17

Challenges to the Rule of Law in Taxation of the Digital Pornography Industry

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Abstract

The chapter examines the largely and regrettably unstudied issue of the rule of law in the taxation of the digital pornography industry. Digital pornography is a sophisticated global business that has developed over the last two decades and is dominated by large multinational enterprises (MNEs) using innovative organisational structures and revenue models. It is precisely this type of business that the Organisation for Economic Co-operation and Development (OECD) Pillar 1 reform proposals target. However, policy debates on comprehensive tax reform for the digital economy have completely neglected this sector, focusing on more conventional digital multinationals. This chapter seeks to fill some of these research gaps. It highlights both the general challenges of the digital economy, which are particularly evident when studying this industry, and the specific challenges that this industry faces, especially under Swiss domestic tax law. Such challenges often undermine the rule of law in tax policy, either from the perspective of the taxpayer or in terms of the proper administration of a tax system. The paper calls for legislative intervention, either at the national or international level, and argues for a closer examination of the digital pornography industry to develop a fairer and more effective corporate tax system.

Introduction

This chapter analyses the concept of the rule of law in relation to the taxation of the digital pornography industry. This industry, that has radically changed[1] with the

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[1] I refer to the research of Betzler and Leuschen who, taking as example Swiss market, analyze the megatrend of digitalisation in film and gaming industries referring to them as 'cultural and creative industries'. However,

widespread digitalisation of the economy, is one of those industries that seem to be able to reap extreme tax benefits from the outdated international corporate tax frameworks. Using revenue models that are radically different from those used in the twentieth century,[2] such multinational enterprises (MNEs) often have no physical presence in the jurisdictions in which they operate (eg streaming adult content) and thus escape most or all corporate income tax. Similar novel business models were also adapted, for instance, by Google and Facebook, two MNEs that control around two-thirds of the global digital advertising income.[3] Tax-related problems in relation to those two MNEs were constantly analysed in the OECD's BEPS reform proposals.[4] However, the digital porn industry was completely overlooked in the BEPS debate, both at international and domestic (for instance Swiss) levels. This is unfortunate because, firstly, pornography appears to take up a huge amount of space on the Internet, so its links with digitisation are significant, and secondly, it appears to have its own specific business characteristics which merit separate consideration in legislative discussions.

In this context, the present chapter focuses on two aspects in relation to the rule of law. Firstly, I study how the fact that the digital porn industry is effectively untaxed is compatible with 'thin' and 'thick' concepts of the rule of law. The key question is how we qualify a situation where the economy and business models are changing radically, but the tax laws are not adapting and therefore failing to capture new ways of generating business income. Secondly, I question the absence of legislative scrutiny related to this industry in the process of the international corporate tax reform. I discuss the extent to which the new economic reality needs to be understood and considered when legislators (national or international) create new tax rules.

The chapter is structured as follows: Section 2 deals with the application of the rule of law in tax law and specifically in Swiss law. Section 3 discusses the emergence and functioning of the digital porn industry and its specificities. Section 4 focuses on general issues that may arise in the taxation of digital porn, both from a national and international perspective. Section 5 provides a critical evaluation.

Rule of Law and Swiss Tax Law

The principle of the rule of law is a multifaceted concept that is often left undefined in national legislation (eg in Switzerland). It can be described as a moral–political philosophy on the objectives and ideals that the law should promote.[5] The interpretation of this

I use the term 'audiovisual industries' without entering the debate as to whether pornography should be classified as a cultural or creative industry. D Betzler and L Leuschen. 'Digitised Value Chains in the Creative Industries: Is there a Convergence of Swiss Film and Game Production?' (2021) 14 (3) *Creative Industries Journal* 226–44.

[2] M Köthenbürger, 'Taxation of Digital Platforms' in S Cnossen and B Jacobs (eds) *Tax by Design for the Netherlands* (Oxford: Oxford University Press, 2022) 169–80, 170.

[3] C Fuchs, *The Online Advertising Tax: A Digital Policy Innovation* (London: University of Westminster Press, 2018). Available at: www.jstor.org/stable/j.ctv5vddvv 5, 7.

[4] OECD Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, (Paris: OECD, 2015). Available at: https://doi.org/10.1787/9789264241046-en.

[5] A Marmor, 'The Rule of Law and Its Limits' (2004) 23(1) *Law and Philosophy* 1, 2, quoting J Raz, *The Authority of Law. Essays on Law and Morality* (Oxford: Oxford University Press, 1979) 210–26, 221.

concept[6] often pits two versions of the rule of law against each other: 'thin' and 'thick'.[7] In the following, I analyse how these standards are delineated in Swiss tax law.

The 'thin' interpretation of the rule of law is that the function of the law is to act as a guide to action.[8] It has two components:[9] procedural (political authorities rule by law[10]) and formal (rule of law describes a 'good law' that could effectively guide human behaviour[11]).

In Swiss law, procedural components of the rule of law are essentially contained in a constitutional norm, stating that all activities of the state are based on and limited by law.[12] It is called 'principle of legality'.[13] It comprises two aspects: (i) the supremacy of law; and (ii) the requirement of a legal basis.[14] In the domain of taxation, the principle of legality strictly limits governmental action: the main structural features of any tax, in particular those liable to pay tax, the object of the tax and its assessment, are regulated by law'.[15] All significant tax provisions that establish binding legal rules must be enacted in the form of a federal act; this includes essential aspects of taxation: the taxpayer, the object of the tax, the amount and the taxable base.[16] In addition, the fundamental modification of an existing tax, as well as the introduction of any new tax, should be submitted to an obligatory referendum.[17] All in all, a formal law is a prerequisite for the action of the state in the field of taxation.[18]

[6] On many aspects of the rule of law, a consensus can be observed between various scholars' jurisdictions. Marmor, ibid, 5.

[7] For a detailed theoretical overview, see Daly, Chapter 2 in this volume; one can also refer to 'narrow' and 'broad' versions of the rule of law – see Lindsay, Chapter 3 in this volume.

[8] Daly, ibid.

[9] Marmor, above n 5, p 2 et seq.

[10] This criterion might seem easy to interpret, but some authors caution against quick judgement. In fact, from a practical point of view, people will always be ruled not by law, but by other people (Members of Parliament adopt laws, judges interpret them, etc.). Nor does this mean that all governmental actions are authorised by law – by definition, any unauthorised governmental acts are illegal. Marmor, above n 5 at 3 citing Raz. It is also difficult to define what government could not rule by law as such an answer depends on the theory of what the law is (Marmor indicates that in the command theory of law, any order backed by sanction of the sovereign would be law.).

[11] Raz, above n 5, 214. In this respect, law must meet certain conditions, on which there is theoretical consensus: generality, promulgation, no retroactivity, clarity, no contradictory rules, no impossible prescriptions, stability, consistent application. Marmor, above n 5 at 5. Even though the observance of these criteria is a matter of degree (no legal system can be perfectly clear and coherent), the law is no longer able to guide human conduct if they fail fundamentally. Marmor at 3 with reference to L Fuller, *The Morality of Law* (New Haven CT, Yale University Press, 1964) 39.

[12] The Federal Constitution of the Swiss Confederation of 18 April 1999, AS 1999 2556 ('Cst.'), art 5 para 1.

[13] Cst art 5 is entitled 'Rule of Law' in unofficial English translation. In the official Swiss languages, art 5 is called 'Grundsätze rechtsstaatlichen Handelns' (DE) and 'Principes de l'activité de l'État régi par le droit' (FR). The literal translation of this title would be 'principles of the State government by law'.

[14] T Tanquerel, *Manuel de droit administratif* (Schulthess éd. romandes, 2011) 15.

[15] Cst, art 127 al. 1.

[16] ibid. art 164, para 1(d). Interpreting those constitutional norms, the Swiss Federal Supreme Court ('the Court') has confirmed on several occasions that the state can levy no tax or any other public contribution (except in some rare cases) if they do not have a sufficient legal basis, identifying at least those three elements. ATF 131 II 562, 56 and cited references; see also G Lideikyte Huber, *Conceptual Problems of the Corporate Tax: Swiss–US Comparative Analysis* (IBFD: Amsterdam, 2019) 1–373, 10.

[17] Cst, arts 140(1)(a), 142(2) and 195; A Auer, G Malinverni and M Hottelier, *Droit constitutionnel suisse*, Vol I (Stämpfli Editions SA, 2013) 404.

[18] S Weerts. 'The Law and the Principle of Legality' In: *Swiss Public Administration: Making the State Work Successfully*, A Ladner, N Soguel, Y Emery, S Weerts and S Nahrath (London: Palgrave Macmillan, 2019) 69–86, 72, 83.

Formal aspects of the rule of law are expressed through various norms. The requirement of defined normative content of a norm derives from the principle of legality (Cst, art 5, para 1), however, according to Federal Supreme Court, it also comes at least from the requirement of legal certainty and equality before the law.[19] Constitutional norms in the field of the rule of law also indicate that the state's activities must be conducted in the public interest and be proportionate to the ends sought; state institutions and private persons must act in good faith.[20] The principles of administrative law, such as proportionality and generality, which reflect the description 'good' law, are applicable to tax law.[21]

The 'thick' version of the rule of law is broader, and contain a moral component, requiring the law (in addition to the standards of 'thin' rule of law) to adhere to more substantive legal standards. It requires for the law to be 'just', protecting, for instance, human rights and dignity, as well as equality, and is concerned with questions of political economy.[22] According to the 'thick' version, if the laws exist and are enforced, but they lack moral content, the concept may be referred to as rule *by* law, rather than rule *of* law.[23]

This 'thick' version of the rule of law is particularly interesting in the present analysis, where a formal legal framework for corporate taxation exists, but some companies (digital porn MNEs) seem to effectively escape it. In tax law, the 'thick' rule of law would generally mean enforcing the moral dimension of taxation. The discussion of morality in tax law and policy could be very diverse. For example, the contributors to this volume look beyond the formal rule of law to the informal norms and values that underpin citizens' sense of fairness and obligation and consider tax morality from a virtue ethics perspective (Badisco/Van de Velde). In the present chapter, I take a purely legal standpoint and argue that the moral element in tax legislation depends on compliance with the constitutional principle (in Switzerland) of the ability to pay. This principle, derived from the humanist philosophy of the Age of Enlightenment, is a fundamental justification for the definition and collection of taxes in Western legal systems.[24] Its meaning remains consistent across Western nations: every taxpayer should be subject to fair taxation, with this fairness embodied in the principles of horizontal and vertical equity.[25] This consensus on what constitutes fairness in a tax law forms the moral core of tax laws; if the principle of ability to pay is not respected, taxation loses its meaning.

The interpretation of some aspects of the principle of ability may differ between jurisdictions and between authors, but these differences do not create substantial gaps in the theory as a whole. One example is the application of this theory in

[19] ATF 123 I 112, para 7(a), 124; Lideikyte Huber, above n 16, 10.
[20] Cst, art 5, paras 2–4.
[21] Lideikyte Huber, above n 16, 10.
[22] R Stein, 'Rule of Law: What Does It Mean' (2009). *Minnesota Journal of International Law* 250, citing F Hayek 'The origins of the rule of law'. In *The Constitution of Liberty* (1960): 162–75, 299 (citing Justice Kennedy). Available at: https://scholarshiatlaw.umn.edu/mjil/250, 297. See Lindsay, Chapter 3 in this volume.
[23] Stein, ibid. 299.
[24] I analyse this principle in a comparative perspective in G Lideikyte Huber, above n 16.
[25] RA Musgrave and PB Musgrave, *Public Finance in Theory and Practice* (London: McGraw-Hill, 1989) 218–19.

corporate taxation: Swiss law holds that the principle applies to both individuals and corporations,[26] whereas some Anglo-Saxon scholars argue that the ability to pay principle can only be applied to individuals.[27] Despite this seemingly large difference, the US and Switzerland have very similar corporate tax systems. This discussion is therefore not very relevant here: in all jurisdictions based on the ability to pay principle, we accept that both companies and their shareholders should be subject to laws that tax their income.

The compatibility of the current taxation of highly digitised porn MNEs with 'thin' and 'thick' concepts of the rule of law will be further developed in this chapter. The main problem here is not that there is no legal framework applicable to porn MNEs – there is indeed one which defines many tax-related aspects for them (their tax residence, etc.) as for other companies. However, the application of these rules, by and large, never leads to the taxation of these companies (at least not sufficiently) due to outdated international tax standards. I will develop this point in the following sections.

Emergence and Structure of the Digital Porn Business

The pornography[28] industry is one of the audiovisual industries that have been the most radically transformed by digitalisation. It's traditional twentieth-century forms – tapes and cinemas – have nearly disappeared and have given way to digital content.[29] Thus, many aspects in the value chain, including distribution, have radically changed as well: instead of being physically sent to or picked up by a user in a specific location, audiovisual product may be digitally transferred in a matter of seconds across the globe. The size of the digital pornography industry has not been estimated by serious academic studies, but rare, usually non-academic, attempts to estimate the economic importance of this sector suggest a billion-francs scale[30] and that it occupies a large part of the internet.[31] This is plausible, because it is widely acknowledged in technology circles that

[26] The Swiss Federal Constitution states that the principle of ability to pay applies to 'all taxes', without specifying whether it applies to all taxpayers (art 127, para 2). However, the Federal Supreme Court highlighted that the existence of economic double taxation is based on the idea that legal entities have their own ability to pay that is independent from that of their owners (see ATF 102 Ib 151, para 6).

[27] Musgrave and Musgrave, above n 23, 218–19.

[28] I use the definition of here pornography as sexually explicit media that are primarily intended to sexually arouse the audience, with a typical content of nudity and/or various sexual acts. N Malamuth, *International Encyclopedia of the Social & Behavioral Sciences* (Amsterdam/New York: Pergamon 2001). However, the definition of pornography is far from being unanimous; this subject is particularly researched in psychology, but less so in other scientific branches. T Kohut et al. 'Surveying Pornography Use: A Shaky Science Resting on Poor Measurement Foundations' (2020) 57(6) *The Journal of Sex Research* 722–42.

[29] Analogue production has become rare as most audiovisual content is now stored as a digital code; the final product in most cases is no longer embodied in a physical form such as videotape, CD or cassette (those products still exist but have become a niche market. D Hesmondhalgh and LM Meier. 'What the Digitalisation of Music Tells Us About Capitalism, Culture and the Power of the Information Technology Sector' (2018) 21(11) *Information, Communication & Society* 1555–70.

[30] J Naughton 'The growth of internet porn tells us more about ourselves than technology', *The Guardian*, 30 December 2018. Available at: www.theguardian.com/commentisfree/2018/dec/30/internet-porn-says-more-about-ourselves-than-technology, last accessed 23 November 2021.

[31] K Buchholz 'How Much of the Internet Consists of Porn?' 11 February 2019, *Statista*. Available at: www.statista.com/chart/16959/share-of-the-internet-that-is-porn/, last accessed 31 January 2022.

pornography has greatly contributed to the development of the internet in general.[32] Adult websites like xvideos, PornHub, and xnxx rank at respectively 11 to 13 of the most visited websites in the world in 2022, meaning that they outrank such websites as Amazon (14), TikTok (15) OpenAI (17).[33] Digitalisation has also brought big changes to other sexual industries, such as prostitution – the live cam industry has been booming during the last decade (with numerous tax aspects to resolve).[34] Overall, it appears that there is a big market with important global revenue streams and supply chains.[35]

Our knowledge of porn's legal structures, business models and markets is scarce and often based on the information provided by porn companies themselves.[36] It is, however, known that a significant part of global porn websites are held by two multinational enterprises named Aylo (previously MindGeek) and Web Group Czech Republic (WGCZ).[37] With headquarters in Luxembourg, this enterprise operates multiple porn websites (including Pornhub) and holds dozens of subsidiaries around the world (including low-tax jurisdictions like Cyprus and Ireland), with its effective siege in Canada. It also possesses companies operating in related areas, such as age verification software, as well as its own ad placement network, TrafficJunky, which exclusively serves the adult industry.[38] Web Group Czech Republic, based in Prague, is a rival company to MindGeek according to an investigation by the *Financial Times*; WGCZ tube sites XVideos and XNXX host about 6bn visits a month. That's roughly the same as Twitter and much more than MineGeek's flagship site Pornhub.[39] Almost nothing is known about this apparently huge second MNE, which keeps its business very secret.[40]

In terms of the reach of digital porn, little official information is available about its markets[41] or other data on consumption.[42] For instance, in Switzerland, local porn

[32] D Tynan, 'Thank You, Porn! 12 Ways the Sex Trade Has Changed the Web', *PCWorld*, 21 December 2008. Available at: www.pcworld.com/article/532547/porn_on_the_web.html, last accessed 11 September 2023.

[33] Similarweb, top worldwide websites, May 2023. Available at: www.similarweb.com/top-websites/, last accessed 18 June 2023.

[34] S Donzallaz and O Crevoisier. 'Digitalisation, innovation and territorial forms: commercial sexual activities between soliciting and livecam.' Working paper 2- 2020/E, The circulation of wealth.

[35] B McNeill. 'An interview with Jennifer Johnson on how pornography influences and harms sexual behavior', 26 January 2015. Available at: https://news.vcu.edu/article/An_interview_with_Jennifer_Johnson_on_how_pornography_influences#.Vp8d6AKozxU.twitter, last accessed 21 January 2022.

[36] Pornhub, for instance, is releasing certain information about its worldwide traffic. Available at: www.pornhub.com/insights/yir-2021#Countries-by-Traffic.

[37] P Nilsson and A Barker 'Knocking on the door of a porn empire' *Financial Times*, 20 January 2023. Available at: www.ft.com/content/cc9ab3c5-bfe1-40d0-862d-c35123ceaf1c.

[38] P Nilsson, 'MindGeek: the secretive owner of Pornhub and RedTube', *Financial Times*, 17 December 2020. Available at: www.ft.com/content/b50dc0a4-54a3-4ef6-88e0-3187511a67a2, last accessed 29 March 2021; K Nicholas, 'The Children of Pornhub. Why does Canada allow this company to profit off videos of exploitation and assault?' *The New York Times*, Opinion, 4 December 2020.

[39] Nilsson and Barker, above n 35.

[40] ibid.

[41] It is possible that Aylo sites target western Europe markets (as well as the North American market), whereas WGCZ dominates emerging markets, especially South America and Asian countries, providing lower-resolution products due to poorer internet connections in those jurisdictions. However, this information has not been confirmed by scientific research. Informal interview with Patricia Nilsson a *Financial Times* journalist, who carried out the investigation 'Hot Money' on the porn industry. Available at: www.ft.com/content/762e4648-06d7-4abd-8d1e-ccefb74b3244.

[42] For instance, in Switzerland. Personal interviews with the Swiss Federal Office of Statistics and the Swiss Federal Office of Telecommunications, December 2021.

production and distribution companies are very rare, and operate not as limited liability companies but as associations.[43] It is thus safe to say that Swiss digital porn consumption is dominated by foreign enterprises. Pornhub, for instance, indicates that porn consumption in Switzerland is high.[44] Websites that belong to either Aylo (Pornhub) or WGCZ (xnxx, xvideos) are in the top 20 most visited websites by traffic share in Switzerland (surpassing Netflix, Amazon, etc.).[45]

In terms of revenue models, a rare study of the digital pornography industry suggests that mainstream digital pornography is largely based on the provision of significant amounts of free content.[46] Companies that adopt such business models use so-called two-sided digital platforms that capitalise on user contributions resulting from indirect network effects and generate a huge amount of advertising revenue.[47] Adopted by some of the largest multinationals such as Google and Facebook, this business model is radically different from traditional twentieth-century approaches.[48] It is particularly important from a tax perspective, as I will discuss later in this chapter.

Overall, it appears that digital porn has become a huge cross-border industry, with at least two significant MNEs – Aylo and WGCZ – operating globally. These MNEs bear similarities to the largest tech giants that are at the centre of the discussion on reforming the international tax framework. At first glance, digital pornography companies seem to resemble companies such as YouTube or Google, whose revenue models are based on the collection of anonymous user data. However, there are many differences between these companies and digital porn. Porn's product is – obviously – very specific. It is neither a social media platform nor a search engine (its form, most closely resembles YouTube, which is owned by Google). Digital porn sites are not allowed to collect and reuse user data in the same way as many multinational companies, because data about a person's sex life or sexual orientation is sensitive and requires additional protection.[49] And, of course, the porn industry is highly stigmatised and therefore does not receive as much scrutiny as other (legitimate) industries.

Current (Non-)Taxation of the Digital Porn Industry

In general, the field of pornography – digital or otherwise – is poorly regulated. Researchers note that many general laws and regulations that are enforced in other industries are ignored in pornography due to its specificity.[50] Many countries, including

[43] A rare example is an ethical porn company Oil Productions: https://oilproductions.ch/. See also: www.letemps.ch/societe/sciences-humaines/melanie-boss-porn-star-ethique, accessed 11 June 2023.

[44] See www.pornhub.com/insights/switzerland, accessed 13 June 2023.

[45] Similarweb. Top Websites Ranking – Most Visited Websites in Switzerland. Available at: www.similarweb.com/top-websites/switzerland/, accessed 1 June 12023.

[46] K Darling, 'IP without IP: A Study of the Online Adult Entertainment Industry.' 17 *Stan Tech L Rev* (2013) 709.

[47] Köthenbürger, above n 2, 170.

[48] ibid.

[49] Regulation 2016/679 of the EU Parliament and the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation), art 9.

[50] Mellish, 35.

Switzerland, do not define the term 'pornography' in law.[51] Porn-specific regulation is essentially done through criminal laws. In this respect, a basic distinction could be made between legislation that bans production, distribution and/or consumption of *all* pornographic content using criminal law countries that ban only *certain* types of 'harmful' pornography,[52] which has been criminalised in most Western countries.[53] In the latter, other 'adult content' is usually not subject to any restrictions.[54] In countries where some types of porn are legal, the supervision of this industry appears to be relatively open to various infringements. For instance, in Switzerland, access to pornography websites is virtually unregulated (for instance, unrestricted to minors).[55]

Tax law, as the most other branches of law, largely overlooks the existence of the digital porn industry and, except in very rare cases, the legislator does not create specific provisions for it, nor does it discuss this opaque industry specifically during corporate tax reforms. However, if one ventures into the analysis of its tax aspects, the starting point would be determining whether this business in a specific jurisdiction is legitimate.

In a significant number of countries even the consumption of porn (not to mention production and distribution) is *illegal*.[56] However, one could safely guess that digital porn is still certainly produced, distributed and consumed in many (if not all) of these countries. This leaves porn operating in a grey area of semi-legality, where authorities tolerate, or at least cannot eradicate, this business activity. In such countries, the porn industry appears to be simply untaxed. For instance, in a rare empirical study on the issue, companies in the Romanian livecam industry[57] have raised the issue of wanting to pay taxes. Notwithstanding, this was not possible due to the illegal (but nonetheless

[51] The definition of child pornography exists in the Optional Protocol of 25 May 2000 to the Convention on the Rights of the Child, on the Sale of Children, Child Prostitution and Child Pornography, in force in Switzerland since 1 December 2006 (AS 2006 5437 5440; BBl 2005 2807). On the US, see P Gewirtz, 'On I Know It When I See It' (1995) 105 *Yale Law Journal* 1023; *Jacobellis v Ohio*, 378 US 187 (1964).

[52] Harmful pornographic content is often defined as including (1) child or (2) violent pornography or (3) animal abuse (see for instance the Swiss Criminal Code (SCC), art 197, para 4).

[53] In Switzerland, the content that is considered the most harmful, ie pornography offences involving prepubescent children, is not subject to a time limit concerning the right to prosecute and impose penalties. Cst, art 123b.

[54] This debate has not disappeared. It emerged and was most prominent in US legal circles in 1980s. It was led by notorious feminist scholars CA MacKinnon and A Dworkin, who defined pornography as a civil rights violation and argued that pornography reinforces patriarchal structures by making gender hierarchy sexy. CA MacKinnon 'Pornography, Civil Rights, and Speech' (1985) 20(1) *Harvard Civil Rights–Civil Liberties Law Review* 1–70.

[55] For instance, until 2023, entering the term 'porn' in a Google search engine directed users to porn websites that are accessible without confirming legal age (parental control could censure porn but it has been shown that most children have it on their phones or PCs). Federal Council acknowledged that there are no specific legal regulations, other than criminal provisions, to protect children and young people from inappropriate content on the Internet or via on-demand or platform services (Dispatch 2020: 7926). A new Federal Act on the protection of minors in the sector of movies and video games (LPMFJ) adopted only in September 2022, requires age verification systems to be put in place for 'unsuitable content' defined largely (Art. 8). Ordinance on the Protection of Minors in the Film and Video Game Industries (OPMFJ) – Draft under consultation. Recently, accessing pornographic websites in Switzerland mandates clicking a confirmation button affirming legal age, commonly stating 'I am 18 or older'. However, its effectiveness remains debatable.

[56] See https://en.wikipedia.org/wiki/Pornography_laws_by_region, accessed 30 June 2024.

[57] In this chapter, I consider livecam business as online prostitution, not pornography, due to its non-reproducible content and live interaction. However, it appears to be qualified as pornography by the Romanian authorities.

tolerated) nature of the 'pornographic' business activity.[58] Overall, such a situation clearly deviates from the principle of the rule of law in the sense that, in such jurisdictions, not all companies are subject to (tax) law, the tax law is not capable of guiding human behaviour (inconsistent application between different companies) and not all taxpayers are taxed according to their ability to pay.

Such situations are difficult to resolve from tax perspective. As such business activities are illegitimate, criminal law applies, and proceeds from illegal activities should be forfeited, not taxed.[59] However, forfeiture is a lengthy and costly task, difficult to enforce and inefficient regarding widespread illegal activities and foreign perpetrators (and its overall aim is altogether different from taxation). The only other option is taxation of income from illicit sources – an approach recognised by many countries, such as the USA and the Netherlands. Those countries encourage declaring income from *certain* illegal activities, for instance, from dealing illegal drugs[60] (in those two jurisdictions, however, the porn industry is not illegal). Understandable from a public finance perspective, such a tax policy raises multiple inconsistencies in a legal system, which are hard to resolve (eg, a taxpayer's right to non-self-incrimination).[61]

In countries where mainstream porn is *legitimate* – which is all the Western countries – such businesses are theoretically either subjected to a general corporate tax regime or a specific regime with controversial 'porn taxes' (usually an add-on of special tax dispositions on the general corporate tax regime, those taxes are quite rare[62]). However, with the digitalisation of porn, this industry became increasingly difficult to tax. In the present work, I will focus on this second category, as the jurisdiction which I study more closely – Switzerland – falls into it.

As mentioned above, local porn production and distribution companies are rare in Switzerland, and the Swiss market appears to be dominated by foreign digital porn multinationals. As Switzerland has not introduced specific porn taxes, general corporate tax rules apply to the activities of foreign companies on its territory. As in most countries in the world, corporate income taxation in Switzerland follows the 'classic' territoriality principle: legal entities are subject to unlimited Swiss tax jurisdiction if they have their registered office or effective management in Switzerland (DFTA, Art 50). They are subject to limited taxation based on their economic connection if they are associated with a company domiciled in Switzerland, if they operate a permanent establishment in Switzerland or if they own real estate and/or rights related to real estate in Switzerland (DFTA, Art 51(1)). The term 'permanent establishment' is defined in Articles 4(2) and 51(2) of the DBA in its traditional sense, ie it requires a fixed place of business in Switzerland. Corporate profits are subject to profit tax at the federal,

[58] Donzallaz and Crevoisier, above n 35, 8.

[59] SCC, art 70, para 1.

[60] IRS 2021.

[61] Those questions are, to a certain extent, researched in relation to other domains, for instance the taxation of drug trade income (Van Der Veen) or financial criminal sanctions in Switzerland (A Opel 'Ist Besteuerung von Unrecht rechtens?' (Basler Juristische Mitteilungen, 2016) *Basler Juristenverein*, 1–37).

[62] Those taxes consist of imposing a higher rate on profits of porn companies or higher indirect taxes on distribution of pornographic content. OECD, *Tax challenges arising from digitalization – interim report*, 16 March 2018. Italy currently has such a tax, France had it until 2021 and it is under discussion in certain US states.

cantonal and, in some cases, municipal level.[63] Unlike some countries,[64] Switzerland has not introduced a Digital Services Tax (DST) or similar taxes in any other form.

Under the corporate tax rules described above, a foreign digital pornography provider that has neither a registered office nor effective management in Switzerland and that offers large quantities of free digital material on the Swiss market and generates revenue by placing foreign advertisers' content on its websites does not have a physical taxable nexus in Switzerland. Under the limited taxation regime, a mere digital presence is not considered a sufficient permanent establishment. As a result, companies using the two-sided digital business models described in the next section escape any corporate income tax in Switzerland. As their service is free of charge, despite the (arguably) huge volume of market activity, they are also likely to escape VAT altogether (the same applies to advertisers).[65]

Critical Assessment in the Light of the Rule of Law

Domestic Context

Unlike other tech giants such as Google and Facebook, porn companies do not appear to have any taxable nexus in Switzerland. This analysis could be applicable to other industries that operate in a similar manner to digital porn and are based in Switzerland. However, I did not identify any similar situations.[66]

This lack of taxation raises concerns about the rule of law that could be interpreted under 'thin' and 'thick' versions of it.

Firstly, porn MNEs can be seen as businesses that are so different from others, in terms of their structure and operations (not in terms of the business content), that they simply do not fall within existing (outdated) tax law norms and should be subject to specific tax rules. As such rules do not exist, they essentially operate in a rule-free environment, which is unacceptable from the 'thin' perspective of the concept of the rule of law.[67]

Such a situation may be treated as a loophole. It is difficult to deal with loopholes in tax laws because of the first aspect of the rule of law, in particular the strict approach to the principle of legality. Theoretically, 'proper' loopholes can be corrected through judicial review (although the interpretation of tax law is intended to avoid the creation of new cases of tax liability, new taxable entities or new events giving rise to taxation).[68]

[63] Federal Direct Tax Act (FDTA), arts 1 and 57. LHID corporate profits apply the rules of FDTA, art 58. At the federal level, net corporate profits are taxed at a fixed proportional rate of 8.5%. At the cantonal level, corporate tax rates are mostly proportional; however, certain cantons apply a mixed-rate system or even progressive rates, with minimum and maximum limits. Lideikyte Huber, above n 14, 175.

[64] R Avi-Yonah, YR Kim and K Sam. 'A New Framework for Digital Taxation' 63 *Harv Int'l LJ* (2022) 279.

[65] Swiss VAT Act; interview with the Federal Tax Administration, personal communication, December 2021.

[66] In informal discussions with the federal Tax Administration, we concluded that the only (rather tiny) industry truly resembling digital porn is the streaming of pirated videos.

[67] Brassey (see Chapter 12 in this volume) analyses a similar situation in a different context.

[68] ATF 131 II 562 567 and cited references.

It is, unfortunately, almost impossible to envisage that a question of such substantial dimension as the taxation of digital presence could be resolved through judicial review. Furthermore, the fact that the Federal Supreme Court is unable to examine the constitutionality of federal laws, including those that contain corporate tax provisions, such as the Federal Direct Tax Acts, further complicates the matter. The Court is unable to challenge such laws and to control whether they are compatible with the constitution (for instance, the principles of equality or of the ability to pay).[69]

This situation also contravenes the formal aspect of the 'thin' conception of the rule of law. A 'good' law should be such that it could guide human behaviour in a logical manner, and I would particularly cite its aspects of generality and consistent application. The principle of generality requires that legal norms must be issued at some level of generality. No legal system can function by addressing its prescriptions to individuals, one by one, or by addressing each act separately.[70] I would like to reverse this argument by proposing that a law should also not be excluding certain specific businesses. The law cannot guide human conduct if actual deviations from it are not treated as such, namely, as deviations from the rule.[71] The digital porn industry currently stands out as completely untaxed, even in comparison with similar enterprises (in terms of revenue generation) like Google or Facebook. This situation is not explicitly treated as an exception to corporate taxation, making the law unclear and its philosophy (even more) confusing to taxpayers. Such inconsistent legal treatments have not only made the law obscure, but also eroded the public's general trust in corporate tax system.

Secondly, the situation could be interpreted as compliant with the 'thin' concept of the rule of law (ultimately, porn MNEs do adhere to the corporate tax law norms). However, it is lacking essential components of the 'thick' concept of the rule of law. The moral aspect of the rule of law requires just and equitable taxation. One possible approach to measuring this is through the principle of ability to pay. In this respect, the fact that a business, generating substantial amounts of internet traffic and using Swiss high-level IT infrastructure to generate its income, does not contribute anything in taxes, is problematic in comparison to other businesses deriving income from the Swiss territory, via more traditional approaches. It is evident that, in accordance with the prevailing tax regulations, digital porn providers based abroad are not considered Swiss taxpayers and, consequently, are excluded from horizontal and vertical equity comparisons. However, the reason why such market players are not considered Swiss taxpayers is that the revenue models have undergone a radical transformation (even though pornographic distribution and consumption remained within the Swiss territory, and perhaps even increased) and the tax laws failed to adapt to this change. Interpreting tax law[72] from a teleological perspective, nothing suggests that

[69] What further complicates the matter is that in Swiss law, the Federal Supreme Court cannot examine the constitutionality of federal laws, meaning it cannot challenge such laws (such as Federal Direct Tax Acts, that contain corporate tax provisions). The Court assumes, however, that the federal legislator does not propose a solution which would be incompatible with the Constitution. Cst, art 191; ATF 130 II 65 consid. 4.2 at 71; ATF 129 II 114 consid. 3.1 118; ATF 129 III 55 consid. 3.1.1 56/57 and cited cases.

[70] Marmor, above n 5, 6.

[71] ibid.

[72] In Swiss tax law cases, the Federal Supreme Court refers to the general interpretation principles: literal, historical, teleological, and systematic interpretations. If several interpretations are permissible, the one chosen must be consistent with the Federal Constitution. ATF 131 II 562 567 and cited references.

the legislator intended, decades ago, to exempt specific business domains or business models from taxation, notably porn. On the contrary, from a historical perspective, porn enterprises operating in Swiss territory (through cinemas, published media, etc) were taxed as other businesses. Concerning the novel digital business models, the legislator could not have mindfully excluded them while creating basic corporate tax laws in Switzerland, as such business models did not yet exist. Again, the situation with digital porn today amounts to a so-called 'proper' or 'apparent' loophole in Swiss tax law,[73] which undermines the principle of ability to pay.

In summary, the non-taxation of digital porn operating in Switzerland is incompatible with the principle of rule of law, that could be analysed both from 'thin' and 'thick' perspectives. As this loophole cannot be corrected by judicial review, this situation must be resolved by the legislator. It would require amending its corporate tax system – either unilaterally, by adapting DTS or similar levies on the digital presence of foreign companies (an option that Switzerland has considered and refused, at least for now) or by following an international tax reform which could be joined by Switzerland, provided that this addresses the specificities (if any) of this industry – which might be unlikely, as discussed below.

International Context

A study of the taxation of the digital porn industry reveals another issue in connection with the rule of law in an international context (although the discussion below could also hold true in certain domestic contexts). In particular, the fact that the analysis of this huge industry is not included in the international discussions about taxing the digital economy exposes the problems in the process of law-making.[74] In the present chapter, I want to highlight the substantive inclusiveness – the need to thoroughly analyse the subject to create rules that are fair (as much as possible) to all taxpayers.

The digital porn industry provides an interesting case study concerning highly digitalised MNEs, where the issue of deficient taxation has been subject to decades-long discussions. To address the problems of under-taxation, a multilateral solution was recently proposed by the OECD through its Base erosion and profit shifting project (BEPS),[75] specifically through its so-called 'Two Pillar solution' announced in 2021. The extent to which ongoing international reforms will affect digital porn taxation remains unclear, given that this significant industry has been overlooked in previous studies.

In its attempts to reform international taxation, the OECD has consistently highlighted the lack of knowledge about digital industries. It has been acknowledged multiple

[73] A 'proper' loophole is a situation where the legislator has failed to settle a point that should have been settled, and no solution is apparent from the text or interpretation of the law. ATF 131 II 562 568.

[74] van Ganzen, Broekhuijsen Vording and Vleggeert (see Chapter 13 in this volume) analyse the rule of law in the law-making process from the inclusiveness of the stakeholders' perspective; The 'Rule of Law Checklist' authored by the Venice Commission of the Council of Europe and cited by those authors, sets recommendations in this respect.

[75] OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. Available at: http://dx.doi.org/10.1787/9789264202719-en, accessed 1 September 2022; OECD, above n 4.

times that BEPS concerns are better identified and addressed by analysing the existing structures adopted by MNEs together with new business models and by focusing on the key features of the digital economy and determining which of those features raise or exacerbate tax challenges. Only in this way can approaches be developed to address those challenges. In certain areas, the OECD has indeed adopted a methodology of analysing specific MNEs and their business models. Different digital industries, such as online gambling, video games, paid streaming (music and video) and social media, were scrutinised. The OECD concluded that the MNEs were diverse and would adjust to tax reforms in a different way. Notwithstanding those studies, researchers and the OECD have continued to emphasise the lack of empirical evidence regarding various facets of the operation of MBEs (a point that was reiterated as late as 2023). The digital porn industry has not been included in any analysis of this nature. Indeed, it is absent from the thousands of pages of OECD documents on this question.[76]

To ignore such an extensive industry within the context of international reform discussions, particularly those which focus on specific industries, is, at the very least, regrettable. To establish efficient tax regulations, a comprehensive understanding of the diverse functions of various digital businesses is crucial, as the OECD itself acknowledges.[77] The digital porn industry appears to exhibit characteristics that would classify it as a targeted business.

Firstly, it fits the description of an extremely mobile digitalised business that is capable in exploiting various loopholes in international corporate tax rules (as current corporate profits are taxed only if a company has a physical presence in a market (source) jurisdiction). One of the aims of the BEPS project, and currently the focus of Pillar Two reforms, is to reduce aggressive business tax planning and tax evasion, where MNEs, using various tax techniques, shift profits from high-tax to low-tax jurisdictions.[78] This was especially easy for highly digitalised businesses like porn, because of the fact that its product is completely digital; those MNEs are likely using extensively modern corporate assets such as software and other intellectual property of an intangible and easily transferrable nature.[79] In rare publications on the subject, scholars argue that, in industries like pornography and gambling, global digital commerce has probably played a role in the growth of controlled foreign corporations' arrangements.[80] Even though we do not have financial data from MNEs such as Aylo, the fact that it has its headquarters in Luxembourg and many subsidiaries in offshore jurisdictions hints to this 'classical' aggressive international corporate planning that was heavily used before

[76] I have gone through the main OECD documents from 2013, the launch of the BEPS project, searching documents for the key terms 'porn', 'pornography', 'adult', 'sex'.

[77] In its 2014 analysis, the OECD highlights the eight 'most common' revenue models in the digital economy: (1) advertising-based revenues; (2) digital purchases or rentals; (3) selling of goods (including virtual items, overlaps in part with (1); (4) subscription-based revenues; (5) selling of services; (6) licensing content and technology (overlaps with (4) and (5)); (7) selling user data and customised market research; and (8) 'hidden' fees and loss leaders. OECD (2014), Addressing the Tax Challenges of the Digital Economy, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. Available at: http://dx.doi.org/10.1787/9789264218789-en, accessed 1 May 2023, 83–84.

[78] Avi-Yonah, Kim and Sam, above n 62.

[79] ibid; OECD 2015, above n 4; 2017.

[80] A Cockfield, W Hellerstein and M Lamensch *Taxing Global Digital Commerce* (Alphen aan den Rijn: Kluwer Law International BV, 2019) 197.

BEPS.[81,82] Such tax planning will be likely to be reduced with the reforms of the Pillar 2 – provided that porn MNEs reach the €750,000 of turnover required for Pillar 2 rules to kick in. However, do porn MNEs reach this threshold? This question remains unanswered, even though I could speculate that due to their business models, discussed below, porn MNEs are significant.

Secondly, and more relevantly, the digital porn industry encompasses MNEs that, like Google or Facebook, use completely new revenue models based on value creation by users (even though the tax-avoidance preferences of companies using such business models are the same as the ones of more traditional businesses).[83] During the last decade, it was increasingly argued that such business models have implications for tax policy and the OECD acknowledged that they present even bigger challenges in taxing the digital economy in comparison with other industries.[84] In such models, as labour and capital are not the prime input factors in generating the added value, traditional rules of international corporate taxation become meaningless.[85] Such ad-based business models become a crucial reference in discussing how taxing rights could be redefined in digital economy, focusing on Google and Facebook.

Analysis of digital porn could give precious insights into this debate, which is still unresolved and is conceptually the most complicated in the discussion about taxation of digital economy.[86] The current Pillar 1 proposal, even being a fresh approach, is very limited in scope and is essentially still proposing taxing business income. Nevertheless, it remains to be seen whether this is the optimal approach to such intricate business models. Moreover, it is evident that a global consensus on this matter is yet to be reached. Other innovative proposals have been put forth by scholars, which, at least at first glance, appear to be more forward-thinking and better suited to taxing digital pornography and similar industries. For example, the conceptual framework for data tax is based on a novel interpretation of the ability to pay.[87] It proposes that data can act as a proxy for this ability, removing concepts of source and residence. Consequently, the user of the data is subject to a tax.[88] The concept is undoubtedly intriguing. However, to implement it, it is essential to conduct a comprehensive analysis of the operational dynamics of the industries in question. It would be prudent to commence with the most significant ones, including digital pornography.

[81] OECD (2013), *Action Plan on Base Erosion and Profit Shifting*. Available at: http://dx.doi.org/10.1787/9789264202719-en, accessed 1 September 2022.

[82] J Vella, R Collier and M Devereux. 'Comparing Proposals to Tax Some Profit in the Market Country' (2021) 13(3) *World Tax Journal* 405–39; European Commission. (2014). Report of the Commission Expert Group on Taxation of the Digital Economy. Available at: https://ec.europa.eu/taxation_customs/system/files/2016-09/report_digital_economy.pdf, accessed 9 June 2022; OECD 2014, above n 73, Action 1; Avi-Yonah, Kim and Sam above n 72, 279 et seq.

[83] Köthenbürger, above n 2, 170.

[84] OECD, above n 4.

[85] Köthenbürger, above n 2.

[86] ibid.

[87] O Marian, 'Taxing Data' (2021) 47 *BYU L. Rev* 511.

[88] ibid, 652.

Conclusions

The digital pornography industry has radically changed in the last decades. Due to the development of the internet and the digitalisation of its product, it has expanded massively and is currently dominated by large MNEs who use novel organisational structures and revenue models based on value creation by users.

The transformation of this industry presents many tax challenges. This chapter showed that under domestic Swiss tax law rules, foreign digital porn MNEs streaming free porn and targeting Swiss-based users escape all taxation. Such an activity does not create the taxable nexus in Switzerland. This tax situation is unique, in comparison with the other dominant companies using ad-based business models, like Facebook or Google, who have a physical presence.

Such a situation is incompatible with the rule of law principle in tax law, both under its 'thin' and 'thick' versions, looking into the domestic Swiss and international contexts.

In terms of 'thin' conception of the rule of law, the question arises whether the porn MNEs, being so different from other corporations in terms of their structure and operations, must not be subjected to separate tax rules. As such rules do not exist, they currently operate in the effectively rules-free environment, which is unacceptable. This situation might be treated as a loophole, requiring legislative intervention. It is also contrary to formal component of the 'thin' rule of law, and the interpretation *a contrario* of the principle of generality: a law should be general enough and not exclude specific businesses. It cannot guide human conduct if actual deviations from the law are not treated as such. The non-taxation of digital porn operating in Switzerland is also incompatible with the 'thick' interpretation of the rule of law in tax law, whose goal, I argue, is applying the principle of ability to pay and treating all taxpayers equally.

This situation can only be rectified by the legislator, either unilaterally or in the framework of an international reform. With respect to the latter, the shortcomings of the international discussions on these intricate business models, which failed to include an analysis of digital pornography, give rise to concerns regarding the rule of law in legislative processes. Due to such deficiencies, porn industry remains opaque, and it is not clear to what extent the ongoing legal proposals, such as Pillar One, could affect it – even though porn MNEs seem to fit into the description of novel businesses reaping extreme profits from digitalisation. Leaving a huge industry out of studies on the taxation of the digitalised economy denies us a better understanding of how the digital economy works in general, and therefore how to tax it more effectively. As a result, this could lead to important (new) loopholes in tax systems.

Other academic proposals, such as taxing data, seem promising, but could only be used if a deeper knowledge of this industry is gained. A closer analysis of digital porn would thus contribute to development of a more efficient corporate tax system – with rules that are 'just' and 'good' for all businesses.