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# PRIMARY SOURCE

## DISTILLED SPIRITS, LIQUOR IMPORTATION AND MINNESOTA'S LACK OF A PRIMARY SOURCE LAW

John Williams  
House Research

Patrick J. McCormack  
Dan Mueller  
Senate Counsel & Research  
State of Minnesota

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## **EXECUTIVE SUMMARY**

The House Research Department and Office of Senate Counsel and Research were directed by Laws 1995, Chapter 198, to study the issue of whether Minnesota's "primary source law," which now applies to beer and wine, should be extended to apply to distilled spirits. Such a statutory change would put an end to Minnesota liquor wholesalers' ability to obtain distilled spirits from someone other than the distiller.

This study examined the likely effects of such a change on the liquor industry itself, other states, and the public interest.

### **EFFECTS ON THE LIQUOR INDUSTRY**

The major impact of the absence of a primary source law for distilled spirits is felt within the liquor industry rather than by the general public. The existing system in the state allows Minnesota wholesalers an alternative to paying distillers' prices for their product, by seeking product from importers and wholesalers in the world market. Not all wholesalers take advantage of this option, and those that do take advantage may do so only on an irregular basis. The wholesalers who do obtain product from non-primary sources feel that this option is an important tool in exercising price discipline in distilled spirits.

The absence of a primary source law is of particular importance to a major Minnesota manufacturer of distilled spirits that often packages its own products with those of other manufacturers for shipment overseas. Some of this product, although probably not a large percentage, comes from non-primary sources.

It is difficult to assess how an extension of the primary source law to distilled spirits would affect Minnesota retail prices for these products, but the effect probably would not be great.

### **EFFECTS ON OTHER STATES**

As part of the study, we contacted liquor control offices in other states and Canadian provinces as to whether Minnesota's lack of primary source protection for distilled spirits was causing any problem within their jurisdictions. State responses were uniform in finding little or no problems as a result of Minnesota's laws.

Ontario officials expressed a concern about smuggling liquor into the province, but noted that the problem was mainly across the New York border. Manitoba reported a suspicion that liquor was being smuggled into the province from Minnesota, but conceded that the evidence was only anecdotal.

## **EFFECTS ON THE PUBLIC INTEREST**

Although the main effect of a change in the primary source law would be felt within the liquor industry itself, there are four aspects of the debate that touch on the public interest.

### **Product purity and integrity.**

Distillers claim that when their product is distributed by a source over which they have no control the purity and integrity of the product can suffer. State liquor officials and retailers report no known problems with product purity or integrity as a result of the lack of primary source protection. No examples of product contamination or compromised product integrity were brought forward.

### **Tax evasion.**

Distillers argue that the multiplicity of suppliers of liquor into Minnesota because of the absence of primary source protection make tax auditing more difficult and can result in liquor tax being evaded. State revenue officials respond that they have adequate controls in place to prevent tax evasion and that there is no reason to believe that any significant evasion is going on.

### **Three-tier system.**

The liquor industry "three-tier" system, where the manufacturing, wholesaling, and retailing levels are kept entirely separate, was created by government partly as an attempt to prevent one level of the industry from dominating the others. Distillers argue that the lack of a primary source law can give wholesalers the same power over a brand as the manufacturer, thus blurring the three-tier distinction. Minnesota does not have a "pure" three-tier system, and creating one would take more statutory changes than just a primary source law.

### **Smuggling.**

The absence of a primary source law could in some instances conceivably contribute to smuggling of liquor into Canada. However adopting a primary source law would not get at the main reason why smuggling exists, which is the disparity between American and Canadian liquor prices.

Most of the public-interest claims on behalf of a primary source law for liquor argue potential rather than immediate benefits, since no evidence has been forthcoming that the public has actually suffered as a result of the present law. In evaluating how to assess these public-interest arguments, the legislature must weigh the seriousness and immediacy of the problems cited by distillers as resulting from the absence of a primary source law, against the probable effects of a law change on Minnesota wholesalers, manufacturers, and consumers.

## **ALTERNATIVES TO A PRIMARY SOURCE LAW**

In the course of our study, some other changes were identified as having the potential to achieve at least some of the objectives of a primary source law. These include (1) requiring all liquor suppliers to register with the Department and Public Safety, and (2) collecting all liquor tax when the product is brought into Minnesota, rather than when it is sold to retailers.

## **COMING ISSUES IN LIQUOR REGULATION**

During the study, several issues other than primary source were identified as deserving further legislative attention:

- Competitiveness within the wholesaling industry
- Whether the open-wholesaling law (Coleman act) is still working as originally intended
- Staffing and resources in the division of liquor control

# PRIMARY SOURCE LAW

## INTRODUCTION

Chapter 198 of the 1995 Session Laws of Minnesota requires that the House Research Department and Office of Senate Counsel and Research study the issue of whether primary source laws should be extended to distilled liquor. This report addresses the history and policy implications of the primary source issue as it applies to distilled spirits.

## BACKGROUND OF THE PRIMARY SOURCE ISSUE

### What is a Primary Source Law?

Under Minnesota law,<sup>1</sup> no brand of alcoholic beverages (beer, wine, or distilled spirits) may be sold in the state unless its brand label has been registered with the Department of Public Safety. In the case of beer and wine, no brand may be imported into Minnesota without the consent of the brand owner or the brand owner's agent. This effectively means that the brand owner, who is usually the manufacturer of the product, can prevent a Minnesota wholesaler from buying that brand from any source other than the brand owner.

A law that restricts importation into the state in this way is called a "primary source law" because the brand owner is considered the "primary source" of the product. Other sources from which a Minnesota wholesaler could obtain the product are called non-primary or secondary sources.

### History of the Law in Minnesota

This law was first enacted in 1980, but was made applicable only to beer.<sup>2</sup> In 1981, it was amended to include wine.<sup>3</sup> In 1985, in the liquor law recodification bill, it was amended to include all brand labels, which had the effect of extending it to distilled spirits.<sup>4</sup>

In 1991, the law was amended again to make it applicable only to wine and beer.<sup>5</sup> This had the effect of removing distilled spirits from the coverage of the law, and allowing their importation into Minnesota without the brand owner's consent.

Since 1991, the primary source law has been a subject of controversy in the Legislature and within the liquor industry. In 1995, another amendment to the primary source law to restore primary source coverage for distilled spirits passed the Senate, but not the House.<sup>6</sup> The House-Senate conference committee that addressed this disagreement eventually decided that the controversy reached the point where an impartial study of the issue was needed.

As part of Laws 1995, Chapter 198, the Legislature directed the House Research Department and Office of Senate Counsel and Research to study whether primary source coverage should again be extended to distilled spirits. The two offices were directed to present findings, but not recommendations, on the issue by March 1, 1996.

### **1995 LEGISLATIVE ACTION**

*The House Research Department and Office of Senate Counsel and Research shall study issues relating to the extension of Minnesota Statutes, Section 340A.311, Paragraph (c), to include distilled spirits. The study shall include findings, but shall not include recommendations on changes in law or rules. The House Research Department and Office of Senate Counsel and Research shall jointly report their findings to the chairs of the legislative committees and divisions with jurisdiction over alcoholic beverage law and policy by March 1, 1996.*

### **ORGANIZATION OF STUDY**

The study required under Chapter 198 was conducted by non-partisan House and Senate staff between June and December, 1995. Various articles, studies and background materials were collected and reviewed. Initial meetings were conducted with the Special Taxes Division of the Department of Revenue and the Liquor Control Division of the Department of Public Safety. Distillers were invited to a meeting and written responses from distillers were solicited (see Appendix). Meetings with wholesalers and rectifiers were supplemented with tours of wholesale and bottling operations, and a meeting with Minnesota retailers was arranged.

A survey of all 50 states was conducted, as well as a separate survey of Canadian provinces. The United States Bureau of Alcohol, Tobacco and Firearms was contacted. Requests for written materials were made.

This study is not a formal audit of any organization. It is a general review of the issues surrounding the primary source question. Both the Department of Revenue and the Department of Public Safety were highly cooperative in completing this study. Wholesale and retail businesses contacted during this study were helpful. Distillers, who are not residents in Minnesota, were unable to attend meetings with the study's authors. Representatives of distillers did meet with the study's authors and distillers did respond with letters outlining their opinions.

## **THE CURRENT SYSTEM: ABSENCE OF A PRIMARY SOURCE LAW**

There is currently no primary source requirement for distilled liquor importation into Minnesota. This absence of a primary source law affects the way the liquor industry does business. Some possible public benefits from the current lack of a primary source law are cited in this section. However, the major impact of the existence of the current system is within the liquor industry, rather than to the public as a whole.

### **MULTIPLE SOURCES**

Under a primary source statute, wholesalers may only buy distilled spirits directly from the distiller, brand owner, or manufacturer. Under the current Minnesota statutory framework, wholesalers are able to seek sources of distilled liquor other than the direct primary source. These non-primary sources include importers from other nations and wholesalers from other states.

Most states have a primary source law. (See Appendix.) The adoption of primary source laws by most states occurred a number of years ago, and it is fair to say that the distilled spirits industry has changed a great deal since.

If the distiller is a primary source, what is the non-primary source market? The non-primary source market consists of sources for distilled products, manufactured by the primary source, that were sold originally in other states or nations. The distilled spirits have the same brand names and often the same labels as found by buying direct from the primary source. These products can be found by Minnesota wholesalers on the world market, at prices that are sometimes cheaper than if the product were bought directly from the primary source. Many non-primary sources are international importers, and the product is often found in free trade zones throughout the world.

The non-primary source market offers an alternative source for products that are also available directly through the primary source market. There are allegations by the manufacturers that although the products available from the non-primary source market are made by the same manufacturers as those in the primary source market, they may have used different formulas or ingredients. This issue is addressed later in this report. The key, at this point, is that the non-primary source market is a separate avenue for these products.

The majority of distilled spirits coming into Minnesota are purchased directly from primary sources, even in the absence of a primary source law. This is the most efficient way to purchase distilled spirits. Non-primary sources require an effort to seek out, secure, and ship the product. Retailers have noted that only a small portion of the liquor sold at retail in this state comes from non-primary sources, and wholesalers note that the primary source is the main source for distilled spirits.

While the amount of liquor bought from non-primary sources is a small fraction of the total market, nonetheless that fraction is important.<sup>7</sup> Use of the non-primary source market is intermittent, depending upon whether deals are available and if wholesalers have the time necessary to access the market. However, this occasional use of the non-primary source market is important far beyond what the volume would indicate. Access to the non-primary source market allows wholesalers to bargain from a better position with the primary source, the distiller.

## MARKET EFFECTS

Under current law, Minnesota wholesalers may not have franchises. Franchises have exclusive rights to sell a brand of distilled spirits. The Minnesota "open wholesaling law" is a cornerstone of the 1973 Coleman Act (M.S. 340A.307), and means that any wholesaler can purchase any product allowed to be sold in Minnesota.

The wholesale market in Minnesota is competitive, and wholesalers operate with thin profit margins in order to compete with other wholesalers, who are able to offer the same products. Wholesalers feel that the ability to go out to the non-primary source market is crucial, because this allows wholesalers to keep distiller prices down, by finding competitive prices for the same products:

**Example:** Suppose Distiller X is making a whiskey, Brand X, and wants to charge a high price for that whiskey in the Minnesota market. A wholesaler can occasionally find a source of the Brand X whiskey in another country or state, at a lower price. Importing that whiskey can serve to notify the distiller and the consumer that prices are too high in the primary source market.

This happens intermittently, but primary sources still supply the bulk of distilled spirits to the Minnesota market.

## FOREIGN MARKETS

It has been argued that Minnesota's lack of a primary source law allows Minnesota to be a major trans-shipment point for foreign markets. This objection holds that Minnesota consumers may not be harmed by the current law, but foreign markets, or even markets in other states, are harmed by Minnesota's policy of allowing extensive transshipment.

The volume of liquor moved through Minnesota to other points is under ten percent of the total amount brought into Minnesota. (See Appendix.) This fraction, however, may have a competitive effect on sales by primary source distillers in other countries:

**Example:** Suppose a small allotment of a whiskey is moved through Minnesota for the Asian market. If the primary source sells a large amount of that whiskey at a high price in Asia, and a Minnesota wholesaler sells

even a small amount at a lower price in Asia, the Minnesota wholesaler could be helping Asian consumers to affect price discipline on the distiller in the Asian market.

These market effects are not relevant to the direct effects of the law on the Minnesota public. There are unique Minnesota business concerns that are related, however, to the foreign market. United States Distilled Products (USDP), a Princeton, Minnesota firm, operates a bottling plant which produces a large amount of liquor for foreign export.

A standard contract for the export market might, for example, require USDP to bottle several hundred cases of vodka, possibly combined with some distilled liquor not bottled by USDP. This means that USDP must purchase distilled liquor, or other alcoholic beverages, and package this liquor with their own bottled product. It is an important part of the business end of USDP to be able to sell both their own product and product from other distillers in one consolidated shipment.

There is concern that adoption of a primary source law would adversely affect this aspect of USDP business. Under a primary source law, USDP could not seek other distilled products on the international market. Having to go directly to the primary source for product to package means doing business with firms that are competitors with USDP. There is concern that these primary sources could attempt to hamper a competitor. However, it is true that most of the product USDP now bundles with its own bottles is directly from a primary source, with the non-primary sources used only as an adjunct.

The absence of a primary source law may have some ability to lower retail prices. The effects are impossible to distinguish from other market factors. The argument that access to a primary source law is a source of price discipline on distillers was made earlier in this section. However, the actual volume of product brought in from the non-primary source market is not large compared to the total volume of alcohol consumed in Minnesota, and it is unclear whether any price savings from the non-primary source market are in fact passed on to consumers.

## OTHER JURISDICTIONS

Liquor control offices in states and Canadian provinces were surveyed about the effects of Minnesota's law on their liquor markets. State responses were uniform in finding little or no problems with Minnesota laws. Respondents were North Dakota, New Jersey, Ohio, Delaware, Colorado, Montana, Connecticut, Puerto Rico, Maine, Virginia, West Virginia, New Hampshire, Indiana, Kentucky, Alabama, Wisconsin, Maryland, Georgia, Florida, California, Virgin Islands, Texas, Arkansas, Tennessee, Missouri, Pennsylvania, Vermont, and Oregon. Other states were given the opportunity to respond, but did not do so in time for this report. It is reasonable to assume that if wholesalers in other states were having a problem with Minnesota's law, the regulator would have heard of it.

Canadian provinces were also surveyed. Saskatchewan, British Columbia, New Brunswick, and Newfoundland expressed no concern over Minnesota's laws. Ontario identified smuggling as a major concern, but as their letter indicates, smuggling does not necessarily involve Minnesota or the primary source issue. (See Appendix.) Manitoba did express concern over smuggling and expressed a desire to see Minnesota establish a primary source law. (See Appendix.)

Manitoba noted that the evidence that smuggling was coming from Minnesota was anecdotal. However, they expressed strong concern, and are conducting further investigations. This issue will be addressed later in this report. The Bureau of Alcohol, Tobacco, and Firearms was contacted for this report, and did not express a general concern over Minnesota's lack of a primary source statute.

## **EFFECTS OF A PRIMARY SOURCE LAW WITHIN THE LIQUOR INDUSTRY**

Some benefits from the standpoint of the public interest (product integrity, enhanced revenue collection) are cited in the next section as justifications for enactment of a primary source law. The immediate results of enactment of such a law would, however, most likely be seen within the liquor industry rather than among the public as a whole.

### **MARKET POWER**

A primary source law would increase distillers' control over the distribution of their products. As the brand owner, a distiller could prohibit the importation of a brand into Minnesota without the distiller's consent. This would allow a distiller to prevent a Minnesota wholesaler from importing into the state any product not purchased directly from the distiller, at the distiller's price.

The net effect would be to increase the relative market power of distillers and reduce the relative market power of wholesalers. The effects would not necessarily be uniform throughout the industry. Those distillers who would use a primary source law to stop the importation of their products into Minnesota from non-primary sources would have their market power increased. Those wholesalers who are now most likely to utilize non-primary sources to obtain product would have their market power reduced. Not all distillers and wholesalers fall into these two categories, but there are enough in both to mean that the relative balance of power between distillers and wholesalers would be changed.

## PRICES

Comments from various sources indicate that the prices charged by distillers to Minnesota wholesalers are among the highest charged anywhere in the U. S. One explanation of this is Minnesota's open-wholesaling law, which acts to keep wholesalers' profit margins lower than they would be in a state with exclusive franchises. Thus, distillers can charge higher prices to Minnesota wholesalers knowing that the wholesalers' lower profit margins will keep their product from being priced off Minnesota shelves. Distillers argue that their prices reflect their inability to share some brand development costs with Minnesota wholesalers.

In the absence of a primary source law, wholesalers have the option of seeking to buy a distiller's product from another source, such as a foreign supplier or a wholesaler in another state. Wholesalers who take advantage of this option believe that they need it to keep from being at the mercy of the distillers' prices.

As noted before, the use of non-primary sources does not appear to be so widespread as to be a major factor in Minnesota retail liquor prices. Although Revenue Department estimates of the volume of distilled spirits moved into and out of Minnesota are at best rough, the total contribution of the non-primary source market to the volume of Minnesota wholesaling is probably less than one-tenth. Non-primary sources do not account for a large share of liquor received into Minnesota, and much of what is received from non-primary sources does not remain in Minnesota, but is shipped out of the state.

Nonetheless, it is possible that a primary source law would have the effect of exerting some upward pressure on Minnesota prices by reducing wholesalers' options. A primary source law is certainly more likely to exert an upward than a downward influence on wholesale and retail liquor prices. Distillers are not seeking a primary source law just so that they can reduce their prices. They are seeking it at least partly in order to prevent their prices from being undercut by non-primary sources.

It further appears that such a law would have a particularly negative effect on one wholesaler, Bellboy Corporation, which -- although having a relatively modest market share -- has been credited by retailers with exercising price discipline in the wholesale market.

## BRAND AVAILABILITY

Some distillers have long claimed that Minnesota law limits brand choices available to consumers by discouraging the introduction and development of new brands in the state. They argue that they are unlikely to spend much time or money developing a new brand in Minnesota without control over its distribution. As one distiller wrote us:

Our financing commitment to advertising and promoting our brands is commensurate with our ability to track its impact and benefits. In states like Minnesota where we cannot accurately track sales of our products, we invest

significantly less in terms of advertising and manpower dollars than we do in states with primary source laws.<sup>8</sup>

To the extent that this problem exists, it may not be principally due to the absence of a primary source law. In 1985, a wholesaler-sponsored study observed that in Minnesota manufacturers have little access to traditional marketing tools such as point-of-sale displays, promotional discounts, and shelf positioning, but blamed the situation on the 1973 open-wholesaling law.<sup>9</sup>

A primary source law might increase the willingness of distillers to undertake brand promotions in the state. However, unless amended, the open-wholesaling law will continue to discourage wholesalers from participating in these efforts as long as wholesalers do not have the benefits of exclusive distribution of the brand in question.

## **EXPORT OF MINNESOTA PRODUCTS**

U.S. Distilled Products (USDP) in Princeton, Minnesota has with little outside notice become a major American exporter of alcoholic beverages to foreign markets. Many of these products are of USDP's own manufacture, to the extent that it now has a permanent workforce of some 250 persons increasing to twice that level at seasonal peaks.

USDP takes orders for other manufacturer's products as well as its own. It argues that it needs the option of obtaining the product from non-primary sources, not only because it might be less expensive, but also because some manufacturers might be reluctant to sell to a distributor who was also a competitor.

Passage of a primary source law would probably not ruin USDP's business, which owes its recent growth primarily to unprecedented opportunities in foreign markets. A primary source law would still adversely affect that business by making it more difficult or expensive for the company to fill out its shipments with other manufacturers' products.

## **PRIMARY SOURCE LAW AND THE PUBLIC INTEREST**

This report considers four separate issues where a possible public interest in a primary source law has been identified: product integrity, tax enforcement and collection, the three-tier system and smuggling of liquor.

### **PRODUCT INTEGRITY**

Passage of a primary source law would reduce the number of sources from which liquor would be imported into Minnesota. This in turn would reduce the likelihood that non-standard product or substandard product would be brought into the state.

This end can be accomplished only at some cost. As we have noted, a primary source law could affect some Minnesota businesses adversely and might conceivably provide upward pressure on prices, although this latter effect probably would not be great. The question therefore is whether the benefits in terms of product integrity outweigh the other costs of a primary source law.

### **Purity of Product**

Distillers' representatives have argued to us that the present distribution system in Minnesota increases the likelihood that impure products will come into the state. These impurities are most likely to come, not because the products are necessarily manufactured negligently, but because they may be negligently handled by distributors with no connection to the manufacturer.

They further argued that the fact that no such problems have arisen in the past does not prove that they could not happen in the future, and that no one had any reason to believe that there could be problems with Tylenol pain reliever or Schwan's ice cream before actual dangers arose with those products. Part of this argument is that a primary source law would make product recalls easier.

It is undoubtedly true that unforeseen problems can arise with the purity of almost any product, even those with pristine reputations, at any point in the product's life from manufacture to final sale. It cannot be guaranteed that no product from non-primary sources will ever prove to be substandard.

We can only observe that, in the four years since the repeal of the primary source law for liquor, no such problems have arisen. We have received no information and no evidence to the effect that any impure product has made its way into Minnesota by way of non-primary sources. Retailer representatives and officials of the Division of Liquor Control stated that they were not aware of any instance of consumer dissatisfaction or public health problems with retail products that had come from these sources. Even the strongest supporters of a primary source law could offer no evidence of any product impurities that have actually occurred in Minnesota or any other state because of acquisition from non-primary sources. For their part, the wholesaler opponents of a primary source law vigorously argue that product quality is completely bogus as an issue in the primary source debate.

### **Integrity of Product**

The distillers' other argument on product purity is that non-standard product will make its way into the state bearing a distiller's label, but without the distiller's consent:

A primary American source law protects Minnesota consumers from product of varying quality and security. Without primary source protection,

Minnesota wholesalers are free to import product from anywhere in the world, including sources of supply that may provide counterfeit product. This exposes the Minnesota consumer to potentially unhealthful product or product that is of a lesser quality than the genuine merchandise for which the consumer has paid.<sup>10</sup>

Although the information we received was that not all products from non-primary sources are manufactured abroad, this is still a problem worth considering. Again, there has been no evidence that this is a problem in Minnesota. There have been no complaints from consumers, retailers, or state liquor officials about any non-standard product being brought into the state. The distillers themselves were able to provide no proof that any product formulated for a foreign market had been disguised as a product for domestic consumption and brought into Minnesota outside the distillers' own distribution channels.

### **Balancing Costs and Benefits**

The product-integrity issue inevitably involves balancing by the Legislature. There is no evidence that product integrity is a significant problem in Minnesota, and no evidence to suggest that future problems are likely to occur. Should they occur, however, the problems could be significant, given that at best consumer satisfaction, and at worst public health, could be at risk. Against this must be balanced the effects of a primary source law on Minnesota businesses and retail prices.

Laws already exist to safeguard product purity. In addition to federal laws on the subject, state law<sup>11</sup> allows the Commissioner of Public Safety to remove from sale any alcoholic beverage that does not meet state purity standards. If a primary source law would discourage impure products, it would be a less costly means than government inspections and seizures for dealing with these problems. Against this potential benefit must be balanced the actual size of the problem and the other costs of a primary source law.

## **TAX ENFORCEMENT AND COLLECTION**

The second major argument from a public-interest standpoint made on behalf of a primary source law is that it would make evasion of state liquor taxes more difficult, and thus enhance collections without additional enforcement activities. One distiller wrote:

The foremost reason to reinstate primary source protection is that there is currently no system in place in Minnesota to ensure that all taxes are paid on product sold in the state or purchased in the state for shipment elsewhere. Most license states have adopted the primary source system wherein wholesalers purchase only from the primary source of supply for a particular brand. Under this system, the wholesaler reports to the state revenue authority the amount of product brought into the state and upon which the tax is due, and the supplier makes a similar report as to the amount

of product sold to wholesalers in the state.

By receiving reports from both the primary source and the wholesaler, the Department of Revenue can easily verify compliance with the state's tax laws by comparing reports received. Verification under this system is simple and inexpensive. It requires no physical inspection of inventory or labor-intensive examination of taxpayer records. It has been adopted by most states because it is the most efficient tax enforcement technique available.<sup>12</sup>

### **Existing Tax Collection Methods**

The Department of Revenue has an extensive system for tracking incoming and outgoing shipments of liquor. It requires a report (Form LB56DS) from wholesalers that shows their beginning and ending inventory, purchases, taxable and non-taxable sales, loss due to breakage, tax due, and other information. It also requires a report (Form LB37) from manufacturers, licensed importers, and state suppliers of shipments to Minnesota wholesalers. The department can then cross-check the information with a computer tracking system. Any omissions or variances are verified during either an audit of the wholesaler's records or an informational visit to the wholesaler. The department may also receive information about shipments into Minnesota from other states' regulatory agencies indicating that a particular wholesaler has shipped liquor into Minnesota and has claimed a tax exemption on that sale.

### **Possibilities for Evasion**

Lack of a primary source law in Minnesota may leave an opening for wholesalers to avoid paying the Minnesota wholesale excise tax. Since Minnesota does not require every non-primary source to report shipments into the state, it is conceivable that a wholesaler could under-report this kind of transaction. The wholesaler could then sell this liquor to a Minnesota retailer without ever showing that it entered the wholesaler's warehouse, thus avoiding paying the Minnesota excise tax.

The current law also allows for Minnesota wholesalers to ship liquor out of the state or out of the country. To avoid paying the excise tax, wholesalers could report in-state sales as out-of-state or foreign sales, although they would run the risk of being caught by the Department's sampling of retail records, which they compare to wholesaler sales records.

While acknowledging that these possibilities exist under current Minnesota liquor laws, the Department of Revenue still states that there is no reason to believe that there is any significant liquor tax evasion in the state. Previous investigations by the department into possible liquor tax evasions did not produce any evidence sufficient to persuade the department to take any enforcement actions.

The department believes that the risk of penalty for avoiding the tax is probably too high compared to the potential gain. The department also believes, and at least some

wholesalers agree, that the high level of competition within the wholesaling industry helps ensure that wholesalers pay close attention to each other's business. If one wholesaler were engaging in tax evasion, the other wholesalers would learn of it through industry sources, and the possible tax evasion would be promptly reported to the state.

In contrast to distiller arguments that a primary source law would ease the enforcement burden, the department stated that such a law would not change the staffing requirements that they now use to enforce current law. Under a primary source law, the department would still feel the need to audit incoming and outgoing shipments to the same extent it does now. The Department further notes that even when Minnesota had a primary source law, it still felt it was necessary to conduct the same auditing function conducted today.

### **Costs and Benefits**

As with the product integrity argument, the tax evasion argument involves a balancing of costs and benefits. A primary source law might lessen the opportunities for tax evasion, but this benefit must be compared to the scope of the problem. As noted above, the department sees no reason to believe that the present tax collection system results in significant tax evasion, or that enactment of a primary source law would result in any more tax being collected. It further believes that "no regulatory structure can guarantee a complete absence of contraband, whether it be alcoholic beverages or another commodity."<sup>13</sup> Under Minnesota's current statutory framework, it is already a felony to avoid paying appropriate liquor taxes. Proponents of a primary source law were unable to cite any evidence of any tax being evaded as a result of the use of non-primary sources for liquor.

Thus, in terms of tax collection, a primary source law is a solution to a problem, the existence of which is unproven. Such a law would be of significant benefit to state tax collection only if uncollected taxes are at significant levels. All that can be said on that point is that we, and the Department of Revenue, have seen no proof that that is the case.

Against this benefit must, again, be balanced the potential costs to Minnesota business of a primary source law. It is up to the Legislature to decide if the potential tax collection benefits, along with other benefits of a primary source law to the public interest, justify those costs.

### **THREE-TIER SYSTEM**

The "three-tier" system in liquor ideally means that the industry's three levels -- manufacture, distribution and retailing -- are kept entirely separate, with no common ownership. The concept goes back to the pre-Prohibition era when it was felt that having the distilling industry controlling the entire marketing process led to the promotion of overconsumption. Since repeal of Prohibition, a three-tier separation has been a widespread feature of liquor regulation.

Distillers have argued that the absence of a primary source law in Minnesota works against the three-tier system. Under a primary source law it is the distillers, rather than wholesalers, who have complete control over whether a product is brought into the state. In the absence of a primary source law for distilled spirits, wholesalers rather than distillers make this determination. Wholesalers can become an alternative source for a product, thereby (in the distillers' eyes) weakening the three-tier distinction.

A primary source law would not restore a "pure" three-tier system in Minnesota for distilled spirits because Minnesota has not had a pure three-tier system for years, if ever.<sup>14</sup> For years, state law (340A.307, Subd. 4) has permitted liquor wholesalers to have their own labels, which allows them to market their own brands, much as distillers might do. These labels are just one of the ways in which Minnesota has chosen to go outside of a strict three-tier system.

Ownership of a major wholesaler (Johnson Brothers) and a major Minnesota liquor manufacturer (USDP) by members of one family has been cited by distillers and other wholesalers as representing a blurring of three-tier distinctions. While representatives of both companies have argued that common family ownership does not prove a corporate or business connection, liquor industry regulators have observed a clear relationship between the two firms. This strongly suggests that the three tiers are not wholly distinct in the state.

A primary source law would not by itself restore all the distinctions between the tiers, but as noted before, it could be expected to move the Minnesota system in the direction of giving distillers complete control over their products' importation into Minnesota at the expense of wholesaler control. Given that the three-tier system is a result of government policy, anything that changes the balance of power within the industry has some public policy dimension even if that dimension is a secondary factor in the controversy. While the original intent of the three-tier system may have been the prevention of overconsumption, an intent only remotely connected to the primary source controversy, it also had the intent of preventing one level of the industry from becoming too powerful at the expense of the other levels.

If the legislature is to consider whether the absence of a primary source law has tilted the balance of power within the industry too much in the direction of wholesalers, it must consider this theory within a broader context. The trend toward concentration of the wholesale market in Minnesota began well before primary source was an issue, and if the legislature were to decide to try to reverse this trend, it would have to address several issues other than primary source, most noticeably the open-wholesaling law.

Later in this report, we raise the possibility that twenty years after its passage, the open wholesaling law might not be working as originally intended, and that the current situation "bears watching." Any legislative review of the wholesaling industry will have to include the way in which the absence of a primary source law for liquor affects the balance of power within the industry, and to what extent that balance of power is as valid concern of the legislature.

## SMUGGLING OF LIQUOR

As noted above, we received a letter from the Manitoba Liquor Control Board advising us that it suspected that liquor is being smuggled into the province from Minnesota. The Manitoba officials concede that they have only anecdotal evidence that this is happening, and we are unable to determine whether this is a significant problem.

### **The Public Interest in the Issue**

Smuggling from Minnesota into Canada does not directly affect Minnesota consumers, but it still has some relation to the public interest. It can be argued that governments have a responsibility to each other not to add to each other's law enforcement problems if they can avoid it. The Manitoba authorities suggested that a Minnesota primary source law might help alleviate the problem. If Minnesota law is aggravating a smuggling problem in an adjacent jurisdiction, it can be considered a public issue. However, if Manitoba has evidence of smuggling, a formal complaint to existing U.S. authorities should result in police action.

### **Effects of Primary Source**

The absence of a primary source law could, in some cases, conceivably contribute to smuggling. Under a primary source law, the suppliers of liquor imported into the state could be limited to entities that are required to report their shipments into the state to the Department of Revenue. A disparity between reported shipments from distillers and reported Minnesota sales and out-of-state transshipments by wholesalers could tip off the department to the possibility that some product entering the state is leaving it through unauthorized channels. It might be that the mere existence of such a cross-checking potential would discourage the practice. The same purpose could also be achieved by requiring all liquor suppliers to register with the state, as described in the next section.

Against this must be balanced the likelihood that smuggling will continue to be a problem in Canada, as long as a major disparity exists between American and Canadian liquor prices. In Canada, liquor is very heavily taxed and is distributed only through government monopolies. In Minnesota, it is much less heavily taxed and is distributed through competitive wholesalers and retailers. It is the resulting price difference, rather than U.S. or Minnesota liquor laws, that is the single biggest contributor to smuggling. For example, the Ontario Liquor Control Board reported to us that smuggling of liquor into that province from New York is a significant problem, despite the fact that New York has had a primary source law for years.

## ALTERNATIVES TO A PRIMARY SOURCE LAW

In the course of interviews conducted during this study, various suggestions were made for alternative methods of achieving some of the same policy goals as a primary source

law. While not endorsing any of these alternatives, the authors feel they should be presented for consideration.

## REQUIRE ALL LIQUOR SUPPLIERS TO REGISTER WITH THE STATE

In testimony to the Senate Commerce and Consumer Protection Committee in 1995, Fred Peterson, Director of the Division of Liquor Control (DLC), said, "I don't care where liquor comes from, retailers have the opportunity to buy where they want to buy, but I [want to] know who they buy from so I can follow it."<sup>15</sup> Mr. Peterson's argument was that in order to exercise its liquor control functions, his office needed to have ways of holding persons accountable for liquor at every stage of distribution within the state. This could not be done, in his view, if some sources from which Minnesota wholesalers obtain products are unknown to the state.

Some of this information is available through the Department of Revenue's accounting system, but even that system does not necessarily include every non-primary source of liquor, such as wholesalers in other states.

Mr. Peterson has suggested that one way of accomplishing this goal, short of passing a primary-source law, would be to require that every entity that supplies liquor to a Minnesota wholesaler or into a free trade zone in the state be required to register in Minnesota and report its shipments to the DLC. The same reports would be required of Minnesota wholesalers and Free Trade Zone receivers, to insure cross-checking of information.

In his view, such a requirement would allow the division to:

- Evaluate the liquor market and help determine the validity of complaints of high prices, anti-competitive practices, and other problems.
- Know what products are being imported into and exported out of Minnesota.
- Improve its ability to enforce product purity standards.
- Monitor false shipping invoices.

Mr. Peterson's letter to us, reprinted in the Appendix to this report, describes a specific incident that he feels could have been better addressed with a supplier-registration requirement.<sup>16</sup>

George Hoyum, Director of the Special Taxes Division of Revenue, endorses this requirement and suggests that if it is enacted, the requirement should also require reporting to the Department of Revenue.

Such a requirement would impose some burden on the liquor industry in the form of registration and filing requirements. These burdens would not necessarily be onerous, especially if the department is flexible about the form of reporting. It would also impose new administrative requirements on DLC, which would probably require additional staff and appropriation.

As with the primary source law, the Legislature must decide if the problem to be addressed by such a requirement justifies the additional reporting burden on the industry and the additional cost to the state.

## **MAKE LIQUOR TAXES DUE ON RECEIPT OF PRODUCT IN MINNESOTA**

Presently, the state's volume-based tax on liquor (as distinct from the special retail sales tax on alcoholic beverages) is payable at the time the product is sold for resale in Minnesota. Liquor that is received in wholesaler warehouses, but subsequently shipped out of the state, is never subject to taxation. The Department of Revenue has suggested that this system be changed to make all liquor taxable at the time it is received in the state. Tax credits against subsequent liability would be used to refund taxes on liquor that was later shipped out of Minnesota.

From the department's point of view, this would improve collection by insuring that when a department agent visits a wholesale warehouse, every bottle that the agent sees will have been subject to tax. Wholesalers would have to verify sooner than under the present procedure, an out-of-state shipment in order to claim the tax credit.

On the other hand, such a system would impose costs on the liquor wholesaling industry by requiring it to pay some taxes immediately that might not be recovered from retailers for several weeks or months, and by having to wait for a period of time to recover taxes on product shipped out of the state. This would inevitably create some cash-flow problems, particularly for smaller wholesalers, and might force them to borrow (or increase their borrowing) to finance their inventory. These problems might inhibit a wholesaler from taking advantage of a low price that was contingent on purchasing large volumes.

Once again, the costs and benefits of such a system have to be weighed. The Legislature must decide whether the costs to the industry are outweighed by benefits to the public, keeping in mind the Department of Revenue's earlier comments on the lack of evidence of tax evasion under the present system. It should be noted that this idea is not part of the Department of Revenue's legislative agenda.

## **COMING ISSUES IN LIQUOR REGULATION**

This report is mainly concerned with the primary source issue. This section of the report briefly touches on several aspects of liquor regulation that came to light during the research for the report and that may be of interest during the next five to ten years.

## **COMPETITIVENESS**

Minnesota currently has five wholesalers. Suppose one or two of the smaller wholesalers close down? If the wholesale industry ceases being competitive, the current way that the industry is regulated may not be sufficient. A concentrated wholesaling industry would raise concerns about the ability of the retail industry to find competitive prices within the current "open wholesaling" law. A close eye should be kept on the wholesale business in Minnesota so that changes in market power do not yield anti-consumer effects.

## **THE COLEMAN LAW**

The 1973 Coleman Act established the structure of liquor regulation in Minnesota that persists today. During the conduct of this report, disturbing allegations were raised that the Coleman Act was fraying at the edges. There was some suggestion that the open wholesaling aspect of the law was being circumvented by distillers and wholesalers. The allegation is that sweetheart deals, some occurring in out-of-state operations, give certain wholesalers de facto franchises.

This allegation is paired with another supposed problem. In Minnesota, a rectifier shares a family connection with a wholesaler, possibly giving the associated operation an advantage that is not available to other wholesalers. This arrangement supposedly leads first to the necessity of some arcane corporate structures to maintain the fiction that the three-tier regulatory structure is sound, and second to the need by other wholesalers to seek ways around open wholesaling in order to compete.

The point is, if franchising is occurring or if the three-tier structure is weakening, there may be reason in coming years to re-examine the entire regulatory structure put in place by the 1973 Coleman Act. This is not related to the primary source issue, but is instead a realization that market power is shifting, and that both distillers and wholesalers are finding ways to use the existing law to its fullest extent. The changing liquor industry bears watching.

## **STAFFING AT DPS**

The Department of Public Safety has been the target of budget cuts in each of the past few budgeting cycles. There have been attempts to abolish the liquor control function. It is important to understand the difficulty in maintaining industry integrity by a regulatory agency weakened by staff reductions.

There is a need to determine if Minnesota wants to enforce the 1973 Coleman Act and, if that is the case, to provide adequate staffing. There is a need to determine if Minnesota would rather have efforts aimed at stopping consumption of alcohol by minors. With the history of budget cuts at Liquor Control, it may be impossible to do both.

## CONCLUSION

Our examination of the issues surrounding extending the primary source law to include distilled spirits has led us to conclude that the greatest effects of such a change would be within the liquor industry itself. Those effects could be extensive, but the effects on the general public or liquor consumers are harder to estimate and probably of a considerably lesser magnitude.

The likely effects within the industry would be to shift market power generally away from Minnesota wholesalers and toward distillers and to require some Minnesota businesses to change their liquor acquisition practices. The absence of a primary source law does seem to have some effect, direct and indirect, on the price of distilled spirits in the state. Passage of such a law might exert some upward pressure on prices, although the extent is problematic given that most non-primary source products do not stay in Minnesota.

The impact on the public interest is harder to determine. A primary source law would address some potential public concerns, mainly product integrity and tax evasion. At present, however, there is insufficient evidence to conclude that either is a significant problem today or is likely to become one in the future. The absence of a primary source law may conceivably be contributing to a liquor smuggling problem in Manitoba, but there is insufficient evidence to draw any conclusions either about the extent of the problem or how much Minnesota liquor law contributes to it.

In resolving this issue, the Legislature must balance the theoretical or potential benefits that a primary source law offers in these areas against the actual changes that such a law would bring within the industry and the cost of those changes to Minnesota businesses and consumers.

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1. Minnesota Statutes 1994, Section 340A.311.
  2. Laws 1980, Chapter 583, Section 1.
  3. Laws 1981, 1st Special Session, Chapter 1, Section 21.
  4. Laws 1985, Chapter 305, Article 5, Section 11.
  5. Laws 1991, Chapter 249, Section 2.
  6. S.F. 936, Section 4 (1995 legislative session).
  7. No volume estimate of the amount of alcohol purchased through the non-primary source market is possible. Wholesalers all estimated that only a small fraction of the total business comes through the non-primary market. (See Appendix.)
  8. Letter from Michael B. Crutcher, Senior Vice President, Brown-Foreman Corporation, November 30, 1995.
  9. Stephen B. Hoenack, "The Effects of Minnesota's 1973 Wholesale Liquor Distribution Law." Minneapolis: University Research Consortium, 1985, p. 8.
  10. Letter from Donald M. Coe, President, Hiram Walker, November 17, 1995.
  11. Minnesota Statutes 1994, Section 340A.508, Subdivision 3.
  12. Letter from Donald M. Coe, President, Hiram Walker, November 17, 1995.
  13. Letter from George Hoyum, Director, Special Taxes Division, Minnesota Department of Revenue, to Claudia Brewington, December 5, 1995.
  14. The states have, and enforce, a strict three-tier separation in the beer industry and the presence of a primary source law for beer probably contributes to this separation.
  15. Testimony of Fred Peterson, Senate Commerce and Consumer Protection Committee, March 31, 1995.
  16. Letter of Fred Peterson, December 13, 1995.

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# **APPENDIX A**

## **PRIMARY SOURCE LAWS OF VARIOUS STATES**

**(Source: Distilled Spirits Council of the United States)**

## PRIMARY SOURCE LAWS OF THE VARIOUS STATES

The following twenty-eight jurisdictions have primary source protection for spirits, and many also include wine and beer. Although some do not use the words "primary source", all prohibit wholesalers from buying spirits from anyone other than the primary source of supply, his agent, or in some cases, in-state wholesalers in order to correct local, short-term shortages of product.

### ARIZONA:

Arizona's primary source law prohibits any wholesaler or retailer from purchasing spirituous liquor from any supplier other than the primary source.

It is unlawful for any wholesaler or any other licensee in this state to order, purchase or receive any spirituous liquor from any supplier unless the supplier is the primary source of supply for the brand ordered, purchased, or received. Ariz. Rev. Stat. Ann. § 4-243.01

"Primary source of supply" means the distiller, producer, owner of the commodity at the time it becomes a marketable product, bottler or exclusive agent of any such distributor or owner. In the case of imported products, the primary source of supply means either the foreign producer, owner, bottler or agent or the prime importer from, or the exclusive agent in, the United States of the foreign distiller, producer, bottler or owner. *Id.*

### ARKANSAS

Arkansas has full primary source protection.

A licensed wholesaler of any spirituous or vinous liquors in Arkansas can only purchase spirituous or vinous liquors from a distiller, importer, rectifier, or a domestic wine producer, provided that this restriction shall not apply to the purchase of native wines. Ark. Stat. Ann. §3-4-605.

"Distiller" means the person, firm or corporation constituting the original source of sale, after distillation, in the United States. Ark. Reg. §2.3.

"Importer" means the person, firm or corporation in the United States holding the basic contract with a foreign supplier, whereby such foreign supplier exports vinous beverages, spirituous liquors or malt beverages into the United States. Ark. Reg. §2.4. "Rectifier" means the person, firm or corporation constituting the original source of sale, after rectification, in the United States. Ark. Reg. § 2.6.

## CALIFORNIA

California has a full primary source law.

A licensed importer shall not purchase or accept delivery of any brand of distilled spirits unless he is designated as an authorized importer of such brand by the brand owner or his authorized agent. Calif. Rev. Stat. Ann. § 23672.

"Importer" means:

(a) Any consignee of alcoholic beverages brought into this State from without the state, when the alcoholic beverages are for delivery or use within the state.

(b) Any person bringing alcoholic beverages into this State from without this State which are not consigned to any person and which are for delivery or use within this State." § 23021.

The United States Supreme Court upheld California's primary source law. Rice v. Norman Williams Co., 458 U.S. 654, rev'g Norman Williams Co. v. Rice (Cal. Ct. App. 1980).

## COLORADO

Colorado has a primary source law applicable to spirits and wine. The language of the statute makes clear that the primary source itself need not be "American", only that it must be the primary source in America, irrespective of its nationality.

It is unlawful for any person to import or sell any imported vinous or spirituous liquor in this state unless such person is the primary source of supply in the United States for the brand of such liquor to be imported into or sold within this state. Colo. Rev. Stat. § 12-47-128(3)(b).

## DISTRICT OF COLUMBIA

D.C. has a full primary source law.

It shall be unlawful for any wholesaler to purchase any distilled spirits for resale unless the alcoholic beverages are purchased from the primary American source of supply for the brand of distilled spirits sought to be resold. D.C. Mun. Regs. tit. 23, § 909.1.

It shall be unlawful for any wholesaler to sell any distilled spirits to licensees in the District of Columbia if the alcoholic beverages have not been purchased by the wholesaler from the primary American source of supply. § 909.2.

"Primary American source of supply" means the owner of the distilled spirits or wine at the time that the beverage became a marketable product in the United States. § 909.3.

## FLORIDA

Florida has a primary source law applicable to spirits and wine.

Distributors licensed in Florida shall not purchase, receive or be in possession of any spirituous liquors or wines unless they were obtained directly from a registered Primary American source of supply and the invoice to the distributor for such product is from the registered Primary American Source of Supply." Fla. Admin. Code Ann. 61A-4.056(4).

"Primary American source of supply" means the manufacturer, rectifier, or owner of spirituous liquor at the time it became a marketable product, or bottler, or the exclusive agent of any such person, who, if the product cannot be secured directly from the manufacturer by an American distributor, is the source closest to the manufacturer in the channel of commerce from whom the product can be secured by an American distributor, or who, if the product can be secured directly from the manufacturer by an American distributor, is the manufacturer." Fla. Stat. § 565.095(1).

## HAWAII

Hawaii has a primary source law applicable to spirits.

No licensee authorized to import liquor into Hawaii shall order, purchase, or receive liquor for resale unless the licensee orders, purchases or receives it from the primary source of supply for the brand of liquor sought to be sold. No licensee authorized to import liquor into Hawaii may sell liquor purchased or received by the licensee to any person if the liquor has not been purchased or received by the licensee from the primary source of supply. Haw. Rev. Stat. § 281-102.5.

No supplier shall solicit, accept or fill any order for any liquor from any licensee authorized to import liquor into this State unless the supplier is the primary source of supply for the brand of liquor sold or sought to be sold. *Id.*

"Primary source of supply" means: (1) the manufacturer of the liquor, if the liquor can be secured directly from the manufacturer by United States wholesalers, or (2) the rectifier, the owner of the liquor at the time it becomes a marketable product, the bottler, the importer, or the exclusive agent of any such person, who, if the liquor cannot be secured from the manufacturer by United States wholesalers, is the source closest to the manufacturer in the chain of distribution from whom the product can be secured by the United States wholesalers. *Id.*

## ILLINOIS

Illinois requires each primary supplier to register the name

of each person granted the right to sell that supplier's products at wholesale. The statute prohibits any person from buying and any supplier from selling spirits unless the buyer is the person authorized by the supplier to sell the product at wholesale.

The statute states as follows:

Each manufacturer, non-resident dealer, distributor, importing distributor, or foreign importer who owns or controls the trade mark, brand or name of any alcoholic liquor shall register with the State Commission the name of each person to whom such manufacturer, non-resident dealer, distributor, importing distributor, or foreign importer grants the right to sell at wholesale in this State any such alcoholic liquor, specifying the particular trade mark, brand or name of alcoholic liquor as to which such right is granted, the geographical area or areas for which such right is granted and the period of time for which such rights are granted to such person. Such manufacturer, non-resident dealer, distributor, importing distributor, or foreign importer may grant the right to sell at wholesale any trade mark, brand or name of any alcoholic liquor in any geographical area to more than one person. Such registration shall be made on a form prescribed by the State Commission and the State Commission may require such registration to be on a form provided by it. No such registration shall be made by any other person or in any other manner than as is provided in this Section, and only those persons registered by the manufacturer, non-resident dealer, distributor, importing distributor or foreign importer, shall have the right to sell at wholesale in this State, the brand of alcoholic liquor specified on the registration form. 235 ILCS 5/6-9.

No manufacturer, importing distributor, distributor, non-resident dealer or foreign importer shall sell or deliver any package containing alcoholic liquor manufactured or distributed by him for resale, unless the person to whom such package is sold or delivered is authorized to received such package in accordance with the provisions of this Act.  
*Id.*

Certain wholesalers who were engaged in grey marketing before a certain date are permitted to continue the practice, but they are subject to restrictions and may only purchase from a licensed Illinois distributor who himself has the right to sell that brand at wholesale in Illinois.  
*Id.*

#### INDIANA

It is unlawful in Indiana to purchase or sell spirits except as authorized by a license. Ind. Code § 7.1-5-10-5. An Indiana wholesaler's license authorizes the purchase of spirits within Indiana from other licensed wholesalers as well as the primary source of supply, but only authorizes purchases outside the state from the primary source of supply. Ind. Code § 7.1-3-8-3(b). In-state purchases from other wholesalers are permitted in order to correct local, short-term shortages of product. This provision does not constitute an exception to primary source protection, as grey marketers do not profit from this activity.

The statute states:

"It is unlawful for a person, except as otherwise permitted by this title, to purchase, receive, manufacture, import, or transport, or cause to be imported or transported from another state, territory, or country, into this state, or transport, ship, barter, give away, exchange, furnish, or otherwise handle, or dispose of an alcoholic beverage, or to possess an alcoholic beverage for purpose of sale. It is unlawful, also, for a person knowingly to receive or acquire an alcoholic beverage from a person who does not hold, unrevoked, the appropriate permit under this title to sell, deliver, furnish, or give the alcoholic beverage to him." Ind. Code § 7.1-5-10-5.

A liquor wholesaler shall be entitled to purchase liquor within this state from a person who holds a distiller's permit, a rectifier's permit, or a liquor wholesaler's permit. A liquor wholesaler also may purchase liquor outside this state from the primary source of supply and, from that source, may transport and import liquor into this state. § 7.1-3-8-3(b).

The term "primary source of supply" means, in regard to the alcoholic beverage being sold to a wholesaler:

- (1) a distiller of the alcoholic beverage;
- (2) a producer of the alcoholic beverage;
- (3) a vintner of the alcoholic beverage;
- (4) a rectifier of the alcoholic beverage;
- (5) an importer into the United States of the alcoholic beverage;
- (6) an owner of the alcoholic beverage at the time it becomes a marketable product;
- (7) a bottler of the alcoholic beverage;
- (8) a brewer of the alcoholic beverage;
- (9) an agent specifically authorized to make sales to an Indiana wholesaler by a person listed in subdivisions (1) through (8). § 7.1-1-3-32.5.

## KANSAS

Kansas has a partial primary source statute.

The Kansas spirits distributors' license permits the purchase of spirits manufactured in the United States only from the primary American source of supply or another spirits distributor who is licensed to distribute spirits in Kansas. Spirits manufactured outside the United States may be purchased from any source of supply. Kan. Stat. Ann. § 41-306, § 41-102(h). Wine distributors' licenses are subject to a similar conditions. § 41-306a.

The statute states that a spirits distributor's license shall allow: the wholesale purchase, importation and storage of spirits, but all such spirits so purchased or imported which are manufactured in the United States shall be purchased from the primary American source of supply or from

another licensed spirits distributor, except that a licensed spirits distributor may purchase confiscated spirits at a sheriff's sale. § 41-306.

"Primary American source of supply" means the manufacturer, the owner of alcoholic liquor at the time it becomes a marketable product or the manufacturer's or owner's exclusive agent who, if the alcoholic liquor cannot be secured directly from such manufacturer or owner by American wholesalers, is the source closest to such manufacturer or owner in the channel of commerce from which the product can be secured by American wholesalers. § 41-307(t).

## KENTUCKY

Kentucky has a full primary source protection law applicable to spirits and wine.

Kentucky prohibits suppliers from selling and wholesalers from buying brands that are not registered. Ky. Rev. Stat. Ann. § 244.440(2). Registration of brands by suppliers who do not own or have an exclusive interest in the brands registered is void. 804 KAR 4:245(sec. 1).

A supplier who owns or has an exclusive interest in any particular brands is the primary American source of supply. 804 KAR 4:245(sec. 1). A primary source of supply is defined as the manufacturer, distiller, rectifier, blender, vintner, or owner of the spirituous or vinous beverages at the time such beverages become a marketable product, or bottler, or the exclusive agent of any such person, who, if the product cannot be secured directly from the manufacturer by an American wholesaler is the source closest to the manufacturer in the channel of commerce from whom the product can be secured by an American wholesaler or who, if the product can be secured from the manufacturer by an American wholesaler, is the manufacturer. 804 KAR 4:240(sec. 2).

Furthermore, Kentucky law requires each supplier with an exclusive interest in any particular brands (these suppliers are defined as the primary American source, above) to register the names of wholesalers to whom rights have been granted on one or more or all the brands of distilled spirits or wine offered for sale in the state. Ky. Rev. Stat. Ann. § 244.440(1). Kentucky prohibits suppliers from selling and wholesalers from buying brands that are not registered. § 244.440(2).

## LOUISIANA

Louisiana has a full primary source law.

A shipper must obtain written approval from the secretary of the Department of Revenue and Taxation or his agent before he may legally bring alcohol beverages into the state. La. Rev. Stat. Ann. § 364(B), § 241(15). The secretary shall not authorize shipments of any alcohol beverages into Louisiana except shipments from the distiller, the producer, the owner of the commodity at the time it becomes a marketable product, the bottler, or the exclusive agent of any such distiller, producer, bottler or owner. § 364(B).

## MAINE

Maine has a full primary source law.

No wholesale licensee may purchase liquor from anyone other than the primary source of supply within the United States. Me. Rev. Stat. Ann. tit. 28-A, § 1453(3). "Primary source

of supply" means the distiller, the bottler, the brewer, the winery, the brand owner or the designated agent of any distiller, brewer, winery or brand owner." § 1451(3).

## MARYLAND

Maryland has a full primary source law.

A person may not sell alcohol beverages unless otherwise provided for in Article 2B, Annotated Code of Maryland. Md. Alco. Bev. Code Ann. § 3(2). A nonresident dealer's permit may be issued only to a brewer, distiller, rectifier, bottler<sup>1</sup>, manufacturer, vintner, winery, importer who purchased directly from the brand owner, or authorized agent of the aforementioned (referred to collectively as the primary source of supply). Md. Alco. Bev. Code Ann. § 4(i). A wholesaler's license entitles the holder to acquire alcohol beverages only from holders of nonresident dealer's permits or their licensees and to sell those beverages to licensed buyers. Md. Alco. Bev. Code Ann. § 4(i). Since wholesalers must buy only from nonresident sellers, and nonresident sellers must be the primary source, wholesalers must buy only from the primary source.

In addition, although a non-U.S. supplier need not obtain a Maryland nonresident dealer's permit in order to sell to a Maryland wholesaler (Md. Alco. Bev. Code Ann. § 4(i)(4)), the Maryland wholesaler is not permitted to buy from a foreign supplier who is not the primary source (Md. Alco. Bev. Code Ann. § 6(b)(3)).

## MISSOURI

Missouri has a full primary source law.

For purposes of tax revenue control, no holder of a license to solicit orders for the sale of intoxicating liquor, other than a wholesale-solicitor, shall solicit, accept, or fill any order for any intoxicating liquor from a holder of a wholesaler's license unless the holder of such solicitor's license has registered as the primary American source of supply for the brand of intoxicating liquor sold or sought to be sold. Mo. Rev. Stat. § 311.275(1).

No holder of a wholesaler's license shall order, purchase or receive any intoxicating liquor from any solicitor, other than a wholesale-solicitor, unless the solicitor has registered as the primary American source of supply for the brand of intoxicating liquor ordered, purchased or received. § 311.275(2).

"Primary American source of supply" means the distiller, producer, the owner of the commodity at the time it became a marketable product, the bottler, or the exclusive agent of

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<sup>1</sup> The business of bottling alcohol beverages for sale is confined to persons who are licensed as manufacturers. The holder of a wholesaler's license has no right to engage in this business. *Atty. Gen. Op.*, Dec. 13, 1933, 18 O.A.G. 150..

any such distiller, producer, bottler or owner, the basic requirement being that the nonresident seller be the first source closest to the manufacturer in the channel of commerce from whom the product can be secured by American wholesalers. § 311.275(3).

## NEBRASKA

Nebraska has full primary source protection.

A holder of an alcoholic liquor wholesale license shall purchase and import all alcoholic liquor from a primary American source of supply. A primary American source of supply means the manufacturer, the owner of alcoholic liquor at the time it becomes a marketable product, or the manufacturer's or owner's agent who, if such liquor cannot be secured directly from such manufacturer or owner by American wholesalers, is the source closest to such manufacturer or owner in the channel of commerce from which the product can be secured by American wholesalers. Neb. Rev. Stat. § 53-192.01.

## NEVADA

Nevada has a complete primary source law.

A person who holds an importer's license or permit may purchase liquor only from the supplier of that liquor. Nev. Rev. Stat. § 369.388.

"Importer" means any person who, in the case of liquors which are brewed, fermented or produced outside Nevada, is first in possession thereof within the state after completion of the act of importation. § 369.030. "Supplier" means, with respect to liquor which is brewed, distilled, fermented, manufactured, produced or bottled: a) outside the United States, the owner of the liquor when it is first transported into any area under the jurisdiction of the United States Government; or b) within the United States but without Nevada, the brewer, distiller, manufacturer, producer, vintner or bottler of the liquor, or his designated agent. § 369.111.

## NEW HAMPSHIRE

New Hampshire requires by regulation that the state only purchase from the primary source.

Suppliers who wish to have their products considered for listing must include with the application a marketing letter that includes a verification of the primary source producer or manufacturer and an exclusive agent agreement if the product is submitted by other than the primary producer or manufacturer. N.H. Code Admin. R. Liq. 302.01.

"Primary source" means the domestic distiller, producer, owner of the commodity at the time it became a marketable product, bottler or exclusive agent of any such distributor or owner. In the case of imported products the primary source of supply means either the foreign producer, owner, bottler or agent or the prime importer or the exclusive agent in the United States or the foreign distiller, producer or owner. Liq. 301.03(s).



## NEW JERSEY

New Jersey has primary source protection in both statute and regulation. It applies to spirits, wine, and beer.

Statute: A holder of a class B license (authorizes the wholesale sale of spirits, beer, and wine) shall not sell or deliver for resale in New Jersey any brand of alcoholic beverage for resale in the state unless the alcoholic beverage is acquired from the brand owner, or his authorized agent, or a wholesale licensee designated as the registered distributor by the brand owner, or his authorized agent. N.J. Rev. Stat. § 33:1-2(b), § 33:1-11.

Regulation: No plenary wholesale, wine wholesale or limited wholesale licensee shall sell or deliver any brand of alcoholic beverage intended for resale in New Jersey unless the alcoholic beverage is acquired from the brand owner, or his authorized agent, or a wholesale licensee designated as a New Jersey registered distributor by the brand owner or his agent. N.J. Admin. Code tit. 13, § 2-25.2. The same primary source restrictions apply to beer. § 2-25.3.

In addition, New Jersey regulations assure primary source protection through the brand registration process. New Jersey regulations prohibit any licensee from knowingly selling any alcoholic beverage unless there is first filed with the Division of Alcoholic Beverage Control a brand registration schedule. § 2-33.1(a). The brand registration schedule must be filed by the manufacturer, importer or wholesaler who owns the brand or trade name and label; or an importer or wholesaler selling such brand who is appointed as authorized agent by the brand owner for the purpose of filing the brand registration schedule. § 2-33.1(b).

## NEW MEXICO

New Mexico has full primary source protection for spirits and wine.

For the purposes of tax revenue control, no holder of a nonresident license or resident broker license may solicit, accept or fill an order for distilled spirits or wine from a holder of any type of wholesaler's license unless the nonresident licensee or resident broker is the primary American source of supply for the brand of distilled spirits or wine that is ordered. N.M. Stat. Ann. § 60-8A-6.

"Primary American source of supply" means the distiller, the producer, the owner of the commodity at the time it becomes a marketable product, the bottler or the exclusive agent of any of those. To be the "primary American source of supply", the nonresident licensee or resident broker must be the first source, that is, the manufacturer or the source closest to the manufacturer, in the channel of commerce from whom the product can be secured by American wholesalers. *id.*



## NEW YORK

New York has full primary source protection, although the statute does not use the term "primary source".

No liquor, wine or beer shall be labeled, offered or advertised for sale unless the brand or trade name label affixed upon the container has been registered and approved. N.Y. Alco. Bev. Cont. Law § 107-a(4)(a). An application for registration of a brand or trade name label may only be filed by the owner of the brand or trade name if the owner is licensed by the authority, or if the owner is not licensed by the authority, by the wholesaler selling such brand who is appointed exclusive agent, in writing, by the owner. § 107-a(4)(b).

## NORTH DAKOTA

North Dakota regulations establish primary source protection for spirits, wine, and beer.

No wholesaler shall purchase any alcohol beverage for resale from any source other than any of the following: 1) The manufacturer, rectifier, distiller, brewer, or winery producing the alcoholic beverage; 2) the owner of the trademark under which the alcoholic beverage is packaged for sale to retailers; 3) the United States importer or United States agent for a foreign manufacturer or trademark owner of the alcoholic beverage; 4) the expressly designated agent for North Dakota, or the primary American source of supply, of any of the above; 5) the North Dakota wholesaler of alcoholic beverages. N.D. Admin. Code § 84-02-01-04.

## RHODE ISLAND

The holders of wholesale licenses in Rhode Island shall purchase beverages only from the distillery, rectifier, winery or brewery manufacturing the same or from the importer holding the basic contract with a foreign supplier whereby such foreign supplier exports distilled spirits, wines or malt beverages into the United States. R.I. Gen. Laws § 3-6-16.

A grandfather clause permits any wholesaler who, prior to the effective date of the act, has made regular purchases from the agent specifically designated by a distillery, rectifier, winery, brewery or importer for the express purpose of making sales of spirits, wines or malt beverages to wholesalers in states other than the one in which such agent is licensed and located. *id.* As the grandfather clause applies only to wholesalers who have made regular purchases from the agent specifically designated by a distillery, it does not diminish the primary source protection.

## SOUTH CAROLINA

South Carolina has full primary source protection.

No alcoholic liquor shall be shipped or moved into South Carolina unless and until each brand of such alcoholic liquor is duly registered. S.C. Code Ann. § 61-7-70.

Only registered producers are permitted to ship alcoholic liquor into South Carolina and no brand may be registered by the producer unless the person registering the brand is either the American producer or the primary American source of supply in the United States of such brand. § 61-7-60. In addition, it is also unlawful for any wholesaler in South Carolina to order, purchase, or receive any alcoholic beverages from any producer who is not the primary American source of supply for the brand ordered, purchased or received. *Id.*

"Primary American source of supply" means the manufacturer, distiller, vintner, winery, or owner of vinous or spirituous beverages at the time it became a marketable product, or bottler, or the exclusive agent of any such person, who, if the product cannot be secured directly from the manufacturer by an American distributor, is the source closest to the manufacturer in the channel of commerce from whom the product can be secured by an American distributor, or who, if the product can be secured directly from the manufacturer by an American distributor, is the manufacturer. *Id.*

## SOUTH DAKOTA

South Dakota has a complete primary source statute. No licensed wholesaler may purchase or accept delivery into this state of any brand of alcoholic beverages, unless those alcoholic beverages are purchased from the brand owner or the brand owner's authorized agent, or from another wholesaler who is licensed under this chapter and operating solely within this state. S.D. Codified Laws Ann. § 35-4-60. Intra-state sales between wholesalers are of no interest to the grey marketer, thus this exception does not limit the primary source protection.

## TENNESSEE

Tennessee has a full primary source law applicable to spirits and wine.

No holder of a nonresident seller's permit may solicit, accept, or fill an order for distilled spirits or wine from a holder of any type of wholesaler's permit unless the nonresident seller is the primary American source of supply for the brand of distilled spirits or wine that is ordered. Tenn. Code Ann. § 57-3-607(a).

"Primary American source of supply" means the distiller, the producer, the owner of the commodity at the time it becomes

a marketable product, the bottler, or the exclusive agent of any of those. To be the "primary American source of supply" the nonresident seller must be the first source, that is, the manufacturer or the source closest to the manufacturer, in the channel of commerce from whom the product can be secured by American wholesalers. § 57-3-607(b).

## TEXAS

Texas has full primary source protection for spirits and wine.

No holder of a nonresident seller's permit may solicit, accept, or fill an order for distilled spirits or wine from a holder of any type of wholesaler's permit unless the nonresident seller is the primary American source of supply for the brand of distilled spirits or wine that is ordered. Tex. Alco. Bev. Code Ann. § 37.10(a).

"Primary American source of supply" means the distiller, the producer, the owner of the commodity at the time it becomes a marketable product, the bottler, or the exclusive agent of any of those. To be the "primary American source of supply" the nonresident seller must be the first source, that is, the manufacturer or the source closest to the manufacturer, in the channel of commerce from whom the product can be secured by American wholesalers. § 37.10(b).

In addition, a manufacturer's agent's permittee may not represent a person with respect to an alcoholic beverage unless the person represented is the primary American source of supply of the beverage. § 36.08.

## WISCONSIN

Wisconsin has a full primary source law. The statute prohibits grey market sales by allowing wholesalers to buy from other wholesalers only if both are residents of Wisconsin.

No wholesaler may purchase intoxicating liquor for resale unless he or she purchases it either from the primary source of supply for the brand of intoxicating liquor sought to be sold or from a wholesaler within Wisconsin who holds a permit issued by the state. No wholesaler may sell intoxicating liquor purchased by the wholesaler to any other licensee or permittee if the intoxicating liquor has not been purchased by the wholesaler from the primary source of supply or from a wholesaler within Wisconsin holding a permit. Wis. Stat. § 125.69(5).

# APPENDIX B

## Distilled Spirits Received and Shipped By Minnesota Wholesalers 1990-1995

Fiscal Year	Liters Received	Liters Shipped Out Of State
1990	30,607,130	439,569
1991	29,819,809	471,852
1992	27,290,530	843,002
1993	29,186,772	3,749,578
1994	29,317,051	1,384,726
1995	34,406,803	582,787

(Source: Department of Revenue)

Liters shipped out of state peaked in 1993 and 1994, in part due to export market conditions.

The category "Liters Received" includes liters directly brought into Minnesota by a wholesaler, and liters received from other Minnesota wholesalers. Some double counting is therefore included.

# **APPENDIX C**

**LETTERS FROM:**

**BROWN-FORMAN CORPORATION**

**HIRAM WALKER**

**JIM BEAM BRANDS**

*Brown-Forman Corporation*

1000 BROADWAY, SUITE 1000, NEW YORK, NY 10018-3001 FAX 212 512 1100

MICHAEL B. CRUTCHER  
VICE PRESIDENT  
LEGAL COUNSEL AND SECRETARY

November 30, 1995

Patrick J. McCormack  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, Minnesota 55155

Dear Mr. McCormack:

Brown-Forman Corporation is pleased to have the opportunity to comment on Minnesota's consideration of a pure primary source law for distilled spirits. We believe adoption of a primary source law will benefit the residents of Minnesota and strongly support such a change.

Primary source laws strengthen a state's ability to trace and collect taxes on alcoholic beverages sold within it. Because the state would know who is authorized to bring each brand into the state, an audit trail is created which facilitates the collection and enforcement burdens of the state's taxing authority. Without such regulation, Minnesota has little ability to track and ensure taxes on distilled spirits are paid.

The lack of a primary source law also presents health and safety issues for Minnesota consumers by allowing the sale of gray market products within the state. Gray market products are typically brand-named products manufactured abroad where product standards and labeling requirements are often quite different than here in the United States. Gray market products may contain dyes, additives and other ingredients that are not approved in the United States, yet authorized for use in another country. Consumers typically cannot identify gray market products and thus would be unaware of the risks involved.

Distilled spirits, like other food and beverage products, are perishable and susceptible to manufacturing defects. Spirit manufacturers in the United

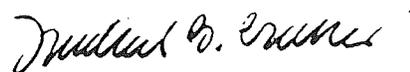
Patrick J. McCormack  
November 30, 1995  
Page Two

States use extensive product coding procedures to ensure their products can be traced and retrieved in the event of a product recall. Gray market goods often either lack product coding or have had the coding scraped off to prevent tracing the source of the product. Adoption of a primary source law goes a long way to ensure the integrity of the product sold to Minnesota consumers.

Another key reason for adopting a primary source law is that primary source promotes competition and efficient marketing of alcoholic beverages. Competition and efficient marketing ensures the widest choice of quality products for Minnesota consumers. Our financial commitment to advertising and promoting our brands, however, is commensurate with our ability to track its impact and benefits. In states like Minnesota where we cannot accurately track sales of our products, we invest significantly less in terms of advertising and manpower dollars than we do in states with primary source laws. The consumer is the one who benefits from competitively priced products generated by a manufacturer's advertising and marketing commitments.

In closing, we advocate the adoption of a primary source law in Minnesota for distilled spirits. The benefits of primary source laws to consumers are numerous while there is no downside. Given the protections already evident from Minnesota's primary source laws covering beer and wine, it makes sense to expand the primary source law to distilled spirits.

Sincerely,



Michael B. Crutcher

November 17, 1995

Mr. Patrick McCormack  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, MN 55155

Dear Mr. McCormack:

Thank you for the opportunity to address the issue of a primary source statute in Minnesota. Minnesota had a primary source statute until its sudden repeal in an omnibus liquor bill at the end of the 1991 legislative session. It is most important to the tax payers and consumers in Minnesota that this law be reinstated.

The foremost reason to reinstate primary source protection is that there is currently no system in place in Minnesota to ensure that all taxes are paid on product sold in the state or purchased in the state for shipment elsewhere. Most license states have adopted the primary source system wherein wholesalers purchase only from the primary source of supply for a particular brand. Under this system, the wholesaler reports to the state revenue authority the amount of product brought into the state and upon which tax is due, and the supplier makes a similar report as to the amount of product sold to wholesalers in the state.

By receiving reports from both the primary source and the wholesaler, the Department of Revenue can easily verify compliance with the state's tax laws by comparing reports received. Verification under this system is simple and inexpensive. It requires no physical inspection of inventory or labor-intensive examination of taxpayer records. It has been adopted by most states because it is the most efficient tax enforcement technique available. During a period of government downsizing, it makes sense to ensure the collection of all taxes due to the state.

Minnesota has become a center for transshipment of spirits. Gray marketers based in Minnesota buy and sell around the world, ostensibly shipping through Minnesota. However, it is likely that much of this product never enters the state, despite the existence of an at-rest law. Little or no tax is paid on this product because of the combination of Minnesota's method of accounting for spirits inventory and the lack of a primary source statute. Minnesota does not benefit in any way from permitting itself to be used as a paper transshipment point unless taxes can be collected on the product that enters or should enter Minnesota. As you know, the Director of Special Taxes Division of the Department of Revenue and the Director of Liquor Control Division of the Department of Public Safety both testified that they have no way of accurately tracking distilled spirits products. A primary source law will give the people of Minnesota a means to collect tax on this transshipped product.

*The Best With the Best*

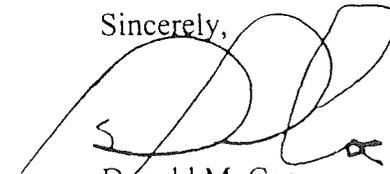
A primary American source law protects Minnesota consumers from product of varying quality and security. Without primary source protection, Minnesota wholesalers are free to import product from anywhere in the world, including sources of supply that may provide counterfeit product. This exposes the Minnesota consumer to potentially unhealthful product or product that is of a lesser quality than the genuine merchandise for which the consumer has paid. In addition, gray marketers typically remove labels and ink-jet code numbers when product enters a free trade zone, making it impossible for my company to locate its product in the unlikely event that a recall is necessary.

Suppliers often produce slightly different product under the same brand name to meet the tastes of consumers in different markets. Minnesota consumers expect that each bottle they purchase will not vary in flavor or other characteristics. With gray products on the state's retail shelves, this uniformity among samples of the same brand cannot be assured. I would also point out that despite predictions to the contrary, retail prices in Minnesota have not decreased as a result of the repeal of primary source protection in 1991.

An important function of a wholesaler is to provide advertising and other brand development services to build sales of a particular company's products. As the result of the Coleman Act, which requires suppliers to sell on the same terms to all wholesalers who wish to purchase, wholesalers in Minnesota carry both Hiram Walker products as well as those of my competitors. Consequently, Minnesota wholesalers are not in a position to provide my company with the advertising and product development it requires. Hiram Walker must expend considerable resources to provide these services itself. Gray marketers who purchase product out-of-state and bring it into Minnesota for sale benefit from the investment the supplier makes in the product without participating in the attendant costs. Suppliers are forced to reduce their advertising and brand development activities, which damages the long-term prospects for all spirits brands, harms the local Minnesota retailers dependent on them, and reduces tax revenue to the state.

I would be happy to provide you with any additional information related to this matter that you may request. Please feel free to call upon me again.

Sincerely,



Donald M. Coe  
President

cc: Mr. G. P. DiBenedetto  
Mr. T. Jensen  
Mr. G. F. McCarthy  
Mr. L. R. Timmons

# JIM BEAM BRANDS CO.

510 Lake Cook Road  
Deerfield, Illinois 60015-4964  
Telephone: (708) 948-8888

December 1, 1995

Via Fax and Federal Express

Mr. Patrick J. McCormack  
Legislative Analyst  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, MN 55155

Re: Restoration of Primary Source

Dear Mr. McCormack:

Thank you for providing us this opportunity to express our opinion regarding the possibility of restoring primary source protection for distilled spirits products in Minnesota. This issue is of great importance for our industry and, we believe, for the State of Minnesota as well.

Minnesota has been a big part of my life. I lived and worked there for eighteen years before moving to Chicago to work in Beam's corporate office, including nine seasons playing for the Minnesota Twins. I met and married my wife there, and in 1989, built a home up by Breezy Point where my family and I spend as much time as we can.

Primary source laws represent simple, effective, and efficient legislation that benefits consumers, the state, and industry. Through enhanced competition, consumers can choose from the widest variety of products at the most competitive prices, receiving the quality products and sales support that the supplier intended. The state benefits from a simple, straightforward system which provides the clearest possible audit trail to allow enforcement of complicated alcoholic beverage regulations, and ensures that the state collects all the tax revenue to which it is entitled. Industry benefits by stemming the flow of "gray market" goods brought into the state without the supplier's knowledge or consent which, by their very nature, can irreparably damage the hard earned reputation of a company or its products.

Mr. Patrick J. McCormack

Page 2

The overwhelming majority of license states, such as Minnesota, have adopted primary source laws. Indeed, the Minnesota Legislature has provided primary source protection to all beer and wine suppliers as well as to Minnesota-based suppliers of distilled spirits.

From a logical standpoint, there is absolutely no basis for the arbitrary distinction between Minnesota based and non-Minnesota based distilled spirits suppliers. The result, however, is that Minnesota's consumers and the State itself have been deprived of the substantial benefits that would have been afforded through an even application of primary source legislation.

Simply stated, this unique departure from pure primary source legislation, and the related open franchising requirement which has also been selectively applied only to non-Minnesota based distilled spirits manufacturers, represent an extreme form of special interest legislation. Both laws sacrifice the interests of the State and its citizens to provide an unfair competitive advantage to a select few. In fact, the primary beneficiary is not some small, endangered business for whom it might be argued that protectionist legislation was in order. Rather, the primary beneficiary is a single well connected Minnesota company which is the eighth largest wine and spirits wholesaler in the country, with operations in twelve states, and annual revenues of half a billion dollars. Such exceptional treatment clearly runs counter to the best interests of Minnesota's consumers, the State, and the industry. Furthermore, because of its discriminatory effect, there is ample reason to believe that such regulation would not withstand a Constitutional challenge.

Proponents of the current system will probably contend that these laws have helped Minnesota's consumers through the benefits of increased competition at the wholesale level, and that they have served to protect jobs in Minnesota as well. The facts, however, demonstrate that just the opposite is true. Before open franchising there were more than twenty distilled spirits wholesalers in Minnesota. Today there are only five. It seems obvious that the potential for competition has not only diminished; it is at a critically low threshold. It is equally obvious that the hundreds of jobs which disappeared along with more than 75% of the State's wholesalers far outweigh any jobs gained through the selective application of primary source.

# JIM BEAM BRANDS CO.

Mr. Patrick J. McCormack

Page 3

Proponents of the current system may also contend that non-Minnesota based distilled spirits suppliers like Jim Beam Brands Co. are supporting a pure primary source law solely for their own benefit. While we would certainly benefit by better controlling the distribution of our products, we believe that the more significant point is that consumers and the State would benefit.

We hope the Legislature will consider that the current special interest driven distilled spirits regulations are blatantly unfair and clearly anti-competitive. At Jim Beam Brands Co. we are proud to produce one of the top selling spirit brands in Minnesota, Windsor Supreme Canadian Whisky. Current Minnesota law, however, requires us to sell our premium Windsor product to a direct competitor in Minnesota who then sells it at as a loss leader, in conjunction with the promotion of its own brands. In doing so, they erode the outstanding reputation of the Windsor brand which was built through substantial investment over many years. Non-Minnesota based manufacturers and suppliers, like Beam, are understandably reluctant to promote and support brands when they can reasonably expect that a competitor who has been granted an unfair advantage will undermine that investment. This unfair situation ultimately hurts Minnesota's consumers, as seen, for example, in the tremendous reduction in the number of wholesalers in Minnesota and the corresponding reduction in competition. Ultimately, as existing brands diminish and new brands are not developed, the State will suffer an inevitable loss of tax revenue.

If returned to Minnesota, pure primary source would strengthen the ability of the State to enforce its beverage alcohol regulations and collect taxes. It would promote competition and efficient marketing of all beverage alcohol products. It would close the door on the gray market in Minnesota, better protecting the health and safety of Minnesota's consumers. And it would be an important first step in eliminating the discrimination inherent in the current system.

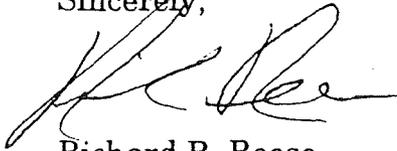
Because Minnesota already has primary source legislation for the vast majority of beverage alcohol products, the question is not whether or not primary source legislation is right for Minnesota. The question is simply whether or not this beneficial legislation will be fairly and evenly applied.

# JIM BEAM BRANDS CO.

Mr. Patrick J. McCormack  
Page 4

A change to a pure primary source law will afford Minnesota an opportunity to enact legislation that is good for the State, good for consumers, and good for the industry. I am available to discuss this with you further on the phone or am available to fly to Minnesota December 6, to meet with you personally. Thank you for your patience in waiting for my response.

Sincerely,



Richard B. Reese  
President and Chief Operating Officer

sf

**APPENDIX D**

**LETTERS FROM:**

**NORTH DAKOTA**

**CONNECTICUT**

**MAINE**

**MANITOBA AND ONTARIO**



STATE OF NORTH DAKOTA  
OFFICE OF THE STATE TREASURER

September 29, 1995

Mr. Patrick J. McCormack  
Senate Counsel and Research  
G-17 State Capitol  
St. Paul, MN 55156

Dear Mr. McCormack:

*The North Dakota Attorney General's Office forwarded your letter to my office for review. The State Treasurer's Office is the wholesale liquor administrator for the state.*

*To the best of my knowledge, I am not aware of any primary source problems on the North Dakota-Minnesota border. However, I would suggest that you may want to survey the North Dakota liquor wholesalers on the border.*

*I am sending you a list of the North Dakota liquor wholesalers names and addresses.*

Sincerely,

A handwritten signature in black ink, appearing to read "K. Gilmore", written over a horizontal line.

Kathi Gilmore  
State Treasurer

jf  
Enclosure



# STATE OF CONNECTICUT

## DEPARTMENT OF CONSUMER PROTECTION

November 3, 1995

Patrick J. McCormack  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, MN 55155

Dear Mr. McCormack:

This is a response to your letter dated October 19, 1995. Connecticut is a license state which firmly believes in strict enforcement of primary source statutes and regulations and rigid adherence to the three-tier system of distribution.

With each state regulating liquor differently and operating independently of each other, it is impossible to monitor interstate shipments, mail order businesses, and ever increasing ways of moving alcoholic beverages.

There may be no solution to the problem, but if each state maintains tight controls over its licensing and distribution systems, all states will benefit.

Sincerely,

A handwritten signature in black ink, appearing to read "G. Langlais", written over a horizontal line.

Gerald C. Langlais  
Director

/ja

PHONE  
(207) 287-3721

FAX  
(207) 287-4049 (LIQUOR)  
(207) 287-6769 (LOTTERY)  
(207) 287-6791 (TTY)



MAIL  
8 STATE HOUSE STATION  
AUGUSTA, MAINE 04333-0008

OFFICES  
10-12 WATER STREET  
HALLOWELL, MAINE 04347

**DEPARTMENT OF ADMINISTRATIVE & FINANCIAL SERVICES**  
**BUREAU OF ALCOHOLIC BEVERAGES & LOTTERY OPERATIONS**

November 1, 1995

**EBEN B. MARSH, DIRECTOR**

Patrick J. McCormack  
Legislative Analysts  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, MN 55155

Dear Mr. McCormack:

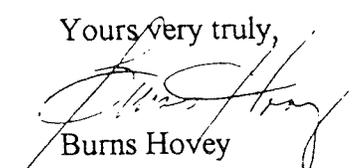
Eben Marsh has asked that I reply to your letter to him on October 19, 1995.

At this time, Maine has no particular concern over grey market or parallel distilled spirits moving thru Minnesota. Should these products reach Maine, however, there would be concern.

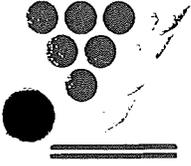
A few years ago, Maine imported grey market products for a short time. The practice of the same was discontinued because of the potential for mis-labeled and/or mis-represented products (and the possible, liability resulting from the same), unsatisfactory deliveries, etc. In short, "the end did not justify the means".

If you have any questions, please feel free to call me at (207) 287-3721.

Yours very truly,

  
Burns Hovey  
Management Analyst II

BH/bl



MANITOBA  
LIQUOR CONTROL COMMISSION  
SOCIÉTÉ DES ALCOOLS

October 31, 1995

Mr Patrick J. McCormack  
Legislative Analyst  
Senate Counsel & Research  
State of Minnesota  
G-17 State Capitol  
St. Paul, Minn. 55155

Dear Mr McCormack:

I was pleased to receive your letter of October 18th, asking our opinion of potential changes to the state liquor laws in Minnesota.

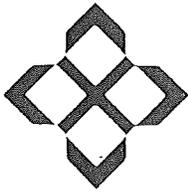
In the opinion of the Manitoba Liquor Control Commission there is a problem with grey market goods being funnelled through Minnesota into Canada, often on an illegal basis. We have investigated this with some of our key contacts in the industry and confirmed that it is indeed a concern. We would, therefore, encourage you to establish a primary source law in the State of Minnesota. Although this law may not totally resolve the problem, it would certainly be a step in the right direction to still the flow of illegal liquor into Canada and presumably elsewhere in the United States.

Thank you for consulting with us on this matter and we would be happy to discuss this further if you so desire.

Yours truly

D.V. Lussier  
Vice President  
Purchasing & Sales

cc: *Derek E.R. Smith, President MLCC*



55 Lake Shore Blvd. East  
Toronto, Canada  
M5E 1A4

Tel: 416/864-2519  
Fax: 416/864-2476

Liquor Control Board  
of Ontario

Régie  
des alcools  
de l'Ontario

CHAIR AND  
CHIEF EXECUTIVE OFFICER  
PRÉSIDENT ET  
DIRECTEUR GÉNÉRAL

November 27, 1995

Mr. Patrick J. McCormack  
Legislative Analyst  
Senate Counsel & Research  
G-17 State Capitol  
St. Paul, MN 55155  
U.S.A.

Dear Mr. McCormack:

Thank you for your letter dated October 18, 1995, with respect to your state's concern in deciding if it would be wise to establish a primary source law.

I understand you have already spoken to Harry Tughan, Director, Loss Prevention and Security, regarding the magnitude of the illegal alcohol market in Ontario.

As you may be aware, the LCBO is the largest importer of alcohol beverage in the world and yet we estimate that approximately 15% of a \$5.3 billion industry is lost to smuggling and the illegal manufacture of alcohol.

Smuggling of American spirits into Ontario has shown a noticeable increase over this past three-year period. This can be attributed mainly to a reduction in cigarette taxes making alcohol the commodity of choice for the smuggler. The largest concentration of smuggling appears to occur at Akwesasne, a Canadian Indian Reserve in the Cornwall area.

The liquor is transported through New York State onto the American side of the Mohawk Reservation where it is then stored at Native-operated warehouses. Ultimately the liquor is smuggled into Canada via a sophisticated smuggling network.

Approximately two years ago the Royal Canadian Mounted Police (RCMP), recognizing the problem, created a Task Force in Cornwall and dedicated a number of officers to deal specifically with the smuggling issue. The Task Force has had a degree of success, but obviously it is unable to completely shut down the smuggling problem.

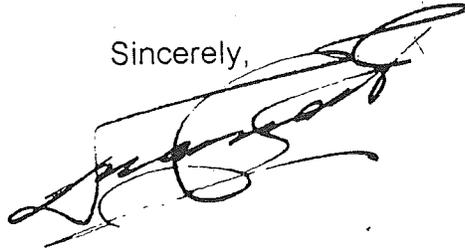
Mr. Patrick J. McCormack -2  
November 27, 1995

Recognizing the impact that the illegal market was having on the legal sales, the LCBO created its own Task Force consisting of four investigators. These investigators deal with many complaints received from the general public concerning the illegal manufacture of wine and sale of American spirits in Canada.

While government control over the entry of alcohol into Ontario is extremely important, it is simply not enough to deal with this massive problem. It would seem that the problem is not likely to decrease significantly until liquor prices in border areas are adjusted to decrease large discrepancies.

I hope these comments are of some assistance to you in dealing with the problem. If we can be of further assistance, please do not hesitate to contact us.

Sincerely,

A handwritten signature in black ink, appearing to read "Andrew S. Brandt", written in a cursive style.

Mr. Andrew S. Brandt  
Chair and Chief Executive Officer

cc: Mr. R.J. Courtoreille, NWT Liquor Licensing Board

# **APPENDIX E**

**LETTER FROM:**

**FRED PETERSON, DIRECTOR OF LIQUOR CONTROL**

**WHY A SUPPLIER REGISTRATION LAW IS NEEDED?**

LIQUOR CONTROL DIVISION  
444 CEDAR STREET  
SUITE 100-L  
ST. PAUL, MN 55101-2156  
(612) 296-6159 • TTY (612) 292-6553  
FAX (612) 297-5259



STATE OF MINNESOTA  
DEPARTMENT OF PUBLIC SAFETY  
SAINT PAUL 55101-2156

December 13, 1995

Patrick McCormack  
Legislative Analysts  
Minnesota State Senate  
G - 17 Capitol  
St. Paul, MN 55155

Dear Mr. McCormack:

The following is a summary as to why we feel a Supplier Registration is needed.

Any supplier of distilled spirits to a Minnesota wholesaler or FTZ should themselves be a licensed entity in the state of Minnesota. These licensed entities should then be required to submit regular reports to Liquor Control, disclosing the brands and amounts shipped to licensed Minnesota wholesalers and the FTZ. We are no longer concerned with gallons or liters. That is a Revenue issue. We are concerned with the brands, containers, sizes, where they are coming from, who is the distributor, and to whom are they being distributed. Likewise, the Minnesota wholesaler receiving the liquor products should also be required to make regular reports on what they receive from suppliers using the same formula. It may be a good idea to discontinue the practice of letting Minnesota wholesalers sell to each other. This could be part of the problem for the distortion of price to consumers, and certainly creates an impossible paper trail to follow. This ability to create a paper trail has led to companies on paper only, the selling and reselling of product without any movement of product and making it impossible to appraise a wholesaler's operation. The information that we would need is already in the suppliers and wholesaler's computers. They order, inventory and sell by this method. A small programming change would give us understandable reports. We are not interested in actual invoices and bills of lading. These are too burdensome to scrutinize. We need a compact report that will outline brands, amounts, prices and destinations.

John M. Williams  
Page 2  
December 13, 1995

### The implementation of a Supplier Registration Law:

- ▶ Would give us the information necessary to evaluate the liquor market and determine the reasons and understand why we are receiving more complaints regarding high prices at the consumer level. Without any regulatory agency keeping track of an industry's product, the sky is the limit. Profits are secret, prices might be too high, competition between big and small liquor wholesalers is not in balance. With a check on how much is going to what market, we will be able to answer these questions and address the problems that occur.
- ▶ We will know what products are in this state for our consumers and what products are being exported. We need to be concerned with the State of Minnesota consumers and the products they are using. Is it the legitimate product being distributed or is it a bogus product being manipulated by someone.
- ▶ The law will aid us in our check for illegal franchising.
- ▶ Product liability should be a MLC concern. This would be the cheapest method of doing that. We do not have the resources to do a chemical analysis of every product that comes into the state. We should be the responsible agency for reporting of such liabilities regarding liquor and the public. Recent cases involving fraudulent baby formula, aircraft parts, shampoo, blackmarket labeling, etc. point out the fact that these type of things are on the rise.
- ▶ MLC has been criticized in the past for not assuming the responsibilities of our tasks. We are more than willing to assume responsibility for the job we are assigned to do. However, with limited resources and constant reduction in staff, we are stressed to the limit. More personnel will be needed to accomplish a Supplier Registration law change. We would suggest an auditor, clerical or agent would be needed to evaluate the information collected and respond to complaints and take administrative action against violators.
- ▶ Currently we have no way of controlling or monitoring false shipping invoices. Invoices indicate products are being shipped to a wholesaler, but actually are received by another wholesalers, possibly in another state. The Minnesota

John M. Williams  
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Liquor Control Division should be in control of this information and address problems related to it. Without Supplier Registration, we are in the dark.

The following is a case report from an agent to illustrate one thing that possibly could have been prevented with a Supplier Registration.

A year ago agent XXX, myself and a revenue investigator worked a case involving the shipment of liquor through Minnesota to Japan. The transaction was handled by a man who claimed to be an ex employee of a Minnesota wholesaler. Revenue had LB 37's showing the name of the product and how many gallons were shipped in. The product was said to have gone to a warehouse in Little Canada. Little Canada does not have an FTZ and this product was supposed to be going to a ship line in Panama. By the time we caught up with the man, the product was gone. There was no warehouse in Little Canada and he claimed the product never physically arrived in Minnesota. If this were the case, why was revenue given an LB37 documenting the transaction. This salesman was working out of a brief case and was well equipped. In the beginning we did not know how to get good documentation of the transaction. We never found any actual product in Minnesota. Supplier Registration would have given us the records we need so we could follow the transaction much faster. An LB37 showing bulk does not help us. Supplier Registration may have prevented this type of unlicensed broker transaction from occurring in Minnesota in the first place.

This is just a summary, if we can be of further assistance please contact us.

Sincerely,



Fredrick C. Petersen  
Director

# **APPENDIX F**

**TRANSCRIPT OF**

**SENATE COMMERCE & CONSUMER PROTECTION**

**COMMITTEE HEARING REGARDING PRIMARY SOURCE**

**MARCH, 31, 1995**

COMMERCE AND CONSUMER PROTECTION COMMITTEE MEETING 3/31/95

Chairman: Meeting called to order...first bill up is S.F. 936...Senator Solon.

Senator Solon: Thank you very much, Mr. Chairman. The omnibus liquor bill, which has about 17 sections and I think, about 16 are noncontroversial. Director Peterson, head of the Liquor Control Board is here. The first section which came to me from Senator Langseth and I have not checked with Mr. Peterson on this one...definitions of restaurants.

Chairman: Senator Solon, perhaps we should move the delete everything amendment.

Does everyone have the amendment in front of them...A-4...all of those in favor, indicate by saying "I"....opposed? Motion carried. Senator Solon...

Sen. Solon: Thank you, Mr. Chairman. The first one is that the state has set up it's own limits of seating in restaurants...and, I think this started way back when we were having Sunday liquor...so, we have this statewide regulation...what this bill would do is to allow each local unit to decide for themselves whether they want to say restaurants for this purpose is 40 or 100 or 125 and I would like to ask Director Peterson if there is any problem with it. If there is, we would yank it from the bill. If not, we will leave it in. Mr. Peterson...

Mr. Peterson: Mr. Chair, committee members...I am Director Peterson, State Liquor Control Director...we have no objections as this time to this section.

Sen. Solon: Thank you. Section 2 has to do with brew pubs and that agreement has been worked out with the beer industry, wholesalers, retailers. We do have a peer system in place and I believe that all of the players now agree and support this language and there has been some concern here because of this operation in Minneapolis that not only sells beer on the premises, but it also makes its own beer. Since, I don't get over to Minneapolis very often, I can't remember the name of the place...rock something...."Rock Bottom." (name of place mentioned by another committee member) Senator Anderson would know that one. (laughter)

And, I think Section 3...you may be able to help me with that one, Mr. Peterson, but, I think, that removes existing language permitting a brew pub to operate a restaurant that is adjacent to the place of the manufacturer...we agreed that is o.k.

Mr. Peterson: Mr. Chair...this has been worked on extensively for two weeks by all levels of industry and this is the agreement that was reached by all parties.

Sen. Solon: Thank you. Section 4 is the one, I believe, that has created some discussion...if this is the Bradley thing...and that is the one we call the "gray law" and all of that sort of stuff. I am sure there will be an amendment later to address that further.

In Section 5, establishes a new law relating to brew on premises stores and maybe that is part of what I discussed earlier, but, Mr. Peterson can you help me further?

Mr. Peterson: Mr. Chair. This is a bill that would allow an individual to open an establishment and have the brewing equipment available and people from the public can come in and brew their own "on-premise" for their own home use...they are allowed to brew up 100 gallons a year. I checked with the BATF and if federal laws would allow this without any license...and we have worked with the senator and staff and we've got language here that we agree with and it may establish also all of the tiers we have talked to and we have got an agreement that this would be alright.

Section 6, Mr. Chairman...I would like to bring out a letter so that I can go through that also. We have had some problems in different areas where peoples licenses have been revoked and then they start charging for people to come in...they would allow them to bring in liquor and beer...and they didn't have a license to do that or consumption display permit...so then what they started to do was have them bring in 3.2 beer and there was no law that would stop anybody from doing that...and they could charge people for doing that. Well, now you've got consumption on an establishment without any license or permit or whatever. The city attorney had submitted this language, especially for a case that he is having a problem with now and the individual retailer is going through a lawsuit...he is being charged by the city. I agree with the language that is in here...it would close a loophole that wasn't intended...cause everyone else is licensed to serve or sell and that is what this language would do.

Sen. Solon: Thank you. Mr. Chairman, members...Section 7 came to us from Senator Linda Berglin, who was here and I said she didn't have to stay. This is to issue an on-sale liquor license to the AAUW to be used on the premises that is owned by the association...I have support from various groups in Minneapolis and I urge your support of that one. Mr. Peterson, I hope you can handle number 8.

Sen. Oliver: Mr. Chair, may I just go back please...on Section 6, is that what some people call a "brown bag" establishment?

Mr. Peterson: Mr. Chair, Senator...actually, what this is...they have no license whatsoever and they were charging people to come into their establishment and it might be interesting for you to see the letter from the attorney that explains it in full.

Sen. Oliver: Mr. Peterson, I was just asking if and I don't know much about this business, but there are certain establishments, or there use to be, where you could bring your liquor in and then you would be charged for a set-up...is that the correct terminology or is that the same thing?

Mr. Peterson: Mr. Chairman, Senator...that is called a consumption and display or a C & D license. We still have that and you will see later on in the bill that we are addressing that issue also.

Sen. Oliver: Thank you.

Sen. Solon: Mr. Chairman, Director Peterson changed the caterer's permit.

Mr. Peterson: Mr. Chair, committee members, the catering permit is a bill that was sent out to caterers of all types and the retail association. At present, we have no caterer's permit whatsoever. We do have people that can get an on-sale license and serve on-sale...they have an off-sale license and they have a food permit and they can also sell on-sale. What it really is, is a traveling liquor license and there was no regulation whatsoever for this license. Now, this bill here is a combination of about ten different states that apply to us and has been gone back and forth between these three groups and there may be some objections by some people on this, but overall what it does is it takes those people...primary people...about 80 percent that cater right now and would require them to get a permit if they are going to put on a function somewhere else and they are going to be serving alcohol and then they would also have to notify the Sheriff when they do that or the Chief of Police in that establishment because you are now serving alcohol outside of where you are licensed...so it gives the cities and the counties an idea where all of the liquor is being served and this is the way many states do and it is an attempt at regulating a traveling license before it gets too far out of hand basically.

Sen. Solon: Section 9 is a technical one that just crosses out intoxicating liquor and inserts the definition of alcoholic beverages in that section. Maybe Mr. Peterson could tell us why that is significant, if it is significant.

Mr. Peterson: Mr. Chair, Sen. Oliver, this is the one addressing the consumption and display license...this gentleman was charging people to come into his establishment...the 3.2 beer that he would allow...and this would close that loophole. The only question I have Senator is that I see they have changed the word permit to license ... now, I don't know if that was what was intended or not...I don't believe it was...because if you see it down at the bottom there it says to obtain a permit from the commissioner.

Sen. Solon: Maybe Senate Counsel...we have the word license in place of the word permit in that subdivision under Section 9.

Tom Stafford: Mr. Chairman, Senator Solon, we should probably go back to the word "permit."

Sen. Solon: O.K., Mr. Chairman, on line 9, we would strike the word "license" and insert the word "permit" back in.

Chairman: Sen. Solon makes that motion...any questions? If not, all in favor say "I"...opposed? Motion carried.

Chairman: While we are still on that, Mr. Peterson, so this would then mean that the old habit of stopping at the corner beer joint and bringing in your brandy and having them pour you a set up would not be permitted, is that correct?

Mr. Peterson: Mr. Chair, it would not affect that whatsoever...you can still maintain and get a consumption and display permit...and it would be perfectly legal to do that...just would just stop someone that has no license from charging people coming in with their product. There was a glitch in the law that a very sharp retailer found after his license was yanked.

Mr. Chair: Thank you.

Sen. Solon: Section 10, Mr. Chairman, I am going to move that be deleted. That has to do with bottle sizes in the state of Minnesota and Director Peterson did not like it and others had some concerns, so I move that we delete Section 10.

Chair: Senator Solon moves to delete Section 10. Any questions? If none, all in favor say "I"...opposed...motion carried. Sections will need to be renumbered later.

Sen. Solon: Section 11 comes from Senator Keith Langseth and permits the Clay County Board to issue one on-sale liquor license and he was here and I said I did not think the committee would vote against your one liquor license for Clay County on approval of the County Board.

And, Section 12 permits the International Falls City Council to issue one temporary on-sale intoxicating liquor license...that came from Senator Lessard.

Section 13 comes to us from Senator Spear who is in the audience and permits the Minneapolis City Council to issue one on-sale line license. Would you like to address that, Senator Spear?

Sen. Oliver: Mr. Chairman, Senator Solon...Section 12, I note that the place that is going to dispense this intoxicating liquor is owned by the independent school district. I assume that any liquor dispensed is not in conjunction with the school or any school activity.

Sen. Solon: Mr. Chairman, Senator Oliver, maybe Mr. Peterson can elaborate further, but this is going to be held during June and July when I presume that school would be out. Actually, it might be more successful if it were held during the school year. (laughter)

Sen. Oliver: Mr. Chairman, Sen. Solon...I see that this is a special event and it is simply using this facility. Thank you.

Sen. Spear: Sen. Samuelson and members of the committee, this section involves the Broders pasta bar at 50th & Penn and the voters; who are here today with their family, have an Italian delicatessen on the north side of 50th Street...they serve no liquor there, but they recently opened a pasta bar across the street and the problem is that the Minneapolis city charter says that no liquor license can be issued in a commercial area of less than seven contiguous acres and this is a smaller commercial area. This provision was put into the charter before we even had wine licenses, so no distinction was made between liquor and wine licenses...the Broders want only a wine license...there is no objection from the neighborhood...the City Council members support it...and this would simply enable the Minneapolis City Council to do that without having to go through the whole process of the charter amendment.

Sen. Solon: We support that Mr. Chairman.

Chairman: Any questions of Senator Spear?

Sen. Oliver: Mr. Chairman, Senator Spear...you mean all intoxicating beverage licenses in Minneapolis are within an area of seven acres? Contiguous acres of commercial? Maybe I misunderstood.

Sen. Spear: Not seven acres for that particular commercial establishment, but it must be in a commercial zone...that is zoned commercial for seven contiguous acres...so, you cannot have a liquor license in an area that is primarily residential...zoned residential...in which there are one or two commercial establishments...and, if you are familiar with the little shopping area at 50th & Penn...there are commercial establishments in all four corners, but it is a very small area and it does not constitute seven acres...so, a liquor license cannot be issued for that area.

Chairman: Thank you, Senator Spear.

Sen. Solon: Thank you Senator Spear and the Broders for being here. Section 14...that looks very controversial. Sen. Janezich wants to make sure that everyone gets an opportunity to drink in St. Louis County...and, it is in the Township 65, Range 18, Section 33. So, we need one more liquor license here.

Chairman: Sen. Janezich, I have been to some conventions up there and I thought that was a requirement. (laughter)

Sen. Solon: Section 15...and, Sen. Bertram was here earlier and this is a one combination off and on sale intoxicating liquor license for Stearns County and I have told him that...I assured him that the committee would be supportive. So, he is in Room 15 if there is any reason to need him.

Section 16 is a repealer. I do not know what it repeals...so, maybe Senate Counsel can help me. Does anyone want to tell me what it does.

Mr. Peterson: Mr. Chair, what that does is clears up the language of the brew pubs that we have gone through earlier where everybody had agreed on...and, this section is actually being put in the regular part of the bill, so it is no longer needed...so, that is why it was repealed.

Sen. Solon: Section 17 has the effective dates and Director Peterson says we do need some other technical language added.

Mr. Peterson: Yes, Sen. Solon, Mr. Chairman...to make it uniform in the brew pub language on page 2 of the bill, line 36, I would request we insert the word "importer" right after the comma behind brewer and before "or." If you look on page 3, lines 4 and 6, and there is one farther back, it just makes it consistent with the rest of the language that was omitted.

Sen. Solon: So, what we need to do, Mr. Chairman, is to add the word "importer" on page 2, line 36, in the appropriate place.

Chairman: Does everyone have a copy of the amendment? Any questions on the amendment? If not, all of those in favor, say "I"...opposed? Motion carried.

Sen. Solon: Mr. Chairman, again I want to thank all of the people who have worked together in trying to work out compromises and agreements and work with Mr. Peterson and with our staff to put together, I think, some good legislation. And, with section 10 out of the bill, I think that we are in pretty good shape. I do know that Section 4...there has been a lot of discussion on that issue...and, it is in the bill and you know my position...and, if that amendment is going to be offered, I would ask that Mr. Peterson would have an opportunity to express the Department's views.

Sen. Janezich: Mr. Chairman, I will offer the A-5 amendment while Mr. Peterson is there...and, the A-5 amendment deletes Section 4. Actually, what it does is just leave the language alone.

Chairman: Mr. Peterson would you like to make comments on the amendment? And, there are some other people who would like to speak as well.

Sen. Solon: Mr. Peterson says he would like to wait and it might be more appropriate for him to speak later.

Chairman: Mr. David Gewolb...

Sen. Kroening: I wonder if I could ask Mr. Janezich why he wants this amendment?

Sen. Janezich: Sen. Kroening. Over the last two years...especially last year, the same issue was brought to this committee. And, at that time, the issue failed and, at that time, I got involved in this issue with the idea that between last year and now...our friends would sit down and work through what supposedly is the problem. Well, I always find it ironic when those kinds of things don't happen...especially because the last time we voted to leave the language alone, the vote was like 8 to 4. The issue here...and, I am going to do my best to explain it without spending a whole lot of time...is about the purchasing of alcohol by a wholesaler. At one time, back in the early 70's, we had a law...the Coleman law, I think...which, pretty much said that you can only purchase certain brands from certain people...in other words, you can only buy Windsor from one person...you can only buy Mist from somebody. And, what effectively happened was while you were doing that, you had to buy some other things that you didn't necessarily need and, the price of one particular item was dictated. What appears we are looking at doing now is doing that to the wholesaler in the market...in other words, putting the kind of pressure on the wholesaler to just purchase from one particular distiller. During that period of time, the argument is the price. Either way, I think the argument that the price goes down or up...I'm not sure...other than the way you buy things in the industry is different. And, I believe, in general that currently the way that it is being done, is just a better way to do it. At least, until some people that are our friends can work out something better.

Sen. Kroening: Well, Mr. Chairman, Sen. Janezich...so let me get this right. You're mad because we didn't sit down and talk about it?

Sen. Janezich: Now, Mr. Chairman, Sen. Kroening...I think what currently is the issue is...don't break what's working. Alright? And, it is working...until someone finds a better way...and, currently no one is finding a better way.

Sen. Kroening: Well, Sen. Janezich, who does it work for?

Sen. Janezich: I think ultimately who it works for is the retailer.

Sen. Kroening: Well, I thought we were working for the consumer.

Sen. Janezich: Mr. Chairman, Sen. Kroening, if it is working for the retailer, it will work for the consumer.

Sen. Kroening: Oh, yeah. Well, perhaps, but I think there are lots of other people involved.

Chairman: Let's hear testimony from those who are interested.

Mr. Gewolb: Mr. Chairman, members of the committee, my name is David Gewolb, I am President and General Manager of Bellboy Wholesale Liquor Company, located in St. Louis Park. However, today I am speaking on behalf of the Minnesota Wine and Spirits Council, which is a group of Minnesota-based liquor wholesalers consisting of approximately 1,200 employees working throughout the state of Minnesota. I am here today to oppose a provision in S.F. 936 dealing with brand registration, or to put it more simply, the primary source law. I would ask that you consider the severe consequences this would place on Minnesota wholesalers, retailers and most of all, Minnesota consumers. The Minnesota consumer has the ability to search and shop for the least expensive bottle of liquor in his or her city. The consumer has the freedom to shop wherever they choose. In 1973, the Coleman law made it possible for the retailer to buy liquor at drastically lower levels. The restaurant owner, the bar owner and the storekeeper has the freedom to find the cheapest price available in the wholesale market. The wholesale set-up in Minnesota allows for nationally popular brands to be carried by any licensed wholesaler in the state. Thus, giving the retailer the freedom of choice. Since the consumer and the retailer both have the ability to buy liquor at the lowest possible price available, it is only fair that the liquor wholesaler has a similar ability to search and find the lowest price possible. A change in S.F. 936 would force the wholesaler to buy from the primary source. The primary source in this case are the foreign-owned distilleries that have over-priced their product to the consumers of Minnesota. I ask you why is Chivas Regal \$30 to \$40 less a case in Europe than in Minnesota...I ask you why is Johnny Walker scotch \$30 to \$40 less a case in Japan...and I ask you why is Absolut Vodka \$30 to \$50 less in Russia. And, most particularly, why is Jack Daniels bourbon \$30 less a case in some other states in the country. Why should the people of Minnesota being paying the highest price in the U.S. We are being taken advantage of by the primary source. Allow us to find these savings available throughout the free world market. Don't keep us captive to an unfair and restrictive pricing system set up by the distilleries. The current law allows us to have the freedom and is non-restrictive. Minnesota retailers and, most of all, Minnesota consumers all benefit from our ability to purchase our products at the lowest possible price. Our association is very proud of

the fact that Minnesota is currently the largest exporter of spirits in the U.S. I ask you to allow us to continue along this path...don't allow outsiders to project an unfair and restrictive pricing system upon the people of Minnesota. Minnesota Wine Spirits Council thanks you for your consideration on this very serious matter.

Chairman: Thank you. Are there any questions for Mr. Gewolb?

Sen. Kroening: Well, I was here last year and I think the same testimony said that the price was going to go down. And, as I understand the price is going up. I am not going to compare it to Germany or Japan because I am not going to go over there and buy that. My point is that I can't...I can't afford the airfare, but my point is they said the same thing last year...I think, that the price is going to go down in Minnesota...and, it hasn't...it has gone up. Forget about comparing with Japan and all of those other places.

Mr. Gewolb: The prices are going up because the distilleries have this control of raising prices. We want another avenue to buy liquor...we don't want to be forced to buy liquor from one particular spot. It is like you going...being told that you can only buy a suit of clothes at Dayton's and if there is a store five blocks away that has a lower price or a better product, you are not allowed to go to that other store. We just don't want to be restricted to buying one product at one particular place.

Sen. Kroening: Well, Mr. Chairman, I didn't say anything about where you buy it...I've got my pocketbook here and I want it and the price is going up...that's all I am thinking about. Sorry, you misunderstood me.

Sen. Janezich: Well, Mr. Chairman, Sen. Kroening. Actually, from what he is talking about compared to what I, as a retailer, have to sell it at...that does become the issue. And, in general, in January of this year, so did the price of beer, so did the price of chips. For all practical purposes, in the last four to five months, everything that went on inside a retailer's establishment for the most part has gone up. Now, what the retailer ends up doing is like the wholesaler...I, for instance...when the price of beer went up 50 cents a case in January, I ate the 50 cents. In the community next to me, they raised the price of their product. So, I think that those decisions do help the consumer and are made ... which do drive the price up or keep it the same.

Chairman: Thank you very much. Thank you for your testimony. Senator Stevens wanted to testify on behalf of supporting the amendment, I believe.

Sen. Stevens: Mr. Chair and members...I am Senator Dan Stevens...not having the benefit of sitting and listening to the issues the last-couple of years, I have asked Senate Research to do some fact-finding for me, but I think it goes back to the fact that everything that has been done in the past has been intended to foster competition amongst the distillers and distributors here to address the problems that Sen. Kroening is bringing out as to the benefit of the consumer who purchases directly from the retailer. Beer and wine continue to be regulated under primary source provisions, but essentially, if this amendment of Mr. Janezich's does not succeed, then a Minnesota distributor could not solicit the international market for the best price on any given

brand. And, I think that is what it gets down to...we have addressed in law at a federal level and at state levels concerning monopolies and the free market system in this country is bound to work very well. You just heard previously from the witness that said this would affect 1,200 employees...of that, a Minnesota company that would be adversely affected is in my district in Princeton, Minnesota. We are talking a Minnesota company here...we are talking Minnesota jobs...we're talking Minnesota taxes here...versus what? I think this is what the balance is...we've been talking international distillers vs. Minnesota companies. And, it is estimated that this could cost my district as much as 200 jobs if this amendment fails and the language in the bill stays in there.

Chairman: Any questions for Senator Stevens? Thank you very much. I believe that Claudia Brewington wants to speak to the issue.

Claudia Brewington: Good afternoon Mr. Chairman, members of the committee, my name is Claudia Brewington. I am the North Central Area Director for DISCUS, the Distilled Spirits Council of the U.S., which is a national association of distillers and manufacturers that distribute over 80% of the distilled spirits in the U.S. I am here on behalf of the companies of DISCUS to testify in support of Section 4 as it appears in the delete all amendment and in opposition to the amendment that is before you to delete that section. Minnesota's primary source law currently protects wine makers and brewers and consumers in all the states regulatory interests by requiring that licensed wholesalers purchase their product from the manufacturer or their authorized agents. This language in Section 4 would require that all alcoholic beverages be regulated in the same manner. This language would no longer allow the most highly taxed of the alcohol beverage products to be excluded from the protection afforded by the primary source laws that benefit not only manufacturers, but also the state and consumers of distilled spirits. Currently, no other state allows what Minnesota allows. We have created through our liquor, tax and other laws an environment where it is not only conceivable, but also highly likely that all excise taxes are not being collected on the most highly taxed commodity sold in our state. In 1991, the primary source law on distilled spirits was stripped from the law books leaving consumer rights exposed and compromising our ability to collect state excise taxes. This repeal has made it very difficult to track the movement of distilled spirits into and out of Minnesota, hampering the state's efforts to collect excise taxes. This is no small matter. Last year, the state collected \$56.2 million in liquor excise taxes with \$38.6 million of that coming from distilled spirits. This does not include the additional 9% sales tax imposed on alcoholic beverages and the license fees that are collected, which amounted in 1992 to \$105.7 million. No other state allows what MN allows. As a result, we have become the market for the national and international movement of distilled spirits, some of which are of questionable safety and quality. Oklahoma retained the top honors for years going back before prohibition as the home of the bootlegger. Any thing could be sold by anyone, anywhere and anytime. Even Oklahoma has come around and now at least they collect taxes on those activities. Oklahoma is also working right now to institute a primary source law for distilled spirits. Three years ago, Oklahoma passed a law that imposes excise taxes on all alcoholic beverages that come into and go out of the state, even if they are purchased by an Oklahoma wholesaler expressly for export to Minnesota or elsewhere. Primary source laws are for the cheapest and easiest means of collecting taxes. Under primary source laws, manufacturers reports and wholesalers reports to the state about shipments can easily be used to verify each other, much like double entry

accounting systems. Revenue staff can quickly audit collections. These revenue records could also be used to save lives in the event of a recall of tainted product. The paper trail created by primary source makes product extremely easy to track from the time it leaves the manufacturer's door to the time it shows up on the retailer's shelf. Primary source also controls the entry into MN of gray market goods. These goods pose threats to the consumers, to the manufacturers and to American jobs. With primary source, consumers get the brand name product they believe they are buying, not a product formulated for another market half way around the world, not a product that has been incorrectly transported or stored, not a product that is designed to fool the consumer (like a knock-off or counterfeit product), not a product that is in an original package, but refilled with something other than what the label claims. When consumers get the product they believe they are buying, trademarks are protected. The benefits resulting from the investment to build and maintain a market are rewarded to the investor, the manufacturer, not the pirates that ship gray market goods indiscriminately eroding gray market business and thus weakening American firms. With the passage of NAFTA and GATT, grain market incursions are likely to expand. Primary source would protect Minnesota against these gray market incursions without containing legal trade. The distillers that I represent are not asking for special treatment, we are merely asking to be treated the same as every other manufacturer both within the liquor industry and in the larger world of industry. We want the same protections as Minnesota bottlers enjoy. Currently, Minnesota bottlers have primary source on their product. They can control the distribution of their product. The right to distribute our product is what we are asking for. This is a time-honored principle of American business. Our reputation hinges on the right to control distribution of our product. We strive to uphold the American business principles of respecting quality and purity in our product. We seek through the reinstatement of your primary source law to be afforded the same treatment as other manufacturers. In summary, obviously we have a stake in this...and that is to protect the integrity and reputation of our product and the rights to have control of its distribution. The state of Minnesota and its consumers also have a stake in primary source laws. At a time when every penny counts, when citizens are demanding the streamlining of government and the institution of nonconstrictive, sensible, effective laws and regulations, when international trade is expanding, the legislature struggles to find solutions. Seldom is the solution so simple, so painless, so cheap and so effective as it is with the reinstatement of the primary source law to include all alcoholic beverages.

I would also like to respond to some of the allegations that we would be losing jobs in Minnesota if this were passed. Passing of the primary source law has nothing whatsoever to do with the business in Princeton. The primary source law has to do with importing manufactured goods and what we are talking about is the ability to export to other states and other markets in the rest of the world. Primary source...it is a very serious to threaten to move outside of the state if this law is enacted and I cannot see any reason why this would affect the business and would appreciate it if someone could tell me precisely how that would work.

Sen. Kroening: Well, that is what I cannot understand. I am sure that the business in Princeton enjoys the benefit of the present primary source law in Minnesota, isn't that right?

Claudia Brewington: Madame Chair (change in Chair), Sen. Kroening, yes, they do.

Sen. Kroening: Well, Sen. Stevens gets up and says, well, we are probably going to lose the jobs. Well, if they went to Oklahoma, they would tax everything... wherever they sell it at home or send it out of state. They don't have that primary source there. Now, let's see, I've got a primary source and I've got a job up in Princeton and I am against this thing. I don't understand. There must be something hidden that I don't see. It can't be the job issue, because that doesn't make any sense to me.

Sen. Belanger: Madame Chair, Miss Brewington...what is it that Minnesota has and nobody else has...that you kept referring to.

Claudia Brewington: Madame Chair, Sen. Belanger... Minnesota has a set of tax laws and another set of liquor laws that have allowed a tremendous amount of gray market products to move in and out of Minnesota in a way that is very difficult to track and sets up a situation where it would be very easy to lose the collection of the excise taxes due on product that remains in the state. If I might add, Sen. Belanger, the product that is produced to stay in the state of Minnesota and for export to other states, under the Phillips label does enjoy primary source. Retailers, in fact, as I understand it, the Phillips brand which is given exclusive distribution to one wholesaler who can distribute that product..the other wholesalers can't get their hands on it because one person has exclusive rights. This was an exception, an exclusion, that was written into the Coleman Act in 1973, to accommodate the Phillips label and that business. Minnesota has in their laws, worked to create a favorable place to do business and the Coleman Act was one of those, and the Coleman Act requires that the distillers, who I represent, sell their product to every licensed wholesaler in the state at the same price...and, that is not the case with the Phillips brand. A retailer, if they want to put Phillips on their shelf, has to buy it from one wholesaler.

Sen. Belanger: Madame Chair, Miss Brewington...have you got another bill in the tax committee?

Claudia Brewington: Madame Chair, Sen. Belanger...no, I don't.

Sen. Belanger: You talk about our system of taxes, but there is nothing in here that affects the taxes.

Claudia Brewington: Madame Chair, Sen. Belanger...this does affect that the primary source facilitates the collection of taxes by providing the paperwork to the Department of Revenue for the quick and easy identification of excise taxes that are due and eases collection.

Sen. Kroening: O.K., what I see is this, Miss Brewington, they are hauling something in here from another place and slapping the Phillips label on it, perhaps, and selling it under that provision exception in the Coleman law. Is that what you are talking about?

Claudia Brewington: Madame Chair, Sen. Kroening, no that is not what I am referring to...there is the possibility under the current primary source of law for distilled spirits, wholesalers can buy distilled spirits from any source they want to in the U.S., across the world, wherever they want to...they don't have to buy it from the manufacturer who was required to

register their product with the state of Minnesota. The Phillips brand is produced in Minnesota and it is a rectifier, they are not a distiller...they purchase the raw alcohol and mix it.

Sen. Belanger: Madame Chair, Sen. Janezich...you are in the business. Have you ever questioned the product you've gotten from your wholesaler, whether it was really what the label said it was?

Sen. Janezich: Madame Chair, Sen. Belanger...the assumption is that nobody is paying attention. When we purchase, we pay attention to the label, we pay attention to the price, we get a book. Every week, the salesman will drop off a book or two weeks or once a month. In that book, it will state how much their product is, the name of the product, how much it costs. Alright? Currently, what happens is the salesman, who are the wholesaler's representative, have different prices and are very competitive all of the time. So, that you do have a group of choices out there. The Phillips brand at one time was a separate company in Minnesota and they just handled Phillips products plus whatever at that time, back about 10 or 15 years ago, I would guess. At that time, they purchased what we would call primary brand types of things. So maybe they just have Windsor, plus Phillips products. Well, what I believe happened...one of our wholesalers purchased Phillips and back then the Phillips name brand was maintained in Minnesota, if you want to buy a Phillips product, you can buy it from only one particular wholesaler in the state of Minnesota. For Phillips products back then, vodka was their number one product. At that time, they put it out cheaper than anybody else and it did have a good market. Today, Phillips Vodka is not the only vodka...there are other brands of vodka that do well in Minnesota and it is far more competitive because of that.

Sen. Oliver: Madame Chair, Miss Brewington...you made a statement that excise taxes were not being collected. Could you elaborate on that because it seems to me that is a very serious allegation.

Claudia Brewington: Madame Chair, Sen. Oliver...to clarify what I had said. We have created a situation where it is very possible and highly likely that there could be nonpayment of excise taxes that are due. Unfortunately, without primary source on distilled spirits, we can neither prove nor disprove that this was occurring.

Sen. Oliver: Madame Chair, Miss Brewington, that is much different from your statement that you made in your testimony. You flatly said that excise taxes were not being collected. You also spoke of NAFTA and GATT and my understanding of this thing that we are talking about...free trade...we're talking about knocking down barriers...talking about eliminating tariffs so that goods move back and forth and we have more trade. Could you explain to me how your position is enhancing that.

Claudia Brewington: Madame Chair, Sen. Oliver, yes. The gray market brings in good that are often times of inferior quality...they are goods that have been formulated and manufactured with a different market in mind...they are often times going to a market where the costs of the overhead and the investment is far less than it is here in the domestic market. The standards under which they are manufactured may not be the same as they are here in the U.S. The types of situation we in no way are asking to restrain legal trade or the kind of trade that will benefit

U.S. firms and agrees to the letter of the law with NAFTA and GATT. What we are concerned about is the erosion of American trademarks whereby an affiliate in another country...the only example that I can think of right off of the top of my head is something like Coca Cola who bottles their product all over the world and authorizes that bottling. Many of us who have been in Mexico or Europe...that product tastes very different there than it does here. It has been manufactured for the particular market there. What we have seen happening is that product that may be authentic, which is Jim Beam, which is shipped someplace else and is reformulated is shipped someplace else and is brought back into the U.S. It is bought by someone other than the manufacturer and it is brought back into Minnesota. The manufacturer, where they have built up the market here through advertising and through servicing...where they have to carry certain liabilities and they are the ones that are responsible. That is not the case of the grain market goods that are coming back in. In some of the distilled products, notably the ones that contain cream like Baileys, that product if it is not stored or transported correctly can break down. It is also formulated differently for different markets...they use artificial vanilla in some markets rather than they do for the ones that are intended for domestic consumption. So, what you have is a different product competing with something under the same trademark and there is no way to tell which one is the one that the consumer has built up a sense of loyalty to and they abandon the trademark when the quality of that product does not hold up.

Sen. Oliver: Madame Chair, this is the last statement from me. What you have been saying is the same things that I heard from persons who opposed NAFTA and who opposed GATT, and I find that a little hard...in other words, that's the same kind of arguments people were making who were against NAFTA and against GATT and I find that sort of interesting. Thank you.

Chair: Sen. Stevens, even though you are not a member of this committee, I will offer you the courtesy...you had a question and I'm almost treating you more like a witness, but I know you have a question you would like to ask.

Sen. Stevens: Well, Madame Chair and members, in response to the reference to the Princeton company and the Princeton company is not only a distiller, they also operate an import/export business as well. Some history that I neglected in my testimony is that they came to Princeton about 12 years ago with fewer than 100 employees...they have had 12 business expansions up there in the last 12 years...one every year. They operate in a million square foot building now and employee approximately 400 employees. I don't want to confuse the issue that the witness is talking about as far as distillers...there is also the import/export business up there, which is a very large part of the business. The other point I wanted to make as far as the total primary source law is, to the best of my knowledge, 29 states do not have a total primary source law as being proposed in this amendment.

Claudia Brewington: Madame Chair, Senator Stevens...this bill would in no way impinge the ability of the plant in Princeton to continue their import/export business...it doesn't have anything to do with that from what I can see. It has to do with importing manufactured goods...completed goods into the state of Minnesota. They can continue to bring things in, place them in the free trade zones, and export them anywhere that they want to...and that is something that is currently taking place and won't change. Additionally, of the 33 licensed states, 29 of them do have some kind of primary source protection and most of them have

complete primary source protection. Of those 33, there are only three that have none or only partial primary source protection. It is something that is working very well...has worked for a very long time in those markets. The businesses there continue to do well. It is something that works in the state of Minnesota for wine and for beer. One of the things that struck me when I went over to the Department of Revenue to look over the records was how easy it was to track product for wine and beer...to look at the tax receipts and match them up. I could see where it had come in and where it was going and what tax was collected. Conversely, it was almost impossible to do that...I never did figure out how to do that with distilled spirits.

Sen. Kroening: Sen. Stevens, first you brought up the fact that you might lose jobs and then you say the benefit comes from the export business and I say o.k., but how does the state benefit from all of this?

Sen. Stevens: Well, Madame Chair, Sen. Kroening, just like any other business, by taxes.

Sen. Kroening: Well, the problem we have is that it is hard to track those taxes that we get from that export business. Whereas, most of the other states tax ....

Sen. Stevens: Madame Chair, Sen. Kroening, I don't think there has ever been any proof that my company up there doesn't pay their proper taxes, whatever business they are in...whether it is import/export, whether it is a distillery, or whatever it is. They pay taxes just like any other Minnesota company.

Sen. Kroening: I suppose, but we just had the witness say that it is difficult...with the Minnesota produced spirits, the wine and beer, it is easy. Isn't that what you said, Miss Brewington? (She agrees) O.K. and with this other business, no one can find out where...I think that is one of the central issues.

Sen. Stevens: Madame Chair, Sen. Kroening...if there was a problem in the 12 years that they have been in business in there as far as not paying excise taxes, I'm sure....

Chair: O.K., I think we are going to get off of this subject. Let's hear from the Director of the Liquor Control Board, Mr. Peterson...welcome. Maybe you could shed a little light on this...just a little.

Mr. Peterson: Madame Chair, the bad part about getting the request that I asked for was coming on last...then no matter what this committee decides, I will probably be blamed for it...so, I'll take that, but I would like to say.

Chair: Would you please state your name for our tape?

Mr. Peterson: Fred Peterson, Director of State Liquor Control. For three years, I have tried to get people together to solve this issue, and I will be blunt, there is no middle ground on this issue...none. The committee will have to make that determination one way or another. We are neutral as a Department on this. I don't care where liquor comes from...retailers have the opportunity to buy where they want to buy, but I know who they buy from so that I can follow

it. The other states that are not primary source...generally speaking, and I may be wrong on some of this...most all do, they have what is called a "supplier's license." I know not what where it concerns from and that is what my concern as the Department is...I could concern myself less about taxes...that is not my issue, that is state revenue. I would like to know where it comes from ... just a "supplier's license"...one state that does this and it works quite well is that they even let the wholesaler's themselves apply for that minimal supplier's application and license with the state liquor control. So, it is not inconvenient when you buy it in a foreign country ... they can do that here, because they can do business with them when they are buying it. Even with that, I will probably be in trouble by saying that, but I mean that my point is we should probably know where it is coming from, but don't dictate maybe who they buy from...I guess that is where I would be.

Chair: Are there any questions for the commissioner?

Sen. Limmer: Madame Chair, Director...if we leave Section 4 in the bill, does that enhance or detract from your ability to enforce the liquor laws that you are given charge over?

Mr. Peterson: Madame Chair, Sen. Limmer...there is no question about it...that is why I stated what I did when I started out here...I don't know where it comes from...so, if I had primary source, of course, I would know where it comes from, but there are alternatives to that.

Sen. Limmer: This is a real confusing issue for me. I am new to this committee and it is probably confusing for a lot of people and between the two sides, it seems like I have been lobbied in the Portuguese language on one side and sanskrit on the other and I don't know either language, so that a lot of the definitions and terms that I have learned in the last seven to ten days are on a fast learning curve. We have heard accusations of quality control, we have heard suspicions of whether taxes are paid or not paid, whether revenues are coming into the state or whether they are not. Director, can you give any comment. I mean, is the quality that comes into the state, is that an issue that we should be directing ourselves on in this narrow focus or not?

Mr. Peterson: Madame Chair, Sen. Limmer...to be very honest with you, we have taken a few samples, but not many and my answer would have to be that it probably is not at this time, but I would like to just add here so that you know exactly where I am at and if you can get any bureaucrat to do that...it ain't bad, I guess, but the answer is that I am probably right in between and I can't get an agreement...I will probably have both sides mad at me here, but I want to know where it comes from so that if we do have a quality problem, we can find out and tell other states and tell other states..you know, have you got a problem with this and pull it back. So, therefore, I am not satisfying prim source people and, therefore, I am probably not satisfying people on the other side because they are now probably going to have to have these people register who they buy from, but on the other hand, you probably see on the news, where if you go to China, I think it was, you can buy a Honda, but let's say it was a fake Honda because they don't have laws that tell where it came from or where it goes...so, all I am saying is that I would like to know where it comes from. And, that is my key issue in this whole thing. I could not get anybody to agree on both sides to do this and that is why I did not submit a bill

this year to do that and I was just hoping we could hear it one more time and probably I would submit a bill to say can we have a supplier's license.

Chair: Are there any more questions for Mr. Peterson?

Sen. Price: No, not for Mr. Peterson. I would like to ask the Department of Revenue, who I know has a representative here...to answer some questions about revenue.

Chair: Welcome to the committee and please state your name for our tape.

Mr. Hoyum: Thank you Madame Chair, my name is George Hoyum and I am Director of the Special Taxes Division at the Department of Revenue.

Sen. Price: Madame Chair, Mr. Hoyum...we use this method that has been discussed here today to collect taxes. I guess what we need to hear from the Department of Revenue is, how does this work...is it working well...what does the Department of Revenue have as an opinion about this Section 4 of the bill.

Mr. Hoyum: Madame Chair, Senator Price...the Department of Revenue has no position on the bill. The taxation of distilled spirits occurs at the wholesale level when the wholesaler transfers control of the product to a retailer. We receive a report from distillers, importers, wineries, reporting what they ship into the state, however, as Ms. Brewington testified, we do not receive that report from an out-of-state wholesaler, such as a wholesaler in Oklahoma, so that is one gap in the reporting system. However, the receiving wholesalers report those receipts on the returns...we have audited for those receipts. We look also at disbursement records. We have not yet found or had reported to us any evasion occurring through this mechanism...I suppose the opportunity would exist for someone to attempt that.

Sen. Price: Madame Chair, Mr. Hoyum...would the primary source method make it easier for the Department of Revenue to know for sure.

Mr. Hoyum: Madame Chair, Senator Price...the primary source legislation would require that all product shipped lawfully into the state be reported to this on the manufacturer or importer's report.

Sen. Price: Thank you, Mr. Hoyum.

Sen. Oliver: Madame Chair, Mr. Hoyum. Do wholesaler's to sell to anyone else other than retailers?

Mr. Hoyum: Madame Chair, Senator Oliver...yes, wholesalers sell to other wholesalers, including wholesalers outside the state of Minnesota.

Sen. Oliver: Madame Chair, Mr. Hoyum...is there a tax involved in that sale...in that transaction?

Mr. Hoyum: No, those are exempt from the tax.

Chair: Any other questions for Mr. Peterson? Thank you, Mr. Peterson.

Mr. Hoyum: Mr. Hoyum.

Chair: Oh, I am sorry, Mr. Hoyum...too many committees.

Sen. Solon: Madame Chair...I don't know if anyone else wishes to testify. We have had an hour's discussion on this issue. I am sure that it is a very difficult choice for members of the committee...just do what you think is best for Minnesota.

Chair: We have before us the A-5 amendment. Sen. Janezich renews his amendment. All of those in favor indicate by saying "I"...opposed "no"...Chair is in doubt...all those in favor, please raise your hand...all of those opposed...Motion is not adopted.

Sen. Janezich: Madame Chair, Mr. Peterson...on section 8...just one quick question...on the caterer's permit...currently, what I think is a problem...if you are a small community, and you do not have a major restaurant, I believe that the on-sale person...or whatever...do you know what I am talking about?

Mr. Peterson: Madame Chair, Sen. Janezich...what you are talking about is in a small community, they get a temporary license for an event or whatever and it goes for a couple of days or whatever...they are allowed to contract to an on-sale to come in and do that banquet and have the liquor and everything...they would still be allowed to do that...that certainly is not affecting that...they would still be able to do that.

Sen. Janezich: Madame Chair, Mr. Peterson...so that an on-sale license...let's say they want to have the party at the arena...on-sale could move the license there and the food is catered from somewhere else?

Mr. Peterson: Madame Chair, Sen. Janezich...there is no law that allows an on-sale to go any place else right now without being contracted by the holder of a temporary license...there is none right now. If the Jaycees put on an event at the arena or whoever, they pay about \$10 or whatever to get a temporary license. They come to an on-sale bar and say we are going to put on this event...will you put it on for us for fifty people or whatever and they can do that now...even with this. I would like to be honest with the whole bill here so that everybody understands it. There is one area here that reduces, it does not stop what this will reduce. You may have a person who has a catering license, but not a liquor license because they have no place or establishment...they have always been food licensees...what they have done in the past is that they cater to the contract or whoever wants to have the meal put on and then they say you buy from the off-sale of your choice and then you bring it here and then we will go ahead and cater our meal and everything else and the liquor is here and you have bought it separately. Those people, that by a mistake by some people in my office, issued an off-sale to people like that, they had no off-sale store so they were buying an off-sale license, now they have an off-sale...then they had an on-sale because they were serving, plus they had food. So, we are

talking a violation that no one else could ever have...so, we are trying to clear that area up. It won't stop those people, it will just mean that they will have to let other people...

Sen. Oliver: Madame Chair, could you announce the count on the vote?

Chair: Yes, Sen. Oliver...it was "seven yes" and "eight no."

Sen. Solon: Madame Chair...I thought there were 14 people present...I thought it was "seven" and "seven"...which would have still beat it.

Chair: There are 15 members of our committee and everyone was here.

Sen. Solon: O.K. Was Senator Chandler here? Yes, Madame Chair, I counted it...you are correct.

Chair: Senator Solon, you move the bill as amended?

Sen. Solon: Senate File 936 as amended is recommended to pass.

Chair: S.F. 936, all those in favor indicate by saying "I"...opposed...the motion is adopted and will be referred to the floor.

Sen. Solon: Thank you very much.

# **APPENDIX G**

**LETTER FROM (A) GEORGE HOYUM, DEPARTMENT OF REVENUE,  
STATE OF MINNESOTA**

**RESPONDING TO (B) LETTER FROM RON WILLIS,  
DIRECTOR OF ALCOHOLIC BEVERAGE LAWS ENFORCEMENT  
STATE OF OKLAHOMA**

Special Taxes Division

Mail Station 3331  
Phone (612) 297-1882  
Toll Free (800) 657-3618

St. Paul, MN 55146-333  
Fax (612) 297-193

December 5, 1995

" A "

Mr. Ron L. Willis  
Director and Secretary to the Commission  
Alcoholic Beverage Laws Enforcement Commission  
4546 North Lincoln Boulevard  
Oklahoma City, OK 73195

**Re: Minnesota Alcoholic Beverage Tax Reporting Requirements**

Dear Mr. Willis:

We have received a copy of Agent Sims Farrow's report of his inspection of our distilled spirits tax return and information filings. I would like to comment on several of his findings.

Agent Farrow states that Dick Kaye and Keith Nelson said that we do not receive reports of all liquor shipments into and out of Minnesota. We acknowledge the possibility that an individual or business might try to circumvent the regulated industry structure or legal requirements. However, we have no knowledge of any such activity.

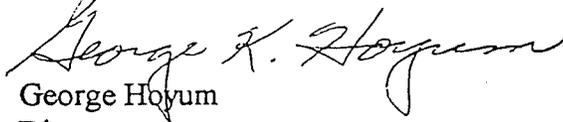
Agent Farrow states, "It was learned that the Distributors and Wholesalers are required to submit only two (2) forms, LB-56, a monthly report of products entering Minnesota, and LB-37, report what alcoholic beverages are shipped out of Minnesota or transferred to other Wholesalers (tax exempt)." Form LB-56 is the wholesaler's monthly tax return. It reports beginning and ending inventory, purchases, taxable and nontaxable sales, breakage, tax due, and other miscellaneous information. Form LB-37 is the importers or manufacturer's report of shipments to licensed Minnesota wholesalers. We cross-check the forms against each other in our processing and edit programs.

The report also asserts that a paper trail would be difficult to follow because Minnesota lacks laws or rules regarding reports of liquor shipped into and out of Minnesota. We do not receive Form LB-37 from suppliers other than the primary source. From our examinations, we believe that is not a significant issue. All primary sources file Form LB-37. Wholesalers' shipments out of Minnesota are reported on Form LB-56. Further, we do not restrict our audits to inventory reconciliations.

Finally, Agent Farrow states that we do not receive reports of Johnson Brothers' receipts at the Foreign Trade Zone (FTZ). We do receive reports of product received by Johnson Brothers, whether at its warehouse or the FTZ. When the product leaves the FTZ, ostensibly in international commerce, it could be diverted into the domestic market. Foreign Trade Zone abuse is a problem nationally, but we have not documented any such abuse of the FTZ in Minneapolis.

If you have any questions, please feel free to contact me at the address or telephone number above. We are willing to receive and provide any information to further compliance with either state's alcoholic beverage laws.

Sincerely,

  
George Hoyum  
Director



STATE OF OKLAHOMA  
ALCOHOLIC BEVERAGE LAWS ENFORCEMENT COMMISSION

DATE: SEPTEMBER 25, 1995 " B "

TO: RON WILLIS, DIRECTOR

THRU: TOMMY MARVELL, SUPERVISOR, SPECIAL PROJECTS DIVISION

FROM: SIMS FARROW, JR., AGENT III, SPECIAL PROJECTS DIVISION

SUBJECT: INVESTIGATION (MINNESOTA LIQUOR WHOLESALERS)

On September 19, 1995, at the direction of Ron Willis, Director, Oklahoma ABLE Commission, Sims Farrow, Jr., Agent III, Special Projects Division, went to Minnesota where he contacted George K. Hoyum, Director, Keith Nelson, Revenue Tax Specialist and Dick Kaye, Revenue Tax Specialist, Minnesota Department of Revenue.

During this meeting it was learned that Minnesota and Oklahoma have the same concerns. That all alcoholic beverages shipped into and out of their respective states be reported to the proper authorities. Dick Kaye and Keith Nelson said it is their opinion that all alcoholic beverages shipped into and out of Minnesota is not reported. With the current reporting system used by Minnesota it is impossible for anyone to know what is shipped into and out of Minnesota.

Agent Farrow made a request to see all records submitted by Minnesota Distributors and Wholesalers. Agent Farrow was given excess to all records submitted to the Minnesota Department of Revenue, Special Taxes Division. It was learned that the Distributors and Wholesalers are required to submit only two (2) forms, LB-56, a monthly report of products entering Minnesota, and LB-37, report what alcoholic beverages are shipped out of Minnesota or transferred to other Wholesalers (tax exempt). These forms are used to report taxable and untaxable liquor sales. In Minnesota liquor tax is paid only when a sale is made to a Minnesota retailer. There is no tax paid on products shipped out of Minnesota. A paper trail would be extremely difficult if not impossible, to follow due to the lack of laws and or Rules and Regulations governing the reporting of liquor shipped into and out of Minnesota.

CARLOS CIAPPALLE - Chairman  
ROBERT V. WILDER - Vice Chairman      JACK GODDARD - Member  
JOHN WRYTELL - Member                      TERRY L. DIONIRE - Member  
JACK E. BLACK - Member                      CHARLES DIXON - Member

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Under current Minnesota law one entity can own and/or control several subsidiaries. Focus was placed on the two largest liquor wholesalers in Minnesota, Johnson Brothers Liquor Company, who owns or controls some 14 plus subsidiaries, some are located in several other states, and Bellboy Corporation. One of many cases was noted where one of Johnson Brothers subsidiaries located in South Dakota had placed an order for alcoholic beverages but the product was shipped to Johnson Brothers in Minnesota. During the check of LB-56 forms it was learned that Central Liquor Company had shipped alcoholic beverages to the Bellboy Corporation in Minnesota on three (3) occasions, 4,020 bottles in October 1994; 2,520 in December 1994; and 2,520 in February 1995. There were no LB-37's or LB-56's indicating any alcoholic beverages were shipped into Oklahoma from Minnesota.

The product goes into a *Free Trade Zone* where it is not reported by Johnson Brothers. There is no requirement for the Johnson Brothers subsidiary to report it to the Minnesota Department of Revenue, Special Tax Division. This product could then be shipped to any one of Johnson Brothers other subsidiaries.

MINNESOTA Department of Revenue  
Special Taxes Division

Mail Station 3331  
Phone (612) 297-1882  
Toll Free (800) 657-3618

St. Paul, MN 55146-3331  
Fax (612) 297-1935

December 5, 1995

Ms. Claudia Brewington  
North Central Area Director  
DISCUS  
1752 Margaret Street  
St. Paul, MN 55106

Re: **Memorandum by Agent Farrow, Oklahoma Alcoholic Beverage Laws Enforcement Commission**

Dear Ms. Brewington:

Thank you for sharing the memorandum that Agent Sims Farrow Jr. prepared subsequent to his September visit. As you know, we disagree with several of Agent Farrow's assertions and conclusions.

In his second paragraph, Agent Farrow states: "Dick Kaye and Keith Nelson said it is their opinion that all alcoholic beverages shipped into and out of Minnesota is not reported. With the current reporting system used by Minnesota it is impossible for anyone to know what is shipped into and out of Minnesota." We *do not* allege that liquor shipments into and out of Minnesota are going unreported. No regulatory structure can guarantee a complete absence of contraband, whether it be alcoholic beverages or another commodity. However, we have no information that licensed wholesalers, manufacturers or any other person is trafficking in contraband alcoholic beverages in Minnesota.

In the third paragraph, Agent Farrow states, "Distributors and Wholesalers are required to submit only two (2) forms, LB-56, a monthly report of products entering Minnesota, and LB-37, report what alcoholic beverages are shipped out of Minnesota or transferred to other Wholesalers (tax exempt)." The LB-56 is the wholesaler's monthly tax return. It reports beginning and ending inventories, purchases, breakage, and sales, taxable and nontaxable alike. The LB-37 is the importers and manufacturers' monthly report of shipments to licensed Minnesota wholesalers. We cross-check the two forms against each other as part of our processing.

Mr. Farrow also asserts that we lack a paper trail. It is true that we do not receive reports from suppliers other than the primary source. Such shipments are relatively

rare based on our analysis of records. Apart from that, we believe that the paper trail is very good. Further, we do not confine our audits to merely tracing the flow of inventory.

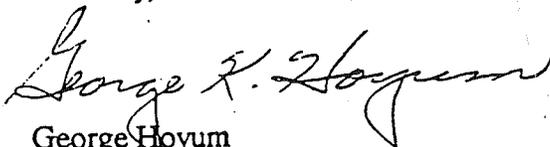
Contrary to Agent Farrow's statement, Bellboy is not one of the two largest wholesalers in the state. Its sales are far smaller than Johnson Brothers' or Griggs Cooper's.

Agent Farrow also cites examples of interwholesaler shipments and a shipment to a Minnesota wholesaler from an order placed by an out-of-state subsidiary. Does he argue that that is a weakness in controls or that such shipments can be difficult to track? He got his information from our records.

Finally, we receive reports of product going into the Foreign Trade Zone (FTZ). When Johnson Brothers, for example, receives product in the state, it reports it to us regardless of whether it receives the product at its warehouse or the FTZ. When product leaves the FTZ, it ostensibly enters international commerce. We are aware of FTZ abuse in many areas of the United States and have participated in investigations ourselves. Our concern, of course, is that untaxed alcoholic beverages and tobacco products will reenter domestic commerce. Thus far, we have no information implicating any Minnesota wholesaler in such tax evasion schemes.

Thank you again for sharing the memorandum with us. Please contact us at your convenience if you wish to discuss this matter further.

Sincerely,



George Hoyum  
Director