

Technology Law Analysis

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MAKE IN INDIA: DEMYSTIFYING THE APPLICABILITY OF PROCUREMENT ORDERS TO SOFTWARE PRODUCTS

BACKGROUND

The Make in India ("MII") policy was initiated to encourage Indian and global companies to increase the development, production, manufacturing, and assembly of products made in India, "to transform India into a global design and manufacturing export hub"¹. The larger objective of the policy is to create a conducive framework to promote foreign investments into the manufacturing sector and develop a robust infrastructure to support such foreign capital entering newly opened sectors, and to enhance income and employment within India.²

In furtherance of this policy objective, the Department of Industrial Policy and Promotion ("DPIIT") of the Ministry of Commerce and Industry, issued the Public Procurement (Preference to Make in India), Order 2017³ [modified by revision orders dated June 04, 2020⁴, and September 16, 2020⁵] (**General Order**).⁶

The DPIIT noted that the government procurement through tenders (through its various ministries and departments) could significantly contribute towards the objectives of the MII program; if preference is given to local goods or services (in India). Therefore, the General Order, introduced a purchase preference for goods and services having a higher extent of *Local Content*.⁷

Given that value addition chains applicable to various products and services may vary depending on the Government's procurement requirements, the DPIIT's General Order enables Nodal Ministries to specify methods of determining local content through separate MII procurement preference orders ("**MII-PP Orders**")

Due to rapid strides in digitalisation and technology adoption across the public and private sector, India is a massive market engaged in both, (i) the research, development, and manufacturing of software products; as well as (ii) the sale of software products.⁸ Resultantly, the Government's own procurement requirements for software products has increased significantly over the past decade.

However, for both Indian and foreign Multi-national companies ("**MNCs**") significant uncertainty remains over the applicability of the MII requirements under the General Order of the DPIIT and orders of the other Nodal Ministries. This is primarily due to the unique nature of software development activities, which do not render themselves to any one method of determining local value addition. Since the DPIIT's General Order, does not specify any particular factors for determining local content in software products, several MNCs continue to face issues with determining and self-certifying the percentage of local content in their software products.

Notably, while the Ministry of Electronics and Information Technology ("**MeitY**"), the Nodal Ministry for the purposes of prescribing methods of determining local content in information technology and software products, has issued separate MII-PP Orders applicable to cyber security products and hardware products – it has yet to specify mechanisms for determining local content in software products.

Similarly, other MII-PP Orders, such as the MII-PP Order for the procurement of telecom goods, services or works issued by the Department of Telecommunications ("**DoT**"), cover software products (e.g. encryption). But they refer to the stipulations contained in the General Order for the purposes of determining local content.

In this paper, we analyse the relevant MII-PP Orders issued by the DPIIT, DoT and MeitY, in order to identify methods of determining local content in software products. Further, we identify how these methods would be applicable to various business models for selling software products in India, and discuss the implications for each business model in terms of qualifying as a "local supplier" for the purposes of the MII-PP Orders, and other implications from a taxation perspective.

APPLICABILITY AND OPERABILITY OF THE MII-PP ORDERS

The applicability of the General Order and other MII-PP Orders is dependent on the terms and conditions of each specific tender. Therefore, based on the scope of products sought to be procured by the Government and the specific conditions of the tender, the bidder entity will need to identify applicable order.

- Where separate *Local Content* criteria has been notified by the relevant Nodal Ministry specific MII-PP Orders issued by the relevant Nodal Ministries (i.e., relevant to the said goods being procured) will apply.
- In other cases, the criteria specified under the General Order would continue to apply.

Both the General Order and other MII-PP Orders set out two classes of *Local Suppliers*, based on the percentage of

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the *Local Content* in their products, i.e., Class I and Class II suppliers. The manner in which the General Order, and existing MII-PP Orders issued by the MeitY define “local suppliers”, and regulate purchase preferences, has been set forth below:

i. **General Order of the Department for Promotion of Industry and Internal Trade (“DPIIT”):**

The General Order requires procuring agencies to provide a preference to bids obtained from Class-I and Class-II Local Suppliers, such that (a) if lowest bid (referred to as “**L1**”) is by a Local Supplier, then the contract for the full quantity is awarded to the L1; (b) if the L1 bid is not by a Local Supplier, 50% of the order quantity is awarded to the L1, and the remaining 50% is offered to the lowest bidder amongst the Local Suppliers willing to match the L1 price (provided that the Local Supplier’s quoted price falls within margin of purchase preference, i.e., the maximum extent to which the quoted price of the Local supplier may be above the L1 for the purpose of purchase preference). If the lowest eligible Local Supplier fails to match the L1 price or accepts less than the offered quantity, the next higher local supplier is invited to match the L1 price, and so on.

A supplier or service provider whose goods, services, or works offered for procurement has a local content equal to or more than 50% percent, is classified as a “Class-I Local Supplier.” When such local content is more than 20% but less than 50%, such supplier or service provider will be considered to be a “Class-II Local Supplier”. Bids from Class-I Local Suppliers are provided a higher preference than those received from Class-II Local Suppliers.

The General Order defines “local content” **as the amount of value added in India, which is equal to the total value of the item procured (excluding net domestic indirect taxes) less the value of imported content in the item (including all applicable customs duties) as a proportion of the total value of the product.**⁹

ii. **Specific Public Procurement (Preference to Make in India) Orders from the relevant Nodal Ministries for certain types of products:**

Public Procurement (Preference to Make in India) Order 2017 for Electronic Products (dated September 7, 2020)¹⁰ (**Electronic Products MII-PP Order**): The MeitY’s Electronic Products MII-PP Order follows the purchase preference mechanism set forth in the General Order (i.e. greater preference to lowest bidder amongst *Local Suppliers*, as opposed to lowest non-local bidder). However, the Electronic Products MII-PP Order **specifies separate component by component approach in the determination of Local Content for specifically identified categories of hardware products such as hard disk drives, memory modules, input devices, etc.**

Each product category has an associated metric for determining local content, which typically includes domestic assembly and testing, and in certain cases a minimum percentage of locally manufactured components (e.g., for Switched Mode Power Supply (**SMPS**) units for thin-clients, value of domestic assembly and testing is considered as *local content*, subject to the condition that 20% of the components assembled have to be locally manufactured). For the value of design and development of certain products (such as cellular mobile phones) to be included towards *Local Content*, the associated intellectual property (**IP**) needs to be localised in India.

Generally, the requirement for locally manufactured components has been avoided for most hardware products, given an inadequate domestic supply base for semiconductor fabrication in India. The Electronic Products MII-PP Order notes that some of the criteria may be revisited once semiconductor fabrication is feasible.

Notably the Electronic Products MII-PP Order is applicable exclusively for the procurement of the specific categories of hardware products listed in the Order.

Public Procurement (Preference to Make in India) Order 2017 Notification Regarding Procurement of Telecom Goods, Services or Works (dated August 31, 2021)¹¹ (**Telecom Products MII-PP Order**): The Telecom Products MII-PP Order retains the purchase preference mechanism and local content determination criteria set forth under the General Order, and extends it to a list of 25 product categories. Resultantly, the Telecom Products MII-PP Order provides no additional guidance on determining local content for software products (such as Unified Threat Management/ Encryption platforms) identified in the Order. Similar to the Electronic Products MII-PP Order, the Telecom Products MII-PP Order acknowledges the lack of an adequate domestic supply base for semiconductor fabrication in India. Resultantly, any value addition from domestic assembly and testing of printed circuit boards, is included within the scope of *Local Content*.

Public Procurement (Preference to Make in India) Order 2019 for Cyber Security Products (dated December 06, 2019)¹² (**Cyber Security Products MII-PP Order**): Similar to the Electronic Products MII-PP Order, the Cyber Security Products MII-PP Order retains the purchase preference mechanism set forth under the General Order. However, the Cyber Security Products MII-PP Order prescribes an approach to ascertain IP ownership, for the determination of *Local Content*.

The Cyber Security Products MII-PP Order stipulates that the intellectual property (“**IP**”) rights of the product needs to be owned by the Indian entity such that (a) it has the right to use and commercialize without third party consent, distribute, and modify the products; (b) and the total licensing / royalty fees being paid by the manufacturer to a third party should not exceed 20% of the total cost of the product.

For cyber security products which contain multiple components (hardware and software) the minimum local content should ordinarily be 60% of the total *cost* of the product, in addition to satisfying the IP related conditions applicable to software components.

While the requirements for *Local Content* set out in the Cyber Security Products MII-PP Order could potentially have provided insight into determining *Local Content* requirements for software products, the MeitY has itself limited the applicability of the Cyber Security Products MII-PP Order to a specific list of products which have been enumerated in the Annexure to the Order. As such, it would seem that MeitY itself does not consider the *Local Content* requirements under the Cyber Security Products MII-PP Order as being applicable to other software products.

Due to their global presence, MNCs typically hold IP in offshore entities, while the research and development may happen in India. The offshore entity, in turn, enters into agreements with their Indian subsidiaries (at arm's length pricing, following transfer pricing rules) under which the Indian subsidiary either gets license to the IP subsisting in software product or distribution rights in relation to the software product. Therefore, it will be important to understand whether locally incurred costs (such as costs of employment and R&D in India) will be relevant to determining local content.

A plain reading of the terms of the General Order, does not clarify whether the local content determination needs to be made on the basis of: (a) locally incurred costs by the Indian subsidiary for development of the software product, as a percentage of the costs of developing a software product; (b) locally retained sales proceeds by the Indian subsidiary as a percentage of the selling price of the software product to the government; or some other metric.

There also lack of clarity around the applicability of the General Order to the procurement of cloud services. Prior to the issuance of the General Order, cloud procurement by the Government was guided by the GI Cloud (MeghRaj) Guidelines, which continues to be in effect, and requires empanelled cloud providers to locally incorporate, localize data centre facilities, and adhere to data residency requirements for storage and processing of data.¹³ Subsequent to the issuance of the General Order, procurement of cloud services entails an additional requirement to determine local content. The GI-Cloud (MeghRaj) Guidelines already require cloud service providers to localize both data centres and data processing activities – therefore it is unclear if this would be sufficient for the purposes of meeting the *local content* requirement under the General Order – or whether cloud service providers would need to demonstrate certain other cost/price-based factors in order to qualify as Local Suppliers.

While the DPIIT has not issued any formal/written clarifications in this regard, based on bids that have been already been validated by the Government, the emerging consensus amongst the industry on the issue of determining local content in software products is based on the selling price of each unit of the software product.

Resultantly, for the purposes of determining non-local content for software products, bidders may take into account the 'royalty'/other price-components paid per product by the bidding entity to any overseas entity, as a percentage of the selling price of the software product (i.e. the price charged of the Government buyer by the bidding entity).

For example, if the price of a single user license for a payroll management software is INR 1,00,000 – then in order to qualify as a Class-I Local Supplier the amount of royalties payable to the offshore entity on account of providing the user license to the procuring agency, should not be more than 50% of the price of the user license, i.e. INR 50,000 (*because the localization requirement for a Class-I Local Supplier is above 50%*).

Similarly, in order to qualify as a Class-II Local Supplier, the amount of royalty payable to the offshore entity should not be more than 80% of the price of the user license, i.e. INR 80,000 (*because the localization requirement for a Class-II Local Supplier is between 20% to 50%*).

Given that this "selling price" based approach has been accepted and validated by the Government, bidders looking to supply software products to the Government may consider adopting a similar approach.

Notably however, this approach presumably focusses on models where the license/authorization to sell the software product, involves the payment of royalty on a per-product basis, such that it can built into the marked up selling price for the software product.

This may not be the case where the IP is acquired on the basis of a one-time payment for acquiring the IP/ license to market the IP to customers. In such cases, such as those involving a territorial assignment of IP based on a one-time payment, the bidder can potentially demonstrate 100% localisation, since no royalties are paid out of the sale consideration. While the costs of for acquiring IP/territorial rights may be amortized over multiple products, in order to determine royalty payable per license, such an exercise is not explicitly mandated – neither is it feasible to amortize royalty payments over actual as well as potential future sales.

Further, the above approach doesn't suit use-cases such as procurement of cloud services, since typical software licensing / assignment models are not applicable in the cloud services industry. Given that localisation of data centres, data processing, and ancillary services are already prescribed as requirements for empanelment under the GI-Cloud (MeghRaj) Guidelines, the MeitY may consider treating GI-Cloud empanelled cloud service providers as Class-I Local Suppliers for the purposes of determining local content under the General Order.

APPLICABILITY OF GENERAL ORDER TO SOFTWARE PRODUCTS SOLD THROUGH VARIOUS BUSINESS MODELS

Presuming that the above interpretation of the General Order vis-a-vis software products, is acceptable to the Government, we try to analyse how various business models for supplying software products, may demonstrate compliance with local content thresholds.

- i. **Territorial Assignment Based on One-Time Payment:** Under this model the Indian entity is granted a territorial assignment of IPs owned by the overseas entity, for the purposes of exploitation of IPs exclusively in India – based on a one-time payment as consideration for the assignment. Under this model, the Indian entity should qualify as a Class-I Local Supplier, irrespective of the arms-length price payable to overseas entity determined in accordance with transfer pricing rules, since the local content percentage would be 100%.
- ii. **Territorial Assignment Based on a Per-Product Royalty:** This model is similar to the first model, barring the manner in which consideration for the assignment of rights is structured, i.e. the royalty payable by the assignee to the IP owner, will be in the form of a fee charged for each license sold by the assignee.

Should this model be adopted by supplier, subject to determination of arm's length pricing for such payments, the payment component could potentially enable the Indian entity to qualify as a Class-I or Class-II local supplier (based on the percentage of selling price which constitutes the payment component to the overseas entity).

- iii. **Licensing Model:** Under this model, the bidding entity obtains a license to sub-license and market the IP in the territory of India. Typically, this model involves the payment of royalty on determined on the basis of each sub-license marketed by the licensee. Therefore, subject to the arm's length pricing of royalty payable to the overseas

entity, this model could enable the Indian entity to qualify as a Local Supplier for the purposes of the General Order.

Alternately, if the royalty payable for obtaining the license is structured as a one-time payment, then similar to the model involving territorial assignment on the basis of a one-time payment, this model would enable the bidder to qualify as a Class-I Local Supplier, since the local content percentage would be 100%.

- iv. **Reseller Model:** Under this model, the bidding entity acts as a distribution/marketing agent of the IP owner. Given that there is no transfer of IP or other exploitation rights, any consideration flowing from the bidding entity to the IP owner cannot be classified as “royalty”.

Further, owing to the applicability of transfer pricing rules, the arm's length pricing of such transactions could be conducted on a resale price basis (i.e., the cost at which an independent reseller would procure from the overseas entity, subtracted from the cost at which the product is sold), or cost-plus basis (i.e. costs of marketing and distribution, along with a reasonable mark-up).

Resultantly, the pricing of the product is likely to involve a significant proportion of the selling price (i.e. the price charged to the procuring entity for the software products) being paid to the IP owner (i.e., overseas entity). Consequently, adopting this model is less likely to enable the bidder to qualify as a Local Supplier.

CONCLUSION AND WAY FORWARD

In the absence of a clearly demarcated approach for calculating *Local Content* in software products, significant uncertainty is likely to persist around the issue. As demonstrated above, *Local Content* stipulations which mandate localization of IP in India (e.g. the Cyber Security Products MII-PP Order) can be met merely by putting in place appropriate territorial assignment of IP to the bidding entity, and structuring the transaction in a manner where despite limited investments towards employment or R&D activities in India, a company can qualify as a Class-I Local Supplier.

A similar situation arises when *Local Content* is viewed as the component of the selling price retained with the bidding entity in India, since the assignment of IP and consideration on that account, can be structured in a manner which limits the pay-out due to off-shore entities, to below 20% of the selling price.

Given the above, the stated objectives of the MII initiative can perhaps be served better through a *Local Content* criteria which takes into account investments in India towards the development and creation of a software product – by taking into account various cost metrics such as employees in India (as a percentage of global employee numbers), or cost of R&D incurred in India as a proportion of global R&D costs. The DPIIT and other Nodal Ministries such as the DoT and MeitY should consult the relevant supplier base in arriving at a clear, certain and uniformly applicable set of rules for determining *Local Content* in software products – such that MNCs, which make significant investments in India, aren't unduly disadvantaged merely because of the manner in which their IP-holdings are structured.

Nonetheless, pending additional clarity from the Government, the emerging approach provides a helpful benchmark for companies looking to qualify as “local suppliers” of software products. Given that the General Order and other MII-PP Orders, leave the task of determining local content to the bidders, companies looking to qualify as “local suppliers” have some room to structure their businesses in a compliant manner, and take a call on appropriate business models for supplying software products to the Indian Government.

Companies looking to structure their business models along the lines of the emerging approach, would need to bear in mind: (a) applicable self-certification requirements, requiring a bidder to self-certify the extent of *Local Content* in its products, accompanied by a certificate from a statutory auditor or a cost auditor of the company, or from a practicing cost or chartered accountant; and (b) the impact of arms' length pricing of IP acquisition costs (license/territorial assignment/purchase) on the eventual local content of the software product.

Given that the interpretation of local content requirements may differ across procuring agencies and Nodal Ministries, companies looking to qualify for Government tenders for software products would be well advised to request clarifications from the procuring agency ahead of self-certifying local content. This would ensure reducing the risk of disqualification on grounds of incorrect calculation and declaration of local content.

– Arijit Ghosh, Indrajeet Sircar & Gowree Gokhale

You can direct your queries or comments to the authors

¹ <https://www.makeinindia.com/about>

² <https://www.makeinindia.com/enhancing-investment-ecosystem>

³ https://dpiit.gov.in/sites/default/files/publicProcurement_MakeinIndia_15June2017.pdf

⁴ <https://dpiit.gov.in/sites/default/files/PPP%20MII%20Order%20dated%204th%20June%202020.pdf>

⁵ https://www.meity.gov.in/writereaddata/files/PPP_MII_Order_dated_16_09_2020.pdf

⁶ <https://timesofindia.indiatimes.com/india/make-in-india-employment-generation-to-get-a-boost/articleshow/60979303.cms>; <https://www.ies.gov.in/pdfs/make-in-india-oct15.pdf>

⁷ Defined in the General Order to mean “amount of value added in India which shall unless otherwise prescribed by the Nodal Ministry, be the total value of the item procured (excluding net domestic indirect taxes) minus the value of imported content in the item (including all customs duties) as a proportion of the total value, in percent.”

⁸ <https://indianexpress.com/article/business/economy/dont-want-to-be-just-fuel-for-global-it-cos-want-ipr-platforms-in-india-7793774/>

⁹ Clause 2 of the General Order

¹⁰ https://www.meity.gov.in/writereaddata/files/Gazette_DPIIT.pdf

¹¹ [https://www.meity.gov.in/writereaddata/files/Public_Procurement_\(Preference_to_make_in_India\)_order_2019_for_Cyber_Security_Products.pdf](https://www.meity.gov.in/writereaddata/files/Public_Procurement_(Preference_to_make_in_India)_order_2019_for_Cyber_Security_Products.pdf)

¹² [https://www.meity.gov.in/writereaddata/files/Public_Procurement_\(Preference_to_make_in_India\)_order_2019_for_Cyber_Security_Products.pdf](https://www.meity.gov.in/writereaddata/files/Public_Procurement_(Preference_to_make_in_India)_order_2019_for_Cyber_Security_Products.pdf)

¹³ See, MeitY, Master Services Agreement – Procurement of Cloud Services (Ver 1.0), Available at URL:

https://www.meity.gov.in/writereaddata/files/Guidelines_Contractual_Terms_Cloud_Procurement_V1.2.pdf; See *also*, Cloud Management Office, e-Governance Division, MeitY, “Stepwise Guide on Process for Empanelment of Cloud Service Providers”, Available at URL: <https://www.meity.gov.in/writereaddata/files/Stepwise%20guide%20on%20empanelment%20process.pdf>

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