Answers
MEMORANDUM
TO: The Directors of MF Ltd
FROM: ACCA Candidate
RE: Income tax effects of future research and development (R&D) activities
Date: 6 December 2010

This memorandum is in three parts. The first concerns the income tax effects of using a building to house R&D activities; the second addresses the income tax effects of the proposed capital expenditure on machines in relation to the R&D activities; and the third the income tax effects of the anticipated revenue expenditure and the deductibility thereof.

(i) Buildings

The South African tax system [s.11D] provides for an accelerated deduction in respect of any building or part of a building or any machinery, plant or other equipment that is owned by the taxpayer and is new or unused when brought into use for the purposes of R&D activities. The accelerated deductions allowed in such circumstances are: 50% of the cost of the asset in the year when it is first brought into use; 30% in the second year; and 20% in the third year.

The current factory building is already being used as part of a process of manufacture, for which an allowance of 5% per annum on the cost of the building is being claimed. Therefore, clearing 10% of this building for use in R&D activities will not qualify for the accelerated allowance as that part of the building is not new or unused. The use of part of the building for R&D activities does not, however, result in the building being apportioned in terms of its use and therefore the 5% per annum allowance on the cost of the building will continue in full. There is thus no tax advantage or detriment from using a portion of the current factory for R&D activities.

If a newly constructed building is acquired and part thereof is immediately brought into use for R&D activities then the portion of the new building used exclusively for R&D activities will qualify for the accelerated allowance. This means that 15% of the building cost will qualify for the accelerated rate of allowances and the cost of the remaining 85% used for commercial purposes will be deductible at the normal rate of 5% per annum [s.13quin].

The additional income tax allowances available in the first three years of the R&D activity for a new building will thus be:

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
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<tbody>
<tr>
<td>R million</td>
<td>R million</td>
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<tr>
<td>Accelerated allowance for R&amp;D use portion of the new building (15% x R15 million) (50%: 30%: 20%)</td>
<td>1·1250</td>
<td>0·6750</td>
<td>0·4500</td>
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<tr>
<td>Commercial building allowance on remainder of building (85% x R15 million) at 5% per year</td>
<td>0·6375</td>
<td>0·6375</td>
<td>0·6375</td>
</tr>
<tr>
<td>Allowances over 3 years for new building if partly used for R&amp;D</td>
<td>1·7625</td>
<td>1·3125</td>
<td>1·0875</td>
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<tr>
<td>Allowances over first 3 years if used only for commercial purposes</td>
<td>0·7500</td>
<td>0·7500</td>
<td>0·7500</td>
</tr>
<tr>
<td>Advanced allowances for R&amp;D use</td>
<td>1·0125</td>
<td>0·5625</td>
<td>0·3375</td>
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It is, however, important to note that the overall effect is only to bring forward the available allowances on 15% of the cost of the building, not to increase those available, in total, over the life of the building. The 5% allowance on 85% of the value of the building would continue to be available for a further 17 years.

(ii) Capital expenditure on machines

As stated in section (i) above, machinery used for R&D activities is also eligible for the accelerated allowance.

Machine A

Like the current factory building, Machine A will not qualify for the accelerated R&D allowance as it is not new or unused. Further, this machine is being used in a process of manufacture. Should this machine be withdrawn from the process of manufacture to be used for R&D activities then, despite it not qualifying for the accelerated R&D allowance, the manufacturing machinery allowance deduction will cease. (i.e. the last 20% of the cost of this machine of R80,000 will not be deductible for tax purposes). Therefore unless Machine A is critical to the R&D activities, it is suggested that this machine remain in the process of manufacture to take advantage of the last portion of the wear and tear allowance.

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Machine B
As this machine will be purchased new it will qualify for the accelerated R&D allowance on the same basis as the qualifying portion of the building. The effect of this accelerated allowance will be an effective write off of the cost of the machine over three years in the ratio 50:30:20. If the machine is not used for R&D purposes (and in the absence of information that the machine would be otherwise used in a process of manufacture), a wear and tear allowance over the years stipulated by the Commissioner (in Interpretation Note 47 read with s.11(e)) would be applicable.

Again it should be noted that the effect, depending on the time period permitted by the Commissioner (in Interpretation Note 47), is only to bring forward the allowances, not to increase the total allowances available.

Machine C
As this machine would be purchased second-hand i.e. used, it would not qualify for the accelerated R&D allowance but only for the normal wear and tear allowance over the years stipulated by the Commissioner (in Interpretation Note 47 read with s.11(e)).

Machine D
The accelerated R&D allowance is available for assets acquired under a suspensive sale agreement on the same basis as for assets purchased outright. Therefore, if Machine D is used exclusively for R&D activities, the cash cost of this new machine of R600,000 will qualify for the accelerated allowance. However, the accelerated allowance is not available in the case of machinery, plant and equipment used only partially for R&D activities (unlike the case with buildings (see (i) above)). So should the use of Machine D be split between the process of manufacture and the R&D activities only s.12C allowances will be available.

Should Machine D be used exclusively for R&D activities, the finance charges from the suspensive sale will qualify as R&D costs of a revenue nature. However, the deduction available is still limited to the actual cost incurred, as the enhanced 150% deduction for revenue R&D costs does not apply to interest charges [s.11D(5B)(b)]. The deduction for the finance charges will thus be the same as those applicable under the normal deduction rule for interest [s.24J] which would give a full deduction for the actual finance charges incurred if the machine’s use is split between the two activities.

(iii) Revenue expenditure
In general, 150% of any revenue expenditure which relates directly to the R&D activity is deductible [s.11D(1)]. However, only certain classes of expenditure are eligible and some are specifically excluded. The treatment of the different types of expenditure anticipated is as follows:
- The costs of the engineering and laboratory technicians and the consumables used in the laboratory are directly related to the R&D activities and would qualify for the 150% deduction.
- Administrative staff costs, the cost of registering trademarks and the consulting fee relating to marketing are specifically excluded from the definition of qualifying expenditure for the purpose of the allowance.
- The payments for technical services and the royalty relate to expenditure incurred outside the Republic and as such they are excluded from the scope of the expenditure qualifying for the enhanced deduction.

However, in all cases these non-qualifying costs remain deductible as normal trading expenditure [ss.11(a)/11(gB)]. MF Ltd will also be required to withhold 12% of the gross royalty payment to be made to the offshore company for technical know-how [s.35].

2 Gerald Jamieson

Gerald Jamieson
[Client’s address]
6 December 2010

Dear Gerald

Further to our meeting on xx November 2010, I set out below our advice regarding the options available to you with regard to your employment package.

(i) Medical aid scheme

Employer contributions to company scheme
You are under the age of 65 and have no apparent disability, so the full amount paid by the company (for which you Gerald are not personally liable) will be treated as a fringe benefit. As a result the R1,500 per month will result in an annual fringe benefit of R18,000 on which tax of R7,200 (18,000 x 40%) will be paid.

Own contributions to private scheme
Alternatively, if you elect to make your own contributions to a private medical aid scheme, you will qualify for an annual deduction of the contributions but limited to a maximum deduction of R7,500 (625 x 12). The disallowed contributions then fall to be included within your qualifying medical expenses, but these are only deductible to the extent that such expenses exceed 7·5% of your taxable income before the deduction of such expenses. Your salary income will be R600,000 per
annum, so it is unlikely that any further deduction will be available to you (7.5% x 600,000 = R45,000) as a result the likely annual saving in tax will be R3,000 (7,500 x 40%).

**Recommendation:**
If you choose for your employer to pay into the company scheme you will have a cash outflow equal to the additional tax of R7,200. Should you choose to pay your own contributions, you will have a net cash outflow of R15,000, comprising an outflow of contributions of R18,000 and an inflow of the tax saving of R3,000. Based on the above, it would be better for you to choose for your employer to pay contributions into the company scheme.

**(ii) Travel allowance vs a company car**

**Travel allowance**
The entire travel allowance is potentially subject to income tax. To claim any relief against the allowance for your business travel you will have to maintain a logbook of mileage. If no logbook is maintained (from 1 March 2010), no claim against the allowance is possible. The allowance, net of any reduction for business mileage allowed, is included in your taxable income. As a worst case scenario, if you do not maintain a logbook, you will be taxed in full on the allowance received of R60,000 on which tax of R24,000 (60,000 x 40%) would be payable. The net cash inflow (ignoring the fuel and maintenance costs that would be payable for your vehicle out of your after tax income) would be R36,000 (60,000 – 24,000). This cash flow effect will, partly, be spread throughout the year as 80% of the travel allowance value (60% before 1 March 2010) would be included in your remuneration for employees tax purposes.

**Company car**
The company car would generate an annual fringe benefit of R60,000 (200,000 x 2.5% x 12) on which tax of R24,000 (60,000 x 40%) is payable. The tax represents a net cash outflow but in this case you will not have to pay for the fuel and maintenance costs of the vehicle, or the capital costs of its purchase/replacement.

**Conclusion**
The decision as to which alternative will be the more beneficial will depend on your actual business mileage and whether or not you are prepared to maintain a logbook, as well as the actual running costs of and the potential second-hand value and replacement cost of your current vehicle.

**(iii) Pension arrangements**
The immediate income tax consequence of a contribution to a pension fund versus a provident fund is that the pension fund contributions are deductible to the extent of the greater of R1,750 or 7.5% of your retirement funding employment income, i.e. in your case your cash salary. Any pension contributions greater than the limit are not permitted as a deduction and will increase the tax-free amount that can be taken as a lumpsum on retirement. However, only one-third of the pension benefit may be taken as a lumpsum. In contrast, no deduction is available for contributions made to a provident fund and thus all contributions to a provident fund increase the tax-free portion of the lumpsum on retirement. Also, the entire provident fund benefit may be taken as a lumpsum on retirement. Your employer’s contributions to either fund does not generate a fringe benefit.

**Tutorial note:** With effect from years of assessment commencing on or after 1 January 2010 the interest exemption can no longer be applied to South African dividends not otherwise exempt.
Distribution of R200,000 to Nomphelo
As the income was distributed to the Trust (as the holder of the participation rights in the portfolio) within 12 months of the collective investment scheme receiving such income, it is deemed to have firstly accrued to the Trust (and not the collective investment scheme) [s.25BA]. As the Trust is then a conduit for such income, the income retains its underlying nature and the income deemed to have been received by and accrued to the beneficiary (Nomphelo) to comprise:

South African interest of R72,727 \((120,000/330,000 \times 200,000)\)
South African dividends of R90,909 \((150,000/330,000 \times 200,000)\)
Foreign interest of R36,364 \((60,000/330,000 \times 200,000)\)

As Nomphelo is a major child, no attribution of income to her parent, Ntombi [s.7(3)] can take place. However, Nomphelo is a non-resident, so that portion of the distribution received by her as is generated by a donation, settlement or other disposition of a resident donor, is attributed back to such donor [s.7(8)].

As the collective investment scheme was donated by Ntombi, the full distribution to Nomphelo is attributable to her. As Ntombi has already exhausted her maximum interest exemption in respect of her annuity income (see above) no further amount in total would be exempt. However, the first R3,500 of that R21,000 exemption must now first be applied against the foreign interest distribution (reducing the portion available for the South African interest above). As this is a discretionary distribution, the South African dividends will be exempt.

Retained income
The income retained from the various income streams would be treated as follows:

(1) Income from the collective investment scheme of R130,000 will be attributable to and taxable on Ntombi. The income will retain its underlying nature, i.e. R47,273 South African interest, R59,091 South African dividends and R23,636 foreign interest, and thus the South African dividends will be exempt.
(2) Foreign rental of R300,000 all of which is retained will be attributable to and taxable on Wallace.
(3) South African interest retained of R60,000 will be taxed in the trust; as the donor is deceased no attribution is possible.
(4) South African dividends of R40,000 will also be taxed in the trust, again as the donor is deceased no attribution is possible; however the dividend exemption will apply.

Tutorial note: There remains the possibility that Nomphelo will also be taxed on the distribution to the extent of the South African source income (i.e. the South African interest and South African dividends). However, the South African dividends would be exempt and the South African interest would also be fully exempt (if received by a non-resident who is not physically present in South Africa for more than 183 days and does not conduct business through a permanent establishment in South Africa) which would appear to be the case for Nomphelo.

(b) The annuity is currently payable partly out of South African dividends and partly out of South African interest. As the South African dividend exemption is lost when income from a trust is paid in the form of an annuity, it would be better to pay all of the annuity from the South African interest income in the Trust. This will have the effect of firstly permitting the dividend exemption to be applied in either the Trust’s hands (if the dividend income is retained) or a beneficiary’s hands (if it is distributed on a discretionary basis). Secondly, the annuity, being paid exclusively from interest income removes a fully taxable income stream from the Trust (where it would be taxed at 40%) and places such liability in the hands of a natural person who is both entitled to a partial interest exemption and is taxed on a progressive basis.

4 Propco Ltd
(a) Acquisition of the two buildings
As the first building was acquired from a VAT vendor, the VAT input would be the amount appearing on the tax invoice issued by the seller (the developer). However, as the building provides mixed supplies, being the exempt supply of residential accommodation and the taxable supply of commercial accommodation, the VAT input would have to be apportioned between the two uses. Such apportionment is usually based on the ratio of taxable supplies (excluding VAT) over total supplies (excluding VAT).

The second building was acquired from a non-vendor. As a result, no tax invoice would have been issued on which Propco Ltd could claim a VAT input. However, property is considered to be a second-hand good so a deemed input may therefore be claimed. Such deemed input is firstly limited to the lower of the VAT on the consideration or the VAT on the market value. In addition, as transfer duty would have been payable by Propco Ltd, the deemed input is further limited to the lower of the deemed input or the transfer duty paid. As the intention of the acquisition was to make taxable supplies and the conversion to such use was immediate, the full deemed input (as determined above) would be claimable.

However, such a VAT claim must be spread on the basis of the payments made. As the payment for the property was made in two instalments, the VAT claim must be spread over two VAT periods.
Disposal of the two buildings

Two alternative treatments need to be considered for the disposal of the two buildings.

Standard sale

The sale of the buildings can be considered a standard taxable supply, on which VAT must be charged. Propco Ltd must account for output VAT on the full consideration (sale price) of the supply even though one of the buildings was only partly used for the provision of taxable supplies. However, as only a partial input was claimed on the acquisition of the building, an input adjustment can be made in respect of the first building, whereby the VAT that was originally disallowed on its acquisition because of the mixed supply can now be claimed as an input credit in the same tax return as the output tax on the sale [s.16(3)(h)]. The input credit is based on the lesser of the adjusted cost of the asset and its open market value at the date of disposal.

Sale as a going concern

The sale of the two buildings could constitute the sale of Propco Ltd's business as a going-concern, in which case it may be zero-rated provided all the necessary requirements are met. These requirements are:

1. The sale must be between VAT vendors.
2. It must be clearly evident and stated in the wording of the written agreement that:
   - the sale is the sale of a going concern;
   - the sale represents the sale of an income earning activity at the date of transfer;
   - all the assets necessary for the income earning activity must form part of the sale; and
   - the consideration includes VAT at the zero rate.

In the case of Propco Ltd these requirements will only be satisfied if the leasing activity is sold with the buildings. But provided this is the case and the agreement is drawn up appropriately the proposed sale to the other rental company should qualify for zero-rating.

Henry and Flat C Glenoaks cc

(a) To qualify for relief under the 2009 temporary provisions, Henry must satisfy the following conditions:

1. Acquire the interest in the residential property and register the property in his own name at the deeds registry before 31 December 2011.
2. Hold directly the entire members’ interest in the close corporation from 11 February 2009 until the date of registration of the residential property in his own name in the deeds registry.
3. Have used the residential property mainly for domestic purposes as his ordinary residence from 11 February 2009 until the date of registration of the property in his own name in the deeds registry.

Henry owns all of the members’ interest in Flat C Glenoaks cc and the residential property has been his permanent home since 1 October 2000, therefore, provided he continues to use the property for this purpose at least until its registration in his own name in the deeds registry, Henry will be able to obtain the exemptions/reliefs afforded by the temporary provisions. Tutorial note: Under proposed legislation (not examinable in this sitting), the above provision’s end date is to be changed to 30 September 2010 and a new provision introduced (with the same purpose) and a new end date of 31 December 2012. The new provision [proposed as paragraph 51A of the Eighth Schedule] will require the corporate entity to be deregistered or liquidated following the transfer of the property. It also contains additional restrictive provisions.

(b) The 2009 temporary provisions provide for the following tax exemptions relevant to Henry and Flat C Glenoaks cc:

- exemption from transfer duty on the transfer of the residential property;
- exemption from secondary tax (STC) on the distribution in specie of the residential property;
- relief from a charge on the capital gain realised on the transfer of the residential property by the close corporation; and
- no recoupment of allowances which may have been claimed in respect of the residential property by the close corporation. For the purposes of the allowances, the close corporation and Henry are treated as one and the same person.

(c) Tax consequences of a subsequent disposal by Henry

The close corporation is deemed to have sold the property to Henry at base cost. Henry is deemed to have acquired the property at the original acquisition date of the close corporation, to have incurred the same expenditure and to have used the property in the same manner as the close corporation. In addition, the market valuation of the property on 1 October 2001 also transfers to Henry (as if the property was owned by him).
As the acquisition of the property predates the introduction of capital gains tax, the base cost needs to be determined. As the sale proceeds of R3,000,000 are greater than the expenditure before and after the valuation date, three options for determining the valuation date value are available:

(1) the market value on 1 October 2001;
(2) 20% x proceeds (net of any post-valuation date expenditure); and
(3) the time apportioned base cost.

These amounts are determined as follows:

(1) Market value: R1,300,000 (close corporation valuation transferred to Henry – as given)
(2) 20% x R3,000,000 = R600,000
(3) \[ Y = B + (P - B) \times \frac{N}{(T+N)} = R320,000 + (R3,000,000 - R320,000) \times \frac{9}{11 + 9} = R1,526,000 \]

As there was no post-valuation date expenditure incurred, the capital gain (before exclusion) is R1,474,000 (3,000,000 – 1,526,000).

The gain is less than the primary residence exclusion of R1,500,000, therefore, there will be no gain to be aggregated with any other capital gains or capital losses that Henry may have in the year of assessment ended 28 February 2013.
### 1 (i) Buildings
- Accelerated deduction available for capital assets, including buildings: 1
- Partial use of building acceptable: 1
- Must be new or unused when brought into use: 1
- Rates of the allowance: 1
- Current factory building not eligible, with reason: 2
- But 5% allowance can continue on the whole building (no apportionment): 1
- Identifying that no tax advantage or detriment arises: 1
- R&D portion of the new building will qualify: 1
- Remaining cost portion eligible for normal 5% allowance: 1
- Supporting computations showing the effect of accelerated allowances: 2
- Identifying the effect as a timing difference only: 1

#### Marks: 13

### 1 (ii) Machines
- Machine A not eligible, with reason: ½
- Currently used in process of manufacture/reference to available depreciation allowance: 1
- Effect of withdrawing Machine A from process of manufacture: 1
- Recommendation (or extending effect to include s.12C): 1
- Machine B qualifies, with reason: ½
- Discussion of R&D effect versus wear & tear (s.11(e)): 2
- Machine C not eligible, with reason: 1
- Will qualify for normal wear and tear allowances, including basis: 1½
- Machine D acquired under suspensive sale can still qualify: 1
- Allowance based on cash cost only: ½
- Machinery must be 100% R&D use: 1
- Effect of partial use: 1
- Normal allowances only (or reference to s.12C): 1
- Qualifying nature of finance charges as R&D expense of a revenue nature: 1
- But limited to deduction of actual expenditure (100% deduction): 1½
- Normal revenue deduction (100%) for finance charges if use is split: 1½

#### Marks: 17

### 1 (iii) Revenue expenditure
- General deduction of 150% of qualifying expenditure: 1
- Identify qualifying costs (2 x ½): 1
- Identify specifically excluded costs (3 x ½): 1½
- Identify the costs incurred outside the Republic, as out of scope (2 x ½): 1
- Confirm that all (both sets of) non-qualifying items are still deductible under the normal rules: 2
- Need to withhold tax from royalty payment: 1
- Correct rate of withholding: ½

#### Marks: 8

### Format and presentation of the memorandum
- 1

### Effectiveness of the communication
- 1

#### Total: 40
### Medical aid scheme

- Employer contribution to a medical fund is a fringe benefit
- Calculating the resultant tax payable at 40%
- Maximum deductible if Gerald contributes to private scheme
- Potential additional deduction as qualifying medical expense
- Explaining why this is unlikely to apply to Gerald
- Calculating the tax saving
- Discussion of cash flow effect of each option and providing a conclusion

### Travel allowance vs company car

- Travel allowance taxable
- Need to keep logbook to claim deduction for business travel
- Calculating the tax effect if the full allowance is taxable and identifying the net cash flow position
- Refer to treatment for employees tax
- Calculating the annual fringe benefit for the company car and identifying the net cash flow position
- Discussion of key comparison issues for purposes of a decision

### Pension arrangements

- Pension fund contributions deductible
- Limitation on deductible pension fund contributions
- Disallowed contributions increase the tax-free lumpsum on retirement
- Limitation on tax-free pension fund lumpsum
- No deduction for provident fund contributions
- Full provident fund contributions add to tax-free amount of benefit
- Employer contributions do not generate a fringe benefit

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<thead>
<tr>
<th>Mark</th>
<th>Description</th>
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<tbody>
<tr>
<td>2</td>
<td>Medical aid scheme</td>
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<tr>
<td>12</td>
<td>Travel allowance vs company car</td>
</tr>
<tr>
<td>6</td>
<td>Pension arrangements</td>
</tr>
</tbody>
</table>

**Total** 20 marks
3 (a) Trust is a conduit for income
Income retains its underlying nature
Distributions:
Annuity income from the trust retains its nature
Giving breakdown of annuity income
Dividend exemption cannot apply, with reason
Interest exemption can apply
Limit applicable, R21,000
Income from collective investment scheme retains its underlying nature, with explanation.
Major child, so no attribution to Ntombi as parent
Attribution to Ntombi as donor, because income distributed to a non-resident
Applicability and effect of interest exemption
Applicability and effect of dividend exemption
Retained income:
Collective investment scheme attributable to Ntombi as donor
Income retains its nature
Applicability of dividend exemption
Foreign rental income attributable to Wallace as donor
No applicability to deceased donors
South African interest and dividends taxed in the Trust
Applicability of dividend exemption

(b) Identify loss of dividend exemption as key issue
Benefits of retaining dividends in Trust/distributing directly to a beneficiary
Benefits of paying annuity exclusively from interest income

Total 20

4 (a) VAT charged and tax invoice issued by the developer
The building relates to a mixed supply
Identifying the mixed supplies
Basis on which the apportionment would be made
Purchased from a non-vendor so no tax invoice/VAT charged
Is purchase of a second hand good, so deemed input may be claimed
Explaining the limitation on the deemed input
Explaining the further limitation because transfer duty is paid
Confirming that full deemed input will be given and when

(b) Mere sale is a normal taxable supply at the standard rate
VAT must be charged on the full sale price
Identify the need for an input adjustment re the first building
Explain the operation of the input adjustment
Identifying that the sale could be the sale of a going concern
Zero-rating may apply
Sale must be between VAT vendors
Requirements of the written agreement (2 x ½)
Need to sell the leasing activity together with the buildings

Total 20
(a) Three conditions to be satisfied (3 x 1)
   Application to Henry and conclusion

(b) Four exemptions/reliefs available (4 x ½)

(c) Transfer to Henry is at base cost
   Basis on which Henry is deemed to have acquired the property (expenditure and use)
   Market valuation of the close corporation also transfers to Henry
   Base cost must be determined, with reason
   Defining and calculating each of the options available:
     Market value
     20% of proceeds
     Time-apportioned base cost
     Identifying the valuation date value as base cost in the absence of post-valuation date expenditure
     Determining the capital gain
     Application of the primary residence exclusion and identifying the impact on the determination of Henry’s taxable capital gains

Marks

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<td>(b)</td>
<td>Four exemptions/reliefs available (4 x ½) 2</td>
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<td>(c)</td>
<td>Transfer to Henry is at base cost 1</td>
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<td>Application of the primary residence exclusion and identifying the impact on the determination of Henry’s taxable capital gains 2</td>
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