

**UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF WISCONSIN**

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**DIRECT SUPPLY, INC.,  
Plaintiff,**

**v.**

**Case No. 20-C-1095**

**UNITED STATES OF AMERICA,  
Defendant.**

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**DECISION AND ORDER**

Plaintiff Direct Supply, Inc., brings this action to obtain a refund of more than \$3 million in federal income taxes and interest that it paid in tax years 2011 through 2015. The issue is whether Direct Supply is entitled to claim a deduction for “domestic production activities” under former Section 199 of the Internal Revenue Code. The deduction generally applies to revenue earned from selling or licensing goods manufactured in the United States. However, with certain exceptions not relevant here, the deduction does not apply to revenue derived from services. In the present case, Direct Supply contends that its revenue from a business line that involved “e-procurement” software qualifies for the Section 199 deduction. The government disagrees, arguing that revenue derived from the business line was revenue derived from a service. Before me now are the parties’ cross-motions for summary judgment on this issue and Direct Supply’s collateral motion to supplement the summary-judgment record.<sup>1</sup>

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<sup>1</sup> The cross-motions also relate to a deduction Direct Supply claimed in connection with software known as TELS. This issue requires little discussion and will be separately addressed at the end of this order.

## I. BACKGROUND

Direct Supply is a Wisconsin corporation with headquarters in Milwaukee. Since its founding in 1985, Direct Supply has been a direct-mail supplier of housekeeping and maintenance equipment. Over time, Direct Supply's core business, known as Direct Supply Equipment & Furnishings, has become a supplier of virtually everything used or consumed in a nursing home, including food equipment, medical supplies, and furniture. Over the years, Direct Supply has added other business lines to its core business of selling supplies to nursing homes. One of those other business lines, known as Direct Supply DSSI (or simply "DSSI"), is the focus of this case. According to Direct Supply, DSSI is computer software that nursing homes and their suppliers use for ordering products over the Internet. According to the government, DSSI is not simply software. Although DSSI involves the use of software, the government contends that DSSI is a service offered by Direct Supply in which it creates and manages custom online marketplaces for nursing-home chains.

The general facts relating to DSSI are undisputed. Nursing-home companies that have multiple facilities across the United States use DSSI for "e-procurement," which is the use of computer software for buying and selling goods. In the case of DSSI, the software assists with buying and selling nursing-home supplies. It is an alternative to ordering goods from a supplier's paper catalog and receiving a paper invoice through the mail. Essentially, DSSI creates an electronic catalog of goods available from all the suppliers with which the nursing-home chain has procurement contracts. The goods listed in the electronic catalog are available at the prices that the chain's corporate headquarters separately negotiated with the suppliers under individual procurement contracts. When

an authorized individual at a particular nursing home needs to order supplies, he or she logs onto the DSSI system from a web browser, selects the desired products, and places an electronic order. The supplier then receives electronic notice of the order through DSSI. After the supplier ships the order, DSSI sends an electronic invoice to the appropriate employee of the nursing-home chain. In a nutshell, when used by a single nursing-home chain, DSSI is like an online marketplace that has been custom-made for the chain, in that it contains only products sold by the chain's chosen suppliers at the prices that the chain independently negotiated with each supplier.

The prior paragraph provides a rough overview of DSSI. But additional details about how the online marketplace is created and administered are relevant to determining whether revenue derived from DSSI is eligible for the Section 199 deduction. When a nursing-home chain decides to use DSSI, it must first sign a contract with Direct Supply. This contract is entitled "Application Service Provider Agreement." (ECF No. 37-3, hereinafter "Provider Agreement.") The Provider Agreement states that Direct Supply's "DSSI division" will "develop and administer a system to electronically receive orders from [the nursing-home chain's] owned and managed [nursing homes] and place such orders with designated . . . suppliers through electronic interfaces . . . for the purpose of processing [the chain's] procurement requirements and providing certain other data and services." (*Id.* at 1.) The electronic interface—that is, the chain's electronic catalog or marketplace—will be called something that reflects its association with the chain, with the suffix "Net." For example, if "Senior Living, Inc." is a hypothetical nursing-home chain, then the catalog or marketplace might be called "SeniorLivingNet." (To enhance

readability, when I quote from the Provider Agreement, I will use “Senior Living, Inc.” and “SeniorLivingNet” to fill in the placeholders that appear in the form.)

The Provider Agreement contains additional terms that pertain to the “development” of the nursing home’s e-procurement system. (*Id.* § 4.) Among these terms is Direct Supply’s obligation to “use reasonable efforts to undertake the development and operation of [SeniorLivingNet].” (*Id.* § 4.a.) Further, Direct Supply must “assign an implementation analyst to work with [Senior Living, Inc.], on a part time basis . . . to complete the integration necessary to meet [Senior Living, Inc.]’s Go-Live Date.” (*Id.* § 4.b.) Finally, the Agreement states that Direct Supply will “build out an electronic catalog” utilizing information provided by the nursing home’s suppliers. (*Id.* § 4.c.i.) Also relevant are the terms in the Agreement providing that Direct Supply “shall operate [SeniorLivingNet] for [Senior Living, Inc.]’s benefit to provide the services selected and paid for by [Senior Living, Inc.]” (*id.* § 5.a), and that Direct Supply “shall maintain a database for [Senior Living, Inc.] containing all order transaction information . . . to be processed by” Direct Supply (*id.* § 6).

The Provider Agreement has two key terms that relate to Direct Supply’s compensation. First, it states that, in exchange for Direct Supply’s providing “Standard Services” as set forth on a schedule attached to the agreement, the nursing-home chain agrees to pay Direct Supply a monthly “Maintenance Fee” that is calculated based upon the total number of beds managed by the chain and the number of facilities operated by the chain that order products through DSSI. (*Id.* § 2.a & Sched. A, Stip. Facts ¶ 44.) The schedule listing the Standard Services contains, among other things, the obligations of Direct Supply that I described in the previous paragraph. Second, the Agreement contains

terms obligating the nursing-home chain to process all its procurement requirements through the e-procurement system to the extent that it is feasible for the chain to do so. (Provider Agreement § 1.) Under this provision, Senior Living, Inc. would be required to procure all its supplies through SeniorLivingNet. As we will see, this provision ensures that Direct Supply will earn revenue from “Transaction Fees” paid by the chain’s suppliers.

After a nursing-home chain signs its contract with Direct Supply, Direct Supply begins working with the chain to get its suppliers to agree to sell their products through the chain’s e-procurement system. (Direct Supply Prop. Findings of Fact [“PFOF”] ¶ 17.) Once the chain identifies its specific suppliers, Direct Supply works with those suppliers to get them integrated into the system. (*Id.* ¶ 20.) As part of this process, Direct Supply requires suppliers to sign a separate agreement with it, called an “Electronic Commerce Supplier Agreement.”<sup>2</sup> (ECF No. 37-4, hereinafter “Supplier Agreement.”) Under this Agreement, the supplier must provide “Content Material” to Direct Supply that Direct Supply will add to the nursing-home chain’s electronic catalog. (*Id.* § 5.) Such material includes “graphics and text accurately describing the items sold by [the supplier], including all prices, code numbers, sizes, colors and other information concerning the Items reasonably required to allow orders for Items to be efficiently placed on and processed via [e-procurement websites].” *Id.*

The Supplier Agreement also has terms regarding Direct Supply’s fees. Two such fees are relevant here. The first is an “Implementation Fee,” which is a one-time fee

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<sup>2</sup> Some of the nursing-home chain’s suppliers might already have a contract with Direct Supply and be integrated into DSSI. If that is the case, Direct Supply simply connects the supplier to the chain’s e-procurement site. (Direct Supply PFOF ¶ 22.)

charged to a supplier for implementing it into DSSI. (*Id.* § 3.a.) Implementation Fees are waived if a supplier's total transaction volume over a specified starting period exceeds a certain threshold. (Stip. Facts ¶ 51.) Direct Supply rarely, if ever, charged suppliers Implementation Fees during the tax years at issue. (*Id.* ¶ 52.) The second fee is the "Transaction Fee," which is a percentage of the amount invoiced by a supplier for goods sold through the e-procurement system. (Supplier Agreement § 3.b.–c., Stip. Facts ¶ 53.) The Transaction Fee percentage is based upon a supplier's average order size for the previous calendar quarter. (Stip. Facts ¶ 54.) The average order size is determined independently for each nursing-home chain for which the supplier is a vendor. (*Id.* ¶ 55.) Moreover, the Transaction Fee varies depending on how particular goods were ordered and invoiced. (*Id.* ¶ 56.) If a nursing home ordered the supplier's goods through DSSI, and the supplier sent an invoice to the nursing home through DSSI, then the supplier is charged a full Transaction Fee. (*Id.* ¶¶ 29 & 57.) If, however, the nursing home ordered the supplier's goods outside of DSSI, such as by calling the supplier, but the supplier still submitted its invoice through DSSI, then the Transaction Fee is lower. (*Id.* ¶¶ 29–30, 57.) Such transactions are known as "invoice only" transactions. (*Id.* ¶ 29.) Transaction Fees for invoice-only transactions are lower because, "in theory, [Direct Supply is] only performing 50 percent of the service." (*Id.* ¶ 57.)

After both a nursing-home chain and its designated suppliers have signed contracts with Direct Supply, Direct Supply integrates that chain's suppliers into the e-procurement system, which enables nursing-home employees to view an electronic catalog that contains those suppliers' products. (Direct Supply PFOF ¶ 25.) The system is accessed using Direct Supply's software, which was developed by Direct Supply

employees working within the United States. (Stip. Facts ¶ 4.) However, Direct Supply does not provide the software to the nursing-home chain and its suppliers on tangible media (such as a disk) or by download over the Internet. Instead, the nursing homes and suppliers access the software by entering login credentials into web portals. (*Id.* ¶¶ 14 & 21.) The software is owned, hosted, maintained, and updated by Direct Supply. (*Id.* ¶¶ 71–72.)

Once logged into the software, a nursing-home employee can search through an online catalog of products that shows only products approved by the nursing-home chain's corporate headquarters. (*Id.* ¶ 19.) The employee may select items by placing them into a virtual shopping cart. (*Id.* ¶ 20.) Once an order is placed, the software transmits a purchase order to the supplier. (*Id.*) The supplier fulfills the order by shipping the items to the nursing home. (*Id.* ¶ 22.) The supplier then transmits an electronic invoice to the nursing home through the software. (*Id.* ¶ 23.)

The DSSI software has various features that nursing-home chains and suppliers can use to manage the procurement process. For nursing-home chains, those features include, among other things, price auditing functions (comparing the price invoiced by the supplier with the price shown on the purchase order submitted by the provider), purchase order approvals (requiring approvals for certain types of orders or orders above a certain amount), formulary management (managing what is available for purchase by individual nursing homes), and operational reports. (Stip. Facts ¶ 32.) Suppliers, in turn, can use the software to access purchase orders, invoices, and payment history; view and control access to the suppliers' online catalog of goods; run "customizable reports" that display

sales information; and access a “best practices” resource page that offers advice on how to maximize sales, including through “cross selling and up selling.” (*Id.* ¶ 33.)

In some circumstances, Direct Supply provides direct customer support to nursing homes and suppliers that use DSSI. (Stip. Facts ¶ 34.) For example, DSSI’s Transaction Management Team provides direct customer support when “exceptions” arise from the processing of invoices. (*Id.* ¶ 35.) An exception occurs, for example, when there is a discrepancy between the price stated in the purchase order submitted by the nursing home and the price specified by the supplier in the invoice, or when there is a technical issue with the transmission of a purchase order or invoice through DSSI. (*Id.* ¶ 36.) For these and other exceptions, Direct Supply has a Transaction Management Team member resolve the problem by working with the nursing home and the supplier. (*Id.* ¶ 37.) During the tax years at issue, Direct Supply did not charge fees for any services provided by DSSI’s Transaction Management Team. (*Id.* ¶ 38.) Direct Supply’s Customer Advocacy Team also provides direct customer support to nursing homes and suppliers. (*Id.* ¶ 39.) Members of the Customer Advocacy Team serve as a “one stop” shop for any customer service needs, including helping with software glitches, integrating new suppliers onto DSSI, and adding new facilities to provider accounts. (*Id.* ¶ 40.) During the tax years at issue, Direct Supply did not charge fees for any services provided by the Customer Advocacy Team. (*Id.* ¶ 41.)

For each of the tax years at issue, roughly 95% of the fees generated by DSSI came from the Transaction Fees paid by suppliers. (Stip. Facts ¶ 63.) The remainder of the fees generated by DSSI came from the monthly Maintenance Fees paid by nursing homes, training fees, and other “special projects.” (*Id.*) During the tax years at issue,



Direct Supply did not charge nursing-home chains or suppliers any subscription fees for DSSI. (*Id.* ¶ 74.)

In the present action, Direct Supply contends that the revenue that it derived from DSSI during tax years 2011 through 2015 is deductible under Section 199 because the software on which DSSI is based was developed in the United States. Direct Supply initially filed federal income tax returns for tax years 2011–13 that did not claim the deduction. However, in 2015 and 2016, Direct Supply filed amended returns for the 2011–13 tax years that claimed the deduction. Direct Supply also filed federal returns for tax years 2014 and 2015 that claimed the Section 199 deduction. On June 3, 2019, the IRS issued a notice disallowing Direct Supply’s claims for a refund for tax years 2011 through 2013 and a notice of deficiency disallowing Direct Supply’s Section 199 deductions for 2014 and 2015. Direct Supply then paid the taxes in question and, after exhausting its administrative remedies with the IRS, commenced the present action. Direct Supply seeks a refund in the amount of \$3,462,928, which represents the federal income taxes and interest it paid due to the IRS’s disallowance of the Section 199 deduction.

The parties have filed cross-motions for summary judgement on whether the revenue derived from DSSI is deductible under Section 199. Direct Supply has also filed a separate motion to supplement the summary-judgment record with a declaration that it obtained after filing its initial briefs. I consider these matters below.

## **II. DISCUSSION**

Summary judgment is required where “there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law.” Fed. R. Civ. P. 56(a). When considering a motion for summary judgment, I view the evidence in the light

most favorable to the non-moving party and must grant the motion if no reasonable juror could find for that party. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248, 255 (1986).

“[T]ax deductions are ‘a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer.’” *VHC, Inc. v. Comm’r*, 968 F.3d 839, 841 (7th Cir. 2020) (quoting *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79 (1992)). Thus, for purposes of summary judgment, Direct Supply has the burden of presenting admissible evidence sufficient to establish at least a genuine dispute as to each element of its claim for a Section 199 deduction. See *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986).

#### **A. The Former Section 199 Deduction**

Section 199 of the Internal Revenue Code, which was enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, created an income tax deduction for certain revenue derived from goods produced in the United States. 26 U.S.C.A. § 199 (West 2015).<sup>3</sup> The purpose of the deduction “was to encourage investment in domestic manufacturing facilities and the creation and preservation of U.S. manufacturing jobs.” *AT&T Advertising, L.P. v. United States*, 147 Fed. Cl. 478, 483 (2020).

Section 199 allowed a taxpayer to deduct, subject to a limitation based on domestic wages paid, an amount equal to 9 percent of the lesser of the taxpayer’s “qualified production activities” or overall taxable income. 26 U.S.C.A. § 199(a)(1). Income from qualified production activities was generally defined as the amount of the taxpayer’s

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<sup>3</sup> Section 199 was repealed effective December 31, 2017. See Pub. L. No. 115-97, Title I, § 13305, 131 Stat. 2054 (2017).

domestic production gross receipts<sup>4</sup> minus allocable expenses and/or costs of goods sold. *Id.* § 199(c). As is relevant here, domestic production gross receipts included gross receipts of the taxpayer that were “derived from” the “lease, rental, license, sale, exchange, or other disposition of qualifying production property<sup>5</sup> which was manufactured, produced, grown, or extracted<sup>6</sup> in the United States.” *Id.* § 199(c)(4)(A)(i).

Qualifying production property includes “any computer software.” *Id.* § 199(c)(5)(B). For the most part, gross receipts derived from services are not eligible for the Section 199 deduction. However, there are exceptions for gross receipts derived from certain engineering, architectural, and construction services performed in the United States. *Id.* § 199(c)(4)(A)(ii)–(iii). Those exceptions are not applicable here.

When it enacted Section 199, Congress authorized the Department of the Treasury to promulgate “such regulations as are necessary to carry out” its purposes. 26 U.S.C.A. § 199(d)(10). The Treasury Regulations further define what it means for gross receipts to be “derived from the lease, rental, license, sale, exchange, or other disposition” of qualifying production property. See 26 C.F.R. § 1.199-3(i)(1)(i) (March 7, 2008). The Regulations state that, to qualify for the deduction, the gross receipts must have been “directly derived” from the disposition of the qualifying production property. *Id.* Further, they state that “[a]pplicable Federal income tax principles apply to determine whether a

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<sup>4</sup> In the Treasury Regulations pertaining to Section 199, “domestic production gross receipts” is abbreviated as DPGR. See 26 C.F.R. § 1.199-3(a) (2015).

<sup>5</sup> The Treasury Regulations abbreviate “qualifying production property” as QPP. See 26 C.F.R. § 1.199-3(a)(1)(i).

<sup>6</sup> The Treasury Regulations abbreviate “manufactured, produced, grown, or extracted” as MPGE. See 26 C.F.R. § 1.199-3(a)(1)(i).

transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.” *Id.* The Regulations reiterate that, except for architectural, engineering, and construction services, “gross receipts derived from the performance of services do not qualify” for the deduction. *Id.* § 1.199-3(i)(4)(i)(A). The Regulations further state that, in the case of an “embedded service,” that is, “a service for which the price, in the normal course of the taxpayer’s business, is not separately stated from the amount charged for the [disposition] of [qualifying production property],” the deduction is available only for the gross receipts derived from the disposition of the qualifying production property, and not for the gross receipts attributable to the embedded service. *Id.*

The Regulations contain provisions relating to computer software. See 26 U.S.C. § 1.199-3(i)(6). Like Section 199 itself, the Regulations state that domestic production gross receipts include receipts derived from the lease, rental, license, sale, exchange, or other disposition of computer software produced in the United States. *Id.* § 1.199-3(i)(6)(i). Such gross receipts qualify “even if the customer provides the computer software to its employees or others over the Internet.” *Id.* However, the Regulations specify that gross receipts derived from computer-related services, such as “customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services,” are not deductible under Section 199. *Id.* § 1.199-3(i)(6)(ii).

After stating that receipts derived from computer-related services are not deductible under Section 199, the Regulations provide that, notwithstanding that

prohibition, gross receipts derived from providing customers with access to online software are deductible if software that is substantially identical to the online software has been provided to customers either affixed to a tangible medium (such as a disk) or by allowing customers to download the software from the Internet. Because this provision is relevant to the present case, I quote it in full:

**(iii) Exceptions.** Notwithstanding paragraph (i)(6)(ii) of this section, if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as being derived from the lease, rental, license, sale, exchange, or other disposition of computer software only if—

(A) The taxpayer also derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the lease, rental, license, sale, exchange, or other disposition to customers that are not related persons (as defined in paragraph (b)(1) of this section) of computer software that—

(1) Has only minor or immaterial differences from the online software;

(2) Has been MPGE by the taxpayer in whole or in significant part within the United States; and

(3) Has been provided to such customers either affixed to a tangible medium (for example, a disk or DVD) or by allowing them to download the computer software from the Internet; or

(B) Another person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section) (as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(3) of this section.

*Id.* § 1.199-3(i)(6)(iii). Subparagraph (iii)(A) applies when the taxpayer has provided software to customers on tangible media or over the Internet, while subparagraph (iii)(B) applies when a third-party has provided software to customers on tangible media or over

the Internet. For these reasons, Subparagraph (iii)(A) is known as the “self-comparable exception,” while Subparagraph (iii)(B) is known as the “third-party comparable exception.” See *BATS Global Mkts. Holdings, Inc. v. Comm’r*, 158 T.C. No. 5, 2022 WL 970316, at \*14 (2022), *appeal docketed*, No. 22-9009 (10th Cir. Aug. 19, 2022).

**B. Whether Gross Receipts Derived from DSSI Are Deductible Under Former Section 199**

The issue presented is whether the revenue that Direct Supply derived from DSSI was revenue “derived from” the “lease, rental, license, sale, exchange, or other disposition” of computer software. 26 U.S.C.A. § 199(c)(4)(A)(i); 26 C.F.R. § 1.199-3(i)(6)(i). The parties agree that the DSSI software was manufactured, produced, grown, or extracted in the United States (Stip. Facts ¶ 4), and so if the revenues at issue were derived from the disposition of the software, they qualify for the Section 199 deduction. Direct Supply contends that the revenues it derived from DSSI—namely, the Maintenance Fees charged to nursing-home chains and the Transaction Fees charged to suppliers—were derived exclusively from a “license” or “sale” of the DSSI software. The United States, in turn, contends that such fees were derived from Direct Supply’s having provided a service to nursing-home chains and their suppliers, namely, the creation and maintenance of a custom online marketplace based on the procurement contracts in force between the chain and its suppliers.

I conclude that the evidence in the record establishes that the revenues derived from DSSI were derived from the provision of a service rather than from a license or rental of software. Direct Supply did not simply rent or license software to a nursing-home chain or supplier and then leave the customers to use the software as they saw fit. Instead, Direct Supply created and maintained a customized online marketplace for the chain and

its suppliers. Services were involved in every step of this process. When the chain initially signed the Provider Agreement, DSSI rendered the service of developing a branded web portal for the chain (e.g., SeniorLivingNet). (Provider Agreement § 4.) Implementing the web portal involved assigning an “implementation analyst” to work with the chain on a part-time basis to meet the chain’s “Go-Live Date.” (*Id.* § 4.b.) Implementation also involved Direct Supply’s employees working with the chain to get the chain’s suppliers to agree to sell their products through DSSI. (Direct Supply PFOF ¶ 17.) Once the chain identified its suppliers, Direct Supply performed the legwork of getting those suppliers to agree to sell their products through DSSI. (*Id.* ¶ 20.) As part of that process, Direct Supply negotiated separate Supplier Agreements with each supplier. After the supplier provided Direct Supply with “Content Material” relating to its products, Direct Supply performed the service of uploading that material to DSSI and integrating it into the nursing-home chain’s electronic catalog. (Supplier Agreement § 5; Stip. Facts ¶ 10.) Once the e-procurement system was set up, Direct Supply continued to render services by operating the web portal for the nursing-home chain’s benefit (Provider Agreement § 5.a), adding new suppliers to the electronic catalog as needed (Stip. Facts ¶ 40), storing order transaction information about the orders processed through the system (*id.* ¶ 33, Provider Agreement § 6), and providing ongoing customer and technical support (Stip. Facts ¶¶ 34–41). *See also id.* ¶ 73 (“Direct Supply maintains its relationships with senior living providers and suppliers throughout the period of time in which they use DSSI.”). In short, Direct supply derived revenue from creating and maintaining customized online marketplaces for its customers, not from renting or licensing software to them.

It is true that computer software developed in the United States was used to run the customized online marketplaces. However, no revenues were “derived from” a “license” or “rental” of the software to nursing-home chains or their suppliers (or anyone else). Direct Supply contends that revenues were derived from a “license” or “rental” of software because Direct Supply necessarily granted permission for nursing homes and suppliers to use its online software for e-procurement. However, even if Direct Supply in some sense “licensed” online software to nursing homes and suppliers as part of its DSSI business by granting them permission to use the software, it would not follow that Direct Supply *derived revenue* from such licensing. Direct Supply did not charge nursing homes or suppliers any fees that were explicitly described as licensing fees or fees charged for access to software. (See Stip. Facts ¶ 74.) What Direct Supply describes as “licensing” was nothing more than providing login credentials to users (Br. in Supp. at 14, ECF No. 40 at 16 of 33), which is something that nearly every online service does. For example, to bank online, a bank customer must log into a bank’s website. To make a purchase on Amazon, a customer must log into Amazon.com. To read a newspaper or a journal online, a subscriber must log into the publication’s website. In all these instances, the online service could be said to have “licensed” access to its software in the same sense that Direct Supply “licensed” DSSI software to nursing homes and their suppliers. Yet no one would contend that the revenues earned by an online bank, Amazon.com, or an online newspaper were derived from licensing software. Indeed, the Treasury Regulations specifically identify the revenues derived from these kinds of online services as revenues that do not qualify for the Section 199 deduction. 26 C.F.R. 1.199-3(i)(6)(ii).



Direct Supply attempts to distinguish DSSI from these online services by contending that DSSI is a form of “Software as a Service.” (Br. in Supp. at 19–22, ECF No. 40 at 24 of 33.) “Software as a Service” or “SaaS” is a way of obtaining access to software. To access SaaS software, a customer does not purchase the software on tangible media (such as a disk) or download it to his or her own computer hardware over the Internet. Instead, the customer accesses the software by connecting to the SaaS provider’s servers over the Internet. See *Dardashtian v. Gitman*, No. 17-CV-4327, 2021 WL 746133, at \*4 n.16 (S.D.N.Y. Feb. 16, 2021). At all times, the software is hosted on the SaaS provider’s servers rather than on the customer’s computer hardware. Because of this, SaaS is sometimes called “hosted software” or “Web-based software.” See Salesforce.com, “What is SaaS?”, <https://www.salesforce.com/in/saas/> (accessed Oct. 18, 2022). Also, because SaaS is typically purchased through a subscription rather than through a permanent sale, SaaS is sometimes referred to as “on-demand software.” See *id.*

Direct Supply contends that at least some SaaS providers derive revenue by “licensing” or “renting” their software to users over the Internet and thus could qualify for the Section 199 deduction if the software was developed in the United States and satisfies the other elements of the deduction. Here, however, I do not need to determine whether Direct Supply is right. That is so because, even if some SaaS providers derive revenue from “licensing” or “renting” software, the record in the present case establishes that Direct Supply did not. As I’ve already discussed, DSSI was a service that involved creating and maintaining a customized online marketplace for nursing-home chains and their suppliers. DSSI was not simply software that nursing-home chains or suppliers could

access and then use without Direct Supply's implementation and ongoing maintenance services. A nursing-home chain could not, for example, purchase access to DSSI software and then have its own IT department work with the chain's suppliers to get their products integrated into an online catalog that was run on licensed DSSI software but managed by the chain's IT department. This makes DSSI unlike the example of SaaS that Direct Supply mentions in its brief: word-processing software. (Br. in Supp. at 20, ECF No. 40 at 22 of 33.) When a customer purchases access to word-processing software, he or she can use the software to create documents without further assistance from the software supplier. DSSI software, however, would be useless without Direct Supply's ongoing services of working with providers and suppliers to create and maintain the customized online marketplace. This is another reason why DSSI is akin to online services such as banking and online shopping: software for banking and online shopping would be useless without the bank or the marketplace host constantly facilitating transactions between the counterparties that use the software. See also *BATS Global Mkts.*, 2022 WL 970316, at \*16 (finding that transaction fees charged to users of securities-trading software were not derived from a disposition of software but from providing "trade execution services" that involved locating counterparties for trades).

Direct Supply also attempts to draw a distinction between software that is accessed "for its own sake," on the one hand, and software that "enables an online service," on the other. (Br. in Supp. at 21, ECF No. 40 at 23 of 33.) Direct Supply contends that the former is eligible for the Section 199 deduction while the latter is not. As part of this argument, Direct Supply contends that, if software is used merely as means to an end—such as to read an online newspaper—rather than for its own sake, then it is

software that enables an online service. But this is a distinction that does not exist. No one accesses software for the sake of doing nothing more than interacting with software. *All* users of software have some other purpose in mind, whether it be to read the newspaper, draft a document, or order products. Direct Supply seems to argue that, if the software is accessed for its “features and its value to the customer” (*id.* at 22), then it is accessed for its own sake rather than for some other purpose. But again, *all* software is accessed for its features and value to the customer. A person who uses online software to read the newspaper does so because he or she finds it more convenient, efficient, or cost-effective than obtaining a print copy. Similarly, a company that uses a customized electronic catalog to order nursing-home supplies does so because it finds e-procurement more convenient, efficient, or cost-effective than using a paper catalog. And both kinds of software could be used for their “features.” Perhaps the person using software to read the newspaper does so because the software has a feature that recommends articles based on the person’s reading history. This would be similar to a nursing-home employee using DSSI for its features, such as the ability to access past order information. Thus, Direct Supply’s proposed distinction between software used for its own sake and software used to achieve another purpose does not support its argument that DSSI involved a license or rental of software.

Direct Supply also contends that, if DSSI is an online service, then it qualifies for the third-party-comparable exception because other companies have made their e-procurement software available to customers by download over the Internet. See 26 C.F.R. § 1.199-3(i)(6)(iii). The third-party comparable exception (and the self-comparable exception, which Direct Supply does not invoke) extends the Section 199 deduction to

software that is accessed over the Internet when it is also provided to customers either on tangible media or by allowing customers to download the software over the Internet. A threshold requirement for either of these exceptions, however, is that the taxpayer “derive[] gross receipts from providing customers access to computer software . . . for the customers’ direct use while connected to the Internet.” *Id.* Direct Supply’s customers do access DSSI while connected to the Internet. However, as explained above, Direct Supply does not *derive gross receipts* from providing access to DSSI over the Internet. Instead, Direct Supply derives revenue from providing the services involved in creating and maintaining customized online marketplaces for nursing-home chains and their suppliers. Again, the mere fact that customers access Direct Supply’s online software while using these services does not convert the services into a provision of software for the customers’ direct use, just like a bank customer’s accessing the bank’s online software to complete an online banking transaction does not convert the banking transaction into a provision of software to the customer. *See also BATS Global Mkts.*, 2022 WL 970316, at \*17 (“Petitioner is an operator of securities exchanges. The fact that the Exchanges use software to operate does not convert petitioner’s trade execution services into the provision of software for customers’ direct use.”). Thus, the Treasury exceptions that treat software accessed over the Internet equivalently to software provided on physical media or by download do not apply to DSSI. No matter how DSSI is provided to or accessed by customers, the customers are not paying fees for the software itself. They are paying fees for Direct Supply’s services involved in creating and maintaining the customized online marketplace.

Because Direct Supply cannot meet the threshold requirement for the third-party-comparable exception, I need not decide whether the third-party software platforms at issue—Ariba, Basware, Ivalua, Wallmedien, and Zycus—are substantially identical to DSSI or made available on tangible media or by download. This, in turn, renders moot Direct Supply's motion to supplement the summary-judgment record. That motion asks me to consider a late-filed declaration from a Basware executive who states that Basware generated gross receipts from licensing Basware e-procurement software to customers who downloaded it from the Internet. (Decl. of Marcia Alonzo ¶¶ 1–2, ECF No. 48-1 at 2.) Because Direct Supply did not generate gross receipts from making DSSI available to customers in any format, the fact that Basware may have been available via download is irrelevant. Accordingly, Direct Supply's motion to supplement the record will be denied.

In short, the only reasonable conclusion that can be drawn from the evidence in the record is that the gross receipts derived from DSSI were derived from the provision of a service rather than from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, the IRS properly disallowed Direct Supply's Section 199 deductions for tax years 2011 through 2015. The United States' motion for summary judgment on this issue will be granted, and Direct Supply's cross-motion will be denied.

**C. Section 199 Deduction for TELS Software**

During tax years 2011 through 2015, Direct Supply claimed the Section 199 deduction for revenues it derived from software known as TELS. (U.S. Resp. to Direct Supply PFOF ¶ 93.) TELS is not part of DSSI. It is a separate computer program that Direct Supply provides to nursing homes to use for building management. (*Id.* ¶ 92.) TELS was manufactured or produced in whole or significant part in the United States. (*Id.* ¶ 94.)

Further, the government concedes that the revenues derived from TELS were properly claimed as deductible under Section 199 on Direct Supply's tax returns for 2011 through 2015. (*Id.* ¶ 95.) Thus, Direct Supply is entitled to summary judgment on this issue.

Although the government concedes that Direct Supply properly claimed the Section 199 deduction with respect to the revenues derived from TELS, it contends that this should not prevent the court from entering summary judgment on all claims. That is so, the government contends, because allowing the deduction for TELS alone (and not also DSSI) would not reduce Direct Supply's overall tax liability sufficiently to entitle it to a refund for the tax years at issue. However, at the parties' request, the court bifurcated proceedings relating to the deductibility of DSSI and TELS revenue from proceedings relating to the calculation of any refund. (Joint Rule 26(f) Report at 4–5, ECF No. 15.) Because I have granted summary judgment to Direct Supply regarding the deductibility of TELS revenue, the parties now have additional time in which to (a) conduct discovery limited to the refund-calculation issue and (b) attempt to stipulate to the amount of the overpayment to be refunded to Direct Supply. (*Id.*) Accordingly, it would be premature for me to decide that the deductibility of TELS revenue does not entitle Direct Supply to a refund. I will deny the United States' motion for summary judgment on this issue. The parties shall have 60 days to conduct discovery on whether the TELS deduction results in a refund and, if so, the amount of the refund. At the end of 60 days, the parties must file either a stipulation resolving this issue or renewed motions for summary judgment.

### III. CONCLUSION

For the reasons stated, **IT IS ORDERED** that the United States' motion for summary judgment (ECF No. 34) is **GRANTED** on the issue of the deductibility of

revenues derived from DSSI but **DENIED** on the issue of whether the deductibility of TELS revenues results in a refund.

**IT IS FURTHER ORDERED** that Direct Supply's motion for partial summary judgment (ECF No. 39) is **DENIED** on the issue of the deductibility of revenues derived from DSSI but **GRANTED** on the issue of the deductibility of revenues derived from TELS.

**IT IS FURTHER ORDERED** that Direct Supply's motion to supplement the summary-judgment record (ECF No. 47) is **DENIED** as **MOOT**.

**FINALLY, IT IS ORDERED** that the parties shall have until **December 19, 2022**, to conduct discovery on whether the TELS deduction results in a refund and to either stipulate to a resolution of this issue or file renewed motions for summary judgment.

Dated at Milwaukee, Wisconsin, this 18th day of October, 2022.

/s/Lynn Adelman  
LYNN ADELMAN  
United States District Judge