

Top Audit Red Flags Businesses Shouldn't Ignore

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My recent blog, [So, The IRS Has Selected Your Return for Audit](#), discussed the four types of IRS audits. What factors may trigger an audit of a business's income tax return? The presence of multiple red flags in a business's income significantly raises the likelihood of an audit.

Round Numbers

While rounding 49 cents up to 50 cents is not problematic—the IRS instructs you to round cents up or down for whole dollar amounts—reporting \$10,000 of income from a customer instead of the actual \$10,089 or reporting depreciation of \$7,500 instead of \$7,448 is. The algorithms the IRS uses to select returns for audit are programmed to identify rounding like this because the IRS knows (as we all do) that transactions are rarely in exact round amounts.

Claiming Excessive Expenses

The IRS compares your deductions against deductions for similarly situated businesses, using figures from returns filed by businesses similar in size and industry sector. The IRS has a bell curve for each category of expense. These figures are tweaked by the Taxpayer Compliance Measurement program. Similarly, your business expenses must be ordinary and necessary. Ordinary means the expense is a type common in your business's industry sector. Necessary means the expense is helpful for your trade or business. If your business's figures are excessive as measured against the IRS's figures or the types of expenses are different than what the IRS routinely sees for businesses of your size or type, the chance of your return being audited increases. The more categories your figures are above the norm or are different from what the IRS usually sees, the greater the chances of an audit. It is also a matter of degree. Being slightly high in several categories is not necessarily an audit flag, but being very high in a few categories is a red flag.

It is important to mention business use of automobiles. As a result of changes to the law in the Tax Cut and Jobs Act of 2017, the ability of *employees* to deduct unreimbursed business expenses was all but eliminated. However, self-employed persons (which includes partners in an entity classified as a partnership for federal income tax purposes) can still deduct business use of automobiles. Claiming 100% business use is a red flag. Likewise, because of accelerated depreciation associated with heavy SUVs and large trucks, the IRS may look twice at purchases near the end of the tax year. So, take advantage of that year-end sale but have the records to substantiate the business purpose and use.

Misreporting Income

First, beyond rounding cents, don't round. Second, just because you didn't receive a 1099 doesn't mean the payor didn't file the 1099 with the IRS. If you know you are missing a 1099, call the payor and ask for it otherwise this brings up the next flag.

Large Cash or Large Numbers of Cash Transactions

Some businesses naturally have large cash transactions or large numbers of cash transactions. If a cash transaction is over \$10,000, financial institutions are required to file a currency transaction report (CTR). Breaking a cash transaction into smaller transactions to avoid the CTR threshold is known as structuring and is a crime under federal law. If your business deals in cash, keeping an accurate record of all transactions and documentation is essential in the event of an audit.

Real Estate Rental Losses

The IRS has strict rules regarding the ability to deduct losses from real estate rental against other income. For those who are not real estate professionals, which means you spend more than 50% of your working hours and more than 750 hours each year materially participating as a developer, landlord, or agent, you must own at least 10% of the value of all interests in the activity (spousal interests are combined for this threshold test) and you must actively participate in the operations of the rental property in the year in which the loss is claimed *and* in the year in which you seek recognition of the loss. If you meet these requirements, then you may deduct \$25,000 of losses from real estate rental activity. This deduction phases out beginning with an adjusted gross income (AGI) of \$100,000 and is completely phased out once AGI reaches \$150,000.

Deducting Hobby Losses

Only losses incurred in a trade or business are deductible, which means you are engaging in the activity *with the reasonable expectation* of making a profit *and* you conduct the activity in a business-like manner. If your activity three out of every five years (two out of seven years for breeding horses), the IRS presumes that the activity is for profit. If not, whether the activity is for profit depends on the facts and circumstances. If you claim losses year after year, which is common among start-up businesses, your business will likely be audited. As with other areas, substantiation of expenses is imperative.

Misclassification of Employees

Whether a worker is an independent contractor, in which case your business issues them a 1099 at year end, or an employee, in which case your business issues the worker a W-2, is a hot bed item with the IRS and the U.S. Department of Labor. If a worker is misclassified as an independent contractor, then your business (and potentially you personally) owe employment taxes and withholding, plus interest and penalties. As with other areas, proper documentation (which includes agreements setting forth the worker's independent contractor status) are essential. If your workers are employees (W-2) consistently filing and paying payroll taxes (941s) will also trigger additional scrutiny that likely will result in an audit.

Claiming the R&D Tax Credit

The R&D credit is great—if *your business qualifies and if your business substantiates the credit*. The One Big Beautiful Bill Act (OBBBA) reversed a 2022 law that required businesses to amortize research and development expenses over a five-year period. Businesses are now permitted to expense R&D costs immediately. The OBBBA also provided additional relief for small businesses that applied the new rule *retroactively for the 2022 through 2024 tax years*. Unscrupulous promoters (for a fee that is a percentage of the R&D credit) offer to analyze a business's records to see if the business can claim the R&D credit retroactively. Often these promoters try to persuade a business to claim routine expenses as R&D activities to qualify for the R&D credit (which increases the promoter's fee). Activities that **are not** eligible for the R&D credit include modifying an existing product, customer-funded research, research after commercial production, or research on a product about which there is no doubt about the expected result (this merely confirms what the company already knows). With proper substantiation costs for these activities still are deductible, just not eligible for the R&D credit.

Growing and Selling Mary Jane

Despite the current administration's proposed rescheduling of marijuana, it is still a controlled substance at the federal level. It does not matter to the IRS that marijuana is legal in your state. Because it is illegal, expenses (other than cost of goods sold) incurred in the production, distribution, and sale, even if permitted under state law, are not deductible. Here is the real burn—you must still report *and pay taxes on* the income generated from your marijuana business. Because marijuana is illegal at the federal level, it also means if you invest in a marijuana business you can't deduct investment losses. It also means you cannot

use your self-directed IRA to invest in marijuana businesses. Bummer man.

Home-Office Expense Deduction

If you can take the home-office deduction (see Claiming Excessive Expenses above regarding restrictions on the ability to deduct unreimbursed business expenses incurred by employees), to claim the deduction you must use the space **exclusively and regularly** as your principal place of business. Guest bedroom, bonus room where the kids watch TV or play X-Box? Nope. Exclusive means exclusive. In the IRS's eyes, returns that claim the home-office deduction is a target rich environment. Don't paint a bullseye on your back.

In the end, avoiding an audit is not about fear—it is about diligence. By keeping accurate records, understanding which expenses truly are allowed, and steering clear of overly aggressive tax positions, businesses can reduce their audit risk significantly. Most importantly, thoughtful documentation and consistent business practices provide the strongest defense should the IRS come knocking.