

Chapter 64 – Royalty Costs

Authoritative Sources

[FAR 31.205-37](#) Royalties and Other Costs for Use of Patents

[FAR 27.2](#) Patents and Copyrights (Section 27.202 Royalty)

[FAR 52.227-6](#) Royalty Information

[FAR 52.227-9](#) Refund of Royalties

[37 CFR Chapter IV, Part 401](#) Patents, Trademarks and Copyrights

Royalty costs are payments made to a patent holder for the use of the underlying invention – a royalty is the benefit of a patent.

General Audit Guidelines

This chapter provides the general audit guidelines for reviewing royalty costs addressing the contractor reporting of royalty costs in proposals, determining allowability, treatment of unpaid royalties, and unique requirements applicable to nonprofit organizations.

This chapter addresses the following topics:

- 64-1** Reporting of Royalty Costs in Proposals
- 64-2** Allowability of Royalty Costs
- 64-3** Unpaid Royalties
- 64-4** Special Requirements for Nonprofit Organizations

64-1 Reporting of Royalty Costs in Proposals

When certified cost or pricing data are required, the solicitation provision at FAR 15.408, Table 15-2, Item II.E requires contractors to submit with their proposals detailed information on all royalty costs of more than \$1,500 which are included in the proposal. This reporting allows the contracting officer to determine whether or not the royalty charges are excessive, improper, or inconsistent with any license or right to an invention which the Government may have acquired under Government-sponsored research.

64-2 Allowability of Royalty Costs

FAR 31.205-37, Royalties and Other Costs for Use of Patents governs allowability.

FAR 31.205-37(a) provides that royalties on a patent or amortization of the cost of purchasing a patent or patent rights necessary for the proper performance of a contract and applicable to contract products or processes are allowable unless –

1. The Government has a license or the right to a free use of the patent;
2. The patent has been adjudicated to be invalid, or has been administratively determined to be invalid;
3. The patent is considered to be unenforceable; or
4. The patent is expired.

FAR 31.205-37(b) provides that care should be exercised in determining the reasonableness when the royalties may not be based on less-than-arm's-length bargaining. Examples include royalties:

1. Paid to persons, including corporations, affiliated with the contractor;
2. Paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded; or
3. Paid under an agreement entered into after the contract award.

FAR 31.205-37(c) addresses the circumstance involving a patent formerly owned by the contractor. In those cases, the allowable royalty cost should not exceed that which would have been allowed had the contractor retained title.

64-3 Unpaid Royalties

We have found cases where contractors included royalty charges in the costs used to negotiate contract prices but subsequently did not have to pay them in whole or in part. The Government can recover these royalty charges when:

1. A contractor finds that it has been released from obligations to pay royalties (that is, when such release is the result of Government antitrust actions against the patent holders); or
2. The royalty estimates were overstated or were based on items that are not subject to royalties (see FAR 27.202-3).

Some contracts contain recapture provisions to become effective in the event actual royalty payments are less than those estimated and included in the negotiated prices. Specifically, FAR 52.227-9, Refund of Royalties, established procedures for the Government to recover royalties not paid by the contractor when the royalties were included in the contractor's fixed price.

In addition, FAR 27.202-3 prescribes actions for the contracting officer to take to protect the Government's interests if royalties paid or to be paid to the contractor are excessive, improper, or not consistent with Government rights. Audit teams should be alert to identify these circumstances and promptly notify the contracting officer.

64-4 Special Requirements for Nonprofit Organizations

37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines on inventions made by small business firms and nonprofit organizations, including universities under funding agreements with Federal agencies. Related to nonprofit organizations, this regulation provides special requirements on the use of royalties and/or income. Specifically, under 37 CFR Chapter IV, Part 401.14(k), nonprofit organizations will use any royalties and/or income, after payment of expenses (including payments to inventors) incidental to the administration of subject inventions, to support scientific research or education.