The Federal Government has announced it will delay the start of the so-called backpacker tax by six months. The delay has been welcomed by the tourism sector and farmers, who rely on backpackers as a relatively cheap source of labour, especially in the crucial harvest season.

But change to the status quo is unnecessary. The furore appears to be based on a misunderstanding of Australia's residency rules and how they currently apply to backpackers. Enforcement appears to have been the real problem, not the law itself.

In last year's budget (2015-16), then-treasurer Joe Hockey proposed to "change" the tax residency rules to treat temporary working holiday makers as non-residents (foreign residents) for income tax purposes, regardless of how long they are here. The change meant the non-resident tax rate of 32.5% would apply immediately to any earnings, with no tax-free threshold.

Last year's Budget Papers stated:

"…a working holiday maker can be treated as a resident for tax purposes if they satisfy the tax residency rules, typically that they are in Australia for more than six months."

This seems to represent a misunderstanding of one of the residency rules. At best, this can be explained as summarising gone too far.

To be a resident of Australia, a person must satisfy one of the residency tests. In brief they are: (i) an ordinarily resides test (ii) a domicile test and (iii) a 183-day presence test.

The test referred to in the Budget Papers is the third test, the 183-day test; the other two tests have little hope of being met by backpackers. The 183-day test does indeed provide that a resident of Australia "includes a person who has actually been in Australia, continuously or intermittently, during more than one half of the year of income."

However, this test also contains an exception, which reads: “unless the Commissioner is satisfied that the person’s usual place of abode is outside Australia and that the person does not intend to take up residence in Australia.” Mere presence for 183-days is not enough.

People who are temporarily in Australia on a working holiday have a usual abode outside Australia. And they clearly don’t intend to take up residence here. Indeed, just two months before the 2015-16 budget, the Administrative Appeals Tribunal handed down three decisions dealing with the residence status of backpackers under the 183-day test.

The deputy president, Professor R.L Deutsch concluded, in all three cases , the taxpayers were non-residents.

So why did the 2015-16 budget announce a measure to “change” the law to treat backpackers as non-residents when current law already does this?

The most likely explanation is that backpackers had been asserting they were residents in their tax returns to obtain the (effective) tax-free threshold of $20,500 applicable to residents ($18,200 threshold along with the $445 low income tax offset). They were probably advised to do so by backpacker agents, or registered tax agents operating in areas of high backpacker concentration.

One significant downside of our self-assessment system of taxation, where the ATO generally accepts tax returns at face value, is that incorrect taxpayer reporting can go undetected for many years. The tax return is lodged, processed and a tax refund is issued pretty much automatically (assuming some tax was withheld by the farmer on payment).

The backpackers are either out of the country when the refund is paid, or they leave pretty soon after. And, it simply isn’t worth it to the ATO to chase them down. They don’t even have to set up camp on an island somewhere and fake a heart attack to avoid extradition. Not for a tax debt of a couple of thousand dollars.

The above does not describe a problem with the substantive residence tax rules. Enforcement

appears to be the problem. It may be that the 2015-16 budget measure was mainly a signalling to all concerned that the Government wants the tax law enforced.

Effectively, the farming and tourism sectors complaint is that the backpackers should continue to be incorrectly treated as residents for tax purposes, or that something similar to that tax treatment should apply to backpackers. As a result of the announced delay, a full policy analysis can be undertaken which can take account of all stakeholder interests in the issue.

Our best bet out of this review is that backpackers will continue to be treated as non-residents and that a concessional rate of tax will apply to backpackers' "harvest" earnings - and perhaps hospitality industry earnings - of somewhere between 0% and 32.5% (most likely 15%-19%).

Non-harvest earnings and perhaps non-hospitality industry earnings will continue to be taxed under the normal non-resident tax scales (that is, 32.5% from first dollar of income).

The authors do not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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