

Contractors Beware: Post-Award Sales Tax Increases May Reduce the Profitability of a Project

By D. Joseph Darr

In response to the economic downturn, many states and municipalities enacted sales tax increases to combat budget deficits and maintain services. Although a sales tax increase occasionally can stimulate the construction industry when those funds are used to maintain or start construction projects, it also may negatively impact contractors when the increase occurs after the contract is awarded, making it important to know who is responsible for a post-award sales tax increase on a construction project.

Generally, a contractor bears the risk associated with a change in law that occurs after the parties reach an agreement stating the contractor agrees to perform the work for a fixed price and also agrees to comply with all laws and regulations governing performance of the work. However, ultimately the terms of the contract between a contractor and an owner or between a general contractor and a subcontractor ultimately determine which party bears the risk for a change in law, including a post-award sales tax increase.

In an effort to shield themselves from these unforeseen costs, some contractors include a change in law provision in their contracts. This may be the most effective method for shifting a contractor's sales tax burden to the owner in the event of a change in law.

If a contract does not contain an explicit change in law provision, a contractor may have several good faith, albeit difficult, arguments entitling the company to additional compensation for a post-award sales tax increase. First, a contractor might contend it is entitled to additional compensation pursuant to a "changed conditions" provision. This argument depends largely on the contractual language of the provision. In most construction contracts, a changed conditions provision is limited to changed subsurface or latent physical conditions at the jobsite, as well as unknown physical conditions that materially differ from those ordinarily encountered. Consequently, a change of the sales tax rate is unlikely to fall into a typical changed conditions provision.

Second, a contractor may assert several different legal principles, such as the doctrines of impossibility, impracticability and frustration of purpose, which could excuse contractual performance. These doctrines may serve as a beneficial tool for a contractor that seeks to cease performance on a project due to a change in law. However, it is debatable whether any of these legal principles would excuse a contractor's performance due to a post-award sales tax increase. Further, if a contractor wants to complete the project and receive an equitable adjustment in the contract price due to a tax increase, the preceding legal principles are unlikely to be helpful because they would merely excuse the contractor from fully performing the contract.

Finally, contractors working on a project for a government entity may be entitled to additional compensation if that entity is responsible for the raised tax. In that context, interesting situations can arise where the government exercises its dual roles as lawgiver and as a contracting partner. For example, the federal government cannot exercise its power to alter, modify, obstruct or

violate contracts it has entered into with private parties. This tension is balanced through the sovereign acts doctrine.

The sovereign acts doctrine is a case-specific inquiry that examines the scope of the legislation in question and determines whether that legislation was designed to target previous government contracts. It can shield the federal government from liability for laws it passes that coincidentally affect one of its contracts with a private party.

In essence, the more it appears a law was passed with the government's self-interest in mind, the less likely the sovereign acts doctrine will protect the federal government from a contractor's claim for additional compensation due to an act such as a post-award increase in the sales tax. Although it is questionable whether the sovereign acts doctrine applies to contracts with non-federal government entities, it is worth noting because a government entity may assert the defense when a contractor seeks additional compensation for a sales tax increase or other change in law.

Although an uphill battle exists for additional compensation for a post-award sales tax increase, contractors should try to contractually shift the risk of a change in law, including an increase in the sales tax, to the owner. In the absence of such a contractual provision, a contractor may find itself struggling to obtain additional compensation from the owner for a sales tax increase, either informally or through litigation. If a contractor chooses to ignore the risk of changes in the law, a post-award sales tax increase could potentially reduce the profitability of a project.

D. Joseph Darr is an attorney with Moye, O'Brien, O'Rourke, Pickert & Dillon, LLP, Orlando, Fla. For more information, call (407) 622-5250 or email jdarr@moopd.com