Automatic Exemption from Penalty (AEP)

The IRS is changing how First-Time Abate works

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Beginning in 2026, the IRS is transitioning from First Time Abate (FTA) to a new administrative relief program called the Automatic Exemption from Penalty (AEP). For qualifying returns, the biggest change is simple: instead of waiting for a penalty to be assessed and then asking the IRS to remove it, the IRS system is designed to determine eligibility during original-return processing and prevent the covered penalty from being assessed. [1]

The short answer: AEP can make penalty relief easier, but it is not a free pass. The return type, penalty type, and prior compliance history still matter. Tax and interest can still be due.

AEP versus First Time Abate

Old approach: FTA	New approach: AEP
Penalty was generally assessed first.	IRS checks eligibility while an eligible original return is processed.
Taxpayer or practitioner usually requested abatement.	Qualifying covered penalties should be prevented automatically.
A phone call, letter, or other abatement request could be needed.	No separate request should be needed when the system applies AEP correctly.
Prior compliance history was central.	Prior compliance history remains central.

Which penalties can AEP cover?

- Failure-to-file penalties.
- Failure-to-pay penalties.
- Failure-to-deposit penalties for qualifying business taxpayers.

AEP does not automatically remove accuracy-related penalties, information-return penalties, daily delinquency penalties, or other penalties outside the program. It also does not erase the underlying tax or the interest charged on unpaid tax. [1]

Which return types can qualify?

Current guidance described in the source material identifies these eligible return series: Forms 1040, 1065, 1120, 1120-S, 940, 941, 943, 944, 945, and CT-1. Event-driven returns such as Forms 706 and 709 generally are not eligible. [1]

The compliance-history test

AEP is intended for taxpayers with a good recent compliance history. For most annual returns, the IRS looks at the prior three years for the same return type. For quarterly Form 941 filers, the lookback is generally the prior 12 consecutive quarters. [1]

- Returns in the lookback period generally need to have been timely filed and paid, with no disqualifying penalty history.
- A prior penalty later removed for reasonable cause or IRS error does not necessarily destroy eligibility.
- Estimated-tax penalties are treated differently and generally do not count against the test.
- A late-filed prior return with no associated penalty - for example, a refund return - generally is not treated as late for this test.

Important: The IRS account history controls. Client memory is useful, but transcripts are the better evidence when deciding whether AEP or FTA should apply.

Business taxpayers

Businesses may qualify for AEP, including S corporations and partnerships with late-filing penalties. The IRS also considers prior failure-to-deposit and late-filing history. AEP can be unavailable when failure-to-deposit penalties were waived four or more times during the applicable lookback period or when the penalty involved avoiding the Electronic Federal Tax Payment System requirement. [1]

S corporations and partnerships

The source material specifically notes that AEP applies to late-filing S corporation and partnership penalties. Those penalties can become expensive quickly because they are often calculated by the number of shareholders or partners and the number of months late. A clean three-year filing history may therefore be especially valuable. [1]

One useful improvement over FTA

Under the new system, when AEP applies, the IRS is expected to suppress future failure-to-pay penalties for that AEP year. Under the older FTA process, failure-to-pay penalties could continue accruing after an initial abatement and sometimes required another contact with the IRS. [1]

What AEP does not do

- It does not forgive the tax itself.
- It does not generally stop interest on unpaid tax.
- It does not cover every IRS penalty.
- It does not mean a late return is consequence-free.
- It does not replace reasonable-cause relief when the facts support that separate remedy.

The 2026 transition

The IRS is phasing AEP in rather than flipping a single switch for every return at once. That means 2025 annual returns and 2026 quarterly returns can be transition cases. Some may receive AEP automatically; others may still need a traditional FTA request if a covered penalty is assessed. [1]

Return or period	Primary relief path
2024 tax-year returns, 2025 quarterly returns, and earlier eligible periods	FTA generally remains the primary administrative relief path.
Eligible 2025 tax-year returns and 2026 quarterly returns processed during the transition	AEP if considered during processing; FTA may still be available if a covered penalty is assessed.
Eligible original returns with due dates on or after January 1, 2027	AEP is expected to replace FTA for covered penalties.

The back-return trap

Filing several delinquent returns at the same time can create a timing problem. The IRS system checks whether prior required returns are posted. If an older return - especially a paper-filed return - has not yet posted, the system may fail to recognize that the taxpayer qualifies for AEP. Once all returns are posted, the practitioner may need to contact the IRS and ask that the relief be applied. [1]

Practical point: When several old returns are being filed together, do not assume an automatic penalty notice means the taxpayer failed the AEP test. Processing order may be the problem.

Reasonable cause still matters

AEP is an administrative shortcut, not the only form of relief. A taxpayer with qualifying reasonable cause may have a separate basis to request penalty relief. Because the IRS system is designed to apply AEP before evaluating reasonable cause, we should preserve the facts and documents supporting reasonable cause when they exist. [1]

Four simple examples

- Individual return. A taxpayer with three prior compliant Form 1040 years files the 2025 return late. If the IRS records support eligibility, AEP may prevent the covered failure-to-file and failure-to-pay penalties from being assessed.
- Corporate transition case. A 2025 Form 1120 receives a covered penalty during the transition. We review the three-year history and may still request FTA if AEP was not applied.
- Quarterly payroll filer. One 2026 Form 941 is late after 12 compliant prior quarters. AEP may prevent covered penalties if no business-specific exclusion applies.
- Form 709. A late gift-tax return generally falls outside AEP, so we evaluate reasonable cause or another available remedy instead.

If you receive an IRS penalty notice

Do not assume the notice is correct, and do not assume AEP wiped out everything. During the transition, the IRS may assess a penalty that should be reviewed for AEP or FTA relief. The notice should be compared with the tax period, penalty code, processing history, and prior compliance record. [1]

- Send our office the entire notice - every page, not just the first page.
- Tell us when the return was filed and whether an extension was filed.
- Tell us about any prior late returns or penalty notices for the same return type.
- Provide facts and documents supporting reasonable cause, if any.
- Do not pay a penalty simply because the notice looks official before we review whether relief is available. Tax and interest, however, may still need to be paid promptly.

Common questions

Does AEP mean the IRS will forgive my balance due? No. AEP is penalty relief. The tax and associated interest generally remain due. [1]

Do I still have to file on time? Yes. AEP is a relief provision for qualifying taxpayers, not permission to file late.

Can I use AEP every year? No. The compliance lookback means the relief is designed for otherwise compliant taxpayers, not recurring late filing or payment.

What if the IRS misses it? We review the account transcript and the notice. Transition-year cases may still be handled through FTA, and back-return cases may require IRS contact after all returns have posted.

Can a business qualify? Yes. Eligible business return series can qualify, but additional deposit and penalty-history rules may apply.

Lenny's Take

AEP is a welcome change because a taxpayer with a clean history should not have to spend hours proving to the IRS that the IRS already has the information needed to grant relief. But “automatic” is not the same as “guaranteed.” Computers process what is posted to the account, not what is sitting in an envelope, a practitioner’s file, or a client’s memory.

My rule is simple: file on time whenever possible, keep the compliance record clean, and if a penalty notice arrives, let us review it before assuming the amount is final.

The bottom line

AEP is intended to move qualifying First Time Abate-type relief to the front end of IRS processing. For eligible returns and covered penalties, a taxpayer with the required compliance history may receive relief without making a separate request. The details still matter, especially during the 2026 transition and when multiple delinquent returns are filed together. [1]

Source and professional-use note

[1] Source material supplied for this guide: practitioner discussion of the IRS transition from First Time Abate to Automatic Exemption from Penalty, current through October 2026. The source notes that, as of October 2026, the Internal Revenue Manual sections describing the older FTA criteria had not yet been updated for the new AEP criteria.

This guide is for general educational purposes and is not tax or legal advice for a particular taxpayer or penalty notice. Eligibility depends on the return series, penalty type, IRS account history, processing timing, and the taxpayer’s specific facts. Contact our office before responding to an IRS penalty notice.