Paparo v. Commissioner, 71 T.C. 692 (1979)

When stock in a subsidiary corporation is sold to a parent corporation, the transaction is treated as a redemption, and if it does not result in a meaningful reduction of the shareholder's proportionate interest, it is considered essentially equivalent to a dividend and taxed as ordinary income, not capital gains.

Summary

Jack and Irving Paparo sold their stock in two textile corporations (Nashville and Jasper) to their commonly controlled corporation, House of Ronnie, Inc. They sought to treat the proceeds as capital gains from a stock redemption under Section 302. The Tax Court held that under Section 304, the sale was treated as a redemption by House of Ronnie. Applying the principles of *United States v. Davis*, the court determined that the redemption was essentially equivalent to a dividend because the Paparos' control and proportionate interest in the corporations were not meaningfully reduced. Therefore, the distributions were taxed as ordinary income, not capital gains.

Facts

Jack and Irving Paparo equally owned House of Ronnie, a women's clothing design and marketing company. Nashville and Jasper, textile corporations, were formed as captive suppliers for House of Ronnie and were owned by Jack, Irving, and Stanley Rappaport (Jack's son-in-law). To facilitate a public stock offering for House of Ronnie and an acquisition of Denise Lingerie Co., underwriters required Nashville and Jasper to be combined with House of Ronnie to avoid potential conflicts of interest. In 1970, House of Ronnie purchased all stock of Nashville and Jasper from Jack, Irving, and Stanley for $800,000, funded by a public stock offering. Jack and Irving received payments in 1970 and 1971, which they treated as capital gains from stock redemption.

Procedural History

The Commissioner of Internal Revenue determined deficiencies against Jack and Irving Paparo, arguing that the amounts received from House of Ronnie were essentially equivalent to dividends and taxable as ordinary income. The Paparos petitioned the Tax Court, claiming the distributions qualified for capital gains treatment as stock redemptions under Section 302.

Issue(s)

1. Whether the amounts received by Jack and Irving Paparo from House of Ronnie in exchange for their stock in Nashville and Jasper are taxable as capital gains under Section 302 or as dividends under Section 301.
2. Whether the stock redemption was

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