MEMORANDUM

TO: All Pension Clients/Administrators

FROM: Klausner & Kaufman, P.A.

RE: Form 1040 - line 16b (Public Safety Officer exclusion from gross income of up to $3,000 for qualified health insurance premiums)

DATE: November 21, 2007

The IRS recently released on its website new tax forms, instructions and publications for the 2007 tax year. Of interest to all governmental plans with public safety members are the changes to line 16 on Form 1040.

Beginning with the 2007 tax year, public safety officers should report their total pension distributions on line 16a of Form 1040. Assuming that the officer qualifies for the insurance premium exclusion, the $3,000 exclusion should be recognized in line 16b of the Form 1040, where the public safety officer should write the initials “PSO” next to the taxable amount received.

According to the newly published 1040 Instructions for 2007, page 22:

If you are an eligible retired public safety officer (law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew) you can elect to exclude from income distributions made from your eligible retirement plan that are used to pay the premiums for accident or health insurance or long term-care insurance. The premiums can be for coverage for you, your spouse, or dependents. The distribution must be made directly from the plan to the insurance provider. You can exclude from income the smaller of the amount of the insurance premiums or $3,000. You can only make this election for amounts that would otherwise be included in your income.
If you make this election, reduce the otherwise taxable amount of your pension or annuity by the amount excluded. The amount shown in box 2a of Form 1099-R does not reflect the exclusion. Report your total distributions on line 16a and the taxable amount on line 16b. Enter “PSO” next to line 16b.

For those who don’t use Form 1040, the exclusion should be reported as follows:

Form 1040A - line 12a (report the total pension distribution)  
- line 12b (report the taxable amount and enter the initials “PSO”)

Form 1040NR - line 17a (report the total pension distribution)  
- line 17b (report the taxable amount and enter the initials “PSO”)

By way of background, this new $3,000 exclusion contained in IRS Code Section 402(l) was adopted as part of the Pension Protection Act of 2006, Section 845(a). The IRS previously provided guidance on this subject in Notice 2007-7. This topic is also discussed on pages 5-6 of IRS Publication 575.

We welcome any questions or comments from our clients on this matter. As a general rule, we recommend against providing individualized tax advice to plan members. Members should be encouraged to discuss the matter with their accountants or other tax professionals. Nevertheless, plans are certainly permitted to provide copies of relevant IRS publications and forms to the membership since the Form 1099-R provided by the plan/custodian will not reflect the exclusion in box 2a.

Copies of the new Form 1040, Instructions, and applicable pages from Publication 575 are attached.
**U.S. Individual Income Tax Return 2007**

**Label**

- Your first name and initial
- Last name
- Your social security number
- Spouse’s social security number

- Home address (number and street). If you have a P.O. box, see page 12.
- Apl. no.

**Presidential Election Campaign**

- Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 12) □

**Filing Status**

- □ Single
- □ Married filing jointly (even if only one had income)
- □ Married filing separately. Enter spouse's SSN above and full name here □
- □ Head of household (with qualifying person). (See page 13). If the qualifying person is a child but not your dependent, enter this child’s name here □

**Exemptions**

- □ Yourself. If someone can claim you as a dependent, do not check box 6a □
- □ Spouse □

**Dependants:**

- (1) First name □
- Last name □
- (2) Dependent’s social security number □
- (3) Dependent’s relationship to you □
- □ Qualifying child or qualifying child for itemized deduction (see page 15)

**Income**

- 7 Wages, salaries, tips, etc. Attach Form(s) W-2 □
- 8a Taxable interest. Attach Schedule B if required □
- 8b Tax-exempt interest. Do not include on line 8a □
- 9a Ordinary dividends. Attach Schedule B if required □
- 9b Qualified dividends (see page 19) □
- 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 20) □
- 11 Allimony received □
- 12 Business income or (loss). Attach Schedule C or Form C-EZ □
- 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here □
- 14 Other gains or (losses). Attach Form 4797 □
- 15a IRA distributions □
- 15b Taxable amount (see page 21) □
- 16a Pensions and annuities □
- 16b Taxable amount (see page 22) □
- 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E □
- 18 Farm income or (loss). Attach Schedule F □
- 19 Unemployment compensation □
- 20a Social security benefit □
- 20b Taxable amount (see page 24) □
- 21 Other income. List type and amount (see page 24) □
- 22 Add the amounts in the far right column for lines 7 through 21. This is your total income □

**Adjusted Gross Income**

- 23 Educator expenses (see page 26) □
- 24 Certain business expenses of reservists, performing artists, and sea-based government officials. Attach Form 2160 or 2106-EZ □
- 25 Health savings account deduction. Attach Form 8889 □
- 26 Moving expenses. Attach Form 3903 □
- 27 One-half of self-employment tax. Attach Schedule SE □
- 28 Self-employed SEP, SIMPLE, and qualified plans □
- 29 Self-employed health insurance deduction (see page 26) □
- 30 Penalty on early withdrawal of savings □
- 31a Allimony paid □
- 31b Recipient’s SSN □
- 32 IRA deduction (see page 27) □
- 33 Student loan interest deduction (see page 30) □
- 34 Tuition and fees deduction. Attach Form 8917 □
- 35 Domestic production activities deduction. Attach Form 8903 □
- 36 Add lines 23 through 31a and 32 through 35 □
- 37 Subtract line 36 from line 22. This is your adjusted gross income □

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 83. Cat. No. 11320B Form 1040 (2007)
INSTRUCTIONS
Including Instructions for Schedules A, B, C, D, E, F, J, and SE

2007

NOTE: THIS BOOKLET DOES NOT CONTAIN TAX FORMS

Explore all electronic filing and payment options, including Free File.

TAKE THE FREE WAY
If you made $54,000 or less in 2007, you're one of the 95+ million taxpayers who are eligible to e-file for free!
See page 4 or go to: www.irs.gov

MAILING YOUR RETURN
You may be mailing your return to a different address this year. See the back cover.

MORTGAGE INSURANCE PREMIUMS
You may be able to deduct qualified mortgage insurance premiums. See the instructions for Schedules A&B.
Partially Taxable Pensions and Annuities

Enter the total pension or annuity payments you received in 2007 on line 16a. If your Form 1099-R does not show the taxable amount, you must use the General Rule explained in Pub. 939 to figure the taxable part to enter on line 16b. But if your annuity starting date (defined below) was after July 1, 1986, see Simplified Method below to find out if you must use that method to figure the taxable part.

You can ask the IRS to figure the taxable part for you for a $380 fee. For details, see Pub. 939.

If your Form 1099-R shows a taxable amount, you can report that amount on line 16b. But you may be able to report a lower taxable amount by using the General Rule or the Simplified Method or if the exclusion for retired public safety officers, discussed next, applies.

Insurance Premiums for Retired Public Safety Officers

If you are an eligible retired public safety officer (law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew), you can elect to exclude from income distributions made from your eligible retirement plan that are used to pay the premiums for accident or health insurance or long-term care insurance. The premiums can be for coverage for you, your spouse, or dependents. The distribution must be made directly from the plan to the insurance provider. You can exclude from income the smaller of the amount of the insurance premiums or $3,000. You can only make this election for amounts that would otherwise be included in your income.

An eligible retirement plan is a governmental plan that is:

- a qualified trust,
- a section 403(a) plan,
- a section 403(b) annuity, or
- a section 437(b) plan.

If you make this election, reduce the otherwise taxable amount of your pension or annuity by the amount excluded. The amount shown in box 2a of Form 1099-R does not reflect the exclusion. Report your total distributions on line 16a and the taxable amount on line 16b. Enter "PSO" next to line 16b.

Annuitant Starting Date

Your annuity starting date is the later of the first day of the first period for which you received a payment or the date the plan's obligations became fixed.

Simplified Method

You must use the Simplified Method if either of the following applies:

1. Your annuity starting date (defined above) was after July 1, 1986, and you used this method last year to figure the taxable part.

2. Your annuity starting date was after November 18, 1996, and both of the following apply.

   a. The payments are from a qualified employee plan, a qualified employee annuity, or a tax-sheltered annuity.

   b. On your annuity starting date, either you were under age 75 or the number of years of guaranteed payments was fewer than 5. See Pub. 575 for the definition of guaranteed payments.

If you must use the Simplified Method, complete the worksheet on page 23 to figure the taxable part of your pension or annuity. For more details on the Simplified Method, see Pub. 575 or Pub. 721 for U.S. Civil Service retirement benefits.

If you received U.S. Civil Service retirement benefits and you choose the alternative annuity option, see Pub. 721 to figure the taxable part of your annuity. Do not use the worksheet on page 23.

Age (or Combined Ages) at Annuity Starting Date

If you are the retiree, use your age on the annuity starting date. If you are the survivor of a retiree, use the retiree's age on his or her annuity starting date. But if your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, use your combined ages on the annuity starting date.

If you are the beneficiary of an employee who died, see Pub. 575. If there is more than one beneficiary, see Pub. 575 or Pub. 721 to figure each beneficiary's taxable amount.

Cost

Your cost is generally your net investment in the plan as of the annuity starting date. It does not include pre-tax contributions. Your net investment should be shown in box 2b of Form 1099-R for the first year you received payments from the plan.

Rollovers

Generally, a qualified rollover is a tax-free distribution of cash or other assets from one retirement plan that is contributed to another plan within 60 days of receiving the distribution. Use lines 16a and 16b to report a qualified rollover, including a direct rollover, from one qualified employer's plan to another or to an IRA or SEP.

Enter on line 16a the total distribution before income tax or other deductions were withheld. This amount should be shown in box 1 of Form 1099-R. From the total on line 16a, subtract any contributions (usually shown in box 5) that were taxable to

Need more information or forms? See page 82.
you when made. From that result, subtract the amount of the qualified rollover. Enter the remaining amount, even if zero, on line 16b. Also, enter “Rollover” next to line 16b.

Special rules apply to partial rollovers of property. For more details on rollovers, including distributions under qualified domestic relations orders, see Pub. 575.

**Lump-Sum Distributions**

If you received a lump-sum distribution from a profit-sharing or retirement plan, your Form 1099-R should have the “Total distribution” box in box 2b checked. You may owe an additional tax if you received an early distribution from a qualified retirement plan and the total amount was not rolled over in a qualified rollover. For details, see the instructions for line 60 that begin on page 41.

**Enter the total distribution on line 16a and the taxable part on line 16b.**

**TIP**

You may be able to pay less tax on the distribution if you were born before January 2, 1936, or you are the beneficiary of a deceased employee who was born before January 2, 1936. For details, see Form 4972.

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**Simplified Method Worksheet—Lines 16a and 16b**

*Keep for Your Records*

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Enter the total pension or annuity payments received in 2007. Also, enter this amount on Form 1040, line 16a.</td>
</tr>
<tr>
<td>2.</td>
<td>Enter your cost in the plan at the annuity starting date. Note: If you completed this worksheet last year, skip line 3 and enter the amount from line 4 of last year’s worksheet on line 4 below (even if the amount of your pension or annuity has changed). Otherwise, go to line 3.</td>
</tr>
<tr>
<td>3.</td>
<td>Enter the appropriate number from Table 1 below. If your annuity starting date was after 1997 and the payments are for your life and that of your beneficiary, enter the appropriate number from Table 2 below.</td>
</tr>
<tr>
<td>4.</td>
<td>Divide line 2 by the number on line 3.</td>
</tr>
<tr>
<td>5.</td>
<td>Multiply line 4 by the number of months for which this year’s payments were made. If your annuity starting date was before 1987, skip lines 6 and 7 and enter this amount on line 8. Otherwise, go to line 6.</td>
</tr>
<tr>
<td>6.</td>
<td>Enter the amount, if any, recovered tax free in years after 1986. If you completed this worksheet last year, enter the amount from line 10 of last year’s worksheet.</td>
</tr>
<tr>
<td>7.</td>
<td>Subtract line 6 from line 2.</td>
</tr>
<tr>
<td>8.</td>
<td>Enter the smaller of line 5 or line 7.</td>
</tr>
<tr>
<td>9.</td>
<td>Taxable amount. Subtract line 8 from line 1. Enter the result, but not less than zero. Also, enter this amount on Form 1040, line 16b. If your Form 1099-R shows a larger amount, use the amount on this line instead of the amount from Form 1099-R. If you are a retired public safety officer, see <em>Insurance Premiums for Retired Public Safety Officers</em> on page 22 before entering an amount on line 16b.</td>
</tr>
<tr>
<td>10.</td>
<td>Was your annuity starting date before 1987? Yes. Leave line 10 blank. No. Add lines 6 and 8. This is the amount you have recovered tax free through 2007. You will need this number when you fill out this worksheet next year.</td>
</tr>
</tbody>
</table>

**Table 1 for Line 3 Above**

<table>
<thead>
<tr>
<th>IF the age at annuity starting date (see page 22) was...</th>
<th>AND your annuity starting date was...</th>
<th>THEN enter on line 3...</th>
</tr>
</thead>
<tbody>
<tr>
<td>55 or under</td>
<td>before November 19, 1996</td>
<td>300</td>
</tr>
<tr>
<td>56-60</td>
<td></td>
<td>250</td>
</tr>
<tr>
<td>61-65</td>
<td></td>
<td>240</td>
</tr>
<tr>
<td>66-70</td>
<td></td>
<td>170</td>
</tr>
<tr>
<td>71 or older</td>
<td></td>
<td>120</td>
</tr>
</tbody>
</table>

**Table 2 for Line 3 Above**

<table>
<thead>
<tr>
<th>IF the combined ages at annuity starting date (see page 22) were...</th>
<th>THEN enter on line 3...</th>
</tr>
</thead>
<tbody>
<tr>
<td>110 or under</td>
<td>410</td>
</tr>
<tr>
<td>111-120</td>
<td>360</td>
</tr>
<tr>
<td>121-130</td>
<td>310</td>
</tr>
<tr>
<td>131-140</td>
<td>260</td>
</tr>
<tr>
<td>141 or older</td>
<td>210</td>
</tr>
</tbody>
</table>

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*Need more information or forms? See page 82.*
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What’s New for 2007

Rollover of after-tax contributions. For tax years beginning in 2007, the nontaxable part of an eligible rollover distribution (such as after-tax contributions) from a qualified retirement plan can be rolled over to another qualified retirement plan that is either a qualified employee plan or an annuity contract described in section 403(b). Previously, this part of the distribution could be rolled over only to another qualified retirement plan that was a defined contribution plan.

The rollover must be a direct trustee-to-trustee transfer. The plan to which the rollover is made must separately account for these contributions and the earnings on them. See Rollover of nontaxable amounts under Rollovers for more information.
free. The tax-free part is based on the ratio of your cost (investment in the contract) to your account balance under the plan.

If your annuity is under a nonqualified plan (including a contract you bought directly from the issuer), the amount withdrawn is allocated first to earnings (the taxable part) and then to your cost (the tax-free part). However, if you bought your annuity contract before August 14, 1982, a different allocation applies to the investment before that date and the earnings on that investment. To the extent the amount withdrawn does not exceed that investment and earnings, it is allocated first to your cost (the tax-free part) and then to earnings (the taxable part).

If you withdraw funds (other than as an annuity) on or after your annuity starting date, the entire amount withdrawn is generally taxable. The amount you receive in a full surrender of your annuity contract at any time is tax free to the extent of any cost that you have not previously recovered tax free. The rest is taxable.

For more information on the tax treatment of withdrawals, see Taxation of Nonperiodic Payments, later. If you withdraw funds from your annuity before you reach age 59 1/2, also see Tax on Early Distributions under Special Additional Taxes, later.

**Annuity payments.** If you receive annuity payments under a variable annuity plan or contract, you recover your cost tax free under either the Simplified Method or the General Rule, as explained under Taxation of Periodic Payments, later. For a variable annuity paid under a qualified plan, you generally must use the Simplified Method. For a variable annuity paid under a nonqualified plan (including a contract you bought directly from the issuer), you must use a special computation under the General Rule. For more information, see Variable annuities in Publication 939 under Computation Under the General Rule.

**Death benefits.** If you receive a single-sum distribution from a variable annuity contract because of the death of the owner or annuitant, the distribution is generally taxable only to the extent it is more than the unrecovered cost of the contract. If you choose to receive an annuity, the payments are subject to tax as described above. If the contract provides a joint and survivor annuity and the primary annuitant had received annuity payments before death, you figure the tax-free part of annuity payments you receive as the survivor in the same way the primary annuitant did. See Survivors and Beneficiaries, later.

**Section 457 Deferred Compensation Plans**

If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are generally taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

This publication covers the tax treatment of benefits under eligible section 457 plans, but it does not cover the treatment of deferrals. For information on deferrals under section 457 plans, see Retirement Plan Contributions under Employee Compensation in Publication 525.

**Is your plan eligible?** To find out if your plan is an eligible plan, check with your employer. Plans that are not eligible section 457 plans include the following.

- Bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans.
- Nonselective deferred compensation plans for nonemployees (independent contractors).
- Deferred compensation plans maintained by churches.
- Length of service award plans for bona fide volunteer firefighters and emergency medical personnel. An exception applies if the total amount paid to a volunteer exceeds $3,000 for any year of service.

**Disability Pensions**

If you retired on disability, you generally must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 7 of Form 1040 or Form 1040A or on line 8 of Form 1040NR until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.

**TIP**

You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see Publication 524.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on Form 1040, lines 16a and 16b; Form 1040A, lines 12a and 12b; or on Form 1040NR, lines 17a and 17b.

**TIP**

Disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies) are not included in income. For more information about payments to survivors of terrorist attacks, see Publication 3920, Tax Relief for Victims of Terrorist Attacks.

**Insurance Premiums for Retired Public Safety Officers**

If you are an eligible retired public safety officer (law enforcement officer, firefighter, chaplain, or member of a rescue squad or ambulance crew), you can elect to exclude from income distributions made from your eligible retirement plan that are used to pay the premiums for accident or health insurance or long-term care insurance. The premiums can be for coverage for you, your spouse, or dependents. The distribution must be made directly from the plan to the insurance provider. You can exclude from
income the smaller of the amount of the insurance premiums or $3,000. You can only make this election for amounts that would otherwise be included in your income. The amount excluded from your income cannot be used to claim a medical expense deduction.

An eligible retirement plan is a governmental plan that is:

- a qualified trust,
- a section 403(a) plan,
- a section 403(b) annuity, or
- a section 457(b) plan.

If you make this election, reduce the otherwise taxable amount of your pension or annuity by the amount excluded. The amount shown in box 2a of Form 1099-R does not reflect this exclusion. Report your total distributions on Form 1040, line 16a; Form 1040A, line 12a; or Form 1040NR, line 17a. Report the taxable amount on Form 1040, line 16b; Form 1040A, line 12b; or Form 1040NR, line 17b. Enter “PSO” next to the appropriate line on which you report the taxable amount.

**Railroad Retirement Benefits**

Benefits paid under the Railroad Retirement Act fall into two categories. These categories are treated differently for income tax purposes.

The first category is the amount of tier 1 railroad retirement benefits that equals the social security benefit that a railroad employee or beneficiary would have been entitled to receive under the social security system. This part of the tier 1 benefit is the social security equivalent benefit (SSEB) and you treat it for tax purposes like social security benefits. If you received, repaid, or had tax withheld from the SSEB portion of tier 1 benefits during 2007, you will receive Form RRB-1099, Payments by the Railroad Retirement Board (or Form RRB-1042S, Statement for Nonresident Alien Recipients of Payments by the Railroad Retirement Board, if you are a nonresident alien) from the U.S. Railroad Retirement Board (RRB).

For more information about the tax treatment of the SSEB portion of tier 1 benefits and Forms RRB-1099 and RRB-1042S, see Publication 915.

The second category contains the rest of the tier 1 railroad retirement benefits, called the non-social security equivalent benefit (NSSEB). It also contains any tier 2 benefit, vested dual benefit (VDB), and supplemental annuity benefit. Treat this category of benefits, shown on Form RRB-1099-R, as an amount received from a qualified employee plan. This allows for the tax-free (nontaxable) recovery of employee contributions from the tier 2 benefits and the NSSEB part of the tier 1 benefits. (The NSSEB and tier 2 benefits, less certain repayments, are combined into one amount called the Contributory Amount Paid on Form RRB-1099-R.) Vested dual benefits and supplemental annuity benefits are non-contributory pensions and are fully taxable. See Taxation of Periodic Payments, later, for information on how to report your benefits and how to recover the employee contributions tax free. Form RRB-1099-R is used for U.S. citizens, resident aliens, and nonresident aliens.

**Nonresident aliens.** A nonresident alien is an individual who is not a citizen or a resident alien of the United States. Nonresident aliens are subject to mandatory U.S. tax withholding unless exempt under a tax treaty between the United States and their country of legal residency. A tax treaty exemption may reduce or eliminate tax withholding from railroad retirement benefits. See Tax Withholding, later, for more information.

If you are a nonresident alien and your tax withholding rate changed or your country of legal residence changed during the year, you may receive more than one Form RRB-1042S or Form RRB-1099-R. To determine your total benefits paid or repaid and total tax withheld for the year, you should add the amounts shown on all forms you received for that year. For information on filing requirements for aliens, see Publication 519, U.S. Tax Guide for Aliens. For information on tax treaties between the United States and other countries that may reduce or eliminate U.S. tax on your benefits, see Publication 901, U.S. Tax Treaties.

**Tax Withholding.** For SSEB payments received, get Form W-4V, Voluntary Withholding Request, from the IRS and file it with the RRB to request or change your income tax withholding. For NSSEB, tier 2, VDB, and supplemental annuity payments received, use Form RRB W-4P, Withholding Certificate for Railroad Retirement Payments, to elect, revoke, or change your income tax withholding. If you are a nonresident alien or a U.S. citizen living abroad, you should provide Form RRB-1001, Nonresident Questionnaire, to the RRB to furnish citizenship and residency information and to claim any treaty exemption from U.S. tax withholding. Nonresident U.S. citizens cannot elect an exempt withholding status on payments delivered outside of the U.S.

**Help from the RRB.** To request an RRB form or to get help with questions about an RRB benefit, you should contact your nearest RRB field office if you reside in the United States (call 1-800-808-0772 for the nearest field office) or U.S. consulate/Embassy if you reside outside the United States. You can visit the RRB on the Internet at www.rrb.gov.

**Form RRB-1099-R.** The following discussion explains the items shown on Form RRB-1099-R. The amounts shown on this form are before any deduction for:

- Federal income tax withholding,
- Medicare premiums,
- Legal process garnishment payments,
- Overall minimum assignment payments,
- Recovery of a prior year overpayment of an NSSEB, tier 2 benefit, VDB, or supplemental annuity benefit, or
- Recovery of Railroad Unemployment Insurance Act benefits received while awaiting payment of your railroad retirement annuity.

The amounts shown on this form are after any offset for:

- Social Security benefits,
- Age reduction,