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16 July 2015

Dr Kathleen Dermody
Committee Secretary
Senate Economics References Committee
Parliament House
CANBERRA ACT 2600

Email Address: economics.sen@aph.gov.au

Dear Dr Dermody

I refer to the Senate Economics Reference Committee's inquiry into corporate tax avoidance and minimization.

Please find attached responses to the questions put to me on notice at the public hearing held on 1 July 2015.

Yours sincerely,

Malini Sundaram

Country Chief Financial Officer

Question on notice: How is profit margin formulated in the Australian entity?

Response

As mentioned in our initial submission to the inquiry dated 19 June 2015 and reiterated during the public hearing, the Australian Novartis entities distribute and market Novartis products, and take part in clinical trials, in Australia.

In determining the appropriate profit level for Novartis companies in Australia, we make an economic analysis into the functions, risks and activities of the Novartis companies in Australia to determine the economic value of those activities which then leads to an appropriate level of profit for the companies.

To ensure that we pay the right amount of tax, we benchmark the operating profit earned by companies performing comparable functions for unrelated and independent companies. This way, we can see what level of profits companies make when they perform comparable functions as our companies perform when there is no relationship between them.

Even between companies with similar functions, there is variability in the profitability, so we take the inter-quartile range of operating margins within the comparable set of companies as the target range of profitability that we aim to achieve. We refer to this range as the “arm’s length range” and is the range of profitability that the companies should achieve to arrive at a fair profit for the functions, risks and activities that they perform.

The cost of the goods that the Novartis Australian companies purchase from Novartis Pharma AG is then set at such a level to achieve this level of profitability in the Australian companies. This is how we determine what the “arm’s length price” is.

We emphasise that this process is in accordance with Australian tax rules and OECD principles, which were created precisely to ensure that the pricing of transactions between related companies could not be manipulated to artificially reduce profitability in companies.

We confirm that the same kind of analysis is performed for the other companies within the Novartis group to ensure that all companies within the Novartis group earn an appropriate level of profit that is commensurate with the functions, risks and activities that each company performs.

Question on notice: What is the cost of goods in comparable Novartis related companies?

Response

As stated in the response to the previous question, we apply the Australian and OECD rules to the pricing of inter-company sales of goods.

We also follow this process for the other companies within the Novartis group to determine the correct pricing for each company under local tax rules and in line with OECD principles.

Although no two companies or countries are the same, the approach and principles that we apply are consistent across different countries and so range of profitability for other companies within the Novartis group performing similar activities to Novartis Australia companies are similar.

The pricing of goods sold to these other Novartis distributors in other countries are then set in the same way as for Australia and will consider among other things local market conditions to the extent that they have an impact on the functions performed locally.

From the above, it is hopefully apparent that a comparison of the absolute value of COGS for different countries will not be helpful in determining whether the level of profit in each country is appropriate as the COGS themselves are determined by reference to the arm's length profitability range. The question rather falls to whether the way we determine the arm's length range is consistent across countries. We confirm that this is the case and that we apply the OECD principles across the different countries.

The reason that the OECD rules have been repeatedly cited in the discussions so far is because the application of OECD principles into national tax rules provides for consistency in the approach taken across different countries and allows for transparency in the approach to pricing to achieve an appropriate allocation of profits between countries where the supply chain crosses national boundaries.

It is for this reason also that Novartis supports multinational efforts such as the BEPS project, to counter tax avoidance. We believe that only through a cooperative and multi-national approach can we achieve consistency, transparency and fairness in taxation for both taxpayers and tax authorities.

A coordinated approach is important to ensure a consistent approach across countries and to avoid a mix of unilateral measures that would lead to inconsistency between countries, reduced transparency in the approach to taxation and potentially lead to costly and time-consuming bilateral disputes between taxing authorities.