

[REDACTED]
[REDACTED]
[REDACTED]

APR 15 1992

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code [herein "Code"]. We have determined that you do not qualify for exemption under that section of the Code. Our reasons for this conclusion and the facts upon which it is based are explained below.

You were incorporated [REDACTED], under the [REDACTED] Non-Profit Corporation Laws for the charitable, civic, social, cultural, and educational purposes, including the promotion, sponsoring, and conduct of a beauty pageant. To this end you sponsor and conduct a beauty pageant in connection with [REDACTED]. You are funded by collecting contributions from local businesses and individuals, membership fees, entry fees, and admission fees. Your expenses include the award of scholarships to those who are winners in the pageant.

There are two relevant contracts related to the pageant; they are the Official Franchise Agreement [herein "Agreement"] and the Contestant Contract [herein "Contract"]. The Agreement is between you and [REDACTED], and the Agreement states that [REDACTED] is a franchisee of [REDACTED]. Thus, it appears that you are part of a pageant system. Under this pageant system, local entities conduct a local scholarship pageant; the winner of this pageant advances to the state level competition; and if that winner wins the state level competition, then she may advance to the national level competition; at the national level competition, she is eligible for and may win the title of [REDACTED]. This is the last level of competition.

The Agreement requires you to pay a scholarship of not less than \$[REDACTED] to the winner, who must be sent to the state level competition. The Agreement requires that each potential contestant enter into the Release and Indemnity Agreement before you can

accept such person as a bona fide contestant. Furthermore, the Agreement requires that the local pageant winner sign a management agreement and a second Contestant's Agreement (so that the winner may compete at the next level of competition). The winner shall also submit a fully completed contestant questionnaire, and five head and shoulder black and white glossy photographs. Additionally, if [REDACTED] should become [REDACTED], she will be under the control and supervision of the [REDACTED].

The Agreement also requires that the pageant be conducted within the rules and regulations of [REDACTED], and that during your pageant, you provide for the mention of all national sponsors of [REDACTED].

Concerning the Contract, the contestant agrees to abide by the rules and regulations governing the pageant, and the decisions of judges. She also agrees that, if she is as the winner of the pageant, she will not sign a management contract or endorse any mercantile commodity or commercial organization or permit her photographs to be used in connection with any advertised commodity or service not associated with the pageant. [REDACTED] agrees that she will not participate in any other pageant without permission. She understands her scholarship monies are held until the third week in July, even though your pageant is conducted in early May.

The administrative file indicates that the participants are to participate in three categories of events; they are (1) a swimsuit competition, (2) a talent competition and (3) an evening gown competition.

Sections 501(a) and 501(c)(3) of the Internal Revenue Code provide for the exemption from federal income taxation of corporations that are organized and operated exclusively for educational or charitable purposes.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations [herein "Regulations"] provides that to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for purposes specified in section 501(c)(3).

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Under section 1.501(c)(3)-1(d)(1)(ii), an organization cannot be organized and operated exclusively for one or more exempt purposes, unless it serves public rather than private interests.

Section 117(a) of the Code provides, in relevant part, that gross income does not include any amount received as a qualified scholarship. However, section 117(c) imposes a limitation thereon, and specifies that the exclusion for "qualified scholarships" shall not apply to that portion of any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship.

A scholarship or fellowship grant represents payment for services if the grantor requires the recipient to perform services in return for the granting of the scholarship or fellowship. A requirement that the recipient pursue studies, research, or other activities primarily for the benefit of the grantor is treated as a requirement to perform services. A scholarship or fellowship grant conditioned upon either past, present, or future services by the recipient, or upon services that are subject to the direction or supervision of the grantor, represents payment for services under this section.

A scholarship or fellowship grant that is includable in gross income under section 117(c) of the Code is considered "wages" for purposes of section 3401(a). Additionally, the grantor of such wages is subject to certain filing and/or reporting requirements respecting wages. See Notice 87-31, 1987-1 C.B. 475.

In Better Business Bureau v. Commissioner, 326 U.S. 279 (1945), the Supreme Court determined that while some activities of the organization under consideration were educational, a substantial purpose of the organization was to promote business. Thus, the organization was not operating exclusively for educational purposes.

Rev. Rul. 66-103, 1966-1 C.B. 134, states that an organization whose primary activity is to provide awards and grants, including scholarship and fellowship grants to needy individuals who could not otherwise pursue their studies for lack of funds, where the grantor organization received no monetary benefit from the activity qualifies for exemption under section 501(c)(3) of the Code. The organization is primarily engaged in a charitable activity of providing relief of the poor.

Rev. Rul. 69-257, 1969-1 C.B. 151, states that an organization providing scholarships selected from a broad class of applications, on the basis of scholastic standing, qualifies for exemption under section 501(c)(3) of the Code. The organization was created for the purpose of advancing education.

[REDACTED]

Miss Georgia Scholarship Fund, Inc. v. Commissioner, 72 T.C. 267 (1979), involves an organization formed for the purpose of giving scholarships to contestants in the Miss Georgia Pageant. To qualify for scholarships, the participants were required to enter into a contract obligating them to abide by the rules and regulations of the Miss America Pageant, including participation in public appearances and similar functions sponsored by Miss Georgia Pageant. These scholarships were unavailable to contestants who failed to execute the contestant's contract. The Tax Court stated that the principal issue in its decision was whether the purported "scholarships" granted by the organization were excludable under section 117 or section 74 of the Code, or were compensatory in nature. The court held that the organization was not exempt under section 501(c)(3) of the Code, because the organization was operated primarily for the purpose of providing compensatory payments, not qualifying for exclusion under section 117, to contestants in the pageants.

The same issue presented to the Tax Court in Miss Georgia Scholarship Fund, Inc. is present in your case. We must determine whether the scholarships you award to contestants in [REDACTED] are compensatory payments as defined in section 117(c), and, thus, not excludable from income pursuant to section 117(a).

The Contract requires that the contestants qualify for the scholarships, *i.e.*, the contestants must win [REDACTED] title or one of three other positions. The Contract impliedly requires the completed execution of participation in a series of events leading up to the final selection of [REDACTED], and adherence to the rules and regulations governing the pageant. There are many other services that each contestant provides you. The contestants agree that they will neither (1) endorse any product or company without your permission, nor (2) participate in other pageants. Additionally, a contestant's title and prizes (including her scholarship) are contractually linked to performance of these services.

Cumulatively, these services, *i.e.*, the participation in the pageant, the promises to avoid certain endorsements, the promise to eschew unpermitted pageants, etc. are substantial services.

It is clear that the scholarships you award to contestants in [REDACTED] are not excludable from the gross incomes of recipients under section 117(a) because the scholarships are described in section 117(c), and represent payment for services that are required of the recipients as a condition to receiving the scholarships.

Furthermore, because you require the contestants to perform certain services for [REDACTED] and to promote [REDACTED]

[REDACTED] 's sponsors, you are serving private rather than public interests because you are providing valuable services to a noncharitable entity. Therefore, you have shown that you are not operated exclusively for one or more exempt purposes under section 501(c)(3). See section 1.501(c)(3)-1(d)(1)(i) of the regulations.

Awarding compensatory scholarships does not exclusively further exempt purposes, unlike the organizations described in Rev. Rul. 66-103 and 69-257 that based their scholarship on need or merit without requiring services in return. Instead, like the organization in the Miss Georgia Scholarship Fund case, you are operated primarily for the non-exempt purpose of providing compensatory payments to pageant contestants. Moreover, the awarding of compensatory scholarships furthers substantial private interests, within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. Accordingly, you are not operated exclusively for exempt purposes, see section 1.501(c)(3)-1(c)(1) of the regulations, and you do not qualify for exemption under section 501(c)(3) of the Code.

Accordingly, we conclude that you fail to qualify for exemption from federal tax under section 501(c)(3) of the Code. You are required to file federal income tax returns on Form 1120.

You have the right to protest our ruling if you believe that it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement must be submitted within 30 days of this letter and must be signed by one of your officers. You also have a right to a conference in this office after your statement is submitted. If you want a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your officers, he/she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the United States Tax Court, the United States Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director. Thereafter, if you have any questions about your federal income tax status, including questions concerning reporting requirements, please contact your key District Director.

[REDACTED]

When submitting additional letters with respect to this case to the Internal Revenue Service, you will expedite their receipt by placing the following symbols on the envelope: [REDACTED]. These symbols do not refer to your case but rather to its location.

Sincerely,

(signed) [REDACTED]

[REDACTED]
Chief, Exempt Organizations
Rulings Branch 2

[REDACTED] [REDACTED]
14 Apr 4 4/15/92