Proposition 2 ½ and Municipal Tax Classification

Property Taxes & Proposition 2 1/2

In Massachusetts, municipal revenues are raised through the property tax levy, state aid, local receipts, and other sources. These revenues support local spending for schools, public safety, and other essential public services. The property tax levy is the largest source of revenue for most cities and towns. Proposition 2½, approved by Massachusetts voters in 1980 and first implemented in fiscal 1982, limits the amount of revenue a city or town may raise (or levy) from local property taxes each year to fund municipal operations.

Prop 2 ½ places two constraints on the amount of property taxes a city or town can levy:

1. A community cannot levy more than 2.5 percent of the total full cash value of all taxable property in the community (called the levy ceiling).
2. A community's allowable levy for a fiscal year (called the levy limit) cannot increase by more than 2.5 percent of the maximum allowable limit for the prior year, plus certain allowable increases such as new growth from property added to the tax rolls.

Key terms:

- ***Levy Limit***: This caps the annual increase in property tax revenue (the levy) a city or town can collect from existing properties to 2.5% over the previous year's levy limit, plus any new growth revenue from new properties or improvements.
- ***Levy Ceiling***: The total property tax levy cannot exceed 2.5% of the total assessed value of all taxable property within the municipality.
- ***Assessed value***: The fair market value of property as of the January 1 preceding the start of the fiscal year.
- ***Overrides and Exclusions***: Municipalities can temporarily exceed these limits through voter-approved overrides and exclusions. Overrides permanently increase the levy limit, while exclusions (such as for debt or capital expenditures) temporarily increase the limit.

Property Tax Classification

In 1978, the Massachusetts General Court approved a law that allows municipalities to set different tax rates for different sectors. Under Prop 2 ½, a municipality can apply different tax rates to different classes of property, as long as it is within the constraints of the levy limit and levy ceiling. Massachusetts cities and towns can adopt a classification system to shift the tax obligation between different types of properties: residential and CIP (commercial, industrial, and personal) property. This flexibility allows a municipality to determine which property taxpayers will pay a higher rate and by how much. This could include a higher tax rate for commercial and industrial property, in order to maintain a lower tax rate for the residential tax base.

When setting the tax rate, the local legislative body determines how much of a shift factor to adopt for the upcoming year. The maximum shift is set by the state. For commercial properties, the shift can be up to 175% of the rate on residential properties.

How Tax Classification Works

- The municipality first calculates a single tax rate as if there were no classification
    - e.g., $14.44 per $1,000 of assessed value.

- Classification allows municipalities to apply a factor to this single rate, multiplying it to shift the tax burden.
    - e.g., Boston currently uses a factor of 1.75 for commercial properties, resulting in a higher tax rate for commercial properties ($14.44 * 1.75 = $25.27 per $1,000 of assessed value) and a lower rate for residential properties ($10.90 per $1,000 of assessed value).

- In fiscal year 2024, just under one-third (110) of municipalities in the state adopted a split tax classification.

City of Boston's Proposed Legislation on Tax Classification

While revenue growth is limited, property tax is a stable and reliable source of revenue. This is essential for all cities and towns in the Commonwealth, as these resources help invest in parks, libraries, schools, street improvements, and other important municipal services.

However, when commercial property values decline, (due to economic downturns or market shifts), the proportion of the total levy paid by commercial properties decreases, shifting more of the tax burden to residential properties.

In anticipation of a potential decline on some commercial property values, the City of Boston has filed legislation that would mitigate the sudden shift in tax burden to residential properties by adjusting the classification factor. The proposal would allow the city to temporarily increase the classification factor up to 2.00, thus increasing the commercial tax rate to counteract the impact of a decline in commercial property values on residential taxpayers.

Even with commercial property value changes and classification adjustments, the total property tax levy must remain within the levy limit set by Proposition 2½. If commercial property values drop significantly and the City maximizes the classification factor, commercial properties might still see a decrease in taxes, but not as significant a decrease as without the classification adjustment.

This helps spread the tax burden more evenly between commercial and residential properties. The proposed legislation provides the City of Boston, with local legislative approval, the ability to adjust the classification factor up to 2.00. Should the legislation pass, this flexibility would be available for 5 years. Even with this potential flexibility, the Boston City Council would still need to approve the shift factor each year when setting the tax rate, giving time to consider the prior year's impacts on both commercial and residential properties.

The concept proposed in the City of Boston's legislation could be beneficial to other municipalities, should they choose to utilize it. For this reason, the MMA fully supports this proposal and broader legislation to allow for this flexibility by local option.