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March 1, 2018

Via Email

Pedro Ramirez
Surface Transportation Board
395 E Street, SW
Washington, DC 20423
Pedro.Ramirez@stb.gov

Dear Mr. Ramirez,

Grand Trunk Corporation and its subsidiaries (collectively GTC) submit this letter seeking approval to treat as an extraordinary item in 2017 the reduction in income tax expense of approximately $1.4 billion resulting from a revaluation of GTC's Deferred Income Tax (DIT) liability. GTC submits this request in connection with its 2017 Annual Report R-1, as well as GTC's Report of Revenues, Expenses and Income (RE&I) for Q4 2017. GTC's request is consistent with the Board's Uniform System of Accounts (USOA), 49 C.F.R. 1201, Instruction 1-2(d).

As explained below, GTC seeks approval to treat as an extraordinary item for accounting purposes the reduction attributable to the one-time change in the DIT liability resulting from the enactment of the federal tax reform legislation in December 2017. This legislation amended the 1986 tax code in part by decreasing the federal corporate income tax rate from 35% to 21% effective January 1, 2018. Because of the legislation enacted in 2017 that resulted in a 14% reduction in the federal tax rate, even though the change in tax rate becomes effective on January 1, 2018, GTC revalued its DIT liability in the period of enactment. GTC's DIT liability is calculated as the temporary differences between accounting and tax balances multiplied by the tax rate expected to apply when the temporary differences are anticipated to reverse. The rate used in this calculation in 2017 reflects the 14% decrease in the federal tax rate. As a result, for the year ending December 31, 2017, GTC's DIT liabilities balance decreased by approximately $1.4 billion. The offset is to Deferred Income Tax Expense, which will be a credit, on the Q4 2017 Form RE&I and Schedule 210 of the 2017 R-1.

GTC's request for extraordinary item treatment of the DIT reduction in 2017 is consistent with the Board's Uniform System of Accounts (USOA) because it is characterized by its "unusual nature and infrequent occurrence taking into account the environment in which the firm operates." 49 C.F.R. 1201, Inst. 1-2(d)(1). It also meets the materiality standard.

- **Unusual nature**: The one-time reduction in GTC's DIT liability in 2017 results from the enactment of a change in the federal corporate tax rate. This change in DIT liability results from a change in the federal tax code and has a "high degree of abnormality." The change in federal tax code is unrelated to GTC's "ordinary and typical activities" to provide interstate freight rail transportation to its customers.
- **Infrequent occurrence**: Until 2017, the federal income tax rate for corporations had remained unchanged since 1986, except for a minor change in 1993. Amendment of the federal tax code on the scale of the 2017 tax reform has not occurred in more than 30 years. President Trump and Congressional leaders have referred to the 2017 tax reform as "once in a generation" legislation.

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GTC does not expect that a similar tax rate enactment or change in DIT liability will recur in the foreseeable future.

- Material: The amendment to the federal income tax code results in a one-time reduction of GTC's DIT liability. The reduction is approximately $1.4 billion, and it exceeds 10 percent of GTC's annual income. In this case, the reduction in DIT exceeds 87 percent of GTC's annual income, which was $1.6 billion in 2017, before extraordinary items.

GTC requests approval from the Board that this one-time reduction in DIT liability be reported in Account 591 – "Provision for Deferred Taxes – Extraordinary Items" – for the year ending December 31, 2017, or, in the alternative, Account 570 for "Extraordinary Items (Net)." We urge the Board to approve our request for this "once in a generation" change for three reasons.

First, the title of the Account 591 itself – "Provision for Deferred Taxes – Extraordinary Items" – makes this the most natural account to record the change resulting from the one-time change in the applicable federal tax rate. This account plainly contemplates that material, one-time changes in deferred taxes from an extraordinary event can be reported in this account. In creating Account 591 for an extraordinary item for deferred taxes, the agency expressly contemplated that it would be appropriate to treat certain deferred taxes as an extraordinary item. However, GTC would have no objection if Account 570 was used to record this unusual and infrequent event.

Indeed, treatment of this DIT reduction as an extraordinary item would be analogous to how the Board treats extinguishment of other large debts. Under the USOA, "Gains from extinguishment of debt shall be aggregated and, if material, credited to account 570, 'Extraordinary Items,' upon approval by the Board." 49 C.F.R. 1201, Inst. Account 519. Here, changes to the tax code resulted in a significant $1.4 billion reduction in the future debt owed to the U.S. Treasury; there is good reason to treat this unusual and infrequent change in DIT liability similar to other extinguishments of debt.

Second, treatment as an extraordinary item is permitted by Board regulations and recent simplifications to GAAP do not change that outcome. In 2015, the Financial Accounting Standards Board (FASB) merged together the concept of "extraordinary" and "unusual or infrequent" events.[1] FASB then reiterated that these unusual or infrequent events (now including the extraordinary events) should be disclosed as separate components of income and emphasized that such events should not be treated as ordinary income.[2] (Attached is a letter from KPMG, GTC's independent accountant, commenting on GTC's request

[1] *See* FASB, Accounting Standards Update 2015-01, Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items (issued Jan 2015).

[2] FASB's standards provided that a "material event or transaction that an entity considers to be of an unusual nature or of a type that indicates infrequency of occurrence **or both** ... shall be reported as a separate component of income from continuing operations." GTC's ultimate parent company, Canadian National Railway Company (CN), therefore included a note regarding the deferred income tax change in its financial statements in accordance with GAAP. However, by including an infrequent item that does not result from CN's normal rail operations, such accounting treatment does not facilitate period-to-period comparisons and could distort operating performance and liquidity. CN thus also presented non-GAAP measures in addition to other indicators of operating performance. These adjusted performance measures—adjusted net income and adjusted earnings per share—excluded the deferred income tax recovery.

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for extraordinary item treatment.) STB reporting regulations have not merged these two concepts; the USOA retains both classifications. However, whether an event is labeled and recorded as "unusual or infrequent" or "extraordinary" has no bearing whatsoever on any Board function. Neither event flows into URCS nor the annual railroad revenue adequacy determinations. There was therefore no reason for the Board to disrupt the extraordinary item classification when it revised its R-1 to conform to other, more material, changes in GAAP.[3] The FASB and USOA use the identical definition of unusual nature, infrequent occurrence, and materiality, and those definitions are plainly met here.

Finally, to treat as ordinary this significant DIT liability reduction would materially distort other financial data published by the Board. It will distort the individual railroad revenue adequacy findings. There is no debate that the changes to corporate tax laws will improve the financial well-being of all corporations, but the cash-flow effects will be realized incrementally in 2018 and beyond when the lower federal tax rate is applicable. It would distort the Board's estimate of the cost-of-equity, under the multi-stage discounted cash flow model, by abnormally raising "Net Railway Operating Income", which would inflate the estimated cost of equity. It will undermine the Revenue Shortfall Allocation Method (RSAM) benchmark used by the Board in simplified rate cases and in its market dominance analysis under the Limit Price test that the Board has applied in prior rate cases.

In addition, the distorting impact of adding $1.4 billion to "Net Railway Operating Income" is not confined to STB proceedings. It will also distort reliance by third parties, such as the multitude of states that rely on STB reports as accurately reporting "Net Railway Operating Income" from Schedule 210 to estimate the value of railroad property for assessing state and local property taxes. This is a non-cash event. Yet adding $1.4 billion to "Net Railway Operating Income" (almost doubling net operating income) will expose GTC to millions of dollars of inflated state property taxes. Therefore—while the Board might be able to reign in the distorting effects on its own proceedings—failure to treat this $1.4 billion reduction to DIT as an extraordinary item will cascade outside the agency and have a real, tangible, and adverse impact on GTC.

In summary, current Board rules permit a railroad to record extraordinary items (including deferred taxes from those extraordinary events) in either Account 570 or 591, with the permission from the Board. The Board chose not to refine these accounts in its Ex Parte 720 proceeding. Treating this extraordinary item as ordinary would materially distort GTC's R-1 for the year 2017 and, in turn, the Board's other financial data. The distorting impact will also ripple beyond the boundaries of the agency. GTC therefore respectfully seeks Board permission to record this event in either Account 570 or 591 for the R-1 for the year 2017. For the 2018 R-1 and going forward, GTC will report ordinary deferred income taxes in Account 557, which is the account GTC used in 2016 and prior years.

Please do not hesitate to contact me if you have any questions.

Salvatore Forgione

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[3] *Accounting and Reporting of Business Combinations, Security Investments, Comprehensive Income, Derivative Instruments and Hedging Activities*, STB Docket No. Ex Parte 720 (served April 6, 2016).

KPMG

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I am the engagement partner on KPMG LLP's audit of Canadian National Railway Company's 2017 consolidated financial statements. Our 'Report of Independent Registered Public Accounting Firm' is included in Canadian National Railway Company's annual form 40-F filed with the SEC on January 31, 2018.

I have read Canadian National Railway Company's letter to you dated March 1, 2018, with regard to their request for approval of reporting classification as a result of the Tax Cuts and Jobs Act ('Tax Reform Act'), which was signed into law on December 22, 2017.

As stated in that letter, Accounting Standards Update No. 2015-02 – Income Statement – Extraordinary and Unusual Items (Subtopic 225-20) was effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. This Update eliminates from U.S. GAAP the concept of extraordinary items.

While the concept of extraordinary items no longer exists in U.S. GAAP, Accounting Standards Codification 225-20-50-1 states, "The nature and financial effects of each event or transaction that is unusual in nature or occurs infrequently or both shall be presented as a separate component of income from continuing operations or, alternatively, disclosed in notes to the financial statements."

The *FASB Master Glossary* defines 'Infrequency of Occurrence' and 'Unusual Nature' as follows:

— Infrequency of Occurrence: The underlying event or transaction should be of a type that would not reasonably expected to recur in the foreseeable future, taking into account the environment in which the entity operates.
— Unusual Nature: The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.

Very truly yours,

KPMG LLP*

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