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The Three-Tier System

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Legislator Briefing Book*

Primer on Kansas' Beverage Alcohol System

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The Three-Tier System:

Overview

Since the passage of the 21st Amendment to the United States Constitution repealed Prohibition and granted each state the right to control the importation, distribution, and use of alcoholic beverages within its borders, Kansas has relied upon the three-tier alcohol distribution system to ensure alcohol is distributed and consumed safely in our state.

Historical Background

Our alcohol distribution system has evolved over time, and here is a historic overview of how our three-tier system has evolved to what it is today.

Tied Houses: Before 1919

From the colonial times until 1919, when the 18th Amendment ushered in Prohibition, alcoholic beverages were sold in a free-wheeling, free-market system. The system had only two tiers—suppliers distributed alcoholic beverages directly to retailers. Back then, suppliers of spirits and beer (wine was a minor market back then) frequently owned or controlled Kansas retailers by threatening to cut off supply or offering rebates only to those who complied with their demands. This "tied" the retailers to the manufacturers so that they typically were forced to sell only one manufacturer's brands or maximize sales without regard to the well being of consumers.

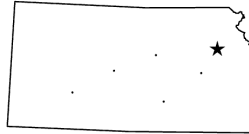


Prohibition: 1919-1933

In 1919, the American Temperance Union and Anti-Saloon League urged lawmakers to outlaw the sale and possession of alcohol. Congress proposed the 18th Amendment to the Constitution, which was later adopted by each state, including Kansas. The advent of Prohibition, however, didn't mean the end of alcohol consumption. Production and distribution went underground through the "bootlegging system," which became big business. It became clear that Prohibition was not a workable solution.

Repeal of Prohibition: 1933

In 1933, the 21st Amendment repealed Prohibition and granted states the authority to control the importation, distribution and use of alcoholic beverages within its boundaries. Kansas, initially enacted a law providing for the sale of cereal malt beverages in 1936. Not until 1949 did Kansas repeal its constitution's prohibition amendment, but like many other states, then decided to create a regulated three-tier system to distribute alcohol that would prevent the abuses seen prior to Prohibition—and would respect those



local communities that decided to remain "dry," which meant alcohol sales were banned or restricted.

New Independent, Kansas-based Tier

Between the supplier and the retailer, Kansas legislators required a new Kansas-based "tier" to be created — the independent licensed distributor, which by law at that time must be owned by Kansas residents. The independent in-state distributor (tier 2) was created to serve as a "buffer" between the other two tiers. In addition, this new business created a new Kansas entity to put a local "face" on the alcoholic beverage industry. Furthermore, legislators could ensure safeguards were followed by providing the Kansas-based distributor an enormous incentive in not losing his or her license to distribute. Kansas distributors were required to follow strict guidelines and procedures for distribution of alcoholic beverages, and provide valuable services to businesses and consumers that reach far beyond the simple pick up and delivery between supplier and retailer.

Kansas' Three-Tier System Today

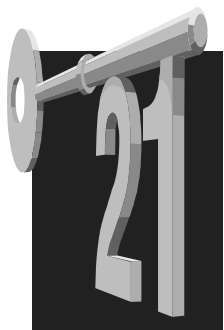
While the three-tier system has evolved since its creation, it continues to provide customers a choice of thousands of products, at the same time ensuring the safe, acceptable delivery of alcohol. Retailers must be Kansas residents but the law no longer requires that wholesalers

be owned solely by Kansans. The three-tier system continues today to ensure that alcohol is not sold or delivered through unlawful channels — which means alcohol is delivered responsibly to the people who are licensed to sell it and who are of legal age to buy it. The law no longer requires that wholesalers be owned solely by Kansans.

How the System Works

The responsibilities and legal requirements of each tier of the three-tier system are laid out clearly in the Kansas Liquor Control Act, which is regulated by the Kansas Alcoholic Beverage Control. The current three-tier system works as follows: tier one: alcoholic beverage producers or manufacturers from all over the world sell their products to tier two: Kansas based licensed beverage distributors who sell only to tier three: properly licensed retailers, who in turn sell alcoholic beverages to customers over the age of 21 in areas where alcohol sales are allowed and only after the proper collection of taxes. Kansas retailers who possess a permit from the federal government also may sell to clubs and drinking establishments.

Key Safeguards



The three-tier system limits the authorized channels through which alcohol enters our state and establishes clear "checks and balances" that Kansas regulators and law enforcement can monitor. The combination of these safeguards ensures that alcohol is distributed and sold safely to consumers. These

checks and balances work to ensure that:

- Minors do not have access to alcohol;
- Alcohol is not sold or distributed in "dry" communities in which alcohol sales are banned or restricted; and,
- Proper taxes are collected and remitted back to state and local governments.

Why the Three-Tier System Works

The three-tier system ensures that alcohol is not sold or delivered through unlawful channels—and is delivered responsibly to the people who are licensed to sell it and subsequently sold to those who are of legal age to buy it. The threat to Kansas based wholesalers or Kansas based retailers of losing their license to do business in Kansas is an enormous incentive for these companies to comply strictly with Kansas law. The same cannot be said for those companies seeking to bypass the three-tier system through unregulated direct shipment of alcoholic beverages by selling products across state lines, over the Internet or through catalogue sales to anyone with a credit card. The Internet's lack of in-state enforceable responsibilities and a clear chain of accountability are the reasons that Kansas adopted a face-to-face transaction law to collect taxes and ensure minors or households in "dry" areas are not receiving alcoholic beverages illegally.

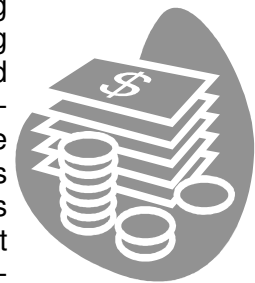
The Benefits for Kansas

Since 1949 Kansas' three-tier system has dutifully provided the state key safeguards. It has also contributed to the state's economy through:

- The creation and maintenance of jobs in Kansas and
- Payment of all general business taxes and special alcoholic beverage taxes

The Three-Tier System Provides Jobs To Thousands of Kansans

Alcoholic beverage sales are a key component to Kansas' growing service sector, including the entertainment, food services and tourism industries. Today, the three-tier system provides thousands of jobs throughout the state at wholesalers, in restaurants and clubs, at farm wineries, and in support businesses.

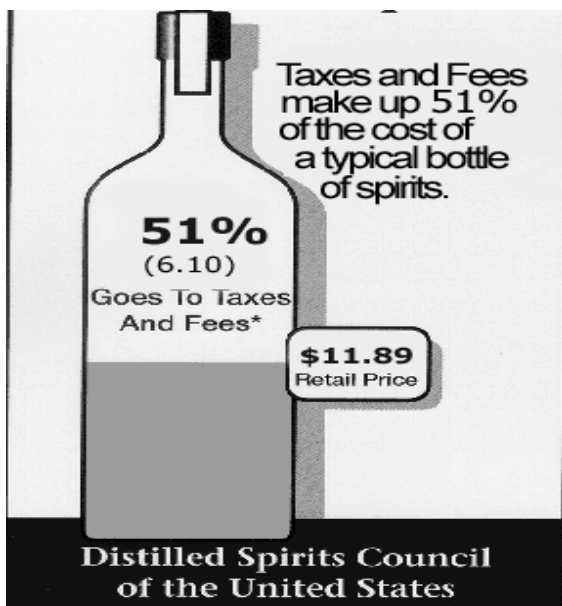


Total Tax Burden

on Alcoholic Beverages in Kansas

In FY2003, Kansans contributed \$81,708,115 million in taxes on purchases of alcohol through excise taxes, gallonage and enforcement taxes, In FY2004 \$85,485,266 and in FY2005 \$90,246,471 and in FY06 \$95,915,827 (a 6.2% increase over the prior year) according to the Alcoholic Beverage Control memorandum dated January 25, 2007.

These collections do not include the millions paid by the three tiers for: Federal alcohol permits, state alcohol permits, Standard business taxes paid by Kansas-based wholesalers and retailers, including: Kansas franchise taxes, motor fuels taxes, sales and use taxes, unemployment compensation taxes and local property taxes.



The Individual Roles of Tiers in Tax Collection

Specific alcohol-related federal, state and local taxes are applied to alcoholic beverages Kansans consume at each level of the three-tier system, as follows:

Tier 1 Tax Collection

The federal excise tax is applied at the manufacturer level (tier 1). For spirits this is \$13.50 per proof gallon (see diagram).

Tier 2 Tax Collection

Kansas-based distributors (tier 2) pay the state a gallonage tax which varies depending on the product and its alcohol content. The Kansas Alcoholic Beverage Control reports that wholesalers paid \$19.6 million in state gallonage taxes for FY06. This excise tax collection would be virtually impossible to collect in a direct sales environment created by the prevalence of the Internet unless some element of the three tiers is involved in such sales.

Tier 3 Tax Collection

Kansas based retailers (tier 3) collect an enforcement tax of 8% and drinking establishments collect an excise tax of 10% on the drink price. Collection for 2005 & 2006 are as follows:

	2005	2006
Enforcement 8%	41,903,994	44,264,770
Drink 10%	29,770,339	32,051,923

The Role of Wholesalers

Between the supplier (tier 1) and retailer (tier 3), alcohol is required to move through another tier — the independent licensed distributor or wholesaler (tier 2). The independent in-state distributor was created by the Kansas legislature to serve as a



"buffer" between the other two tiers, and legislators could ensure safeguards were followed by providing the Kansas-based distributor an enormous incentive in not losing its license to distribute. Kansas has issued 56 wine, beer and spirits wholesale licenses. Without the wholesaler or the three tier system, enforcing the legal and responsible distribution of alcohol in our state would be impossible for Kansas law enforcement. Kansas distributors are required to follow strict guidelines and procedures for distribution of alcoholic beverages, and provide valuable services to businesses and consumers that reach far beyond the simple pick up and delivery between supplier and retailer.

What do Wholesalers Do?

Throughout the state, Kansas consumers over the age of 21 have access to wine, spirits and beer from around the world, largely due to the role that Kansas-based wholesalers play in responsibly distributing alcohol between suppliers and retailers. In this role, these Kansas-based companies:

- Consolidate orders for both manufactures and retailers,
- Promote and market alcoholic beverages to properly licensed retailers in the state—big or small
- Warehouse tens of thousands of distinct alcoholic beverage products from around the world in Kansas buildings for easy and timely delivery to Kansas-based retailers
- Provide retailers with products—both in-stock and special-order—to meet the demands of customers
- Pay gallonage taxes for the state
- Ensure alcohol is sold only in "wet" areas of the state by limiting the channel of alcohol from distributor to properly licensed retailers
- Provide accountability and responsibility for the safe delivery of alcohol in Kansas, thereby supporting efforts to stop underage drinking and impaired driving.
- Provide thousands of quality local jobs that are not transferable out of the community (distributors must, by necessity, be near their retail customers)
- Are responsible, philanthropic members of their respective communities, accounting for quality jobs, millions of dollars in charitable donations, and thousands of hours of community service
- As proponents of responsible alcohol distribution, Kansas' wholesalers support laws and standards that discourage alcohol sales to minors, drunk driving and other unsafe and illegal uses of alcohol. The responsibilities of wholesalers allow the state to do its job of ensuring the safe distribution and sale of alcohol within its borders

The Role of Retailers

Kansas retailers represent the third tier of the three tier alcohol distribution system .

As the businesses that have direct interaction with customers, retailers play a significant role in ensuring Kansas' safeguards are followed and enforced.



Kansas has over 730 licensed retailers who are permitted to sell alcoholic beverages to customers over the age of 21.

Retailers include the following businesses:

Package stores

And DO NOT include:

Grocery stores or Convenience stores

Kansas retailers purchase alcoholic beverages from Kansas based licensed distributors. Today, it is estimated that tens of thousands of different beverage alcohol products from Kansas and around the world are available at Kansas retailers for sale to customers over the age of 21.

	2004	2005	2006
Retail liquor stores	717	724	731
Class "A" clubs	317	315	315
Class "B" clubs	158	155	150
Drinking Establishments	1,509	1,565	1,674
Caterers	111	117	120
Beer Distributors	44	44	42
Spirits Distributors	7	7	6
Wine Distributors	10	11	8
Microbreweries	9	12	14
Farm Wineries	14	16	18
Outlets	5	5	6
Manufacturers	5	6	6
Temporary Permits	338	309	328
Supplier Permits	556	547	565
Total	3,807	3,841	3,983

Requirements of the Third Tier

Clear responsibilities and legal requirements for Kansas retailers are laid out in the Liquor Control Act, which is regulated by the Kansas Alcoholic Beverage Control and enforced by Kansas law officers. What types of alcohol—beer, wine, or liquor—are sold by retailers and how it is consumed—on-premise or off-premise—depends on a number of factors:

- The Liquor Control Act and the Club and Drinking Establishment Act allow only authorized retailers to sell specific alcoholic beverages during specified business hours
- County and city ordinances, which can limit alcohol sales all together such as in dry counties, or partially restrict some sales in certain zoned areas, or restrict purchases near schools or churches.

Microbreweries and farm winery outlets operate as part of the third tier selling directly to consumers. Wineries may also ship out-of-state in conformity with other states' laws.

Clear Safeguards

Because face-to-face transactions with the customer occurs at the third tier, retailers must follow strict requirements regarding the sale of alcohol to minors and intoxicated customers.

The state recognizes the significance of this responsibility, and while such is not mandatory, approves seller-server training courses. These server training programs (offered by various industry associations) cover the sale and service of alcoholic beverages, particularly discussing the consequences of selling to minors and intoxicated customers, as well as techniques to prevent such sales.

In adopting a **face-to-face wine shipping law** in 2006 the Legislature provided for consumers to purchase and ship to their home wine while at any winery in the U.S. and for internet purchasing that is delivered to the



K · A · N · S · A · S WINE & SPIRITS WHOLESALE ASSOCIATION

The Kansas Wine & Spirits Wholesalers Association (KWSWA) is dedicated to promoting responsible beverage alcohol practices in the state of Kansas. KWSWA is the Kansas trade organization representing the wholesale branch of the wine and spirits industry. It is dedicated to advancing the interest and independence of wholesale distributors of wine and/or spirits. KWSWA provides its members with representation before the Legislature, state agencies, regulatory bodies, courts, and other alcohol beverage industry organizations. In addition, KWSWA offers a wide range of services in the areas of public affairs, education and social responsibility issues. This Primer on Kansas' Beverage Alcohol Laws has been prepared to assist you in understanding the intricate workings of our present system.

local retail liquor store in order to assure that IDs are checked and that state taxes are collected and paid.

CONCLUSION

Since 1949 the three tier system of distribution has served Kansas well. In light of recent court decisions, preserving this system will ensure that the market place remains orderly and that the state collects the taxes it has imposed on beverage alcohol.

For further information on Kansas' beverage alcohol laws consult the Kansas Legislator Briefing Book, 41 K.S.A. the Liquor Control Act, the Club and Drinking Establishment Act and the Cereal Malt Beverage Act.