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How Do States Tax Exempt-Interest Dividends?

Exempt-interest dividends, often paid by municipal bond funds, are generally free from federal taxes. However, they may still be taxed at the state level. How states tax exempt-interest dividends depends on factors like the investor's residency and where the bonds were issued. Some states exclude dividends from in-state municipal bonds while taxing those from out-of-state issuers. Others tax all exempt-interest dividends regardless of origin.

What Are Exempt-Interest Dividends?

Exempt-interest dividends are distributions from mutual funds that invest in municipal bonds issued by state and local governments to finance public projects. These dividends represent the tax-free interest earned by the fund on its bond holdings, which passes to investors. Unlike traditional dividends from stocks or taxable bond funds, exempt-interest dividends do not stem from corporate earnings but rather from government-issued debt instruments.

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