STATE OF MICHIGAN

COURT OF CLAIMS

R.J. REYNOLDS TOBACCO COMPANY,

Plaintiff,

v

DEPARTMENT OF TREASURY, STATE OF MICHIGAN,

Defendant.
_____/

OPINION AND ORDER

Case No. 22-000076-MT

Hon. James Robert Redford

OPINION AND ORDER DENYING BOTH PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY DISPOSITION

Plaintiff, R.J. Reynolds Tobacco Company (RJR), and defendant, Michigan Department of Treasury, filed competing motions for summary disposition under MCR 2.116(C)(10) in this corporate income tax (CIT) dispute. The questions before the Court are 1) whether the gain from the sale of international brand-name rights and trademarks from a wholly owned Swiss subsidiary to a Japanese company may be attributed to RJR's unitary business group (UBG) and taxed by apportionment in Michigan under the CIT provisions of the Income Tax Act (CIT Act); 2) if so, whether Michigan was constitutionally permitted to tax the gain; and 3) if so, whether defendant should have employed an alternative tax apportionment formula to avoid a distorted assessment. Because there remain genuine issues of material fact, the Court DENIES both parties' motions to dismiss.

I. BACKGROUND

This case stems from audits performed by defendant of the 2014-2017 Michigan CIT filings of RJR, a North Carolina corporation. RJR is the second largest tobacco company in the United States and is a wholly owned subsidiary of Reynolds American Inc. (RAI). RAI owns RJR and RJR in turn owns a wide array of companies, some of which own additional companies. At the federal level, RAI filed mass unitary business tax returns for the years in question and included all the subsidiaries referenced in this opinion.

Large, multistate corporations must file tax returns in many states and apportion their income for taxation. In Michigan, RJR (rather than RAI) filed CIT returns including some, but not all, its subsidiaries. One such omitted subsidiary was Santa Fe Natural Tobacco Company, Inc. (SF Domestic), which filed separately in Michigan.[1] SF Domestic is an organic tobacco product company that manufactures and sells Natural American Spirit (NAS) cigarettes in the United States. In its separate Michigan tax filings, SF Domestic claimed it owed no CIT in Michigan because its only business in Michigan was the solicitation of sales of NAS products, a protection referred to as PL 86-272. Other RJR subsidiaries are involved in manufacturing and selling NAS products abroad. One such company was SFR Tobacco International GmbH (SF Int'l), which was incorporated in Switzerland.

Although many challenges were raised in the Department of Treasury, the treatment of only one transaction is the basis of this suit. In 2016, SF Domestic sold the international rights to

[1] The proceedings in the Department of Treasury involved other subsidiaries as well, but no issues related to those companies are before this Court.

the NAS brand-name and trademarks to Japan Tobacco Inc. (JTI) for $4,882,455,000. Following that sale, SF Int'l was "integrated" into JTI. RAI reported the nearly $5 billion "gain" as "taxable income" in the federal income tax documents for its federal unitary business. However, neither RJR nor SF Domestic reported this gain in their Michigan CIT filings.

During the audit of tax years 2014 through 2017, defendant determined that SF Domestic should have been included in RJR's Michigan UBG and that a portion of the $5 billion gain from the sale to JTI was taxable in Michigan for the 2016 tax year. As a result, defendant determined that RJR owed $8,942,705.45 in back taxes and $1,708,420.12 in interest for the 2016 tax year.

MCL 206.623 imposes the CIT in Michigan, in relevant part, as follows:

> (1) Except as otherwise provided in this part, there is levied and imposed a [CIT] on every taxpayer with business activity within this state or ownership interest or beneficial interest in a flow-through entity that has business activity in this state unless prohibited by 15 USC 381 to 384. The [CIT] is imposed on the [CIT] base, after allocation or apportionment to this state, at the rate of 6.0%.
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> (2) The [CIT] base means a taxpayer's business income subject to the following adjustments, before allocation or apportionment, and the adjustment in subsection (4) after allocation or apportionment: [None are relevant to this matter]
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> * * *
>
> (3) For purposes of subsection (2), the business income of a [UBG] is the sum of the business income of each person included in the [UBG] less any items of income and related deductions arising from transactions including dividends between persons included in the [UBG] . . . .

Defendant determined that the sale of the international rights to the brand-name and trademarks was taxable "business activity" under MCL 206.623(1). "Business activity" is defined as including "a transfer of legal or equitable title to . . . property, whether real, personal, or mixed, tangible or intangible, . . . made or engaged in, or caused to be made or engaged in, whether in intrastate, interstate, or foreign commerce, with the object of gain, benefit, or advantage, whether direct or

indirect, to the taxpayer or to others. . . ." MCL 206.603(2). Business activity therefore includes the transfer of title to intangible personal property, such as a trademark or brand-name rights.

Defendant also determined that SF Domestic was a part of RJR's UBG, which is defined in Michigan as

> a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the [UBG] or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. . . . [MCL 206.611(6).][2]

The first count of RJR's verified complaint in this action challenged defendant's determination that SF Domestic was a member of RJR's UBG. However, the parties stipulated to the dismissal of that count. This Court, therefore, is not being asked to resolve whether SF Domestic should have been included in the RJR Michigan UBG for the tax years in question.

In the Department of Treasury proceedings, and now before this Court, RJR contends that the gain from the sale of the international brand-name rights and trademarks had no relationship to any business activity in Michigan and, therefore, no portion of the $5 billion gain could be taxed in Michigan. Defendant disagrees. In the alternative, RJR challenges the method of apportioning the tax.

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[2] The benefit of filing as a UBG is that transactions among its members are not taxable. See, e.g., MCL 206.691(1).

II. METHOD OF ASSESSING AND APPORTIONING TAXES

Under Michigan's CIT statutes, a taxpayer's "business income" is subject to an apportioned tax. "Business income" is defined by MCL 206.603(3) as the taxpayer's "federal taxable income." A business taxpayer, including a UBG, that earns "income from business activity which is taxable both within and without" the state of Michigan must "allocate and apportion [its] net income as provided" under the tax act. MCL 206.103. As of January 1, 2012, "all business income . . . shall be apportioned to this state by multiplying the income by the sales factor calculated under" MCL 206.121. MCL 206.115(2). MCL 206.121 defines the "sales factor" as "a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period," or

$$\text{Sales Factor} = \frac{\text{Total Sales in Michigan During Tax Period}}{\text{Total Sales Everywhere During Tax Period}}$$

To allocate or apportion taxes, the tax base is multiplied by this sales factor or, as described in *Vectren Infrastructure Servs Corp v Dep't of Treasury*, 512 Mich 594, 603; 999 NW2d 748 (2023):

Apportioned Tax Base = (Tax Base) x (Michigan Sales/Total Sales)

"Sales" has a legal definition for purposes of the sales factor. Sales as defined by MCL 206.609(4) are "amounts received by the taxpayer as consideration from" the following sources:

> (a) The transfer of title to, or possession of, property that is stock in trade or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax period or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. For intangible property, the amounts received shall be limited to any gain received from the disposition of that property.
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> (b) The performance of services that constitute business activities.

(c) The rental, lease, licensing, or use of tangible or intangible property, including interest that constitutes business activity.

(d) Any combination of business activities described in subdivisions (a), (b), and (c).

(e) For taxpayers not engaged in any other business activities, sales include interest, dividends, and other income from investment assets and activities and from trading assets and activities.

Defendant asserted that the sale of the international brand-name rights and trademarks to JTI did not meet the statutory definition of a "sale" within the sales factor. The gain from the sale, however, did fall within the tax base. Accordingly, defendant's taxation formula was as follows:

$$\text{Apportioned Tax Base} = (\text{Tax Base with JTI sale gain}) \times \frac{\text{Total Mich Sales during tax period}}{\text{Total Sales everywhere (without JTI sale gain)}}$$

As noted, RJR contended that the gain could not be included in its Michigan tax base. In the alternative, RJR argued that the gain must be included in the denominator of the sales factor. Not including the gain in the denominator led to unreasonable asymmetry between the tax base and the apportionment factor, RJR insisted, leading to the apportioned tax being out of proportion with RJR's actual Michigan business activity.[3] In yet another alternative argument, RJR contended

[3] MCL 206.667 provides for alternative methods of allocation when application of the sales factor formula would be unjust:

(1) If the apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state treasurer may require the following, with respect to all or a portion of the taxpayer's business activity, if reasonable:

(a) Separate accounting.

(b) The inclusion of 1 or more additional or alternative factors that will fairly represent the taxpayer's business activity in this state.

that the method of apportionment violated the Due Process and Commerce Clauses of the United States Constitution by allowing Michigan to collect income tax from a completely out-of-state transaction.

III. TREASURY INFORMAL CONFERENCE AND FINAL DECISION

As noted, defendant's mathematical solution created a large tax deficit owed by RJR for the 2016 tax year. RJR requested and defendant granted an informal conference to contest this and other assessments.

Following the informal conference, the hearing referee issued a recommendation, noting, "There are two tests to determine if one is a member of a UBG: the control test and the relationship test." These tests are outlined in detail in § V of this opinion. The referee asserted that RJR did not dispute the control test at the conference and "failed to provide any explanation as to why it believed the relationship test was not met." The referee concluded that defendant established a flow of value sufficient to treat the subsidiaries as part of the UBG because of shared services in human resources, legal, taxation, marketing, accounting, strategic planning, and information

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(c) The use of any other method to effectuate an equitable allocation and apportionment of the taxpayer's tax base.

(2) An alternate method may be used only if it is approved by the department.

(3) The apportionment provisions of this part shall be rebuttably presumed to fairly represent the business activity attributed to the taxpayer in this state, taken as a whole and without a separate examination of the specific elements of the tax base unless it can be demonstrated that the business activity attributed to the taxpayer in this state is out of all appropriate proportion to the actual business activity transacted in this state and leads to a grossly distorted result or would operate unconstitutionally to tax the extraterritorial activity of the taxpayer.

technology services, as well as insurance and benefit plans. The referee further found intercompany receivables and payables. The referee also rejected RJR's various arguments that the profit from the sale of the NAS international trademarks and brand-name rights should be apportioned under an alternative sales formula.

RJR was partially successful in its challenges related to the 2014, 2015, and 2017 assessments. However, defendant ultimately upheld the 2016 assessment of almost $9 million plus interest.

RJR filed this suit to challenge the 2016 assessment.

IV. STANDARD OF REVIEW

The parties have filed competing motions for summary disposition under MCR 2.116(C)(10). "A motion under MCR 2.116(C)(10) . . . tests the factual sufficiency of a claim." *El-Khalil v Oakwood Healthcare, Inc*, 504 Mich 152, 160; 934 NW2d 665 (2019) (emphasis omitted). When considering a (C)(10) motion, a court must consider the evidence in the light most favorable to the nonmoving party to determine if there are any genuine issues of material fact. *Id.* The court must "draw[] all reasonable inferences in favor of the nonmoving party," *Dextrom v Wexford Co*, 287 Mich App 406, 415; 789 NW2d 211 (2010), and may not "assess credibility, weigh the evidence, or resolve factual disputes." *Pioneer State Mut Ins Co v Dells*, 301 Mich App 368, 377; 836 NW2d 257 (2013).

Resolving these summary disposition motions requires the interpretation of various statutes. The goal of statutory interpretation is to give effect to the Legislature's intent. *TRJ & E Props, LLC v Lansing*, 323 Mich App 664, 670; 919 NW2d 795 (2018). The language of the

statute itself is the best indicator of the Legislature's intent. *Id.* When the language of the statute is clear and unambiguous, judicial construction is not permitted, and this Court must give the words their plain and ordinary meaning. *Mich Federation of Teachers & Sch Related Personnel, AFT, AFL-CIO v Univ of Mich*, 481 Mich 657, 664; 753 NW2d 28 (2008).

V. ATTRIBUTING GAIN TO RJR'S UBG

In their cross-motions for summary disposition, the parties dispute whether the nearly $5 billion gain from the sale of the NAS international brand-name rights and trademarks can be attributed to RJR's Michigan UBG. This involves a fact-intensive review of the relationships between SF Int'l, SF Domestic, and RJR. Although RJR no longer challenges defendant's decision to include SF Domestic in the RJR UBG, the Court must analyze the law underlying that decision to determine if it was proper to attribute the challenged gain to RJR's UBG under the CIT Act.

A. UBG LEGAL PRINCIPLES

Again, MCL 206.623(3) defines a UBG as:

> a group of United States persons that are corporations, insurance companies, or financial institutions, other than a foreign operating entity, 1 of which owns or controls, directly or indirectly, more than 50% of the ownership interest with voting rights or ownership interests that confer comparable rights to voting rights of the other members, and that has business activities or operations which result in a flow of value between or among members included in the [UBG] or has business activities or operations that are integrated with, are dependent upon, or contribute to each other. . . .

The Court of Appeals has provided guidance on the statutory definition of a UBG:

> "A [UBG] is not a separate and distinct legal entity, like a corporation, limited liability company, or partnership; rather, the group is purely a creation of tax law. In general, a [UBG] is a group of related US persons whose business activities are sufficiently interdependent. MCL 206.611(6) (CIT); MCL 208.1117(6) (MBT).

> To qualify as a [UBG], one member of the proposed group must own or control more than 50% of the other members and there must be a sufficient connection between the members to meet one of two relationship tests. MCL 206.611(6) (CIT); MCL 208.1117(6) (MBT). If a group of businesses qualifies as a [UBG] in a particular tax year, then the group must file a unitary tax return for that year. MCL 206.691(1) (CIT); MCL 208.1511 (MBT). Michigan, like several other states, has adopted the [UBG] concept in an effort to measure more accurately the related group's taxable activities in the state." *Nationwide Agribusiness Ins Co v Dep't of Treasury*, ___ Mich App ___; ___ NW3d ___ (2024) (Docket No. 364790); slip op at 4, quoting *D'Agostini Land Co, LLC v Dep't of Treasury*, 322 Mich App 545, 551; 912 NW2d 593 (2018).]

Distilled to its elements, to establish membership in a UBG, there must be:

1) Ownership or control *and*

2) A relationship demonstrated by *either*

a) business activities or operations which result in a flow of value between or among members *or*

b) business activities or operations that are integrated with, are dependent upon, or contribute to each other.

Federal law must also be considered because "[t]he Due Process and Commerce Clauses forbid the States to tax extraterritorial values." *MeadWestvaco Corp v Ill Dep't of Revenue*, 553 US 16, 19; 128 S Ct 1498; 170 L Ed 2d 404 (2008) (quotation marks and citation omitted). Just as under Michigan law, under federal law, "[a] State may . . . tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a unitary business." *Id.* (quotation marks and citation omitted). Relative to the relationship test for a UBG, the United States Supreme Court has described that courts must consider "the 'hallmarks' of a unitary relationship," which are "functional integration, centralized management, and economies of scale." *Id.* at 30. Michigan courts have added to these hallmarks, directing courts to also consider "economic realities" and whether the companies have "substantial mutual interdependence." *Malpass v Dep't of Treasury*, 494 Mich 237, 256; 833 NW2d 272 (2013)

(quotation marks and citation omitted). "These factors are not exhaustive or exclusive. Nor is any one factor dispositive." *Id.* The totality of the circumstances control. *Id.*

The economic realities "address[] whether the regularly conducted activities of the business in question are related." *Id.* (quotation marks and citation omitted). "[F]unctional integration[] concerns the extent to which business functions are blended to promote a unitary relationship." *Id.* at 257 (quotation marks and citation omitted). As described by the Treasury Department, functional integration "refers to the transfers between, or pooling among, business activities that significantly affect the operations of the entities," including "the transfer or pooling of products or services, shared technical information, marketing information, purchasing, distribution systems and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, or processes." Department of Treasury, Revenue Administrative Bulletin (RAB) 2019-12 (May 23, 2018), p 6. Centralized management "examines the extent to which management was centralized across the potentially unitary business." *Malpass*, 494 Mich at 257 (quotation marks and citation omitted). Economies of scale includes "show[ing] profits through bulk purchasing or improved allocation of resources," "cheaper component parts, an expanded customer base, increasing economic diversification, and improved financing conditions." *Id.* (quotation marks and citation omitted). Substantial mutual interdependence is exactly what its name suggests. *Id.*

B. ANALYSIS

The parties' evidence creates a genuine issue of material fact regarding whether the gain from the sale of the international name brand rights and trademarks to JTI should have been attributed to RJR's Michigan UBG.

MCL 206.603(3)'s definition of "business income" is simply the taxpayer's "federal taxable income." RAI, RJR's parent company, included the nearly $5 billion gain as part of its federal taxable income. Accordingly, at first glance, it appears that defendant properly attributed this gain to RJR in Michigan. However, there are many factors to consider when determining whether a company and its gains may be attributed to another company's UBG in a particular state. And the parties have presented thousands of pages of documents to support their positions.

It is not dispositive that SF Int'l was incorporated in Switzerland. There is evidence that SF Domestic and RJR controlled and had a significant relationship with SF Int'l, creating a question of fact regarding whether the gain from the sale of the international brand-name rights and trademarks could be attributed to RJR's UBG. As described by the United States Supreme Court in *Mobil Oil Corp v Comm'r of Taxes*, 445 US 425, 438; 100 S Ct 1223; 63 L Ed 2d 510 (1980):

> The argument that the source of the income precludes its taxability runs contrary to precedent. In the past, apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting. The Court has rejected that contention so long as the intrastate and extrastate activities formed part of a single unitary business. In these circumstances, the Court has noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.
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> The Court has applied the same rationale to businesses operating both here and abroad. [Citations omitted.]

There is evidence that SF Domestic and RJR had interworking relationships with SF Int'l, and exercised a level of control over SF Int'l. However, there is also evidence that SF Int'l

operated independently and engaged in arm's-length transactions with RJR and SF Domestic. The same is true of the relationship between RJR and SF Domestic.

One piece of evidence of RJR's control over these affiliates is that when SF Domestic sold the NAS international trademarks and brand-name rights to JTI, RJR as a whole agreed not to sell organic tobacco products outside the United States for five years. (United States Securities and Exchange Commission Form 10-K, DF MSD, Ex 2, p 29.) A level of centralized management is supported by evidence that the SF Domestic president reported to a vice president at RJR, and the former president of SF Int'l reported to both the president of SF Domestic and executives at RJR. (Moranchnick Dep, DF MSD, Ex 7, p 14; Little Dep, DF MSD, Ex 6, p 66.) Functional integration is supported by a series of service agreements under which RJR agreed to provide human resources, research and development, and regulatory services to SF Int'l. (DF MSD, Exs 20-22.) Research and development for operating subsidiaries are conducted mainly by RJR. (SEC Form, DF MSD, Ex 2, p 14.) There was also some sharing, or "seconding," of employees. For example, Paul Tomlinson spent most of his career with RJR and its affiliates working directly for RJR in North Carolina. However, he also spent two-and-a-half years working in finance in Switzerland, for SF Int'l. (Tomlinson Dep, DF MSD, Ex 23, pp 6-7, 15-16.) Economies of scale are arguably demonstrated by a system of cut leaf tobacco purchasing in which SF Domestic purchased organic tobacco through RJR, and SF Int'l purchased organic tobacco through SF Domestic. (Dixon Dep, DF MSD, Ex 10, pp 28-29.) Tomlinson testified that SF Int'l was required to report financial forecasts and "actual numbers" to RJR because RJR owned SF Int'l and needed this information for financial planning to "add to their overall company expectations." (Tomlinson Dep, DF MSD, Ex 23, pp 17-18.)

A significant amount of evidence contradicts defendant's position, however. There is conflicting evidence about SF Domestic's and SF Int'l's levels of involvement in procuring overseas organic tobacco, training staff at new overseas facilities, and participating in overseas trade shows. The Toll Agreement between SF Domestic and SF Int'l describes the companies as "independent contractors" and not "a partnership, agency, franchise, or joint venture." (Toll Agreement, DF MSD, Ex 17, p 14.) The former SF Int'l president asserted in an affidavit that SF Int'l "operated with a high level of autonomy" and separately arranged for the manufacture of products in overseas facilities. (Moranchnick Aff, PF MSD, Ex pp 41-42[4].) SF Int'l reimbursed RJR and SF Domestic for the services detailed in the services agreements at a rate above cost and paid royalties. Expert witnesses for RJR reported that these various services and the purchase of materials from RJR and SF Domestic met United States tax code parameters for arm's-length transactions. (Messick Dep PF MSD, Ex p 174; Manori Aff, Ex p 724; Manori Report, Ex p 728; Pomp Aff, Ex p 753.) One example of an arm's-length transaction is that SF Int'l reimbursed RJR for Tomlinson's salary and benefits during the time he worked in Zurich. Despite arranging services through RJR, SF Int'l also had its own marketing, human resources, information technology, and legal teams. (Moranchnick Dep, PF MSD, Ex p 43.) Tomlinson described SF Int'l's financial and human resources independence of the U.S. affiliates. (Tomlinson Dep, DF MSD, Ex 23, pp 45-46.) In its response to defendant's first set of interrogatories, RJR asserted that trade marketing services were not consolidated until 2017, and that SF Domestic previously managed its own trade marketing. (Interrogatory Response, DF MSD, Ex 3, pp 3-4.) Further, SF Domestic owned its own manufacturing facilities and, despite arranging tobacco purchases

[4] Because plaintiff's exhibits are not clearly labeled, the Court refers to page numbers in the electronically filed brief.

through RJR, worked directly with its organic tobacco suppliers. (SEC Form, DF MSD, Ex 2, pp 10, 34.) And RJR claimed in its interrogatory responses that SF Domestic used less than $100,000 in research and development services in 2013 and 2014, and only $168,000 in 2015. (Interrogatory Response, DF MSD, Ex 3, p 5.)

The voluminous and often contradictory evidence does not establish as a matter of law whether the nearly $5 billion gain is attributable to RJR's UBG under the Michigan CIT Act. Summary disposition cannot be granted to either party given these factual disputes.

VI. DOES IT VIOLATE THE DUE PROCESS OR COMMERCE CLAUSES FOR MICHIGAN TO TAX THE $5 BILLION GAIN?

Even if permitted under the CIT act, RJR contends that it violates the federal Due Process and Commerce Clauses for Michigan to assess any tax on the nearly $5 billion gain to SF Domestic from the sale of the international brand-name rights and trademarks. RJR contends that the international brand-name rights and trademarks never had any connection to Michigan because they were used to manufacture and sell NAS products in foreign countries and no part of the sale of these intangible assets occurred in Michigan.

"To survive a due-process challenge, there must be some definite link, ' "some minimum connection, between a state and the person, property or transaction it seeks to tax." ' " *Apex Labs Int'l, Inc v Detroit*, 331 Mich App 1, 4; 951 NW2d 45 (2020), quoting *South Dakota v Wayfair, Inc*, 585 US 162, 177; 138 S Ct 2080; 201 L Ed 2d 403 (2018), quoting *Miller Bros Co v Maryland*, 347 US 340, 344-345; 74 S Ct 535; 98 L Ed 744 (1954). This does not require physical presence. "[A] foreign corporation may be subject to a state's in personam jurisdiction without the requirement of a physical presence in the state if it 'purposefully avails itself of the benefits of an economic market in the forum State.' " *Apex Labs*, 331 Mich App at 5, quoting *Quill Corp v North*

Dakota, 504 US 298, 307; 112 S Ct 1904; 119 L Ed 2d 91 (1992), overruled in part on other grounds *Wayfair*, 585 US 162.

After recent changes effectuated by the United States Supreme Court, the first prong of a Commerce Clause challenge "simply asks whether the tax applies to an activity with a substantial nexus with the taxing State." *Wayfair*, 558 US at 188. "Such a nexus is established when the taxpayer or collector avails itself of the substantial privilege of carrying on business in that jurisdiction." *Id.* (cleaned up). The remainder of the test of constitutionality under the Commerce Clause considers whether the tax "(2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services the state provides." *Apex Labs*, 331 Mich App at 4.

These questions, too, involve intensive factual inquiries into the nature of RJR's and SF Domestic's businesses and their unitary nature. As described by the Michigan Supreme Court in *Vectren Infrastructure Servs Corp*, 512 Mich at 632, regarding the sale of one company in a UBG:

> Vectren and Justice ZAHRA's dissent argue that ML's [a Vectren subsidiary] sale price should not be included in the tax base because the value is attributable to tangible assets, intangible assets, and the goodwill accumulated primarily outside of Michigan. But the "linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp* [*v Comm'r of Taxes*], 445 US [425, 439; 100 S Ct 1223; 63 L Ed 2d 510 (1980)]. To show that income is earned outside the stream of the unitary business, ML must show that the challenged income "was earned in the course of activities *unrelated to*" the business activities it carried on in Michigan. *Id.* (emphasis added). A lone contention that the income source is from out of state does not suffice. See *id.* ("*Bass, Ratcliff & Gretton* forecloses the contention that the foreign source of the . . . income alone suffices for this purpose."). [Ellipsis in original.]

The many factual contests that preclude a summary resolution of whether the gain from the sale of the international brand-name rights and trademarks could be attributed to RJR's UBG under the Michigan CIT Act also preclude a summary ruling on whether there exist sufficient

connections to constitutionally tax this gain in Michigan. Accordingly, the parties' motions for summary disposition are also denied in this regard.

VII. WHERE DO THE SALE PROCEEDS BELONG IN THE TAX FORMULA?

Alternatively, RJR asks the Court to summarily determine that the nearly $5 billion gain should be included in the denominator of the sale factor, a number which includes the taxpayer's sales everywhere. RJR does not contend that this is statutorily mandated. Rather, it argues that including this gain in RJR's business income but not in the sales factor denominator results in an artificially skewed and unfair tax apportionment for Michigan.

As noted, a business's income is defined by MCL 206.603(3) simply as the taxpayer's "federal taxable income." The nearly $5 billion gain was reported as part of RAI's federal taxable income. However, the sale of international brand-name rights and trademarks does not fall within the definition of "sales" for purposes of the sale factor. See MCL 206.609(4).

A taxpayer may request an alternative method of allocation "[i]f the apportionment provisions of this part do not fairly represent the extent of the taxpayer's business activity in this state." MCL 206.667(1). It would be premature to reach this issue without first resolving whether the gain is taxable in Michigan as part of RJR's UBG in the first instance. The Court declines to reach this issue at this time.

VIII. CONCLUSION

The thousands of pages of documents presented by both parties reveal many open questions of material fact that preclude summary disposition in either party's favor. Trial is required to fully address whether the gain from SF Domestic's sale of the NAS international brand-name rights and

trademarks may be attributed to RJR's UBG in Michigan, both under the CIT Act and constitutionally. Accordingly, neither party is entitled to relief at this time and pretrial proceedings will continue.

IT IS ORDERED:

1. Both parties' motions for summary disposition under MCR 2.116(C)(10) are DENIED.

2. A status conference will be conducted via Zoom to schedule pretrial and trial dates. Court staff will contact the parties to schedule the conference.

3. The parties are encouraged to use self-instituted ADR.

IT IS SO ORDERED.

Date: December 11, 2024

James Robert Redford
Judge, Court of Claims