

B. BEAUTY PAGEANTS: PRIVATE BENEFIT WORTH WATCHING

by

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1. Introduction

Beauty pageants have long been part of American popular culture. The Miss America Pageant, the most well-known, started in 1921 as a "bathing beauty" contest. As times changed, though, so have beauty pageants. Today, this annual national competition, as well as state and local pageants, showcase the talent, intellect, and beauty of modern women. The pageants provide popular entertainment for those at the competitions and, through the broadcast media, to those watching at home.

Funds for sponsoring the pageants and providing the prizes are traditionally drawn from individuals, small businesses, corporations, civic groups, foundations, and universities. Business sponsors reap favorable publicity (leading to increased product visibility and market share) generated from their association with the popular pageants. Prizes include the coveted crown, and may also include trophies, vacations, clothes, jewelry, savings bonds, and cash. Besides prizes, the winner has the opportunity to pursue her career and community service goals as well as the obligation to represent the pageant sponsors' commercial interests.

Pageants award scholarships in varying amounts for recipients to use at their choice of schools. Pageants may also give scholarships as special prizes for certain attributes shown during the competition. The "Miss Congeniality Award" is an example. Ancillary organizations, such as scholarship foundations, have also grown to assist pageant organizations administer, supervise, control, and pay the growing number of scholarships awarded to the pageant winners.

Nonprofit beauty pageant organizations, including those that award cash prizes or educational expenses, have been and will continue to be recognized as exempt under I.R.C. 501(c)(4). Such organizations traditionally promote, publicize, organize, and operate the pageants. They encourage and promote local pageants in their respective states, and often select contestants to represent the state in national competitions such as the Miss America Pageant. Although pageant organizations offer substantial benefits to the contestants and sponsors, their primary activity of providing a forum depicting community customs and traditions promotes the growth and development of the community and substantially benefits the community as a whole. Pageants also offer a recreational outlet for participants and community members.

This article will look at the legal issues raised by scholarships awarded as pageant prizes and consider whether pageant organizations or separate scholarship foundations

that administer the grants can serve exclusively educational purposes and qualify under I.R.C. 501(c)(3).

2. Scholarship Assistance: Is it Educational Under I.R.C. 501(c)(3)?

The law of charity has long recognized that educational organizations or organizations advancing education further charitable purposes. Providing scholarships to students for higher education advances education within the meaning of I.R.C. 501(c)(3). For instance, Rev. Rul. 66-103, 1966-1 C.B. 134, provides that an organization making fellowship grants to needy individuals who otherwise would not be able to pursue their studies qualifies for exemption. Scholarships can also be educational when no financial hardship exists. Rev. Rul. 69-257, 1969-1 C.B. 151, states that an organization providing scholarships by scholastic standing is advancing education so long as it selects recipients from a broad class of applicants. A class of applicants may be broad enough to serve charitable purposes even if it is limited to a particular group. Rev. Rul. 56-403, 1956-2 C.B. 307, describes an organization that awarded scholarships to a limited group. Because the organization did not specifically designate the eligible persons, the IRS ruled that the organization's purposes were not so personal, private, or selfish in nature as to lack the elements of public usefulness and benefit.

Most non-profit pageant organizations have entrance requirements broad enough to ensure a large class of eligible recipients. If they award college scholarships with "no strings attached," (non-forfeitable), they may be described in I.R.C. 501(c)(3). However, if a scholarship program also serves the substantial non-exempt purpose of compensating the recipients for past, present, or future services, it will not qualify for exemption under I.R.C. 501(c)(3). Thus, the IRS inquiry must start with the scholarship program to determine if it makes grants for exclusively educational purposes.

3. What is a Scholarship?

The Code does not define "scholarship." The regulations provide a "scholarship" is an amount paid or allowed to, or for the benefit of, a student, whether undergraduate or graduate, to help him or her pursue studies. It includes the value of room, board, laundry, and other similar services furnished to a student, as well as tuition, matriculation costs, and other fees incurred in pursuit of studies. (Regs. 1.117-3(a) and (d))

A "qualified scholarship" under I.R.C. 117(b), is any amount received by an individual as a scholarship to the extent the individual establishes that, by the conditions of the grant, such amount was used for qualified tuition and related expenses as defined in I.R.C. 117(b)(2). Reg. 1.117-6(c)(2) states that qualified tuition and related expenses are (1) tuition and fees required for the enrollment or attendance of a student at an

educational organization described in section 170(b)(1)(A)(ii); and (2) fees, books, supplies, and equipment required for courses of instruction.

Gross income does not include any amount received as a "qualified scholarship" under I.R.C. 117(a). However, scholarships that, by their nature, require something in return from the recipient are taxable as compensation. See, I.R.C. 117(c). Prop. Reg. 1.117-6(d)(2)¹ provides that a scholarship or fellowship grant represents payment for services when the grantor requires the recipient to perform services in return for the granting of the scholarship or fellowship. So, a scholarship or fellowship grant conditioned upon past, present, or future services by the recipient is compensatory.

Determining if a scholarship is compensatory requires analyzing all the facts and circumstances. Bingler v. Johnson, 394 U.S. 741 (1969), which considered whether educational stipends paid by Westinghouse Electric Corp., to its employees were "scholarships" excludable from gross income, is the landmark case for this inquiry. The U. S. Court of Appeals for the Third Circuit had held the payments to be scholarships after concluding Reg. 1.117-4(c), which provides that amounts paid as compensation for services or primarily for the benefit of the grantor are not scholarships or fellowships, was an invalid interpretation of the statute. The Supreme Court reversed the Third Circuit. It held the stipends were compensation, not scholarships excludable from income, because they required employees to submit progress reports while on educational leave of absence and return to Westinghouse's employ for a substantial period of time after completing the leave. The Court explained that under I.R.C. 117 scholarship grants must be "relatively disinterested, 'no strings' educational grants, with no requirements of any substantial quid pro quo from the recipients."

To reach its decision, the Court examined Congress' intent in creating I.R.C. 117. Noting that the legislative history was "far from clear," the Court found that the definition of "scholarships" and "fellowships" in Regs. 1.117-3(a) and (c) was proper because Congress omitted the definitions in the statute. Next, the Court concluded that Congress' intent to aid scholarship students must be reconciled with its apparent intent to tax amounts that represent compensation for services. In footnotes, the Court noted that the House version of the bill creating I.R.C. 117 taxed only amounts received as payment for teaching and research services. The Senate amended the provision to include payments for "other services" as well. Based on its reading of the legislative history, the Court concluded that "the thrust of the provision dealing with compensation is that bargained-for payments, given only as a 'quo' in return for the quid of services rendered - whether past, present, or future - should not be excludable from income as 'scholarship' funds."

¹ The Service issued proposed regulations under I.R.C. 117 on June 9, 1988. Although these regulations remain in proposed form, they provide the current basis for deciding which scholarships are excluded from gross income under I.R.C. 117.

In MacDonald v. Commissioner, 52 T.C. 386 (1969), the Tax Court held that money received under an employer-sponsored education program was not excludable from gross income as a scholarship under I.R.C. 117 even though the recipient was not contractually obligated to perform services in return. The court considered the evidence as a whole, and not just whether a contract existed between the employer and employee, to find that payments to the employee were compensatory.

The Fourth Circuit Court of Appeals looked at the compensation issue in Hembree v. United States, 464 F.2d 1262 (4th Cir. 1972). The court held that payments received by a doctor for his internship/residency were compensation for his services. Thus, he could not exclude them from his gross income as a fellowship under I.R.C. 117. The court looked to the primary purpose for the payments rather than to the form in which they were made. Because the doctor's internship/residency arrangements had all the indicia of an employer-employee relationship, the payments were like compensation.

Rev. Rul. 68-20, 1968-1 C.B. 55, considered the facts and circumstances in holding "scholarships" awarded to beauty pageant winners compensation for services were includable in gross income under I.R.C. 61. The payments were not excludable scholarships under I.R.C. 117 because the contest winner had to participate in the contest, play a leading role in the televised pageant, and perform subsequent services for, or at the direction of, the pageant organization.

4. Miss Georgia Scholarship Fund, Inc. v. Commissioner

The 1970's saw a significant increase in the amount of scholarships awarded by various pageants. Pageants continued to challenge the Service's position that the compensatory nature of the awards prevented them from qualifying as scholarships under I.R.C. 117. The Service continued to deny exemption under I.R.C. 501(c)(3) to organizations serving the dual purposes of advancing education and compensating contestants. To try to avoid this result, some pageants spun off the scholarship activity to a separate entity.

In Miss Georgia Scholarship Fund, Inc. v. Commissioner, 72 T.C. 267 (1979), the Tax Court held that a separate fund created by the Miss Georgia Pageant (Pageant), which was recognized exempt under I.R.C. 501(c)(4) solely to award scholarships to the Pageant's contestants, did not qualify under I.R.C. 501(c)(3) because the scholarships were awarded in consideration of contractual obligations.

The Pageant selected "Miss Georgia" to represent Georgia in the Miss America Pageant and perform promotional activities for the City of Columbus and the State. The Pageant awarded prizes including scholarships for future college study. The Pageant considered the "scholarship program" essential to its success as it helped attract "quality"

contestants for the Miss Georgia crown. Contestants had to sign the Miss Georgia Pageant Contestant Contract (Contract) to enter the Pageant and qualify for a "scholarship." The Contract required contestants to participate in the Miss Georgia Pageant and appear in public as directed by Pageant officials. The Contract also authorized the Pageant and its duly licensed representatives to televise, broadcast, and take moving pictures of the contestants. A winning contestant who failed to honor the Contract forfeited all rights to her "scholarship."

The Pageant formed the Miss Georgia Scholarship Fund, Inc. (Fund), to solicit contributions for the scholarships and administer the program. The Pageant controlled the Fund by appointing a majority of its board of trustees. The Fund paid scholarships solely to educational institutions attended by Pageant winners. The Fund applied for exemption under I.R.C. 501(c)(3).

The primary issue presented to the court was whether the "scholarships" offered by the Fund were excluded from the recipients' gross income under I.R.C. 74 because they were described in I.R.C. 117(a), or whether the "scholarships" were compensatory and so taxable under Reg. 1.117-4(c)(1). I.R.C. 74 provided, among other things, that gross income did not include scholarships under I.R.C. 117 and amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if -

- (1) the recipient was selected without any action on his part to enter the contest or proceeding; and
- (2) the recipient was not required to render substantial future services as a condition to receiving the prize or award.

In reaching its conclusion that the Fund's scholarship program was compensatory in nature, the court relied on the analysis in Bingler v. Johnson, *supra*. Following the Supreme Court's rationale, the Tax Court concluded that the Fund "scholarships" were compensation for signing the Pageant Contract and for performing services under it. So, these awards were not I.R.C. 117 scholarships and the Fund was not operated exclusively for I.R.C. 501(c)(3) purposes.

The U.S. District Court for Kansas addressed a similar issue in Wilson v. United States, 322 F. Supp. 830 (D. Kans. 1971). The issue was whether a scholarship won in the Miss America Pageant was includable in her gross income. The government argued, as it did later in Miss Georgia, *supra*, that the scholarship was partial payment for services rendered, or to be rendered, to the pageant sponsors, who contributed the scholarship funds. The court denied the government's motion for partial summary judgment and allowed the deduction because the contract did not clearly state that Miss America would

forfeit her scholarship if she did not fulfill the terms of her contract as a contestant. A close reading of the Contestant Contract is essential in analyzing the facts and circumstances.

5. Private Benefit

Although the court in Miss Georgia, supra, did not rely on private benefit to deny exemption under I.R.C. 501(c)(3), it implied that paying scholarships for the Pageant bestowed a substantial, non-exempt private benefit on that organization. An organization does not qualify under I.R.C. 501(c)(3) if it serves substantial private interests of an organization that is not exempt under I.R.C. 501(c)(3).

General Counsel Memoranda cannot be relied on as precedent, but may illustrate how an issue is analyzed. G.C.M. 39681 (Dec. 1, 1987) provides an example of how facts were analyzed in concluding that a separate scholarship foundation had a substantial non-exempt purpose of benefiting its I.R.C. 501(c)(4) creator.

The I.R.C. 501(c)(4) pageant organization held the franchise to sponsor a State beauty pageant. It selected participants in the State pageant through local events sponsored by civic organizations. Before entering the State pageant, each local winner was required to execute three agreements: (1) the Release and Indemnity Agreement, (2) the Letter of Understanding, and (3) the Application and Contestant's Rules and Regulations. The Application and Contestant's Rules and Regulations placed requirements on the contestants including certain obligations if the contestant was selected as the winner. Once the scholarship was awarded, it was non-forfeitable even if the participant chose not to, or was unable to, participate in the State beauty pageant.

The pageant organization formed a separate foundation to administer the scholarship program. However, under the contestant agreements, no contestant was entitled to a minimum scholarship unless she entered the pageant, participated in and won a local event, and entered an agreement to perform numerous services for, or at the direction or supervision of, the pageant corporation. Next, the contestant was not entitled to a second scholarship unless she qualified for a minimum scholarship and entered, participated in, and won various secondary categories.

G.C.M. 39681 applied the rationale in Miss Georgia, supra, in concluding the "scholarships" paid by the foundation were not described in I.R.C. 117. Rather, they were compensation to the contestants for performing certain services for the pageant. The foundation did not operate exclusively for one or more of the exempt purposes specified in I.R.C. 501(c)(3) because it paid compensatory awards rather than true scholarships.

G.C.M. 39681 also concluded that the scholarships were awarded primarily to benefit the I.R.C. 501(c)(4) organization and the pageant corporation. Providing the scholarships promoted the pageant by adding an “educational hue” to the women’s display of their beauty and talent. The educational hue attracted individuals, civic leaders, and business organizations that would otherwise not have contributed, to make contributions and become involved in the scholarship portion of the program. The scholarship foundation's activities helped the I.R.C. 501(c)(4) organization meet its obligation to provide the promised prizes.

G.C.M. 37579 (June 16, 1978) analyzed private benefit in the context of a scholarship-granting organization affiliated with an I.R.C. 501(c)(6) business league. The business league formed an organization to make grants to individuals for educational purposes by awarding scholarships to the winners of an essay contest sponsored by the business league. The business league expected the contest to increase public interest in its members' businesses and the lines of business they represented. Also, the essay contest and prizes were advertised nationally in connection with regular activities carried on by the business league. Three of the organization’s seven directors were affiliated with the business league. The organization was funded by contributions from members of the business league. The business league paid all advertising costs as well as the costs to hire an independent firm to make the initial selection of the best 50 essays (from which the business league itself then selected the first, second, and third place winners).

G.C.M. 37579 concluded that the business league’s use of the essay, the advertising and promotion of the contest, and the very topic of the essays all helped promote the parent organization. The organization failed to qualify for exemption under I.R.C. 501(c)(3) because, although the scholarships evidenced a charitable purpose, they also promoted the private interests of the business league.

6. Twists on the Same Plot

Based on the above discussion, the position of the Service is clear - scholarships that are granted as a form of compensation are not exclusively educational or charitable. They serve the private purpose of compensating the individual for services. Whether the compensatory scholarship is granted by the pageant organization or a separate scholarship foundation does not matter. Exemption will be denied under I.R.C. 501(c)(3) because the organization is not operated exclusively for exempt purposes. In addition, a substantial purpose of a pageant scholarship foundation is to administer a grant program for the benefit of an I.R.C. 501(c)(4) pageant-sponsoring organization. The grant program serves the non-exempt purposes of attracting contestants to enter the beauty pageant and sponsors to support the program.

It is important to keep the above principles in mind when analyzing applications from scholarship foundations whose facts may differ in some respects from the published authority. For instance, it is not necessary that a scholarship foundation be closely controlled by a pageant sponsoring organization to conclude that it is not exempt. An organization that is not associated with the pageant in any way other than funding the grants will still fail to qualify for exemption under I.R.C. 501(c)(3) if the scholarship recipients are required by contract to participate in all events or forfeit their scholarships. A close reading of all the contracts contestants are subject to is essential in making a determination as to whether the scholarship is, in fact, compensatory. An independent organization providing administrative services for the benefit of an I.R.C. 501(c)(4) organization will also fail to qualify for exemption under I.R.C. 501(c)(3) because it furthers a substantial non-exempt purpose whether or not it provides compensatory scholarships.

The question as to whether a scholarship is compensatory may also be raised in applications from organizations whose purposes are not limited to funding pageant scholarships. In these cases, the critical question remains whether the grant recipients are required to perform services to receive a scholarship. This cannot be determined without a thorough evaluation of all contracts that bind the grant recipients.

7. Conclusion

Beauty pageants continue to fulfill the traditional role of promoting the common good and general welfare of the community. Although the scholarships offer various contestants the chance to enhance their education, the opportunities for the winners to represent their communities and the sponsors of the pageants during their reigning year enhances their career aspirations as well as the economic prospects of the participating businesses. This duality - the public benefit co-existing with the private benefit - will often defeat a claim for exemption under I.R.C. 501(c)(3), though supporting continued recognition of exempt status under I.R.C. 501(c)(4).

These cases should be thoroughly developed because whether a scholarship is compensatory depends on the contract terms. The contestant agreement, along with the local and national franchise agreements, should be carefully examined to determine the obligations of the pageant participants. If a pageant:

- has no national, regional or local agreements with sponsors to use the event for commercial purposes and
- has scholarships that are not forfeitable once the winner is selected,

it may qualify for exemption under I.R.C. 501(c)(3).