

ABA LEGAL NOTES

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Arizona's Sales Tax Increase: Are Owners Ultimately Liable?

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Proposition 301 passed last November increasing the state sales tax from 5 percent to 5.6 percent, effective June 1, 2001. The proposition, however, did not include any protections for contracts entered into before Election Day. As a result, a general contractor that signed a lump sum contract with an owner before the voters approved the tax increase undoubtedly did not include the higher tax rate in its price for work to be performed after June 1, 2001.

The Arizona Builders' Alliance and other industry groups sought a legislative solution to this problem. However, after much legislative wrangling, Governor Hull vetoed a bill on November 8 that would have allowed companies to maintain the 5 percent rate on any contract signed before the June 1 effective date.

Therefore, the new 5.6 percent tax rate takes effect for all contracts on June 1, 2001. The central question for contractors is whether a contractor will be entitled to pass thru the cost of the tax increase to the project owner on contracts entered into before the effective date of the new law. The short answer is that a contractor will be liable for the increased taxes unless the owner-contractor agreement expressly provides a basis for a claim.

The General Rule

As a starting point, the general rule places the cost of performance on the performing party. In other words, there is not implied right for the contractor to collect additional compensation because it encounters some unforeseen condition or because the cost to perform is greater than expected. The United States Supreme Court clearly enunciated this principle in the *Spearin* case: "Where one agrees to do, for a fixed sum, a thing possible to be performed, he will not be excused or become entitled to additional compensation because unforeseen difficulties are encountered."

For a contractor to recover additional compensation for an unforeseen condition, the construction contract must provide the basis for relief. Changed conditions clauses vary between contracts and a item covered under one clause may not be recoverable under a differently worded language. Thus, to determine who is ultimately responsible for the tax rate increase, the entire contract must be carefully reviewed.

Recovery Under the AIA A201 General Conditions?

Under the mostly widely used contract form—the AIA A201 -1997 General Conditions—the contractor has a shot at recovering the additional costs resulting from the tax increase. At least two provisions in the AIA A201 general conditions are relevant to the analysis:

- Subparagraph 3.4.1 requires that the contractor "unless otherwise provided in the Contract Documents ... provide and pay for labor, materials, equipment, tools, construction equipment and machinery," and other items needed for the work.
- Subparagraph 3.6.1 provides that the contractor must pay those taxes "which are legally enacted when bids are received or negotiations concluded, whether or not yet effective or merely scheduled to go into effect."

An owner will likely contend that the broad language in subparagraph 3.4.1 indicates that increased taxes are the contractor's responsibility. In response, the general contractor will argue that subparagraph 3.6.1 defines the

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specific taxes to be included in the contract price and that this provision falls within subparagraph 3.4.1's "unless otherwise provided" exception.

The contractor's most compelling argument for recovery is that the language in subparagraph 3.6.1 does not require the contractor to include any contingency for tax increases; rather, the contract directs the contractor to check taxes that will be in effect during the life of the contract and price the work accordingly. Therefore, the contractor has a right to assume that a tax increase during performance is a risk assumed by the owner.

However, Professor Justin Sweet in his treatise on the AIA documents concluded that which party bears the risk for tax rate changes is "not clear." He explained: "The emphasis upon the term 'enactment' in ... Subparagraph 3.6.1 would support a contention that the contractor bears the cost of increases in existing taxes."

Contractual Changed Conditions Clauses

Contracts often do not mention taxes. Under those circumstances, contractors have attempted to rely on contractual changed conditions clauses or differing site conditions provisions to recover for tax increases after the contract has been awarded. However, in at least two reported decisions, recovery has not been allowed under this type of clause.

In *Western Contracting Corp. v. State Board of Equalization*, 39 Cal. App. 3d 341, 114 Cal. Rptr. 227 (1974), the court held that a tax increase did not constitute a changed condition within the meaning of a changed condition clause. The facts are similar to the situation now confronting contractors in Arizona. The contractor's cost of performance increased considerably because of a hike in the sales and use tax rate. The contractor sought compensation for the increased tax rate under the changed conditions clause because the new tax materially increased the cost of the work.

The court in *Western Contracting* rejected the contractor's argument because the clause required that the changed condition be either subsurface, latent or unknown physical conditions at the worksite and a change in the tax rate did not fall into any of these categories.

Likewise, in *RB. Hazard Inc.*, ASBCA No. 35752, 88-3 B.C.A. (CCH) ¶20,873 (1988), the Armed Services Board of Contract Appeals held that the contractor assumes the risk of a sales tax increase after the contract is awarded. While the contract provided that the contractor would receive a price adjustment for an increase in any federal taxes, it was silent

as to state taxes. The Board held that the contract language did not shift the risk of an increase in the state taxes from the contractor to the owner. The Board explained: "It is axiomatic that—absent a special adjustment clause or statutory relief—the contractor with a firm, fixed-price contract assumes the risk of increased costs not attributable to the Government as the other contracting party." One judge dissented based on the reasonable expectations of the parties and the need to eliminate contingencies in the bid.

Other Issues

There are two other issues that merit mention. First, a contractor obviously has a much stronger argument to recover for increased taxes on contracts that were bid, finally negotiated or entered into before Election Day on November 7, 2000. Owners will be able to argue persuasively that after that date, contractors knew or should have known that the tax rate was going to increase after June 1, 2001.

Moreover, contractors with guaranteed maximum price or cost-plus contracts should be able to recover the actual costs of increased taxes unless the contract specifically provides for the recoverable tax rate, which is highly unlikely. However, whether a contractor will be entitled to an increase in the GMP to cover the tax increase again depends on the contract language.

The Bottom Line

On contracts negotiated or awarded before November 7, 2000, the issue whether the owner or the contractor bears the risk for the sales tax rate increase will depend on the specific language of the contract. Contractors affected by this change should carefully review all contract provisions to determine whether the owner expressly or implicitly assumed responsibility for the tax increase.