Tax reform update & investment implications

On December 15, 2017, the House-Senate Conference Committee released a reconciled version of the tax reform legislation (Tax Cuts and Jobs Act (HR 1)) passed by the House on November 16th. It is anticipated that the full House may vote on the pending legislation as early as Tuesday, December 19th, with the Senate voting later in the week. If this happens as expected, the President has indicated he will sign the legislation before Christmas.

Below is a two-part overview of some planning and investment implications of the pending legislation as released on December 15, 2017 (the "Bill"). Further, we have included some planning considerations for year-end that you should discuss with your legal and tax advisors. Note that the majority of individual measures are set to be effective January 1, 2018, with a sunset at the end of 2025, and most of the business measures are set to be effective January 1, 2018, without any sunset.

Please note that the information and planning considerations below are meant for a broad audience and are not intended to be individual legal or tax advice. You should not rely on it as legal or tax advice. Each person's tax situation is unique and the Bill will impact each person differently. Therefore, you should discuss with your legal and tax advisors how the Bill might impact your situation and the planning considerations that are right for you.

We also provide projections on how we think the market will perform as a result of the tax reform. These projections are not guaranteed.

Executive Summary

- Sweeping tax changes appear to be forthcoming for most individuals and all entities.
- A number of provisions under current tax law do not change for individuals, including long term capital gain and qualified dividend income individual tax rates, the net investment income tax for high-income taxpayers, the exemption of gain on the sale of a principal residence, and tax deferred retirement savings in 401(k) and IRA accounts.
- Specific individual effects may not be known until well after the beginning of the year.
- A "clean-up" bill is expected after the dust settles to fix certain unresolved issues within the Bill.
- The market has already priced in the majority of tax reform; however, we expect positive momentum to continue into the first half of 2018.

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- The tax plan could be the right incentive to spur a business investment boom. This could create longer-term growth from productivity gains, not simply be a short-term stimulus.
- The impact of corporate tax reform will likely be felt more by smaller domestic companies. These smaller domestic companies typically pay tax rates closer to the 35% federal rate, while the average effective tax rate among S&P 500 companies is already 26%.
- Fiscal stimulus is typically enacted in times of uncertainty and market downturns. However, this corporate tax reform comes at a time when GDP growth is accelerating and the unemployment rate is 4.1%, the lowest level in 17 years.
- It is likely that the majority of tax savings will go toward stock buybacks, dividend hikes, and debt retirement, but the tight labor market may draw a small proportion of the benefit to wage gains, particularly if productivity begins to trend higher.
- The increased U.S. growth from tax reform likely will add to the global upturn that is underway. While over-heating may be an eventual concern, it is likely not a near-term concern.

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Part I: Tax reform summary

Richard J. Kollauf, CPA, AEP®, CFP®, Vice President & Director of Business Advisory, BMO Private Bank

Personal tax reform

Individual income taxes: We summarize a number of changes that the Bill makes that may be of importance to you. This summary is not comprehensive, and other provisions of the Bill may impact your individual tax situation. These planning considerations are offered for you to discuss with your independent legal and tax advisors. The Bill makes the following changes (among others) to individual income taxes:

- Lowers the individual tax rates to 10, 12, 22, 24, 32, 35, and 37%. For joint returns, the 12% would start at $19,051 of taxable income, at $77,401 for the 22% bracket, at $165,001 for the 24% bracket, at $315,001 for the 32% bracket, at $400,001 for the 35% bracket, and at $600,001 for the 37% bracket. The taxpayer-brackets for single filers would start at half of those taxable income amounts, except for the highest bracket which would start at $500,001.

  Planning consideration: Consider deferring income and accelerating deductions if your cash needs are otherwise met. For example, if your income bracket next year would be lower than expected this year under the Bill, then deferring income could achieve an overall lower tax bill. Further, accelerating deductions into this year could possibly provide more value at higher rates.

- Modifies the alternative minimum tax (AMT) for individuals by increasing the exemption amount to $109,400 for married filing jointly (MFJ), and increasing the threshold at which the phase-out of the exemption starts to $1 million for MFJ.

  Planning consideration: Consider deferring deductions yet to be paid this year to next year if those deductions would otherwise cause AMT in 2017. Grouping some 2017 and 2018 deductions together may result in your 2018 deductions exceeding the new standard deduction, which may allow you to itemize those deductions in 2018 rather than using the new standard deduction. Note that AMT for 2018 should be part of the consideration for whether you defer any deductions from this year into next year.

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- Increases the standard deduction to $24,000 for MFJ and to $12,000 for single filers.

  Planning consideration: Consider prepaying applicable itemized deductions in 2017 if those deductions wouldn't cause AMT and those amounts would not otherwise exceed the new standard deduction for 2018.

- Eliminates personal exemptions.
- Limits the home mortgage interest deduction to interest on $750,000 of acquisition indebtedness incurred after December 15, 2017, but retains the $1 million limitation for older debt. Disallows deduction for home equity loan interest.

  Planning consideration: Consider reducing mortgage debt after also considering the impact on your investment rate of return.

- Limits the deduction for state and local property, sales, and income taxes to a total of $10,000.

  Planning consideration: Consider paying property or income taxes normally paid in early 2018 before the end of 2017 if those taxes are in excess of $10,000 and doing so wouldn't cause AMT in 2017. Note that prepayment works only if the expense is deductible in 2017. For example, Illinois real estate taxes paid in 2017 are for taxes incurred and deductible in 2017 because Illinois charges in arrears. Other states charge currently and the prepayment may not be deductible. In addition, a specific provision has been added clearly disallowing a deduction for state and local income taxes that are not imposed in a tax year after 2017 yet paid in 2017. Those taxes will be deductible in the year imposed.

- Modifies the medical expense deduction. The Bill retains the itemized deduction and also lowers the threshold for the deduction to 7.5% of adjusted gross income for tax years 2017 and 2018. After 2018, the old threshold will apply.
- Eliminates many itemized deductions other than those mentioned above. Also retains charitable deductions while increasing the adjusted gross income limitation on the contribution of cash to public charities from 50% to 60%. However, with higher standard deductions, it may be hard for any remaining itemized deductions to be claimed.

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Planning consideration: Consider grouping two years of deductions together every other year if it will put you over the standard deduction and allow you to itemize the deductions.

- Eliminates the payer's ability to deduct alimony payments and the recipient's requirement to include alimony payments in income for divorce or separation instruments entered into after December 31, 2018.
- Expands the Child Tax Credit from $1,000 to $2,000 (up to $1,400 refundable) and provides a nonrefundable $500 credit for dependents other than children.

Remember, your situation is unique, and you should speak to your tax adviser to determine whether any of these planning considerations will benefit you.

Transfer taxes: We summarize a number of changes that the Bill makes that may be of importance to you. This summary is not comprehensive, and other provisions of the Bill may impact your individual tax situation. These planning considerations are offered for you to discuss with your independent legal and tax advisors. The Bill makes the following changes to transfer taxes:

- Doubles the lifetime estate and gift tax exclusion to $10 million, adjusted for inflation.
- Doubles the GST tax exemption to $10 million, adjusted for inflation.

Planning consideration: Flexibility remains key. The increase in the estate and gift tax exclusion and the GST tax exemption will cause many high net worth taxpayers currently exposed to transfer taxes to be exempt. Consider reviewing your previous planning with your estate planning lawyer to determine if any changes are required for your estate plan or how you (or trusts created by you) hold your assets.

Remember, your situation is unique, and you should speak to your tax adviser and estate planning lawyer to determine whether any of these planning considerations will benefit you.

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Business tax reform

We summarize a number of changes that the Bill makes that may be of importance to you. This summary is not comprehensive, and other provisions of the Bill may impact your individual tax situation. These planning considerations are offered for you to discuss with your independent legal and tax advisors. The Bill makes the following changes (among others) to business taxes:

- Lowers the corporate rate to 21% and repeals corporate AMT.

  Planning consideration: Consider deferring corporate income to 2018 and accelerating deductions in 2017.

- Provides a 20% deduction to certain pass-through entities (e.g., partnerships and S corporations) for qualified business income, which could effectively lower the business income tax on pass-through entities to about 30%. This is because the deduction will generally be limited to (i) the greater of 50% of wage income measured by the owner or that owner's allocable share of the entity's wage income, or (ii) 25% of wage income plus 2.5% of the unadjusted basis of all qualified property. Professional service providers, including doctors, lawyers, accountants and others, generally will not qualify for the reduced rate.

  Planning consideration: Consider weighing the amount of compensation versus pass-through income being currently allocated, to maximize the tax effectiveness of the balance as permitted by the legislation.

- Permits 100% depreciation for certain business assets through 2022. The new rule applies to assets placed into service after September 27, 2017. Qualified property will include new and used property.

  Planning consideration: Consider whether to purchase qualified property before the end of the year since the Bill would permit purchases after Sept. 27, 2017 to effectively receive 100% bonus depreciation.

- Increases the amount that a taxpayer may deduct under Section 179 to $1 million, with the phase-out stating at $2.5 million.

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- Caps the net interest expense deduction at 30% of adjusted taxable income with an exception for small businesses and real estate companies. Interest deductions for every business, regardless of entity form, would be subject to disallowance for net interest expense in excess of 30% of the business's adjusted taxable income. Adjusted taxable income is defined as a business's taxable income computed without regard to business interest expense, business interest income, net operating losses, and depreciation, amortization, and depletion though 2022 and then the definition would no longer include an adjustment for depreciation, amortization, and depletion. For pass-through entities, the disallowance would be determined at the entity level rather than the partner or shareholder level. This rule would not apply to small businesses with average gross receipts of less than $25 million.

  Planning consideration: Consider reducing corporate debt; however, you should also consider the impact on the business's investment rate of return.

- Eliminates the deduction for entertainment, amusement, or recreation expenses.
- Eliminates the deduction for certain executive pay above $1 million which is allowable now as performance-based pay.
- Limits the nonrecognition treatment for like-kind exchanges after 2017. However, exchanges of real property could still qualify for nonrecognition treatment if the property is not held primarily for sale.
- Modifies the net operating loss (NOL) deduction. Taxpayers will only be able to deduct a NOL carryover to the extent of 80% of the taxpayer's taxable income (determined without regard to the NOL deduction). In addition, the Bill will allow NOLs arising in tax years beginning after 2017 and that are carried forward to be increased by an interest factor to preserve value.
- Generally adopts a territorial system of international taxation with base erosion rules. The Bill includes numerous changes to the taxation of foreign income and foreign persons/businesses.

Remember, each taxpaying entity is unique, and you should speak to your tax adviser to determine whether any of these planning considerations will be of benefit.

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Part II: Investment implications

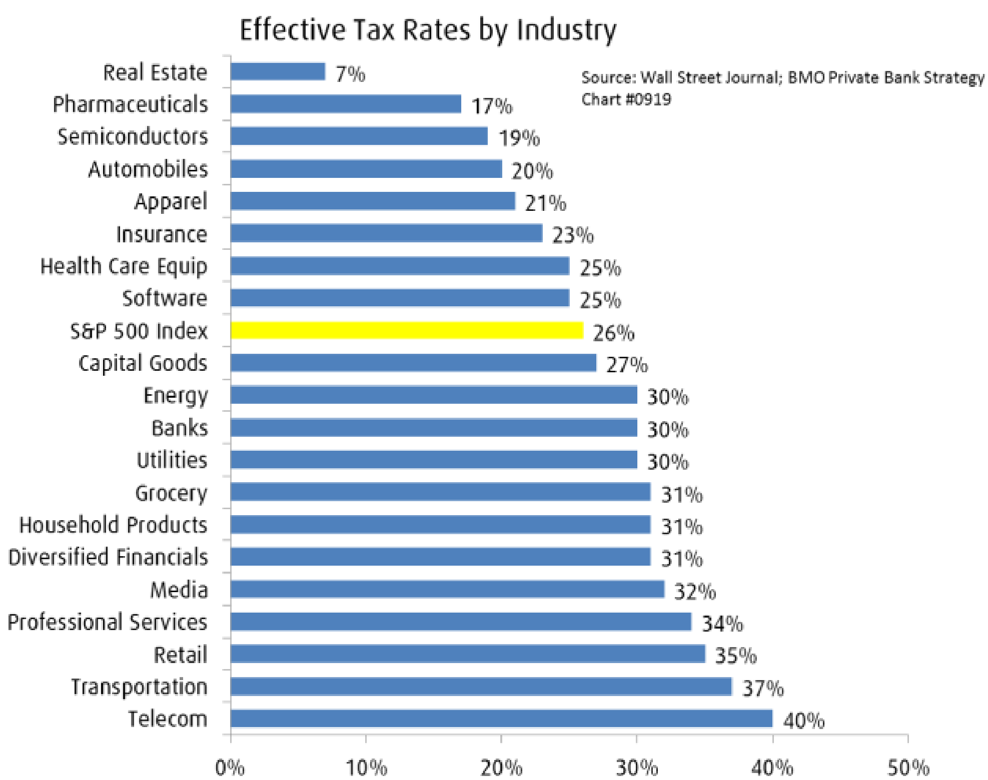
Jack Ablin, CFA, *Chief Investment Officer, BMO Wealth Management U.S.*
Yung Ma, Ph.D., *Chief Investment Strategist, CTC | myCFO*
Dylan Kremer, *Senior Investment Strategist, BMO Wealth Management U.S.*

Stock Market Impact

Tax reform has been on the top of investors' watch list since the Presidential election in late-2016. We believe that since the initial stages of tax reform investors have placed at or slightly above a 50% chance of some form of tax reform being passed in 2017 or early 2018. Therefore, the majority of price movement has most likely been baked into current market levels. However, the passing of the Bill will probably be a bullish catalyst for the broader stock market on the back of stronger-than-expected earnings; we expect the momentum can continue into the first half of next year, though we cannot guarantee that our forward looking opinions will occur.

Economic Prospects

The lower tax rate combined with incentives to expand capital expenditures may grow businesses, has the potential to create jobs, and could lead to additional domestic growth. The impact of the Bill likely will be felt more by smaller domestic companies. These smaller domestic companies typically pay a tax rate closer to the 35% federal rate, while the average effective tax rate among S&P 500 companies is already 26%. A 21% corporate tax rate will help large companies, but it is not as big of an advantage to large companies as it will be to



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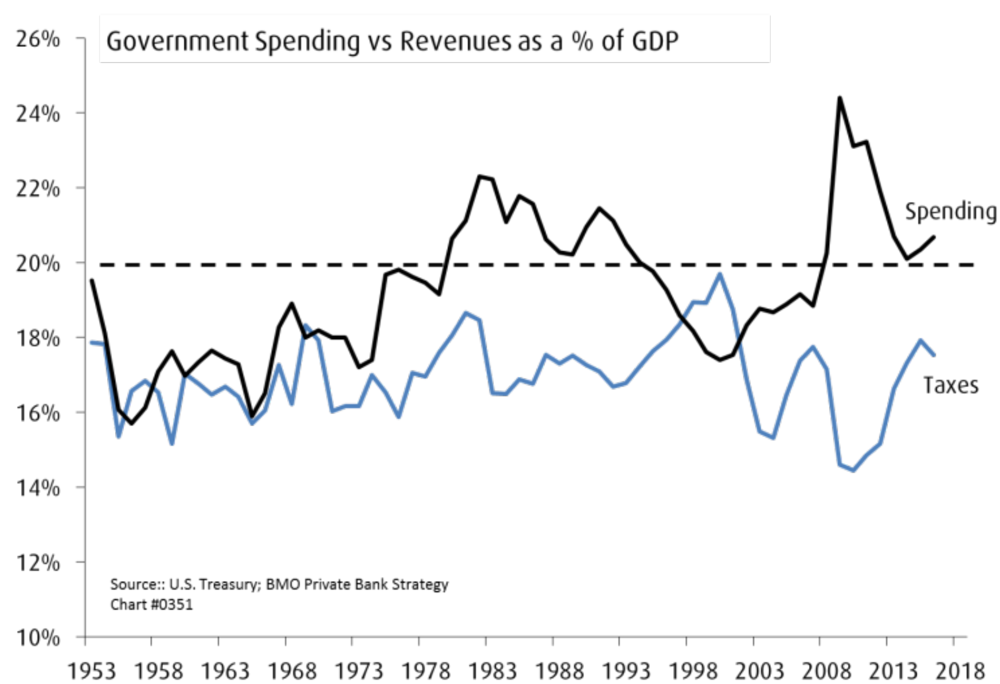
small companies. This tax reform also benefits businesses that are set up as pass-through entities. In November, the NFIB Small Business Optimism Index registered its second highest reading in 44 years.

As mentioned in our January 2018 *Outlook for Financial Markets*, reengaging businesses with a lower tax rate and capital expenditure incentives will work. Multinational companies collectively are sitting on nearly $3 trillion of cash in lower tax territories like Ireland, Singapore and Hong Kong. Apple alone holds over $252 billion overseas, according to company filings. The government can't create productivity, but it can create an environment conducive for business investments to flourish. Capital expenditure growth has declined and capital assets of American companies need a refresh. The average age of industrial equipment is 10 years, among the oldest in over a generation. The tax plan could be the right incentive to spur a business investment boom. This could create longer-term growth from productivity gains, not simply short-term stimulus. Capital expenditures and productivity were already expected to move upward in 2018, but the coming tax changes will accelerate the trends.

Economic Prospects



Fiscal policy is typically enacted in times of uncertainty and market downturns, like in 2009, when the credit crisis caused the worst global recession since the 1930s. Now, we see corporate tax reform coming at a time when our economy is accelerating and the unemployment rate is 4.1%, the lowest level in 17 years. All of this suggests that the current economy may not need stimulus from a tax reform. There is a risk that the economy and inflation could overheat, leading to a more aggressive Fed and tighter financial conditions. Significant wage pressure that was not accompanied by productivity gains would flash a warning signal. For the near term, however, the tax reform may add fuel to the global upturn that is underway.

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While wage gains may ultimately claim a small portion of the tax savings, market participants expect the majority of savings will be applied to increased stock buy-backs, dividends, and debt retirement. For example, a slew of companies, including Boeing, Honeywell, and United Airlines, recently announced large repurchase programs. Republicans see this tax reform as helping the economy and helping us all, but Democrats are sure to present it as a gift to the rich and a handout to already too powerful corporations. In less than 11 months we'll have a better understanding of which narrative was more persuasive when the congressional midterm elections roll around in November.

Conclusion & Next Steps

Despite claims that this bill is "simplifying" taxes, the legislation is dense and has been pushed through Congress quickly. Congress has set the stage for additional amendments to prevent unintended loopholes. Market participants have long expected some form of tax-reform to pass since late – 2016 and the current market levels reflect much of this stance. We anticipate increased business spending and higher productivity that will provide the markets an additional thrust through the first half of 2018. Clients should consult with their advisors on their current plans and investment portfolios to discuss how these changes could affect them.

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Forward-Looking Statements

The words "may," "could," "should," "would," "suspect," "outlook," "believe," "plan," "anticipate," "estimate," "expect," "intend," "forecast," "objective" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are not guarantees of future performance or events. Forward-looking statements involve inherent risks and uncertainties about general economic factors, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. We caution you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made. Factors that could cause our predications or projections to change include, but are not limited to, changes in laws and regulations, general economic, political and market factors the United States and internationally, interest and foreign exchange rates, global equity and capital markets, commodities markets, business competition, technological changes, judicial or regulatory judgments, legal proceedings and catastrophic events.

The above list of important factors that may affect future results is not exhaustive. Before making any decisions, we encourage you to consider these and other factors carefully. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility. We undertake no obligation to publicly update or revise any forward-looking statements or the risks, uncertainties or other factors described in this presentation, as a result of new information, future events or changed circumstances or for any other reason after the date of this presentation.

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