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## Netflix India Transfer Pricing Case: ITAT Mumbai Delivers Landmark Ruling on Digital Distribution Model

### Relevant Facts

The Mumbai Income Tax Appellate Tribunal ("ITAT") recently delivered a significant judgment in Netflix Entertainment Services India LLP for Assessment Year 2021-22, deleting a substantial transfer pricing adjustment of ₹445 crores proposed by the Transfer Pricing Officer ("TPO").

Netflix Entertainment Services India LLP ("Netflix India") was incorporated in April 2017 as a non-exclusive distributor of access to the global Netflix streaming platform in India. Under Distribution Agreements with Netflix International B.V. and subsequently Netflix US, the entity's functions were limited to promoting subscriptions, entering into Terms of Use with Indian subscribers, collecting subscription fees, providing local customer support, and ensuring regulatory compliance. Netflix India employed approximately 60 professionals in marketing, operations, finance, and compliance roles, with no involvement in content acquisition, technology development, or platform design.

The commercial arrangement operated on a cost-plus model wherein Netflix India earned a fixed return on sales of 1.36%, with all costs fully reimbursed by Associated Enterprises ("AEs"), thereby insulating it from business risks.



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Netflix India's assets comprised office premises, IT equipment, and Open Connect Appliances ("OCAs")—cache devices for bandwidth optimization—totaling ₹75 crores. Critically, Netflix India owned no intellectual property rights; all content, technology, and trademarks remained vested with Netflix US/NIBV.

Netflix India benchmarked its distribution fee payment using the Transactional Net Margin Method ("TNMM"), selecting 17 functionally analogous software and product distributors. Its operating margin of 1.36% fell within the comparable range of 0.77% to 1.47%.

The TPO rejected this characterization, recharacterizing Netflix India as an entrepreneurial content and technology provider bearing significant risks. The TPO concluded that Netflix India had obtained content and technology on license from its AEs and invoked the "Other Method" under Rule 10AB, sourcing six unrelated royalty agreements from RoyaltyStat. Computing aggregated royalty rates of 57.12% of revenue, the TPO proposed an adjustment of ₹444.93 crores. The Dispute Resolution Panel ("DRP") affirmed these findings, emphasizing Netflix India's ownership of OCAs as evidence of investment risk, and devised an ad-hoc allocation attributing 43% of revenue to the Indian entity.

## ITAT Decision

The ITAT examined the contractual framework, functional profile, assets and



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risk allocation, ruling decisively in favor of Netflix India and deleting the entire adjustment.

**Contractual Analysis:** The Tribunal held that the Distribution Agreement unambiguously appointed Netflix India as a distributor of access only, with no license to use, reproduce, or sublicense content or technology. The Terms of Use confirmed that subscribers obtained merely a limited, non-exclusive right to access content, with all intellectual property remaining with Netflix US/NIBV. The TPO's contrary inference was found "internally inconsistent" and contradictory to contractual record.

**Functional Characterization:** The ITAT rejected the TPO's reliance on selective Distribution Agreement clauses, holding that provisions regarding pricing, discounts, and customer service granted only operational flexibility within parameters prescribed by the parent entity, not entrepreneurial control. The subscription fee was determined centrally by Netflix's global pricing algorithm.

**Open Connect Appliances:** On the critical OCA issue, the Tribunal held these devices are "mere mirror cache servers" storing transitory data for bandwidth optimization, performing no processing, analytics, or data hosting. All algorithmic functions—content recommendation, compression, streaming—were developed and operated by Netflix US on AWS servers outside India. The ITAT stated that equating caching devices with technological assets is "mistaking warehousing for authorship."



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**DEMPE Analysis:** The Tribunal conducted detailed Development, Enhancement, Maintenance, Protection, Exploitation ("DEMPE") analysis, finding all value-creating functions resided with foreign AEs. Netflix India's 64 employees performed only marketing support and compliance, with none engaged in content or technology development. The asset disparity—Netflix India's ₹75 crores versus Netflix US's USD 39.28 billion (4,000 times larger)—confirmed the limited-risk profile.

**Risk Allocation:** The ITAT observed that all entrepreneurial risks—market, investment, service liability, technological obsolescence—were borne by AEs. The cost-plus structure with full reimbursement and fixed 1.36% return completely insulated Netflix India from losses, negating entrepreneurial exposure.

**Benchmarking Methodology:** The ITAT strongly upheld TNMM as the Most Appropriate Method, emphasizing that functional comparability, not sectoral labels, is determinative. Citing Turner International India, Star Den Media Services, and Sony Pictures Networks, the Tribunal held that software distributors constitute valid functional analogues for media content distributors absent direct comparables. Netflix India's 1.36% margin within the 0.77%-1.47% range conclusively established arm's length compliance.

**Rejection of "Other Method":** The Tribunal held the TPO's "Other Method" factually and legally untenable. Rule 10AB's residual method applies only when no recognized method can reasonably apply—not the case here. The



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Royalty Stat agreements were found to price "an imaginary transaction," being non-contemporaneous, unsigned, and related to outright IP licenses wholly absent in Netflix India's operations. The method proceeded on "circular reasoning, assuming the disputed fact to justify a notional benchmark."

**DRP's Ad-Hoc Attribution:** The DRP's allocation grid was characterized as "a spreadsheet fiction" and "breach of statutory duty," lacking external benchmarks, economic rationale, or linkage to risk contribution. The Tribunal held that Chapter X is "not an invitation to economic imagination" but requires objective comparability, citing Supreme Court precedents in Vodafone India Services and Maruti Suzuki India that recharacterization is impermissible absent proof of sham.

Applying Engineering Analysis Centre of Excellence, the ITAT held that distribution of access without copyright transfer does not constitute royalty. The Tribunal concluded that attributing 43% of global revenue to an entity owning no content or technology violates "the symmetry between function, asset, and risk—the triad that defines economic ownership."

## Key Takeaways

- (i) **Functional Analysis Prevails Over Physical Presence:** Infrastructure or personnel presence does not automatically confer value-creation status. The ITAT's principle that "technological presence cannot be conflated with economic ownership" provides critical guidance for digital business models.



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- (ii) **DEMPE Analysis Remains Paramount:** Entities claiming entrepreneurial returns must demonstrate actual performance of DEMPE functions. Marketing support and regulatory compliance do not warrant such returns.
- (iii) **Limitations on "Other Method":** Rule 10AB cannot be invoked when recognized methods are workable. It requires comparable uncontrolled transactions with functional similarity—arbitrary attribution grids are impermissible.
- (iv) **Cache Infrastructure as Logistical Tools:** OCAs and similar devices serve purely logistical functions analogous to warehousing, not core asset ownership—vital for CDN and streaming models.
- (v) **Cost-Plus Structures Indicate Limited Risk:** Full cost reimbursement with fixed markup conclusively demonstrates risk insulation, regardless of other operational responsibilities.
- (vi) **Functional Comparability Transcends Industries:** When direct comparables are unavailable, functionally analogous entities from different industries may serve as valid benchmarks.

## Implications for Taxpayers

This decision provides substantial relief for multinational enterprises operating digital distribution models in India, particularly in OTT, streaming, e-commerce, and SaaS sectors.



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- (i) **Documentation Imperatives:** Taxpayers should ensure robust contemporaneous documentation explicitly delineating functional profiles, asset, and risk allocation. Distribution agreements must clearly reserve intellectual property rights with foreign principals and define the distributor's role as facilitating access. Terms of Use should consistently reflect no IP transfer to end customers.
- (ii) **Validation of Cost-Plus Structures:** The judgment validates cost-plus remuneration with full cost reimbursement and fixed markups as appropriate compensation for limited-risk distributors, providing strong defense against recharacterization attempts.
- (iii) **Infrastructure Deployment:** Maintain detailed technical documentation establishing that local servers perform purely logistical functions without processing or analytics capabilities. All algorithmic and strategic functions should remain demonstrably centralized with foreign AEs.
- (iv) **DEMPE Documentation:** Proactively conduct DEMPE analyses demonstrating local entities perform no development or enhancement functions. Employee roles, organizational charts, and decision protocols should reflect routine marketing and compliance functions.
- (v) **Pending Disputes:** Taxpayers can leverage this precedent to challenge royalty-based "Other Method" computations lacking comparable transactions, arbitrary profit attributions, and recharacterizations contradicting documentation. The decision strengthens arguments that distribution of digital access—without copyright transfer—falls outside royalty characterization under domestic law and treaties.





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- (vi) **Structuring Implications:** The judgment validates centralized IP ownership models with local limited-risk distribution, providing clarity on permissible functional profiles and remuneration benchmarks. However, operational reality must strictly adhere to documented structures, as substance-over-form analysis remains legitimate where conduct diverges from contractual terms.

