



MEMORANDUM

**Accounting & Tax Organization
Jacksonville, Florida**

March 6, 2018

TO: Pedro Ramirez, Section Chief
Surface Transportation Board

FROM: Angie Williams, Assistant Controller
CSX

SUBJECT: ***Request for impacts of tax reform to be classified as an extraordinary item***

In the fourth quarter of 2017, CSX Transportation, Inc. ("CSXT" or "the Company") recognized a \$3.5 billion benefit as a result of federal tax reform. The Company believes this event meets the criteria of an extraordinary item under 49 CFR 1201, Instruction 1-2(d) and is requesting approval from the STB to classify the effects of tax reform as such.

Background

The Tax Cuts and Jobs Act (or "tax reform") was enacted on December 22, 2017. Section 13001 of the Act reduced the federal corporate tax rate from 35% to 21% effective January 1, 2018. Accounting rules require accumulated deferred income tax debits and credits ("deferred tax assets and liabilities"), which represent taxes receivable or payable in future years as a result of temporary tax treatment differences, to be valued at the currently enacted tax rate for the period in which the differences reverse. Because tax reform was enacted before the Company's year end date of December 31, 2017, all of the Company's net deferred tax liabilities had to be revalued using the new, lower rate as of December 31, 2017. This one-time revaluation resulted in a \$3.4 billion non-cash income tax benefit which, if not classified as an extraordinary item, would otherwise be included in Provision for Deferred Income Taxes. Going forward, the tax rate used to calculate income tax expense on ordinary income and the provision for deferred taxes will be the newly-enacted 21% federal corporate income tax rate.

The Company's affiliates were also required to revalue their deferred tax liabilities to reflect the lower federal corporate tax rate, which resulted in the Company recognizing a non-cash benefit of approximately \$145 million. This benefit, if not classified as an extraordinary item, would otherwise be included in Operating Expenses (All Other Equipment Accounts) and Equity in Undistributed Earnings.

Presentation of Tax Reform Impacts as Extraordinary Item

The Surface Transportation Board's rules under 49 CFR Ch. X, Part 1201 cover the accounts, records, and reports required of railroads. Further, Instruction 1-2(d)(1) ("the instruction") provides instructions for the treatment of extraordinary items. Under the rules, to be classified as an extraordinary item, an event or transaction must meet the following three criteria:

1. Unusual in nature,
2. Infrequent in occurrence, and
3. Material.

The instruction states that an unusual event or transaction must "possess a high degree of abnormality and be of the type clearly unrelated to, or only incidentally related to the ordinary and typical activities of the entity." Federal income tax reform is an event out of the Company's control and is not related to the Company's ordinary or typical activities. The nature of this event as an adjustment to a long-term liability that does not have a cash impact in the year realized further indicates that it is not associated with the normal operations of the Company.

The instruction defines an infrequent event or transaction as one that is “not reasonably expected to recur in the foreseeable future.” The top marginal corporate tax rate has been 35% since 1993. The last time Congress enacted a significant reduction of the corporate rate was The Tax Reform Act of 1986 (P.L. 99-514) when the corporate income tax rate was reduced from 46% to 34%. Given the 31 year difference between that Act and tax reform in 2017, and given no indications otherwise, it is a reasonable expectation that significant federal tax reform legislation is not likely to recur in the foreseeable future.

Finally, Instruction 1-2(d)(6) says an item shall be material when it exceeds 10 percent of annual income (loss) before extraordinary items. The Company’s annual income (loss), excluding the effects of tax reform, was \$1.9 billion for fiscal year 2017. The \$3.5 billion benefit related to tax reform is material at 184% of annual income.

In addition to considering the criteria outlined in Instructions 1-2(d)(1) and 1-2(d)(6), the Company also considered the impact of including the effects of tax reform in Income From Continuing Operations and Net Railway Operating Income on a potential stakeholder’s evaluation of CSXT’s financial results. To not consider these items extraordinary could grossly overstate the Company’s earnings from continuing operations, and it may not be clear to all users of the information that such results are not indicative of an ongoing earnings trend.

Conclusion

The nature of this significant federal tax reform is unusual and infrequent, and the effects of tax reform are material under Instructions 1-2(d)(1) and 1-2(d)(6), respectively. The Company believes that including such effects in Income from Continuing Operations and Net Railway Operating Income would not accurately depict the results of CSXT’s railway operations. Accordingly, CSXT respectfully requests approval from the STB to include the effects of tax reform in the accounts provided for extraordinary items. If approved, the Company will include the portion of the benefit related to revaluation of net deferred tax liabilities in the Provision for Deferred Taxes – Extraordinary Items and the portion of the benefit related to the Company’s affiliates in Extraordinary Items (Net) and Income Taxes on Extraordinary Items.

Enclosure: Letter from the Company’s independent auditor



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Report of Independent Accountants

Management and the Board of Directors
CSX Corporation
Jacksonville, Florida
And
Surface Transportation Board
Washington D.C.

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of CSX Corporation (the Company) as of and for the year ended December 31, 2017, and have issued our report, with an unqualified opinion thereon, dated February 7, 2018. As noted in our opinion, we have been the auditors of CSX since 1981.

The aforementioned consolidated financial statements included a combined \$3.6 billion benefit related to net deferred tax liability revaluation as a result of the reduction in federal corporate income tax rates attributable to the Tax Cuts and Jobs Act (P.L. 115-97) ("the Act"). Of the \$3.6 billion, \$3.5 billion is reflected in the reduced net deferred tax liability of \$6.4 billion on CSX's consolidated balance sheet as of December 31, 2017. The remaining \$142 million is as a result of increased equity investment assets related to deferred tax liability reductions of CSX equity investments. As part of our audit, we performed procedures to test that the amounts included in the net deferred tax liability account were revalued. Additionally, we performed audit procedures to test the amounts recorded by CSX within Equity Earnings of Affiliates as CSX's portion of the equity method investments' benefit. As the impact of the Act affects the comparability of the financial statements year over year, the Company discussed the impact of the Act in the footnotes of the financial statements for the period ending December 31, 2017, in accordance with Accounting Standard Codification 205, *Presentation of Financial Statements*.

We are issuing this report in accordance with the Surface Transportation Board's (STB) instruction 1-2(d) requesting a letter commenting on aspects of CSXT's, a subsidiary of CSX Corporation, inclusion of \$3.6 billion within the lines for extraordinary items on its Form R-1, Schedule 210. The Company is requesting the STB to allow them to present the impact of the Act as follows:

- Record approximately \$145 million of Equity Earnings of Affiliates resulting from the Act on Line 56, Account 570, *Extraordinary items, net*
- Record approximately \$39 million for taxes owed on Equity Earnings of Affiliates attributable to the Act in Line 57, Account 590, *Income taxes on extraordinary items*, and
- Record approximately \$3.4 billion of tax benefit from the Act in row 58, Account 591, *Provision for deferred taxes – Extraordinary items*.

Based on our audit of the consolidated financial statements, we view the combined \$3.6 billion as material to the aforementioned consolidated financial statements.

In connection with our audits of the Company since 1981, we are not aware of a single event creating a U.S. Federal deferred tax provision or benefit in excess of \$1 billion, other than the event discussed within this report.



While we believe the information we have provided is responsive to your request, we are not in a position to assure the Company or the Surface Transportation Board (STB) of the sufficiency of the information we have provided or the procedures we performed in relation to our audits for your purposes. This report is intended solely for the information and use of management and the Board of Directors of CSX Corporation and the STB in connection with CSX's submission of its Form R-1 filing as of December 31, 2017, and is not intended to be and should not be used by anyone other than these specified parties or for any other purpose.

Ernst + Young LLP

Certified Public Accountants

February 7, 2018