Bloomberg Law News 2023-10-02T00:04:14989502848-04:00

Cloud Transactions: A Survey of Six Countries in Southeast Asia

2023-09-13T12:55:06000-04:00

Businesses increasingly rely on cloud computing services, but currently there is scant guidance on the tax treatment of these transactions. In this article, we discuss the characterization of Cloud Transactions in Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam under generally applicable tax principles and we encourage the OECD to publish guidance promoting common tax treatment for Cloud Transactions across the globe. Given the vital importance of the cloud computing industry, a clear set of generally applicable rules would be a welcome development.

Cloud Computing

Cloud computing has changed the way that businesses operate and was likened to the Industrial Revolution at least as early as 2011. At that time, cloud computing was "already transforming the world," and it was projected that, by 2015, nearly 50% of Global 1000 enterprises were expected to use cloud computing for their top 10 revenue-generating processes. Since 2011, "cloud computing has become the foundation for the delivery of mobile and content services as well as an alternative to traditional enterprise computing environments." As of the end of 2022, the estimated value of the global cloud computing market was $545.8 billion, with a projected growth rate through 2026 of 17.9% to $1,240.9 billion. The Asia-Pacific Economic Cooperation (**APEC**) forum, a regional economic forum established in 1989 to leverage the growing interdependence of the Asia Pacific region, stated in the project summary for "Smart Cloud for Government and Business" that cloud computing "is set to become not only an integral component of the global workforce but the means by which companies and governments deliver services to customers and citizens [and it] is expected that the use of cloud computing systems will continue to grow throughout the APEC region, contributing to both economic and jobs growth." The growing importance and significance of cloud was also shared by the Southeast Asia Development Solutions:

"Over the past decade, cloud computing has revolutionized how people and organizations work around the world by democratizing access to technology, affording organizations of all sizes with access to a plethora of digital tools, as well as the security and sustainability benefits of the cloud. Cloud computing is the foundational enabler of the digital transformation of governments, businesses,

and organizations of all sizes, the default pathway for innovation."

The National Institute of Standards and Technology (**NIST**) describes cloud computing as a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources that can be rapidly provisioned and released with minimal management effort or service provider interaction. According to the NIST's Definition of Cloud Computing, the cloud model has five essential characteristics: (i) on-demand self-service, (ii) broad network access, (iii) resource pooling, (iv) rapid elasticity, and (v) measured service.

Cloud computing operates on virtual networks. Data centers housing servers that host cloud computing functionality can be established in centralized and remote locations, making access to cloud services borderless. Customers purchasing cloud computing services enjoy more flexibility over the procurement of computing power, data storage and compute capacity, and achieve significant cost savings compared to traditional computer infrastructure investment and software supply models.

Due to the often cross-border nature of cloud computing services, both cloud service customers and providers are in need of guidance on the proper characterization of payments arising from cloud services for tax purposes. Due to the fact that cloud computing services are still new to local tax authorities, there is little published domestic law guidance in the Asia-Pacific region on the character of income derived by cloud service providers. Suppliers and customers alike would benefit from specific, published guidance even though fundamental rules relating to payments for the right to use copyrights ought to apply to the types of transactions analyzed in this article. In addition, suppliers and customers would benefit from published guidance because the character of the income often determines whether the income is subject to source-country gross-based withholding taxes. Incentivizing and facilitating access to cloud computing technology and services also can be crucial to building a vibrant start-up sector in a given locality because start-up companies that embrace cloud computing services can increase productivity, leverage efficiencies, and accelerate innovation despite often having smaller budgets. Given the increasing reliance on cloud computing services and the significant volume of cross-border payments, including via financial intermediaries, domestic law guidance on the character of cloud computing services revenue will enhance international trade in cloud services, promote digital trade and further unlock the potential of the digital economy.

Accordingly, we analyze the income tax characterization and income tax treatment of the three main segments of the cloud computing industry: software as a service (**SaaS**); platform as a service (**PaaS**); and infrastructure-as-a-service (**IaaS**). We use the term "Cloud Transactions" throughout this article to refer to typical SaaS, PaaS, and IaaS transactions, collectively. Moreover, we examine the applicable guidance in six important countries in Southeast Asia: Indonesia, Malaysia, the Philippines,

Singapore, Thailand, and Vietnam.

IaaS, PaaS, and SaaS Segments

The IaaS segment provides infrastructure that customers use for a variety of IT-related activities, ranging from web hosting to automated data entry services. IaaS offers standardized and highly automated offerings whereby computing resources and storage/networking capabilities are hosted by a service provider and offered on demand to customers. IaaS encompasses a diverse set of services and offerings, including:

- allowing customers (or providers) to migrate applications to the cloud;
- providing a platform for testing and development;
- providing storage, backup, and recovery of an organization's data; and
- supporting web applications.

IaaS customers do not manage or control the underlying cloud infrastructure or the technology that provides the actual services, but they do control their own operating systems and application software which they may upload and run on the IaaS platform.

The PaaS segment builds on the basic IaaS transaction model with a development platform that may potentially include programming languages, libraries, services, and other development tools, to allow the consumer to develop and deploy applications in the cloud. The consumer does not manage or control the cloud infrastructure or the development platform but does control the development and deployment of its own applications. In addition, the consumer does not manage or control the systems or tools that are available on the development platform. Typical PaaS transactions for web development include:

- operating systems;
- programming languages and libraries;
- development tools and templates;
- database systems; and
- IT resources.

The SaaS segment involves a consumer receiving access over the cloud to application software running on the cloud infrastructure. The consumer does not manage or control the underlying cloud infrastructure or the software applications. Where required, on a limited basis, customers may

configure the user-specific application configuration settings solely for the purpose of accessing the services. Examples of typical SaaS offerings include large enterprise applications and cloud-based desktop suites.

Characterization for Tax Purposes

Each of the three segments described above should give rise to the same income tax characterization and tax treatment in the typical case. Customers in Cloud Transactions do not obtain the right to use any underlying copyrights or intangible property rights. Customers also do not typically obtain any rights with respect to the intangible property of the cloud service provider. Customers do not acquire or use any rights in any of the cloud service provider's intellectual property rights, including rights to commercially exploit, modify, copy, develop, or enhance the intellectual property rights or to license or permit any third party to exercise such rights. The customers also are not permitted to grant any license under the intellectual property rights. All intellectual property rights associated with the cloud services are owned and retained by the cloud service providers. Customers in Cloud Transactions are also not paying to acquire, or use the physical equipment, such as servers in a data center. Instead, in IaaS transactions in particular, customers are paying for the computing capacity, and the cloud service providers retain control over the data center, its equipment, and any maintenance thereof. These principles generally apply for all three types of Cloud Transactions. Accordingly, we do not differentiate between SaaS, PaaS, and IaaS transactions in the analysis below.

Domestic tax law characterization of Cloud Transactions can have wide-ranging impacts on both the recipients and providers of cloud services. Most obviously, in many cases a cross-border services payment is not subject to source-country withholding, while a cross-border royalty is subject to withholding in the country of source. Moreover, recent changes to the U.S. foreign tax credit regulations use the foreign tax law characterization of a foreign-source payment as the first step in applying the source attribution rules, which determine whether the U.S. recipient of the payment can claim a foreign tax credit for withholding taxes on that payment imposed by the source country (*See* Treas. Reg. §1.901-2(b)(5)(i)(B)). Prior to these new rules, whether a non-U.S. withholding tax was eligible for a foreign tax credit in the U.S. depended on the structure of the foreign tax as a tax imposed in lieu of a generally imposed income tax (e.g., a withholding tax on certain categories of payments to foreign persons), but did not hinge in any significant way on whether the income was properly characterized as services, royalties, or any other category of income under foreign tax law. Under the current rules, when analyzing the creditability of a foreign withholding tax, the U.S. foreign tax credit regulations require that the income subject to the foreign withholding tax satisfies the requirement for income attribution based on source (*See* Treas. Reg. §1.903-1(c)(2)(iii), referring to

Treas. Reg. §1.901-2(b)(5)(i)(B)). To satisfy this requirement, the nonresident's income must be subject to tax in the foreign country based on its source and the foreign country's sourcing rules must be reasonably similar to the sourcing rules that apply for U.S. federal income tax purposes (Treas. Reg. §1.901-2(b)(5)(i)(B)). To determine whether the sourcing rules of the foreign tax law are reasonably similar to the sourcing rules that apply under the Internal Revenue Code, the foreign tax credit regulations explicitly provide that the character of gross income arising from gross receipts must be determined under the foreign tax law (Treas. Reg. §1.901-2(b)(5)(i)(B)).

Practical Observation: *On July 21, 2023, the U.S. Internal Revenue Service published* Notice 2023-55 *, which delayed until 2024 some of the recent changes made to the U.S. foreign tax credit regulations. As relevant here,* Notice 2023-55 *, provides that taxpayers can apply the rules in existing* Treas. Reg. §1.903-1 *(governing the creditability of taxes in lieu of income taxes, e.g., gross-basis withholding taxes) without applying the jurisdiction to tax excluded income or source-based attribution requirement. This means, during the specified relief period, taxpayers do not need to apply the attribution requirement that requires determining the foreign tax law characterization of the income subject to the tax in question.* Notice 2023-55 *provides relief for foreign taxes paid in any relief year if the taxpayer satisfies the requirements for creditability as modified by* Notice 2023-55 *. For these purposes, the relief period means tax years beginning on or after December 28, 2021, and ending on or before December 31, 2023, and "relief year" means any tax year within the relief period.*

Often, a key element in the income characterization analysis is whether the payment represents consideration for the right to use copyright rights or to acquire a copyrighted article, or, depending on the context, something else. Generally, transfers of copyright rights are distinguished from transfers of copyrighted articles based on the types of rights granted to the transferee. Under U.S. law, for example, a transfer of a copyright right occurs only if a transferee acquires one or more specified copyright rights, including the right to reproduce and distribute the copyrighted work to the public, or to prepare derivative works (*See* Treas. Reg. § 1.861-18(c)(1)(i), (c)(2)). A transfer of a copyrighted article occurs if a transferee obtains a copy of a copyrighted work (e.g., a computer program), without a right to use the underlying copyright. A transfer of less than all of the benefits and burdens of ownership associated with a copyrighted article to the transferee results in a lease that generates rental income (*See* Treas. Reg. §1.861-18(f)(2)). Finally, if the transaction does not involve a transfer of copyright rights or a copyrighted article, the proper characterization, as discussed below, is likely the provision of a service instead of royalties or rental as further discussed below in the country surveys.

Typical royalty definitions apply to "payments for" various items, including, most importantly, for the right to use copyrights and other specified intellectual property, such as patents, trademarks, designs

or models, plans, secret formulas, or processes (*See*, *e.g.*, Article 12(2) of the OECD Model). Typically, the provision of cloud services does not involve the grant to customers to use any of those rights. Accordingly, the main technical issue is whether cloud payments by either a customer or reseller (discussed below) are essentially for the use of, or right to use, copyrights. If instead cloud payments are essentially made to obtain access to a service (e.g., to obtain access to the functionality created by the combination of hardware and software that comprises an IaaS offering), the expected conclusion is that the payment would be characterized as a service fee. Even if the customer makes some ancillary or de minimis use of copyright or other intellectual property in order to access the cloud service, the better tax policy result is to ignore that ancillary or de minimis use so that such use does not affect the characterization of the cloud payments.

Payments in Cloud Transactions are essentially made to obtain access to a suite of services, which include significant hardware as well as software functionality in the IaaS context, access to platforms in the PaaS context, and access to applications over the internet in the SaaS context. In typical Cloud Transactions, there is not a license of intellectual property rights from the cloud provider to customers (or resellers) and it is the cloud provider, not the customer, that may be regarded under the applicable copyright law as using the copy of the applications hosted on the provider's hardware. It is for these reasons that Cloud Transactions normally fall outside of the scope of typical royalty definitions.

Note: Some countries may characterize income from Cloud Transactions as payments for technical services. In addition, some tax treaties include payments for technical services within the definition of royalties. Other than in Singapore which is discussed in further detail below, the domestic law provisions of the other countries discussed in this article do not have a technical services concept.

Typical Transaction Models—Direct v. Reseller

Cloud Transactions can take the form of direct commercial transactions between cloud computing service providers and their customers.

Reseller models are also common. Generally, cloud providers structure their arrangements with affiliate resellers and third-party resellers, so that the local reseller is authorized to enter into contracts with end customers under which those customers may obtain access to the cloud computing services. In these types of transactions, like the direct model, the copyright owner (i.e., the cloud computing services provider) typically does not give the reseller the right to use any material copyright rights. Moreover, the copyright owner is not required to provide to the reseller the right to

use any material copyright rights for the reseller to be able to on-sell the cloud computing services because resellers normally do not use any copyright rights to perform their sales, contracting, and invoicing functions.

The focus of this article is cross-border transactions, where (i) in the direct model, the customer is domestic and the provider is offshore, or (ii) in the reseller model, the reseller is domestic and the provider is offshore. The specific commercial circumstances will dictate which of the two models makes sense for any given cloud provider in the context of any given Cloud Transaction. The reseller model may be preferred for a number of commercial reasons, including to improve local customer experiences or to reduce administrative complexity and banking costs for customers associated with cross-border payments, among other reasons.

OECD, UN, and U.S. Guidance

OECD Guidance. The OECD has not provided guidance that is specific to Cloud Transactions in the Commentary to the OECD Model Tax Convention ("OECD Model"). Article 12(2) of the OECD Model defines royalties to mean "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience." To determine the proper characterization of revenue from transactions that involve software to some degree, like Cloud Transactions, it can be helpful to consider the guidance on analogous transactions provided in the OECD Commentary to Article 12 ("Article 12 Commentary").

The Article 12 Commentary bases the characterization analysis on whether a transaction involves the extension to the transferee of certain rights in the underlying copyright by distinguishing between transfers of "rights in the underlying copyright" and transfers of "rights in a copy of the program" (a "program copy"). Paragraph 13.1 of the Article 12 Commentary provides that the transfer of rights in a copyright can give rise to royalty income where "the payments are for the right to use the copyright in the program (i.e., to exploit the rights that would otherwise be the sole prerogative of the copyright holder)." The examples of transactions that give rise to royalty characterization in Paragraph 13.1 all clearly involve market exploitation licenses, namely "licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program." In these types of transactions, Paragraph 13.1 states that the "payments are for the right to use the copyright in the program (i.e., to exploit the rights that would otherwise be the sole prerogative of the copyright holder)."

In contrast, where a transaction only involves the transfer of rights that are "limited to those necessary to enable the user to operate the program," the transaction is one involving the acquisition of program copies (Paragraph 14 of the Article 12 Commentary). For example, the transferee may receive limited rights to reproduce the software program, which would be common in transactions for the acquisition of a software copy. In these types of transactions, the rights that are transferred are specific to the nature of the computer program and may be limited to the right to copy the program (e.g., for copying the software onto the user's computer hard drive). Paragraph 14.1 of the Article 12 Commentary explicitly states that the method of transferring the software to the transferee is not relevant to the characterization analysis and it does not matter if there are restrictions on the use to which the transferee can put the software. Licenses to users that allow users to make multiple copies for use only within the transferee's own business are explicitly characterized as giving rise to business profits in most cases (Paragraph 14.2 of the Article 12 Commentary).

Paragraph 14.4 of the Article 12 Commentary provides that "in a transaction where the distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analyzing the character of the transaction for tax purposes." Thus, a payment pursuant to a license that is limited to the right to distribute copyrighted articles in a certain territory, which is the central right that allows a reseller to perform its main function as a distributor, should not constitute a royalty.

Under the OECD Model, if a payment for a cloud service is not described in Article 12 (or any other specific income category in the OECD Model), then it should fall under Article 7 (business profits). First, in a Cloud Transaction, the payments are not essentially made for "software" and there is no transfer or license of software to customers (or resellers) in a typical Cloud Transaction. Rather, the payments are made to gain access to a service. Second, Cloud Transactions do not involve transfers of physical possession, access or control of infrastructure or hardware to customers (or local resellers) by the cloud provider. While some treaties include in the definition of royalties payments for the use of industrial, commercial, or scientific equipment, that category should not apply to a typical Cloud Transaction because the customer (or local reseller) does not use the equipment; rather, the provider uses its equipment itself to provide services to customers.

Due to the fact that contracts in the cloud computing context are complex and may involve several components, it is necessary to consider whether a transaction should be unbundled into its separate components. Paragraphs 11.6 (know-how and technical assistance) and 17 (software and digital products) of the Article 12 Commentary provide that transactions should be segregated into their component parts, unless one of the parts is "of an ancillary and largely unimportant character" in which case the income should be characterized according to its principal part. Paragraph 11.6

specifically provides, “If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.”

The more specific OECD document for addressing Cloud Transactions is a report prepared by the Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments published in 2001 and adopted by the OECD Committee on Fiscal Affairs in 2002. The report is titled, “Tax Treaty Characterization Issues Arising from E-Commerce” (the “TAG Report”) and provides recommendations on the character of digital transactions, including digital products and services. The Article 12 Commentary mostly deals with more traditional transactions, including transactions involving digital downloads of software; it does not offer specific guidance on Cloud Transactions (although the principles expressed in the Commentary can easily be applied to Cloud Transactions generally). The TAG Report provides helpful guidance on the character of payments for certain transactions that are similar to IaaS transactions. For instance, in a transaction in which a provider offers space on its servers to host its customers’ websites, the TAG Report concludes that the transaction gives rise to business profits. The TAG Report explicitly states the conclusion is the same even if the definition of royalty in the treaty includes “payments for the use of, or the right to use, industrial, commercial or scientific equipment” or that the treaty otherwise allows source taxation of technical services fees.

The TAG Report concluded that the payments for “application hosting” are not for the use of, or the right to use, industrial, commercial or scientific equipment because the vendor uses the equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilize the equipment concurrently with other customers. The TAG Report also concluded that payments for “application hosting” are not technical services fees because, to the extent that main service being provided is merely that of storing the data and software of customers, this service is akin to mere warehousing and the performance of that function does not require the direct exercise of any special technical skill or knowledge.

UN Guidance: Article 12B was included in the 2021 version of the UN Model Double Taxation Convention (“UN Model”) and would allow source taxation of payments for automated digital services on a gross or net basis. Advocates in favor of Article 12B seem to have regarded its inclusion in the UN Model to encourage countries to develop domestic legislation on the taxation of automated digital services. The UN Commentary on Article 12B notes that a “large minority” of members of the UN

Committee of Experts on International Cooperation in Tax Matters, the committee that approved the inclusion of Article 12B and commentary thereunder, did not agree that "the advent of modern means of telecommunications and the ability to conclude contracts remotely without the involvement of individual employees or dependent agents, on its own" justifies the allocation of taxing rights on income from automated digital services to the source state (Paragraph 8 of the UN Commentary on Article 12B). These dissenting members had multiple specific concerns with the prospect of allocating taxing rights to source jurisdictions during the discussions on whether to approve the inclusion of Article 12B in the UN Model and these views were memorialized in Paragraphs 8-16 of the UN Commentary on Article 12B. The commentary to Article 12B clearly reflects that the principles underlying Article 12B, and the inclusion of the article itself did not reflect a unanimous or even a large majority position among Committee members.

The definition of "automated digital services" in Article 12B(6) includes, among others, "cloud computing services." Moreover, the commentary to Article 12B provides that "cloud computing services" includes "those providing standardized on-demand network access to information technology resources, including infrastructure as a service, platforms as a service, or software as a service (such as computing services, storage services, database services, migration services, networking and content delivery services, webhosting, and end-user applications and software)" (*See* Paragraph 58(h) of the UN Commentary on Article 12B). Article 12B will be relevant only if a state's domestic law allows withholding on such payments, and the article is incorporated into a double tax treaty, if any, between that state and the state of residence of the cloud supplier. The terms of any actual treaty provision would be subject to negotiations between bilateral treaty partners. Article 12B has not been adopted in any U.S. treaty. We observe that under the UN Model, fees for any service of a managerial, technical or consultancy nature are covered by Article 12A, while fees for automated digital services are covered by Article 12B. That suggests that fees for automated digital services would not normally be classified as fees for services of a managerial, technical or consultancy nature in treaties that allow withholding only for that category of services.

U.S. Guidance. The U.S. Treasury published proposed Treasury Regulations on the classification of cloud transactions in 2019, providing guidance on the characterization of common types of Cloud Transactions (See Prop. Reg. § 1.861-19, "the Proposed -19 Regulations"). This guidance, which remains in proposed form as of the date of this article, would require that a cloud transaction be classified as solely a lease of property or solely the provision of services. The Proposed -19 Regulations do not include as an option that a transaction within their scope can be characterized as a royalty. The proposed guidance and their specific examples conclude that the provision of computing capacity and data storage should be treated as the provision of services (*See* Prop. Reg. §1.861-19(d)(1), (2), and (8)).

The preamble explicitly notes that transactions that qualify as cloud transactions according to the definition in the Proposed -19 Regulations are not within scope of Treas. Regs. §1.861-18 (the "-18 Regulations"), which categorize transfers of computer programs (i.e., software) as transactions involving copyright rights or a copy of a copyrighted work. On the one hand, income from transactions that qualify as transactions involving copyright rights can be classified as a license giving rise to royalty income or a sale or exchange of the copyright right depending on if there has been a partial or complete transfer of the copyright right (*See* Treas. Reg. § 1.861-18(f)(1)). On the other hand, income from transactions involving a copy of a copyrighted article can be treated as giving rise to rental income or a sale or exchange of the copyrighted article depending on whether there has been a partial or complete transfer of the copyrighted article (*See* Treas. Reg. §1.861-18(f)(2)). U.S. Treasury specifically noted in the preamble to the Proposed -19 Regulations that the -18 Regulations "would not apply" to Cloud Transactions because the -18 Regulations do not address "the provision of online access to use" software even if certain Cloud Transactions provide customers with "similar functionality with respect to computer programs as transactions subject to Treas. Reg. §1.861-18" (REG-130700-14, 84 Fed. Reg. 40317, 40318 (Aug. 14, 2019)). Further, the preamble noted, "In general, a cloud transaction involves access to property or use of property, instead of the sale, exchange, or license of property, and therefore typically would be classified as either a lease of property or a provision of services" (84 Fed. Reg. at 40318). This proposed guidance was necessary because the existing guidance relating to software transactions in the -18 Regulations did not expressly cover Cloud Transactions as Cloud Transactions generally do not typically involve the transfer of a computer program. In addition, the proposed guidance and related commentary from U.S. Treasury in the preamble demonstrates that royalty characterization for Cloud Transactions as defined in this article is not a normal result in the U.S. tax framework.

Treatment in Various APAC Countries

Before moving to the treatment of Cloud Transactions in the countries surveyed herein, it is worth noting that tax treaties modify results arising under a country's domestic law. Tax treaties do not impose income tax, instead they allocate taxing rights between treaty partners. It is a generally accepted principle that taxpayers are entitled to avail themselves of the tax treatment provided by the applicable domestic law or by an applicable income tax treaty, whichever is more favorable. This means that if the tax treatment of a Cloud Transaction is clear under an applicable tax treaty, then it should not matter that domestic law may be unclear or provide for a higher or positive rate of tax.

Indonesia. Indonesian domestic law does not include specific provisions that provide guidance on the characterization of payments for cloud services. The Indonesian Tax Law includes four income

categorization categories:

- income from working or employment relationships;
- income from business activities, which includes service fees;
- income from capital, which includes rents and royalties; and
- other income, which includes gifts and debt forgiveness.

The two possible income categories for income derived from cloud computing transactions are income from business activities (i.e., service fees) and royalties.

Little guidance exists under the Indonesian Tax Law on what types of income constitute income from business activities. Indonesian Tax Law defines royalties to include payments in respect of any type of method of calculation (whether or not made on a periodic basis), as consideration for the use of, or the right to use, copyrights, and the use of, or the right to use, industrial, commercial, or scientific tools or equipment (*See* Article 4(1)(h) of the Indonesian Income Tax Law).

Income from Cloud Transactions is better characterized as giving rise to income from business activities based on a recent private ruling from the Indonesian tax authorities and VAT regulation.

In the recent ruling, the Indonesian tax authorities provided that payments received in connection with a sale and purchase transaction of a cloud-based computing product will be considered royalties provided that the sale and purchase transactions are accompanied by (i) the grant of the right to use copyright under the Indonesian copyright law; or (ii) the grant of a license from copyright holders or holders of related rights to publish and/or reproduce their creations or other related rights under certain conditions. Typical Cloud Transactions do not involve a grant of rights to use copyrights and do not involve a grant of a license from the copyright holder of rights to publish or reproduce the copyrighted works.

The Indonesian tax authorities also indirectly provided guidance on the proper characterization of payments for cloud services generally in a recent VAT regulation (Minister of Finance Regulation No. 32/PMK.010/2019). In this regulation, the Indonesian tax authorities provided that cloud computing services are considered part of technology and information services for export VAT purposes. The “technology and information services” category for export VAT purposes is analogous to the income from business activities category for income tax purposes, and we would expect that payments that are characterized as technology and information services for export VAT purposes would be characterized as income from business activities for income tax purposes. Taken together with their

conclusion in the ruling above, it is likely that the tax authorities are inclined to view income from cloud services generally as income from business activities because there is no grant of the use of, or rights to use, copyrights and no grant of a license from the copyright holder of rights to publish or reproduce the copyrighted works. It may be interpreted that the reference to cloud computing services in this regulation is broad enough to also encompass all Cloud Transactions.

Although Indonesia is not a member of the OECD, Indonesia is considered a key partner of the OECD. Indonesia has based several tax treaties , at least in part, on the OECD Model, and the interpretation of Article 12 arguably should follow the OECD Commentary. Therefore, the character of Cloud Transactions should be determined in light of Indonesia's tax treaties and the relevant guidance from the OECD.

Note: Unless specifically noted, all conclusions and analysis regarding the application of treaties in this article assumes that the relevant treaty conforms to OECD Model in all material respects in Articles 7 (business profits) and 12 (royalties).

Generally, Indonesia's tax treaties include language that is similar or substantially similar to the definition of royalties in Article 12(2) of the OECD Model. Thus, the analysis of payments in the context of Cloud Transactions under the OECD Model should generally apply in the context of Indonesia's tax treaties. The payments should not be considered to give rise to royalty income and should instead give rise to business profits. Under Indonesia's tax treaties, if the payment for cloud computing services is considered a service and falls under "business profits" and the cloud provider does not have a permanent establishment in Indonesia, the payment should be exempt from withholding tax in Indonesia.

In a typical cloud reseller arrangement in which the Indonesian reseller does not acquire rights to use copyrights or a license to intellectual property from the offshore cloud provider and instead enters into a distribution agreement with the offshore cloud provider, which allows the reseller to sell contracts to end customers allowing them to access the cloud service, the payments the reseller makes to the offshore cloud provider are better characterized as business profits for the same reasons as described above. There is nothing about a reseller transaction that should change the analysis or conclusion in Indonesia under domestic law or in the context of Indonesia's tax treaties.

Malaysia. Effective January 17, 2017, amendments to the Malaysian Income Tax Act 1967 (ITA) expanded the definition of "royalties" to include payments "in respect of software", thus raising the issue of whether payments for cloud services provided to Malaysian customers by foreign service

providers are royalty payments “in respect of software,” which would be subject to Malaysian withholding tax.

This amendment created confusion because the term “software” is not defined in the Malaysian tax law, and the phrase “in respect of” remains vague. Further, there is no clarification of the intent or purpose of the amendment in the explanatory notes to the Finance Bill or the Parliamentary Hansard when the amendment was tabled before the Malaysian Parliament. The Malaysian tax authority’s attempt to provide guidance on the definition of “royalties” by way of its Guidelines on Taxation of Electronic Commerce Transactions in 2019, which does not form part of legislation, also raised some concerns among industry members due to inconsistencies with the approach adopted by other jurisdictions.

As discussed above, customers in Cloud Transactions are paying for services that are provided by the cloud services provider by utilizing its hardware infrastructure and software functionalities, and the customers are not paying the cloud services provider for rights to use the underlying software or for the right to use the copyrights of the underlying software. Accordingly, the Cloud Transactions payments are more properly characterized as service fees, rather than payments “in respect of software” under Malaysian domestic law. Income that is characterized as services income under Malaysian tax law should not give rise to withholding tax provided that the services are performed by the non-resident cloud services provider outside of Malaysia. Moreover, because cloud payments are not made in consideration solely for the straightforward usage of hardware infrastructure without other functionalities, such payments also are not properly characterized as rents.

Note: Whether or not services are regarded as being performed in Malaysia depends on the facts and circumstances of each transaction. As an example, where the operating platform and software which are primarily responsible for and critical to the delivery of all the functionalities of the cloud services are designed and developed outside of Malaysia, these would be strong indicators that the cloud services are performed outside of Malaysia when determining whether the payments for such cloud services will be exempted from withholding tax. Moreover, under Malaysian domestic law, service fees will be subject to WHT only if (i) the service fees are deemed to be derived from Malaysia, and (ii) the service fees relate to services performed in Malaysia.

The analysis and considerations above should not change in the context of typical cloud services reseller transactions.

The Philippines. Under Philippine law there is no specific guidance on the characterization of Cloud

Transactions. Gross income includes income derived from services in whatever form paid and income derived from the conduct of a trade or business. Royalties are specifically defined under §42(4)(a) of the National Internal Revenue Code as payments for the "use of or the right or privilege to use in the Philippines any copyright, patent, design or model, plan, secret formula or process, goodwill, trademark, trade brand or other like property or right." There is no definition of "services" under domestic tax law.

Although there is some debate as to the proper characterization of payments in the context of traditional software supply models where an offshore copyright holder provides local users with a copy of software under a license, those debates are not applicable in the cloud computing context generally. This is because, in Cloud Transactions, the offshore provider is not required to, and in fact does not, grant the rights to use, modify or exploit intellectual property to customers except typically in the limited case of the use of intellectual property only for the purpose of using the cloud services. Thus, under domestic law, income from Cloud Transactions should be characterized as services income, and not royalty income. This income should not be subject to withholding tax in the Philippines under Philippines domestic law when the services are performed outside of the Philippines because the income would not be Philippines-sourced income, and there should be no need to consider the application of Philippines' tax treaties.

In the context of a tax treaty, however, income from Cloud Transactions should be treated as business profits and exempt from tax in the Philippines where the cloud service provider does not have a permanent establishment in the Philippines. In a recent ruling, the Philippines tax authorities (the "BIR") held that the income of an offshore provider of hardware, firewall services, and cloud computing services was business profits and exempt from income tax in the Philippines under the U.S.-Philippines Tax Treaty.

The facts of this ruling involved a cloud computing services provider, without a permanent establishment in the Philippines, which engaged a domestic corporation as a reseller. Pursuant to the arrangement, the offshore provider produced and sold, and made available to the local reseller, products and services, including hardware, firewall services, and cloud computing services. Under the agreement, the local reseller was prohibited from copying, altering, disassembling, decompiling, or renting any products or services. The local reseller was also prohibited from modifying or reverse engineering any products or services. The ruling held that the offshore provider would be entitled to avail itself of the U.S.-Philippines Tax Treaty to exempt its income arising from the transaction because it was able to prove that it did not have a permanent establishment in the Philippines.

Singapore. Under the Singapore Income Tax Act 1947, certain categories of payments that are

deemed sourced in Singapore and made to non-Singapore tax residents are subject to withholding tax. These payments are deemed sourced in Singapore if they are, among other conditions, borne (directly or indirectly) by a Singapore tax resident. The relevant categories of payments for purposes of this article include:

- Royalties or other payments for the use of, or the right to use, any movable property (including intellectual property rights), or any payment for the use of, or the right to use, scientific, technical, industrial, or commercial knowledge or information ("**technical knowledge or information**"); and

- Any payment for the rendering of assistance or service in connection with the application or use of technical knowledge or information ("**technical service fees**").

Note: There are other categories of payments that may trigger Singapore withholding tax, such as interest, management fees, and rent. These are not relevant for the present purposes, and we have not discussed these in detail. In particular, we would not expect a rental characterization (i.e., payments for the use of any tangible movable property) to be relevant where the Cloud Transactions do not involve any supply of use of tangible movable property to the Singapore customers, particularly where the customers do not have physical control, possession of, or access to any such tangible movable property.

Because a customer in a Cloud Transaction does not pay for the use of any intellectual property rights, or technical knowledge or information, the payments in a Cloud Transaction made by Singapore customers should not be characterized as royalties that trigger withholding tax in Singapore. Instead, payments in Cloud Transactions are more likely characterized as payments for services under Singapore tax law, given that they are, in essence, payments for IT services delivered over the internet. Notwithstanding the characterization as services, such services should not give rise to Singapore withholding tax unless they are considered technical service fees. Even if such services are considered technical service fees, an exception may apply where the services are rendered or performed outside Singapore (among other conditions).

Cloud service customers pay for access to the functionalities provided by a cloud provider and do not acquire any use rights in intellectual property or information or knowledge. Typically, the Cloud Transaction does not create any technical knowledge or information transferred to the customer, impart existing technical knowledge or information to the customer, or assist a customer in applying or using existing technical knowledge or information. The payments customers make should therefore not be regarded as technical service fees that potentially trigger Singapore withholding tax.

Similar arguments apply in the context of reseller payments made by a Singapore reseller to the non-resident cloud provider. The characterization of such reseller payments is similarly a question of fact.

Such reseller payments also should not be characterized as royalties, either where the Singapore reseller does not acquire technical knowledge or information from the cloud provider or a license of intellectual property rights from the cloud provider, or such use or rights to use are granted on a royalty-free basis and at no cost (e.g., rights to use trademarks solely for marketing and reselling activities). A reseller whose sole authorized activity is to resell cloud computing services that is delivered by the non-resident cloud provider to local customers would ordinarily not require any intellectual property rights or confidential information relating to the proprietary operating platform or software operated by the cloud provider. This is particularly the case given that specific rights to use the hardware or software functionalities are likely governed under an end user agreement entered into directly between the cloud provider and the customers, without the Singapore reseller being a party to such an agreement.

As discussed above, the Singapore reseller enters into a distribution agreement with the cloud provider, which allows the reseller to resell cloud computing services to end customers. The payments by the reseller under this arrangement are therefore more naturally characterized as payments for services under Singapore law. Notwithstanding this, the reseller payments similarly should not be characterized as technical service fees that potentially trigger Singapore withholding tax, where the payments do not procure for the Singapore reseller any benefit associated with the application or use of any technical knowledge or information for the same reasons as discussed above.

Thailand. In general, a foreign entity not carrying on business through a taxable presence in Thailand, who receives certain types of income categorized under §40(2) to §40(6) of the Thai Revenue Code (e.g., service fees, royalties, and rental) derived in or from Thailand, will be taxed in Thailand by way of withholding tax at the rate of 15% on gross income, according to §70.

Section 40(3) defines royalties broadly as value received for goodwill, copyright, or any other rights. Thai domestic law does not include a specific definition of services. Income from the provision of general services could generally and mainly be regarded as income under §40(2) or §40(8). Section 40(2) covers income derived from the performance of work which includes income from a hire of work.

Note: The term “hire of work” income in relation to §40(2) of the Thai Revenue Code is not intended

to be the same as the work-for-hire concept that exists under the U.S. Copyright Act. There is not a clear definition of performance of work under Thai domestic law. Income under §40(2) of the Thai Revenue Code includes income derived from the performance of work, such as fees, service fees, commissions, and discounts. An important example of income under §40(2) is income from hire of work, which is defined under the Civil and Commercial Code as a contract whereby a person, called a "contractor," agrees to accomplish a definite work for another person, called a "hirer," who agrees to pay a remuneration for the result of the work.

If the provision of services is general in nature or does not require advanced technology or high-cost of services, then the service fees are likely to be categorized as income under §40(2). The definition of income under §40(8) is income from business, commerce, agriculture, industry, transport, or any other activity not specified by §40(1)–(7) ("other income"). Income that is categorized as "other income" under §40(8) is not subject to withholding tax under Thai domestic law, while income that is categorized as income derived from the performance of work under §40(2) or royalty income under §40(3) is subject to withholding tax at 15%, unless reduced or exempt under an applicable tax treaty.

There are no clear regulations, precedents, or guidelines in the domestic law of Thailand which state the applicable criteria used to classify income derived from Cloud Transactions. In the absence of specific guidance, the characterization analysis of IaaS and PaaS in Thailand likely proceeds as follows:

- The characterization analysis of IaaS transactions would take note of the fact that the offshore IaaS provider only provides online facilities by allowing customers to store, access, control, and manage their own data remotely through the online system. The IaaS provider does not grant the right to use any software, intellectual property, or specific know-how. In addition, there is no delivery of physical equipment or hardware to the customers. Under Thai principles, these factors all indicate that the IaaS fees should not be classified as royalties or rent from a Thai tax perspective and should instead fall within the category of income derived from the performance of work under §40(2) or "other income" under §40(8).

- The characterization analysis of PaaS transactions would take note of the fact that the offshore PaaS provider offers application development and deployment, where customers do not manage or control the cloud infrastructure or the development platform. The PaaS provider does not grant the right to use any software, intellectual property, or specific know-how. Similar to IaaS, these factors should indicate that PaaS fees should be classified as income derived from the performance of work under §40(2) or other income under §40(8).

For SaaS transactions, the Thai tax authorities may take the position that fees should be classified as

royalties under §40(3), in line with the treatment of payments for the delivery of software copies, instead of income under §40(2) or §40(8). However, SaaS transactions are inherently different from traditional supply of software transactions as SaaS transactions do not involve the distribution of copies of software or payments for the use of or the right to use software or other intellectual property.

The Thai tax authority has concluded in various tax rulings that payments in consideration for the use of or the right to use software (including in connection with services relating to software such as software maintenance and support services) should be characterized as royalties. In these rulings, the Thai tax authority did not describe what constitutes the exercise of, or transfer of, any copyright rights. Instead, the Thai tax authority seems to conclude that all payments that relate in any way to the delivery of software constitute royalties. The emergence of new business models that do not involve the transfer of copies of software requires a closer examination of the distinction between a license arrangement and a services arrangement. The presence or absence of the exercise of a protected intangible property right by the payor should determine whether a particular transaction gives rise to royalty income, services income or another character of income. In our view, SaaS transactions should be analyzed in the same way as IaaS and PaaS transactions. Accordingly, when we refer to “Cloud Transactions” in the remainder of this section, we are referring to IaaS, PaaS, and SaaS transactions.

The Thai tax authority in prior cases has concluded that if a provision of services involves advanced technology, requires high-value investment by the provider, and the provider incurs a significant amount of expenses, the fees paid for the provision of these services may be characterized as “other income” under §40(8). “Other income” is not subject to withholding tax under domestic laws. Accordingly, if the services do not involve a grant of the right to use any software, intellectual property, or specific know-how, then the resulting payments should be characterized as other income under §40(8). Examples of services that have previously been classified as other income under §40(8) include, but are not limited to, the following:

- Website and server hosting services;
- Internet access services;
- Data network services;
- Data center hosting services;
- Long term email archive services;
- Firewall management and support services;
- Application development services;
- Internet protocol virtual private network services;
- Network equipment rental services;

- Large file transfer services; and
- Video conferencing services.

Given that Cloud Transactions involve advanced technology, require high-value investment by the provider, and the provider incurs a great amount of expenses, fees paid in Cloud Transactions should be regarded as other income under §40(8) which is not subject to withholding tax under domestic laws.

If the better characterization for income from Cloud Transactions is “other income” under §40(8), there should be no need to consider the application of Thailand’s treaties. However, to be complete, in the tax treaty context, if income from Cloud Transactions were to fall outside the scope of other income, and instead be classified as income derived from the performance of work under §40(2), the income still should be exempt from tax in Thailand because it should be characterized as business profits in Thailand’s tax treaties.

This conclusion should prevail under those treaties which include an express reference to software in the royalty definition. A number of Thailand’s tax treaties include within the definition of royalties payments for “software.” Cloud Transactions do not involve payments for the right to use equipment and should not implicate the “industrial, commercial, or scientific equipment” clause of an applicable tax treaty’s royalty definition. The more expansive definition of royalties in Thailand’s treaties may thus give rise to questions about whether payments for cloud services should be characterized as royalties in the treaty context if there is doubt that the income should be characterized as other income under §40(8) or income derived from the performance of work under §40(2). For the reasons discussed above, Cloud Transactions should not be characterized as royalties in the context of Thailand’s tax treaties, even those with the more expansive definition of royalties that includes payments for “software.” Income that is characterized under §40(2) as income derived from the performance of work should generally fall under the category of business profits in Thailand’s tax treaties and should be exempt from Thai withholding tax, provided that the service provider does not carry on business through a permanent establishment in Thailand.

The analysis and considerations above should not change in the context of typical cloud services reseller transactions.

Vietnam. Under Vietnamese law, a foreign entity is subject to VAT and corporate income tax on its income derived in Vietnam. Foreign entities are considered to derive income in Vietnam generally from payments made by a Vietnam-based entity to that foreign entity for its provision of goods, services, or other type of items such as loan interest, capital gains, and royalties. If a foreign entity

does not meet the conditions for directly declaring and paying taxes in Vietnam or if it does not choose to do so, then, by default, the local entities doing business and making payments to a foreign entity are responsible for withholding taxes (*See* Circular No. 103/2014/TT-BTC). Starting from January 1, 2022, a foreign company that engages in an e-commerce business or a digital-based business and that does not have a permanent establishment in Vietnam can register to directly declare and pay tax in Vietnam (*See* Circular No. 80/2021/TT-BTC). If foreign companies do not register, then local entities (including corporate customers or banks/intermediary payment service providers) will be responsible for withholding tax on their payments or transfers to foreign companies. This regime is referred to as the foreign contractor tax.

Under the foreign contractor tax regime, cloud services providers are subject to Vietnamese taxes on the income they derive from Vietnam-based customers and from local resellers. The applicable corporate income tax rates vary depending on whether the offshore cloud services providers' income is characterized as services (5%) or royalties (10%).

Note: The applicable VAT rate for services is 5%. For royalties paid for software licensing, VAT is exempt. For royalties paid for licensing of other intellectual property rights, the VAT rate is 5%.

The foreign contractor tax regime does not differentiate between different types of services (e.g., services generally v. technical services). If a contract separates different items of income, the corresponding tax rate will apply to the items of income separately. If a contract does not separate different items of income, then the highest tax rate will apply to the entire contract price.

Vietnamese domestic law defines royalties as income of any kind paid for a right to use, a transfer of intellectual property rights and a transfer of technology, software copyright (including payments for use rights, a transfer of copyright and work owner rights; a transfer of industrial property rights; and a transfer of technology). Services are defined in the Vietnamese Commercial Law as a commercial activity whereby a service provider is obliged to perform services for another party and receive payments. The service recipient is obliged to pay the service provider and use the service as agreed. Similarly, under the Civil Code, a service contract is an agreement between parties whereby a service provider performs work for a service recipient in exchange for payment.

Although there is no specific definition of cloud computing services generally under Vietnamese tax law, cloud computing services were mentioned in the correspondence of the Ministry of Information and Communication (MIC) to other Vietnamese state agencies regarding the technical criteria for evaluating and selecting cloud computing solutions for e-government. Specifically, the MIC defined cloud computing, PaaS, SaaS, and IaaS as follows (*See* MIC official letter No. 1145/BTTTT-CATTT

(April 2, 2020)):

- Cloud computing is a service model that allows the use of shared computing resources (networks, servers, storage, applications, services) through a network connection. This cloud resource can be set up or cancelled by the user without the intervention of the service provider.

- PaaS is the concept of cloud computing platform rental services. Vendors are responsible for administering and operating the entire service infrastructure and providing customers with software platforms to run applications and services. Customers simply use the rented platform to build applications and services for users without worrying about the performance, scalability and upgradeability of the system. This service provision model is suitable for the public cloud deployment model, for small and medium-sized customers that do not require high data security.

- SaaS is the concept of renting applications on cloud computing platform. Users simply rent and use applications without worrying about the infrastructure or software platform they use. This service provision model is suitable for the public cloud deployment model, for end users using the cloud service as a service application.

- IaaS is the concept of a service that provides cloud computing infrastructure. Customers rent out infrastructure services and pay only for what they use. In this model, customers have full control over the server infrastructure including the operating system, applications, and data on the server.

Note: The MIC's definitions above come from the original Vietnamese language versions of the official letter are not exactly the same as the commonly accepted definitions of SaaS, PaaS, and IaaS. For example, in the typical IaaS transaction, customers do not have control over the server infrastructure. The vendor (cloud service provider) controls the infrastructure but the customer controls their applications that they choose to upload onto the infrastructure. This is in contrast to the MIC's definition of IaaS, which states that customers have control over the server infrastructure.

Note: The reference to rented platforms, applications, and infrastructure come from the original Vietnamese language version of the official letter. Because the platform, applications, and infrastructure in question remain under the control/possession of the cloud services provider, typical Cloud Transactions should not result in a rental characterization. In any case, the applicable tax rate for rental income is the same as that for services income, i.e., 5% corporate income tax and 5% VAT.

The MIC is the authority in Vietnam that the local tax authorities would reach out to seek an opinion

on the proper characterization of cloud computing services generally and PaaS, SaaS, and IaaS specifically.

The Hanoi Tax Department, in an October 2020 ruling issued to a local bank regarding the withholding tax treatment of payments for cloud computing services, provided little guidance for characterizing payments for cloud services. In this ruling, the local tax department did not specifically state which corporate income tax rate should apply to the services in question and instead instructed the bank to make a self-assessment on the characterization of the payments.

It is helpful that the MIC has already written in an official letter that Cloud Transactions are “the concept of a service” and cloud computing generally is a “service model.” This is helpful guidance in clarifying that income from Cloud Transactions should be characterized as services under domestic Vietnamese law. Moreover, typical Cloud Transactions do not involve the license of software or intellectual property rights to customers as anything more than an auxiliary part of the transaction (usually in order for the customers to be able to use the services) and thus should clearly fall outside of the scope of the domestic definition of royalties.

The Ministry of Finance has published guidance for implementing Vietnam’s tax treaties, which provide that “business profits” means income derived from conducting production and business activities in Vietnam, other than the specifically listed categories of income covered in the treaties, which include, for example, income from immovable property, income from international transportation, dividends, loan interest, royalties, technical services, and income from asset transfers. Accordingly, Cloud Transactions payments should fall within the “business profits” category if they do not fall within the scope of one of these specific categories, and they do not.

Implications

Although finding the proper characterization for income generated by Cloud Transactions may be complex, as Cloud Transactions continue to grow in importance in an increasingly digitalized economy, it is increasingly important that tax administrations provide guidance.

Even in the absence of specific guidance, we can articulate principles that are broadly applicable to typical Cloud Transactions. Certain facts that are common to typical Cloud Transactions should point to the proper income tax characterization of Cloud Transactions. Primary among these is that typical Cloud Transactions do not involve a transfer of the right to use copyright rights. Instead, the cloud

service provider exercises its own copyright to provide its services.

That fact leads to the conclusion that there should be a common treatment for Cloud Transactions in the countries discussed in this article. In Indonesia, Malaysia, the Philippines, Singapore and Vietnam, the proper characterization of Cloud Transactions should be as a service.

In Thailand, PaaS transactions and IaaS transactions should be characterized as services, and there are clear substantive arguments for why SaaS transactions also should be characterized as services. As discussed in greater detail above, there is increased sensitivity when a transaction involves software whether directly, tangentially, or even in name only, given that payments for the transfer of software copies are commonly regarded as royalties. The character analysis for Cloud Transactions, however, should take into account the differences in the commercial relationship between the provider and the customer (i.e., there is not a transfer of a software copy to customers in any meaningful way). That difference supports the conclusion that the substance of a SaaS transaction is a service and not a delivery of software.

In all cases analyzed herein, the result should not change in a reseller model.

Given the global nature of this business, the OECD could contribute to international harmonization by supplementing the Article 12 Commentary relating to software transactions with additional guidance on Cloud Transactions. It is time that the OECD provide this additional guidance to taxpayers and tax administrators by defining Cloud Transactions in a way that is similar or the same as the definition in the U.S. Treasury Regulations and by clarifying that payments in the context of Cloud Transactions should be characterized as business profits, and not royalties. Similarly, we encourage the countries discussed in this article to issue administrative guidance to confirm that payments in the context of Cloud Transactions are not subject to withholding tax (as royalties, rentals, payments for the use of software, technical service fees, or otherwise).

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