

# THE NETFLIX RULING - UNRAVELLING THE DIGITAL DISTRIBUTION CONUNDRUM

## A. Introduction

The Hon'ble Mumbai Bench of the Income Tax Appellate Tribunal (ITAT/the Tribunal) has delivered a pivotal ruling



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in Netflix Entertainment Services India LLP<sup>1</sup>, which throws light on the transfer pricing treatment of digital/platform-based businesses. The epicentre of the ruling is about the functional characterisation of Netflix India wherein the Tribunal evaluated the facts and circumstances of the taxpayer through the transfer pricing lens and beyond the superficial economic reconstruction portrayed by the tax authorities.

The Tribunal critically examined various key aspects such as the selection and application of the Most Appropriate Method (TNMM vs. "Other Method"), the scope of recharacterization under Indian TP rules, and the interpretation of intellectual property rights and Development, Enhancement, Maintenance, Protection, Exploitation ("DEMPE") functions in the context of digital streaming models.

<sup>1</sup>[TS-636-ITAT-2025(Mum)-TP]; (ITA No. 6857/Mum/2024, AY 2021-22)

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## B. Background

### *Overview*

Netflix Inc. (“Netflix US”) is the owner of Netflix platform offering video on-demand globally and it offered official distribution rights to Netflix International B.V. (“NIBV”), a Netherlands-based affiliate, which managed non-U.S. territories until December 2020.

Netflix India was incorporated in April 2017 to distribute access to the global Netflix Service in India under a non-exclusive Distribution Agreement, initially with Netflix international B.V. (effective September 2017) and, from January 2021, directly with Netflix US. Under this agreement. Netflix India was authorised to promote subscriptions, invoice customers, collect subscription fees, and provide limited customer support, while all intellectual property rights including content, technology, and trademarks, remained exclusively with Netflix US/NIBV.

### *Factual matrix*

<b>Characterisation</b>	<b>Limited risk distributor of access to Netflix Service</b>
<b>Remuneration model</b>	Subscription revenue net of local costs plus a fixed return on sales
<b>International transaction</b>	Payment of distribution fee to AE
<b>Most Appropriate Method (“MAM”)</b>	Transactional Net Margin Method (“TNMM”) ; PLI - OP/OR
<b>Margin earned</b>	1.36% on sales
<b>Arm’s length margin range</b>	Unadjusted margins = 1.88% to 2.33% Post working capital adjustment= 0.77% to 1.47%

Further Netflix India does not own or develop any intangible assets, nor does it perform DEMPE functions. Its tangible assets comprise routine office equipment and certain Open Connect Appliances (OCAs), which are cache servers deployed at ISP nodes to optimize streaming efficiency akin to logistical tools rather than core technology assets.

This structural model, based on cost-plus remuneration and risk insulation, formed the basis of Netflix India's transfer pricing position, which became the focal point of debate.

### ***Intercompany Arrangements***

The following intercompany arrangements governed Netflix India's operations:

Arrangement	Description & Pricing Policy
<b>Distribution Agreement</b>	<ul style="list-style-type: none"><li>• Netflix India appointed as a non-exclusive distributor of access to the Netflix Service in India.</li><li>• Authorized to promote subscriptions, invoice customers, and provide limited customer support.</li><li>• Remunerated on a cost-plus basis, ensuring a fixed return on sales (ROS) after reimbursement of all local costs.</li></ul>
<b>Terms of Use with Subscribers</b>	<ul style="list-style-type: none"><li>• Formalized Netflix India's role in contracting with Indian subscribers.</li><li>• Subscribers granted only a limited, non-exclusive right to access content; all IP rights retained by Netflix US/NIBV.</li></ul>
<b>Marketing Support &amp; Compliance</b>	<ul style="list-style-type: none"><li>• Netflix India undertook localized marketing campaigns and regulatory compliance.</li><li>• Activities executed under global guidelines and budgetary approvals from AEs</li></ul>

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## *Transfer pricing scrutiny*

### i. Transfer Pricing Officer

The Transfer Pricing Officer (TPO), however, challenged both the characterization and the benchmarking approach, asserting that:

- Netflix India was not a mere distributor but an entrepreneurial provider of content and technology, bearing significant risks and performing high-value functions.
- The TNMM was “unscientific” and unsuitable for the complex OTT streaming model; instead, the TPO invoked the “Other Method” under Rule 10AB, imputing a royalty-based approach
- By sourcing six unrelated royalty agreements from the RoyaltyStat database, the TPO computed an arm’s-length royalty rate of 57.12% of revenue, resulting in a transfer pricing adjustment of <sup>1</sup> 444.93 crore.

### ii. DRP Approach

The DRP substantially endorsed the TPOs position, which was premised on recharacterizing Netflix India from a limited-risk distributor to a full-fledged entrepreneurial operator in the Indian market. The key findings of the DRP are as below:

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- **Functional Recharacterization**

Netflix India undertook a “plethora of functions” beyond mere distribution of access. It enumerated fifteen activities, including entering into user agreements, promoting the Netflix Service, issuing gift subscriptions, providing infrastructure support, etc., Ownership of OCAs was viewed as evidence of investment risk, elevating Netflix India’s profile to that of a significant technological and operational hub rather than a routine distributor.

- **Rejection of TNMM and Assessee’s Comparables**

Dismissed TNMM adopted by the assessee as “unscientific, misdirected, and incompatible” with the business model and criticized use of software distributors as comparables. It also rejected asset-intensity and marketing-intensity adjustments furnished by the assessee, terming them baseless.

- **Endorsement of Royalty-Based ‘Other Method’**

The Panel reasoned that Royalty based approach better reflected the economic substance of Netflix India’s operations and thereby affirmed TPO’s invocation of Rule 10AB and upheld adoption of “Other Method” as MAM. It endorsed benchmarking based on six unrelated royalty agreements sourced from the RoyaltyStat database, three for content rights and three for technology platform rights, resulting in a blended royalty rate of 57.12% of revenue.

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- **Introduction of Ad-hoc Attribution Model**

Devised an alternative attribution grid, allocating arbitrary percentages to functional clusters (e.g., content storage 5%, marketing 5%, technology 5%) and concluded that 43% of revenue should be attributed to Netflix India.

### **C. Key Disputes**

At the outset, the key disputes emanating from the ruling are:

1. Netflix India's characterization – Limited-risk distributor Vs an entrepreneurial content-and-technology provider?
2. MAM – TNMM Vs Other Method based on royalty rates under Rule 10AB?
3. Remuneration – Distribution fee Vs. Royalty?
4. Ownership of Open Connect Appliances ((OCAs) - Logical tools Vs. Deployment of significant technological asset?
5. Whether the comparables selected by Netflix India (software and product distributors) were functionally appropriate?

### **D. Analysis and Tribunal's Standpoint**

The Tribunal undertook a detailed review of Netflix India's functional profile, contractual framework, and transfer pricing methodology vis-à-vis Indian TP regulations.

A quick glance at the key disputes and the Tribunal's position is provided below:

Key Dispute	Tribunal's Contention
Functional characterization of Netflix India	<ul style="list-style-type: none"> <li>• Netflix India performs routine distribution and marketing-support functions under strict supervision of AEs.</li> <li>• Owns no IP and undertakes no DEMPE functions, risk profile remains limited.</li> <li>• Opined - functional reality, not perceived commercial importance determines characterization.</li> </ul>
Method selection (TNMM vs. Other Method)	<ul style="list-style-type: none"> <li>• Affirmed TNMM as the MAM under Rule 10B.</li> <li>• Rejected royalty-based "Other Method" as arbitrary.</li> <li>• Benchmarking hypothetical transaction was impermissible under law</li> </ul>
IP ownership and royalty characterization	<ul style="list-style-type: none"> <li>• Found no transfer or license of content or technology; Netflix India merely facilitates access.</li> <li>• Payments cannot be treated as royalty under section 9(1)(vi) or treaties – placed reliance on SC judgement on Engineering Analysis Centre of Excellence</li> <li>• Netflix India's small employee headcount evidenced routine functions and returns</li> </ul>
Treatment of OCAs and infrastructure	<ul style="list-style-type: none"> <li>• OCAs are logistical cache devices, not core technology assets. <i>To equate such caching devices with core technological assets is to mistake warehousing for authorship,</i>" the Tribunal remarked, rejecting the Revenue's characterization.</li> </ul>
Comparables selection / rejection	<ul style="list-style-type: none"> <li>• Accepted software distributors as valid analogues for benchmarking distribution of intangible access rights.</li> <li>• Criticized DRP for ignoring adjusted margins and adopting ad-hoc attribution without statutory basis.</li> </ul>

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## *Final outcome*

- Netflix is a limited risk distributor
- TNMM upheld as MAM
- Royalty-based approach rejected and DRP's ad-hoc attribution model rejected as legally unsustainable and economically flawed
- Entire TP adjustment of <sup>1</sup> 444.93 crore deleted

In essence, the ruling reaffirms that contractual and functional realities must prevail over speculative recharacterization, and that TNMM remains the most reliable method for routine distribution models in the digital economy.

## **E. Key learnings / takeaways**

This decision sheds light on fundamental principles such as method selection, comparability standards and the treatment of digital infrastructure assets and is expected to shape the approach toward benchmarking transactions in the OTT, SaaS, and e-commerce sectors globally.

It vehemently underpins that the tax authorities cannot attempt to paint genuine intercompany arrangements as sham, especially in digital businesses, by imputing royalty or entrepreneurial returns. While the Tribunal's conclusions are firmly grounded in Indian transfer pricing regulations and judicial precedents,

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the case also offers an opportunity to reflect on its interplay with global transfer pricing framework. A snapshot of the key learnings is provided below:

- *Need for robust documentation*

Robust documents such as intercompany agreements anchored the Tribunal's analysis. The Distribution Agreement explicitly appointed Netflix India as a non exclusive distributor of access and reserved all IP rights (content, technology, trademarks) to NIBV/Netflix US, which the Tribunal treated as decisive on functional characterization. The Terms of Use with subscribers mirrored this, granting only a limited, non exclusive right to access and view content, not any ownership or exploitation rights. Hence this ruling is a testament that clear drafting of contracts capturing the rights and duties of the parties, IP ownership, etc., are essential.

- *Recharacterization of business profile*

This ruling has poised a notable point that recharacterization cannot be done by the authorities on a customary basis. If the taxpayer is able to demonstrate the alignment of conduct of parties with the underlying contract with concrete evidence it would ringfence the taxpayer from such recharacterization

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Across jurisdictions, taxpayers operate through various business models and a thorough understanding of the business dynamics is essential in order to determine the remuneration model. In recent times sizeable number of entities in India are operating in SaaS / digital environment. While India being the second largest eco-system for start-up enterprises, thorough understanding of their complex business structure and suitable billing model i.e., whether it warrants a royalty-based approach or it is a mere distribution model expecting a routine return, etc., acts as a prerequisite.

- *Asset profiling*

In determining the characterisation of a taxpayer and the resultant remuneration model, apart from the functional analysis, the presence and deployment of asset play a pivotal role. In the present case, the assets in the form of OCAs deployed by Netflix India are considered to be integral part of offering seamless Netflix streaming service to the customers whereas Tribunal had pondered over the quantum of assets employed by Netflix India vis-à-vis the AE. While the quantum of assets may not be significant, however one must evaluate the impact, it has on the revenue model of the taxpayer, due to the absence of such assets and accordingly the weightage to be determined.

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- ***Importance of DEMPE***

The Tribunal has deliberated on the importance of DEMPE analysis as it is relevant to understand the transaction from the perspective of value creation. Hence while structuring IP related transaction, one needs to perform DEMPE analysis as a part of the functional profiling of the taxpayer.

### **Bottom Line**

This ruling emphasises a noteworthy aspect that the law does not permit tax authorities to take shelter under the name of complex business models to recharacterize transactions. The Tribunal's approach by relying on contractual arrangements, the FAR profile, and the binding judicial precedents (i.e., Supreme court ruling on Engineering Analysis), reiterates the importance of maintaining robust documentation by the taxpayers.

The Tribunal reaffirmed that contractual terms and the actual FAR profile govern transfer pricing outcomes under the transfer pricing regulations. By upholding TNMM and rejecting royalty-based and ad-hoc attribution approaches, the ruling underscores that complex business models cannot justify arbitrary recharacterization.

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