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Tax Flash News

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Mumbai Tribunal affirms limited-risk distributor status for Netflix and rejects entrepreneurial re-characterisation

Executive summary

The Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal), in the case of *Netflix Entertainment Services India LLP*[1] (the taxpayer) rejected the Revenue's re-characterisation of the taxpayer, from a limited-risk distributor to an entrepreneurial provider of content and technology and upheld the taxpayer's use of Transactional Net Margin Method (TNMM) over the Other Method adopted by the Revenue.

The Tribunal noted that the taxpayer's role was contractually and functionally confined to distributing access to the Netflix Service in India, with all intellectual property, content, and technology owned and controlled by its foreign associated enterprises (AEs).

In so adjudicating, the Tribunal critically analysed the taxpayer's fact pattern against the provisions of law, various judicial precedents, as also the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines[2], emphasising the primacy of functional comparability in the absence of product or market comparability, while undertaking a comparability exercise.

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1 ITA No.6857/Mum/2024

2 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022

Facts of the case

Netflix Inc. (Netflix US), was engaged in the digital streaming model globally, enabling subscribers to view movies, documentaries, and television series on any internet-enabled device. It operated on a subscription model whereby users gained access to a curated library of video-on-demand (VOD) content, through the Netflix application or website.

The taxpayer, entered into distribution agreements with its associated enterprise (Netflix International B.V. (NIBV) and later Netflix US), appointing it as a non-exclusive distributor of access to 'Netflix Service' (defined as access to a global video-on-demand service that is delivered through streaming over the internet for personal use), in India. All content, technology, and intellectual property were owned by Netflix US and NIBV.

The taxpayer entered into 'Terms of Use' with the Indian subscribers, explicitly clarifying that it did not acquire any intellectual property rights, nor was it entitled to any proprietary rights in respect of the service architecture, content, trademarks, or technology comprising the Netflix Service. There was no transfer of any know-how, model, invention, or other intellectual property, patented or otherwise, to the taxpayer.

Taxpayer's role was limited to marketing, invoicing, customer support, and regulatory compliance, for which it was compensated, a fixed return (on sales) over and above, all its local costs. The balance consideration (subscription revenue, less local costs plus a fixed return) was paid to the AEs as a distribution fee.

The taxpayer benchmarked such payment of distribution fee under the TNMM, using comparable companies engaged in distribution of software and related products.

The Revenue disputed the taxpayer's functional characterisation as a limited risk distributor and considered it to be a principal service provider. Applying Other Method, using royalty agreements as comparables, the Revenue computed an arm's length price (ALP) at 57.12 per cent of revenue (INR 444.93 crore). The Dispute Resolution Panel (DRP) upheld this approach, citing complexity and lack of comparables, further proposing ad-hoc margin attribution across functional clusters, to support the Revenue's approach. Aggrieved, the taxpayer preferred an appeal before the Tribunal.

Issues for consideration

The Tribunal lucidly yet categorically framed a total of ten issues for its consideration as under:

Characterisation - whether the taxpayer functions merely as a limited-risk distributor of access or, as an entrepreneurial content-and-technology service provider, bearing significant risks and therefore entitled to commensurate remuneration?

Acquisition of rights - whether taxpayer acquires any rights, title, or licence in the IP or technology constituting the Netflix Service?

Open Connect Appliances (OCAs) – whether these appliances are to be viewed as core technological assets or routine logistical aids?

Benchmarking methodology - whether the Revenue and DRP were justified in discarding the TNMM universally regarded as the most pragmatic for routine distribution functions in favour of an untested and empirically unsupported royalty-based construct?

Selection and rejection of comparables - whether, in the absence of industry-specific comparables, the use of software distributors was a legitimate proxy?

Re-characterisation - whether the Revenue can, by mere inference, rewrite the legal relationship between the parties and substitute its own economic characterization?

Quantum and reasonableness of the adjustment – whether the adjustment founded upon third-party royalty agreements bearing no functional comparability to taxpayer's operations, justified?

Applicability of judicial precedence – whether Supreme Court's ruling in *Engineering Analysis Centre of Excellence (P.) Ltd.*[3] which clarifies that payments by distributors for non-exclusive, non-transferable licences, do not constitute royalty, governs the present facts?

Appropriateness of DRP's alternative benchmarking – whether DRP's ad-hoc alternate benchmarking analysis is conceptually sound and evidence based and therefore legally sustainable?

Administrative over-reach - whether the Revenue was justified in disregarding the taxpayer's contemporaneous documentation and substituting it with an uncorroborated hypothetical model divorced from market realities?

[3] [2021] 432 ITR 471 (SC)

Revenue's contentions

Taxpayer is not a limited-risk distributor but a principal service provider of Netflix content and platform in India. Taxpayer's self-characterisation as a 'limited-risk distributor' is a strategic understatement, artfully crafted to minimize its Indian tax exposure and to shield its AE from the incidence of royalty taxation. If substance over form evaluated, the taxpayer is the operative face, arm, and engine of the global Netflix enterprise in India, performing the core revenue-generating and customer-facing functions essential to the Group's streaming business.

The OTT business (taxpayer's business) rested upon three critical pillars viz. content, technology platform, and marketing & sales, and thus the ALP should be determined on the basis of royalties payable for these components, since the taxpayer allegedly obtained content and technology on license from its AEs.

The flow of consideration demonstrates that the taxpayer effectively commercialises the content and platform in India, since it earns revenue entirely from local subscribers, while making internal payments to its AEs that is akin to royalty for the use of content and technology, rather than distribution fees.

The taxpayer's conduct in the market belied its claim of limited functionality, since it is responsible for advertising, local market promotion, and brand development through massive online and offline campaigns tailored to Indian consumers. It undertakes public relations, social media engagement, and collaborations with telecom and consumer electronics companies for bundled subscriptions, all of which, represent entrepreneurial marketing initiatives rather than routine promotional activity. Such extensive marketing and customer acquisition efforts demonstrate taxpayer's functionality as an economic entrepreneur of the Netflix brand in India.

OCAs are not minor logistical tools but core technological assets forming the backbone of Netflix's streaming architecture. The OCAs store and deliver content to Indian subscribers, forming an integral part of the content delivery network (CDN). Without these OCAs, Netflix's global content library could not be streamed efficiently within India. Thus, by owning and maintaining these devices, the taxpayer assumes not only investment risk, but also technological and operational risks typically borne by an entrepreneur rather than a limited-risk distributor.

The taxpayer's responsibility, for maintaining relationships and negotiating contracts with Internet Service Providers (ISPs), ensuring seamless content delivery across India's bandwidth constrained network, require technical expertise, capital investment, and regulatory compliance, which are indicative of infrastructure ownership and operational autonomy inconsistent with the role of a mere distributor.

The streaming-media industry represents a new-age digital business model wherein traditional comparables such as software distributors or B2B resellers cannot capture the economic substance of the underlying transactions. Thus, TNMM, is ill-suited to evaluate a hybrid model involving both content licensing and technology exploitation. Flexibility under Other Method is warranted in certain complex or unique transactions, where no external comparables exist. Taxpayer's case characterises such complexity - it has exclusive territorial responsibility for content distribution, maintains critical infrastructure, and controls customer facing operations.

Royalty based ALP computation using external agreements (content rights and technology platforms) is a reasonable proxy for the value of intangibles used by the taxpayer.

The massive transfer-pricing adjustment of INR 444.93 crores merely reflects the economic value extracted by the taxpayer from its access to these intangibles, which it commercially deploys in the Indian market.

The Supreme Court's decision of *Engineering Analysis* was inapplicable, since the said decision concerned shrink-wrapped software licences for installation on user devices, unlike the Netflix model, which involved real-time streaming and dynamic content consumption, dependent on continuous access to a global content library and technological infrastructure.

The taxpayer's comparables as per transfer pricing study report (TPSR) were functionally incomparable, as they dealt in physical goods or software products, operated under B2B models, and earned wafer-thin margins based on trading economics. Contrarily, the taxpayer, functioned under a B2C subscription model delivering digital content directly to millions of consumers, thereby operating in a completely different market dynamic.

DRP's alternative ad-hoc margin attribution was not arbitrary but merely an illustrative corroboration of the functional significance of taxpayer's role. The percentage allocations were drawn from a reasoned assessment of the taxpayer's multifaceted responsibilities including content storage, distribution, customer management, and technological upkeep. The attribution merely demonstrated that the Indian entity's share in the overall profit pool was substantial and not consistent with a low-risk distributor's profile.

The taxpayer's claim of risk insulation was contradicted by its actual conduct whereby, it faces regulatory exposure under Indian laws relating to content certification, consumer protection, and taxation; bears contractual obligations towards customers under the Terms of Use; and manages local compliance, legal disputes, and data-security issues. Such exposures, go far beyond the limited operational risk that a cost-plus distributor would ordinarily bear.

Consequently, the Revenue's and DRP's findings represented a faithful reflection of economic reality, that the taxpayer's Functions, Assets, and Risks (FAR) profile corresponded to that of a full-fledged entrepreneurial service provider.

Taxpayer's contentions

The Revenue and the DRP misconstrued the entire factual and legal framework, by selective reading of contractual clauses and unfounded presumptions, thereby re-characterising a simple distribution arrangement into a complex license transaction of content and technology.

'Netflix Service', is nothing more than access to a global video-on-demand platform for personal streaming, and the taxpayer's limited role is confined to distributing that access in India. The users are granted only a limited, non-exclusive, non-transferable license to view content, and that all ownership and IP rights remain vested exclusively with AEs. The taxpayer neither licenses nor sublicenses any content, but rather, facilitates the subscription interface and billing process. Thus, there can be no inference of transfer of any copyright or technology rights to the taxpayer or to the subscribers. Thus, the taxpayer is merely a distributor of access to the Netflix Service, functioning as a limited-risk entity with routine marketing and administrative responsibilities.

OCA's serve purely as logistical enablers, its ownership does not translate into ownership or control over the underlying content or technology.

The Revenue's allegation of pricing autonomy and marketing discretion was misconceived, as the taxpayer was required to operate within strict parameters laid down by the parent entity's global marketing policies and under advance budgetary approvals. The Group's global pricing algorithm determined the subscription fee centrally, based on uniform tier structures and the taxpayer had no power to unilaterally change or fix the price.

Re-characterisation of the taxpayer's functions and risks was perverse, as it ignored the commercial and contractual realities. The Group's organisational model clearly segregated responsibility for content creation, technological innovation, and platform management with the AE, while the distribution and customer-facing functions were decentralised to country-level entities such as the taxpayer, on a limited-risk basis. The taxpayer's remuneration model fully insulated it from the business risks.

The Taxpayer undertook a methodical benchmarking analysis under TNMM. Moreover, in the absence of direct comparables for the distribution of digital streaming services, the taxpayer resorted to selecting distributors of software and related products whose business model likewise involved reselling access rights to intangible products without ownership, as functionally analogous. This approach was justified as supported by various judicial decisions.[4]

The Revenue's approach was completely flawed as the selected agreements were neither comparable in nature nor in substance as these involved transfers of actual content libraries, film rights, or technology platform licences transactions, which was wholly absent in taxpayer's factual matrix. Even the DRP's corroborative approach lacked any comparable data, quantitative filters or economic reasoning thereby devoid of any statutory merit.

The taxpayer's agreements were genuine, contemporaneous, and consistently acted upon. The Revenue had no jurisdiction to re-characterise the transaction beyond its contractual contours, in the absence of any allegation of sham or collusion.

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[4] *Turner International India (P.) Ltd*. v. *ACIT* [2018] 95 taxmann.com 285 (Delhi Tribunal); *Star Den Media Services Pvt. Ltd.* v. *ACIT* [2020] 118 taxmann.com 662 (Mumbai Tribunal); *Sony Pictures Networks India Pvt. Ltd*. v. *ACIT* [2021] 126 taxmann.com 330 (Mumbai Tribunal); *PCIT* v. *Warnermedia India (P.) Ltd*. [2024] 167 taxmann.com 307 (Delhi High Court)

Tribunal's decision

Based on a threadbare analysis of taxpayer's factual matrix having regard to the Distribution Agreement, Terms of Use, detailed explanation on OCAs, DEMPE analysis, taxpayer's asset & employee strength comparison vis-à-vis Netflix US the Tribunal accepted that:

- Taxpayer performed routine distribution and marketing support function under the strict supervision of its AEs;
- It owned no valuable intangible assets and undertook no development, enhancement, maintenance, protection, exploitation (DEMPE) functions;
- Its risks are limited and cost-insulated;
- Accordingly, its profitability benchmark under TNMM reflected an arm's-length outcome.

The Revenue's rejection of the taxpayer's TNMM benchmarking, on the ground that the taxpayer 'is not a trader of goods' and that comparables comprising software distributors were functionally divergent, was fundamentally flawed, as various judicial decisions emphasized that functional similarity, not sectoral label, is the touchstone of comparability.

The Tribunal further noted that a method that reasonably reflects the economic reality of the tested party cannot be rejected merely because the industry label differs. Consequently, it concurred that comparable companies selected by the taxpayer were appropriate, having regard to its functional profile.

The Tribunal observed that the law contemplated a residual method, only when no recognized method can be reasonably applied. In the instant case, though TNMM was demonstrably workable, the Revenue invoked the residual method merely to justify an ex-post royalty mosaic, which is both factually and legally untenable, since this approach presupposed that the taxpayer held license to content and platform technology, an assumption directly contradicted by the Distribution Agreement and Terms of Use.

It noted that neither the Revenue nor the DRP demonstrated even a single third-party agreement that mirrored taxpayer's role as a distributor of access. The Revenue's hybrid royalty construct reduced reliability by introducing incomparable property rights and by ignoring actual tested-party data. Thus, the Revenue's and the DRP's benchmarking analysis bore no resemblance to any recognized transfer pricing method, contained no

external benchmarks, no economic rationale, and no linkage to risk or cost contribution. The Tribunal termed it as a spreadsheet fiction, at best and a breach of statutory duty, at worst.

The Tribunal highlighted that Chapter X of the Income-tax Act, 1961 is not an invitation to economic imagination, but rather, a discipline founded upon objective comparability, i.e. Rule 10AB of the Income-tax rules, 1962 is not a gateway for conjectural pricing and benchmarking must rest on objective comparability, not hypothetical constructs divorced from tested-party realities.

The Tribunal, relying on the *Vodafone ruling*[5], reiterated that transfer pricing adjustments cannot proceed on hypothetical or notional income. Further, it also emphasised the decision of *Maruti Suzuki India Ltd*.[6], which held that re-characterisation of a transaction is impermissible unless the arrangement is shown to be a sham or colourable device. Based thereon, the Tribunal noted that neither of this circumstance existed in the instant case. The agreements between the taxpayer and its AEs were found to be genuine, executed, and approved by regulatory authorities.

The Tribunal noted that the taxpayer's benchmarking approach was in accordance with the law and the OECD TP guidance, while refuting the Revenue and DRP's approach stating it to be against the provisions of law, the jurisprudence, as also against the arm's length principle codified under Article 9 of the OECD Model tax convention. Consequently, the Tribunal found the attribution of 43 per cent of global subscription revenue, to an entity that neither owns nor develops the underlying content or technology, to be violative of FAR profile, which defines the economic ownership.

In light of the above, the Tribunal held that that taxpayer's FAR profile, asset composition, risk insulation, and contractual obligations unequivocally categorize it as a limited-risk distributor. Consequently, it upheld the taxpayer's benchmarking under TNMM while rejecting the Revenue's adoption of Royalty-stat based 'Other Method' and the DRP's corroboration using attribution model to be legally & factually unsustainable.

The Tribunal, therefore, treated the re-characterisation of the taxpayer as a full-fledged entrepreneur or content-provider to be contrary to record and law, and deleted the entire transfer pricing adjustment.

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[5] *Vodafone India Services (P.) Ltd.* v. *UOI* [2014] 368 ITR 1

[6] *Maruti Suzuki India Ltd*. v. *CIT* [2015] 381 ITR 117 (Delhi High Court)

From a principle standpoint, the Tribunal further went on to raise an important concern regarding the increasing tendency of transfer-pricing officers to conflate technological presence with economic ownership. It clarified that the technological presence alone would not always equate to value creation. If there are no controls or exploitation of intangibles, the remuneration must remain aligned to the routine functional profile.

Our comments

This ruling reinstates that the contractual language and its interpretation is critical to substantiate the conduct of the parties. The Tribunal has given due importance to the same and has reinforced the settled principle, that unless the contractual arrangements are proven to be sham, the same cannot be re-characterised. The Tribunal also highlights the importance of methodical benchmarking approach and echoes the eminence of FAR as the underlying bedrock for determining the arm's length pricing of an intercompany transaction.

This ruling highlights the trend of debates which are likely to emerge in the near future, especially with the introduction of new business models due to advent of technology. Having said the same, it is also important to understand the approach adopted by the Revenue to invoke alternate benchmarking approaches, the contours of which can be found in draft rules for profit attribution to permanent establishment as well as Pillar One of BEPS 2.0 initiative.

Further, it is important for the businesses to review their inter-company agreements and transfer pricing policies to confirm they reflect substance in letter and in conduct, to mitigate any potential litigation risk.

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