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Does a high-frequency trading server constitute a permanent establishment?

1 Introduction

The recent trend of M&A activity among stock exchanges is evidence of global competition to increase market share and attract investors. Exchanges have sought to facilitate platforms for high-frequency trading and have encouraged related infrastructure investment. So-called 'co-location machines' (ie, servers maintained by securities firms and other market participants) enable orders to be placed within a few milliseconds of each other, thus allowing investors to conduct high-frequency, algorithm-based transactions. The Tokyo Stock Exchange allows investors using such servers to place orders automatically pursuant to quote information from the Tokyo Stock Exchange market information system. In order to achieve maximum efficiency, such servers should be located in or very close to the stock exchange buildings so that the physical distance between server and data centre does not delay each transaction-an issue known as 'latency' - and thus reduce the frequency of the trades.

2 Permanent establishment problem

Given the need for physical proximity to the Tokyo Stock Exchange data centre, the server must be in Japan. This gives rise to a tax question: does the server constitute a permanent establishment in Japan for foreign investors that conduct high-frequency trades through the server? The answer is likely to affect the appeal of high-frequency trading on the Tokyo Stock Exchange and may be a matter of concern for foreign investors that enter into transactions in the Tokyo market.

The issue of whether a server constitutes a permanent establishment is one of the most significant tax questions arising from electronic commercial transactions. Although Japanese tax law does not directly resolve it, the results of a discussion by the Committee of Fiscal Affairs at the Organisation for Economic Cooperation and Development (OECD) provide some guidance. These results are summarised in the commentary on the OECD Model Tax Convention and the Supreme Court has held in another context that the commentary may be referred to as a supplementary means of interpretation. Under Article 5.1 of the convention, the term 'permanent establishment' is defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on". Although several factors may determine whether a server fits this definition, one of the most important is whether the server is deemed to be at the disposal of the taxpayer. Paragraph 42.3 of the commentary on Article 5 provides that:

"if the enterprise carrying on business through a website has the server at its own disposal - for example, it owns (or leases) and operates the server on which the website is stored and used - the place where the server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met."

Thus, the key issue is whether a server for high-frequency trades is a fixed place of business at the disposal of foreign investors.

3 National Tax Agency interpretation and qualifications

On June 11 2010 the Tokyo Stock Exchange announced that it had received a response to an enquiry submitted to the National Tax Agency. The response confirmed that foreign investors which use a server located in Japan to conduct high-frequency trades do not have a permanent establishment in Japan. Such foreign investors are not regarded as having the "right to dispose of", or "virtual control over", the server beyond "receiving and enjoying an environment for high-speed placement of orders". However, this conclusion is subject to the following assumptions in the enquiry:

- The foreign investor does not hold an ownership or leasehold right to the server.
- The foreign investor cannot use the server at its discretion, except to execute the high-speed placement of orders.
- The foreign investor has no right or option to purchase the server from the trading participant (ie, the securities firm that owns the server).
- The contract between the trading participant and the foreign investor is a service agreement.
- Contracting with the maintenance operator and payment of expenses are conducted by the trading participant.
- In principle, the foreign investor is prohibited from entering the space where the server has been installed.

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- The restrictions that the foreign investor imposes on the trading participant represent the minimum agreed contractual restrictions which are necessary to ensure the stable provision of services and the protection of the programs stored on the server, as well as certain parameters and other data.

On June 11 2011 the Tokyo Stock Exchange announced that Japan's stock exchanges and the Japan Securities Dealers Association had received a second response from the agency. It stated that the tax treatment of foreign investors which was outlined in the June 11 2010 statement will also apply to the placing of orders with financial instruments markets other than those established by the Tokyo Stock Exchange and the use of data centres operated by institutions other than the Tokyo Stock Exchange, assuming that "the foreign investor is not entitled, at its discretion, to dispose of such server (eg, to sell, provide as collateral [or] destroy)", and that the foreign investor will not be entitled to "utilise and derive profit from such server (eg, subleasing to third parties [or] converting for other purposes)" at its discretion.

4 Key factors

Given the assumptions in the Tokyo Stock Exchange inquiry and the agency's two responses, foreign investors should tread carefully around the issue of whether a server at the Tokyo Stock Exchange may be deemed to be 'at their disposal' and therefore constitute a permanent establishment. Three factors deserve particularly close attention.

(1) Restriction on securities firm's disposal of server

It may be unclear whether a securities firm owns a server if there are strict restrictions on the disposal or destruction of the server. Under Japanese civil law, 'ownership' is defined as "the right to freely use, obtain profit from and dispose of a thing owned, subject to the restrictions prescribed by laws and regulations". Therefore, it is advisable that restrictions on the disposal or destruction of a server be for a limited time and not exceed the necessary requirements of confidentiality. Foreign investors would be well advised to include appropriate language in their agreements with securities firms, setting clear limits to their rights in order to prevent challenges by the tax authorities.

(2) Re-use of server for other purposes

The enquiry and the agency's June 2010 response presuppose that the securities firm which owns the server is authorised to reuse the server for other purposes, to the extent that the programs, parameters and other client data are completely erased before the server is reused. Therefore, if a contract between a securities firm and a foreign investor prohibits the reuse of the server, it is far from clear that the agency would conclude that the server was not a permanent establishment; nor does the June 2011 response indicate whether a prohibition against reusing the server would be equate to a party having the server at its disposal. Such a conclusion would suggest that the server is not entirely controlled by the securities firm and might be a contributing factor in determining whether a server is at the investor's disposal.

It can reasonably be argued that a confidentiality agreement between a securities firm and a foreign investor should not be considered to relate to disposal of the server itself, given that the confidentiality of information related to programs or algorithms which foreign investors have customised and installed on the server is conceptually distinct from the use of the physical object (ie, the server itself).

(3) Installing programs and receiving feedback

The enquiry and response in June 2010 assume that the foreign investor will upload, install and store computer programs and various parameters and other data for use when making orders, in order to receive and enjoy an environment for high-speed placement of orders. However, they do not address the position where a foreign investor uses the server for other purposes, such as the exchange of historical trading information pertaining to its entrustment of orders, with other trading participants so as to upgrade the computer programs. The June 2011 response is also unclear on this point.

If servers are equipped with other functions, such as providing a foreign investor with feedback by collecting data or by other methods (eg, performance evaluation and program correction), this may undermine a foreign investor's claim that it has no right to use and dispose of the server. A physical item, separately offered by foreign investors or their agents or contractors (eg, a chip that contains the necessary programs to tailor the server to the foreign investor's needs), could be a factor in determining whether the server is at the investor's disposal. It might be argued that such a server is not at the disposal of an investor solely because the investor installs programs on it to place orders and to obtain statistical data, given that such actions do not limit the securities firm's rights regarding the physical substance of the server. Further clarification is needed on the practical aspects of such arrangements.

It is advisable for foreign investors to make enquiries with the tax authorities as to the tax treatment of their arrangement.

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