losses to an investor's individual return.

KILOGRAM (kg) The basic metric unit of mass and weight equal to the mass of a platinum-iridium cylinder kept at the International Bureau of Weights and Measures near Paris and nearly equal to 1000 cubic centimeters of water at the temperature of its maximum density.

KILOMETER 1,000 meters; approximate equivalent equals 0.62 mile.

LATERAL A horizontal mine working. A drift in the footwall of a vein is often called a lateral.

LEASE A contract by which the owner of operating rights assigns all or a portion of such rights to another person whether for no immediate consideration or for cash and its equivalent, and retains a continuing nonoperating interest in production.

LESSEE A person who obtains a lease on mining land.

LESSOR The grantor of a lease.

LEVEL All the connected horizontal mine openings at a certain elevation.

LIMITED PARTNER An investor in a partnership whose personal liability is limited. Presumed to be not materially participating (passive) according to the passive activity rules.

LOCATING The marking of the boundaries and staking of a mining claim.

LODE A tabular deposit between definite walls.

LONG TOM An inclined trough used to concentrate gold from auriferous earth.

MATERIAL PARTICIPATION Regular, substantial, and continuous involvement in a business. Allows losses to be deducted in full and not limited by the passive activity rules.

MILL A machine for crushing or comminuting.

MILLING ORE Ore that must be concentrated at or near the mine before it is shipped.

MINE A pit or excavation in the earth from which mineral substances are taken.

MINERAL A solid homogenous crystalline chemical element or compound that results from the inorganic processes of nature.

MODIFIED ADJUSTED GROSS INCOME (AGI) See definition for Adjusted Gross Income.

MUCK To move or load muck.

MUCK Broken underground rock removed in the process of excavating or mining.

MUCKER A shoveler, or one who handles muck.

NITRO Short for nitroglycerin, which is any nitrate of glycerol, a colorless, heavy, oily, explosive liquid used in making dynamite.

NONPASSIVE ACTIVITY A trade or business in which the taxpayer materially participates, that is, on a regular, continuous, and substantial basis. Losses can be deducted in full.

NUGGET A piece of gold of any shape or size larger than a flake, usually rounded by stream or water action.

OPTION The right to purchase at a stated price.

ORE A source from which valuable matter is extracted.

ORE A mineral aggregate containing a valuable constituent (as metal) for which it is mined and worked for a profit.

ORE BODY The part of a vein that carries ore. Generally, all parts of a vein are not ore. Ore shoot has the same meaning.

OUTCROP The edge or surface of a mineral deposit or sedimentary bed which appears on the surface.

OVERBURDEN The valueless material overlaying the pay zone in a placer deposit or the waste or valueless material of a solid outcrop.

OXIDE A compound of a metal and oxygen.

OZ. Ounce.

PASSIVE ACTIVITY Any activity which involves the conduct of a trade or business which the taxpayer does not materially participate.

PASSIVE INCOME Income from a passive activity.

PASSIVE LOSS Loss from a passive activity.

PATENT Conveyance of title to government land.

PAY Ore or a natural situation that yields metal and/or gold in profitable amounts.

PIT A hole, shaft, or cavity in the ground.

PLACER An alluvial or glacial deposit containing particles of valuable mineral-bearing gravel or gold.

PLANE An even surface. A horizontal plane is a flat, even, level surface.

PORTFOLIO INCOME All gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest, dividends, royalties, and gains from the sale of stocks and bonds as well as other investment activities.

PRECIOUS Of great value or high price.

PRECIPICE A very steep or overhanging place.

PROXIMITY The quality or state of being proximate.

QUADRANGLE A tract of the land in the U.S. Governmental Survey System measuring 24 miles on each side of the square, sometimes referred to as a "check".

QUARRY An open excavation usually for obtaining building stone, slate, or limestone.

QUITCLAIM DEED A deed given when the grantee already has, or claims, complete or partial title to the premises and the grantor has a possible interest that otherwise would constitute a cloud upon the title.

RAISE An excavation of restricted cross-section, driven upwards either vertically or at an angle from a level in the mine.

RAKE The trend of the ore body within the vein.

RECHARACTERIZATION RULES Rules which recharacterize passive income as nonpassive.

REFINE To reduce to a pure state.

RIFFLES Obstacles placed along the bottom of a sluice or rocker that form pockets to catch gold by concentrating heavier materials.

RIPARIAN Pertaining to the banks of a river, stream, waterway, and so forth.

RIPARIAN OWNER One who owns lands bounding upon a river or water course.

RIPRAP ROCK Selected hard, angular, quarried stone generally weighing between 25 and 5,400 pounds individually and placed to protect beds, banks, shores, and embankments against wave action, tidal forces, and stream currents.

ROCK Naturally occurring, consolidated materials composed of one or more minerals of the earth's crust. Any hard, consolidated materials derived from the earth and usually of relatively small size.

ROCKER A mechanical panning device comprised of three parts: a body or sluice box, a screen, and an apron.

SAND Particles of rock that pass a No.4 (4.75 mm) U.S. Standard sieve and are retained on a No. 200 (.075 mm) U.S. Standard sieve.

SECTION A section of land established by government survey and containing 640 acres or 1 square mile.

SELF-RENTED PROPERTY Personal or real property rented to an entity which the taxpayer personally controls. Stated in different terms, property rented to a nonpassive activity of the taxpayer.

SHAFT A vertical or inclined opening of a uniform and limited cross section made for finding or mining ore, raising water, or ventilating underground workings (as in a cave).

SIGNIFICANT PARTICIPATION An individual is treated as significantly participating in an activity if the individual participates in the activity for more than 100 hours during such taxable year and in which the taxpayer did not materially participate under any of the material participation tests, other than this test.

SLIP A small fault.

SLUICE BOX A sloping trough, having riffles on the bottom, through which gravel and wash from placer mining operations pass to catch and save the gold and other valuable minerals.

SPECIAL WARRANTY DEED A deed wherein the grantor limits his liability to the grantee to anyone claiming, by, from, through, or under him.

SPECIFIC GRAVITY The ratio of the weight of any substance to the weight of an equal volume of water.

STONE Natural rock material of adequate integrity and quality that can be quarried and then sawed, cut, split, or otherwise sized, shaped, or finished for specific purposes. Natural building stone includes granitic rocks, greenstones, limestones, marbles, massive serpentinite (antigorite), and sandstones.

STOPE A step-like excavation underground for the removal of ore. It is formed as the ore is mined in successive layers.

STRIKE The bearing of a horizontal line in the plane of a vein, bed, or fault in respect to the cardinal points of the compass.

STRIPPING Removal of the overburden from a placer deposit or the barren outcrop from an ore deposit.

STULL A timber used to support loose rocks or slabs. It may also be used to support a platform in a working area.

SUMP The lowest part of a mine shaft into which water drains.

SURVEY The process by which a parcel of land is measured and its area ascertained.

SUSPENDED LOSSES Passive losses which are carried forward indefinitely until the taxpayer has passive income or there is an entire disposition of the activity.

TAILINGS Residue separated in the preparation of various products (as grains or ores).

TIERED ENTITIES Partnerships or trusts or corporations invested in other partnerships or trusts or corporations.

TOPOGRAPHY The contour and slope of land, hills, valleys, streams, etc.

TRAVERTINE A variety of layered or banded, porous to dense, crystalline to microcrystalline limestone that is deposited by springs, seeps, or running water.

TREND The general direction or bearing of a vein, fault, or rock outcrop.

UNDERCURRENT A wide, flat sluice box placed beneath the main sluice box used to save fine gold.

VALUE Refers to the mineral substance sought. In the case of gold, the term is synonymous with color.

VEIN A well-defined, tabular, mineralized zone which may or may not have valuable ore bodies.

VERTICAL Perpendicular to the plane of the horizon or to a primary axis.

WALL The waste or country rock on either side of a vein.

WARRANTY DEED One that contains a covenant that the grantor will protect the grantee against any claimant.

WASTE Barren rock or mineralized material which does not have enough value to be classified as an ore.

WELL An issue of water from the earth. A shaft or hole sunk to obtain oil, brine, or gas.

WINZE A steeply inclined passageway connecting a mine working place with a lower one.

WORKING FACE Any portion of the mine where work is under way, such as the face of a drift or the face of a raise.

