actually been included in the service provider's gross income, the general rule in former § 1.83–6(a)(1) permitted the deduction for the amount ''includible'' in the service provider's gross income. Thus, the deduction was allowed to the service recipient even if the service provider did not properly report the includible amount. Where the service provider was an employee of the service recipient, however, the special rule in § 1.83–6(a)(2) provided that a deduction could be claimed only if the service recipient (employer) deducted and withheld income tax in accordance with section 3402. The special rule was designed to ensure that the service recipient's deduction was in fact offset by a corresponding inclusion in the service provider's gross income. The special rule was limited to employer-employee situations because in other situations there was no underlying withholding requirement upon which the deduction could be conditioned.

Taxpayers expressed concern that it was often difficult to satisfy the prerequisite that employers must deduct and withhold income tax from payments in kind as a condition for claiming a deduction. These regulations address this concern by eliminating this prerequisite, while still ensuring consistent treatment between service recipients and service providers as required by the statute. In addition, because the deduction no longer is conditioned on withholding, there no longer is a need to have different rules for those who receive services from employees and those who receive services from others.

Under these regulations, the former general rule and special rule are replaced by a revised general rule that more closely follows the statutory language of section 83(h). The service recipient is allowed a deduction for the amount ''included'' in the service provider's gross income. For this purpose, the amount included means the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the service provider.

Because of the potential difficulty of demonstrating actual inclusion by the service provider, a special rule provides that, if the service recipient timely complies with applicable Form W–2 or 1099 reporting requirements under section 6041 (or 6041A), as appropriate, with respect to the amount includible in income by the service provider, the service provider is deemed to have included the amount in gross income for this purpose. Thus, the regulations allow the deduction without requiring the service recipient to demonstrate actual inclusion by the service provider. If a transfer meets the requirements for exemption from reporting for payments aggregating less than $600 in any taxable year, or is eligible for any other reporting exemption, no reporting is required in order for the service recipient to rely on the deemed inclusion rule.

In order to allow service recipients to take advantage of the deemed inclusion rule with respect to property transfers to all service providers, these regulations also permit service recipients to use the special rule in the case of transfers to corporate service providers. To that end, service recipients are permitted, solely for purposes of this rule, to treat the Form 1099 reporting requirements as applicable to transfers to corporate service providers in the same manner as those requirements apply to transfers to noncorporate service providers. Thus, if a service recipient who transferred property to a corporate service provider timely reports that income on Form 1099 (to both the service provider and the federal government), the service recipient is entitled to rely on the deemed inclusion rule in claiming a deduction for the amount of that income. If the transfer meets the requirements for exemption from reporting for payments aggregating less than $600 in any taxable year, or is eligible for any other reporting exemption applicable to a service provider that is not a corporation, no reporting is required in order for the service recipient to rely on the deemed inclusion rule.

The deemed inclusion rule may be used only by a service recipient whose compliance with applicable Form W–2 or 1099 reporting requirements is timely. Thus, for example, under the current reporting requirements, if amounts attributable to one or more section 83 transfers of property are includible in an employee's income in year 1 (and are not eligible for any reporting exemption), the employer generally is required to furnish the employee a Form W–2 reflecting that amount by January 31 of year 2 and generally is required to file a copy of the Form W–2 with the federal government by the last day of February of year 2. If the employer reports to the employee and the government in a timely manner, the employer can rely on the deemed inclusion rule to claim a deduction for the amount in year 1. If the employee's Form W–2 is not furnished until after January 31 of year 2 or the government's copy of Form W–2 is not filed until after the last day of February of year 2, the employer generally is required to demonstrate that the employee actually included the amount in income in order to support its deduction of the amount.

Under these regulations, a special rule applies with respect to an amount includible in an employee's or former employee's income by reason of a disqualifying disposition of stock that had been acquired pursuant to a statutory stock option. In the case of such a disposition, and solely for the purpose of determining whether an employer may use the deemed inclusion rule under these regulations, a Form W–2 or W–2c (as appropriate) will be considered timely if it is furnished to the employee or former employee, and filed with the federal government, by the date on which the employer files its tax return (including an amended return) claiming a deduction for that amount.

With respect to disqualifying dispositions, these regulations modify the conditions for an employer's deduction under section 83(h) in a manner that is not inconsistent with the guidance provided by Notice 87–49 (Changes to Incentive Stock Option Requirements by Section 321 of the Tax Reform Act of 1986), 1987–2 C.B. 355. These regulations are not intended to have any effect on the application of Notice 87–49 or the analysis contained therein, and therefore should not be viewed as constituting a reconsideration of Revenue Ruling 71–52, 1971–1 C.B. 278, within the meaning of Notice 87–49.

Three written comments were received from the public on the proposed regulations. One dealt specifically with the withholding requirements as they apply to disqualifying dispositions of stock received under an employee stock purchase plan and, therefore, is beyond the scope of this regulation. The remaining two comments generally applauded the proposed amendments, but they both expressed a concern that, even after elimination of the withholding requirement as a prerequisite for claiming a deduction under section 83(h), there remains a statutory requirement, under subtitle C, to withhold income tax from compensatory transfers of property. Both commentators suggested that regulations be published to exclude transfers of property in payment for services from the withholding requirements.

Treasury and the IRS have carefully considered the comments. However, section 3402 of the Code requires every employer making payment of wages to deduct and withhold income tax from the wages. Section 3401(a) (relating to the definition of wages for income tax