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Hidden Tax Traps in the Current Private Credit Environment

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As private credit refinancing and restructuring activity accelerates, borrowers, lenders and sponsors are increasingly focused on preserving liquidity, extending maturities and maintaining financial flexibility. Many transactions intended to achieve those objectives can trigger significant tax consequences, however, that may not become apparent until well after terms have been negotiated.

At PKF O'Connor Davies, many of our private credit, private equity and portfolio company clients are evaluating amendments, refinancing transactions, payment in kind (PIK) structures and other liability management strategies in response to continued market pressures. While these transactions are often driven by operational and financing considerations, the related tax consequences can materially affect their economics.

Original issue discount (OID), debt modification rules and cancellation of debt (COD) income are becoming increasingly important considerations in private credit transactions, particularly as more borrowers seek to refinance or restructure existing obligations in a stressed environment. In some cases, transactions intended to improve liquidity can create taxable income without generating cash, defer anticipated tax deductions or trigger unexpected gain recognition.

Understanding these consequences before executing a transaction can help borrowers and lenders avoid surprises and make more informed decisions regarding structure, timing and overall transaction strategy.

Interest Accrual and Deduction

Many investments in the private credit market generate OID. OID is generally a discount on a debt instrument and is treated as taxable interest over the term of the debt. OID interest must be recognized as current taxable income by the lender without the receipt of any cash (phantom income), while the borrower generally receives a current tax deduction without any corresponding cash expenditure.

OID is defined as the excess of the debt's stated redemption price at maturity over its issue price. Stated redemption price at maturity is the sum of all payments due excluding any qualified stated interest. Only interest that is unconditionally payable in cash or property (other than the borrower's own note) at least annually constitutes qualified stated interest. The issue price in most direct lending transactions is simply the cash advanced less points and other borrower-paid fees, though the determination of issue price will differ if the debt is issued for property or is publicly traded. The issue price will also become critically important upon any subsequent significant modification of the debt.

While the receipt of certain exit fees or warrants common in private credit and direct lending transactions can generate OID, a growing driver is the increasing presence of PIK interest and PIK toggles. PIK interest allows interest to be paid in kind, either by issuing additional debt or increasing the principal balance of the outstanding debt. A PIK toggle gives the borrower the option to pay interest in cash or in kind, typically at a higher rate during periods when the in-kind option is elected.

Because PIK interest generally is not treated as qualified stated interest, most loans with PIK interest or PIK toggles will have significant OID. A PIK toggle is often a sign of liquidity stress or aggressive structuring, but the flexibility it provides can create significant phantom income for lenders.

Many private credit borrowers are turning to PIK structures to preserve liquidity and create additional runway. While these arrangements can provide meaningful flexibility, borrowers and lenders should understand how the resulting OID may affect taxable income, deductions and overall transaction economics.

OID always creates phantom income for the lender, but the borrower's deduction is not guaranteed.

The deductibility of interest expense, including OID accruals, may be limited by Section 163(j). Excluding small businesses (those under a three-year average gross receipts threshold − for 2026, $32 million), this provision limits deductible business interest expense to business interest income plus 30% of adjusted taxable income (ATI). ATI is taxable income adjusted to add back interest expense, depreciation and amortization and certain other items.

Because both stated paid interest and OID accruals are subject to the same limitation, more borrowers may face deferred interest deductions as loans are refinanced under current market conditions. Before introducing PIK features or other forms of deferred interest, borrowers should evaluate whether anticipated liquidity benefits may be offset by delayed tax deductions.

Corporate borrowers with PIK interest or other high levels of OID may also be subject to the applicable high yield discount obligation (AHYDO) rules. The AHYDO rules may also apply to a corporate partner of a partnership borrower. If these rules apply, a portion of the OID may be permanently disallowed and the remaining OID deduction deferred until it is paid.

This treatment generally does not affect the lender, which must continue recognizing OID income as it accrues even before the borrower is permitted a corresponding deduction. The disqualified portion of the OID may be eligible for the dividends received deduction if received by a corporate lender.

Debt Restructuring, Modification and Cancellation of Debt Income

Debt restructurings and loan amendments have become increasingly common as borrowers seek additional flexibility and lenders work to protect value in a more challenging environment. While these transactions are often approached primarily from a commercial perspective, the tax consequences can be equally important.

The lender may recognize gain or loss on a deemed taxable sale of the pre-existing debt and the borrower could recognize cancellation of debt income. Importantly and often counterintuitively, there may be material tax consequences even if no principal amount is forgiven.

There is a deemed taxable sale of existing debt if:
1. The change constitutes a modification; and
2. The modification is significant.

A modification is defined broadly as any alteration, deletion or addition, in whole or in part, of any legal right or obligation of an issuer or holder, whether by express agreement, action of the parties or otherwise. This excludes anything that occurs in accordance with the terms of the existing agreement or instrument, such as periodic rate resetting. Replacing the debtor, adding or deleting a co-debtor, or changing the nature of debt from recourse to nonrecourse or vice versa are always modifications.

If there is a modification, it is significant if the legal rights or obligations and the degree to which they are altered are economically significant. The regulations also provide bright-line tests for certain types of changes.

- A change in yield is significant if the change exceeds the greater of 25 basis points or 5% of the original annual yield.
- A safe harbor generally provides that a deferral in the timing of payments for the lesser of five years or 50% of the original term of the instrument is not significant.

Other significant modifications include an additional or material change to a guarantee on recourse debt if it results in a change in payment expectations, a change in the collateral of a nonrecourse note and a change in the priority of the debt.

In our experience, tax considerations are often evaluated after commercial terms have largely been negotiated. By that stage, opportunities to address unintended tax consequences may be more limited. Evaluating these issues early in the process can help stakeholders avoid unexpected outcomes and make more informed decisions.

If there is a significant modification, the lender will have taxable gain or loss based on the difference between the lender's tax basis in the old debt and the issue price of the new debt. The borrower will be treated as if it satisfied the old debt with an amount of money equal to the issue price of the new debt.

If the issue price of the new debt is less than the adjusted issue price of the pre-existing debt, the borrower generally will recognize COD income in the amount of the excess. Borrowers may recognize COD income in a debt modification − even if principal is not reduced − if payments are significantly deferred, for example.

The amount of lender gain or loss, or borrower COD income, will vary greatly depending on the applicable issue-price rules, including whether the debt is publicly traded. The definition of publicly traded is very broad, such that a debt instrument could be treated as publicly traded if there is merely one timely indicative non-binding quote from at least one broker, dealer or pricing service. This can inadvertently create a massive unexpected taxable income event.

For example, assume that the adjusted issue price of existing distressed debt is $200 million. If at the time of a significant modification there was an indicative quote such that the debt qualified as publicly traded, the quoted price is presumed to be the issue price of the new debt. If the quote was $140 million (70% of face value, not unexpected for distressed debt), the borrower would recognize $60 million of COD income. If the debt were not publicly traded, the issue price would generally be the face amount, assuming a not below-market interest rate and there would have been no COD income.

For sponsors and management teams, this is often where tax and transaction economics intersect. A restructuring that appears beneficial from a liquidity perspective may create a significant taxable event if issue-price rules are not carefully considered.

In practice, the determination of issue price will often be the most important, and potentially contentious, aspect of a restructuring. While lenders are often focused on the calculation in order to quantify tax losses, borrowers are often focused on publicly traded status and issue-price determinations to avoid unexpected COD income.

The parties to any debt restructuring should consider tax cooperation or consistency provisions to help ensure aligned reporting positions and reduce the risk of future disputes.

Any COD income will generally be fully taxable to the borrower as ordinary income unless an applicable exclusion applies. For partnership borrowers, COD income is recognized at the partnership level, but most exclusions, such as insolvency or bankruptcy, are determined at the partner level. COD income exclusion generally involves the reduction of net operating loss carryforwards, tax basis and other tax attributes.

Situations Warranting Additional Tax Analysis

As refinancing activity increases across the private credit market, parties should pay particular attention when considering:

- Amendment-and-extend transactions
- PIK interest or PIK toggle features
- Liability management transactions
- Debt-for-equity exchanges
- Distressed debt restructurings
- Transactions involving potentially publicly traded debt

In each of these situations, tax consequences can materially affect the anticipated economic outcome. Understanding those consequences before terms are finalized can help avoid surprises and support better transaction execution.

Tax Planning Should Be a Core Workstream in Every Restructuring

The tax consequences associated with private credit transactions are becoming increasingly significant as refinancing activity accelerates and distressed debt modifications become more common.

Debt restructurings intended to improve liquidity or preserve value may generate immediate taxable income, deferred deductions, phantom income or unexpected gain recognition. Sponsors, lenders and portfolio company management teams should evaluate these consequences alongside legal, operational and financing considerations before executing amendments or restructurings.

Careful modeling of tax outcomes before negotiations begin can help avoid surprises, preserve transaction value and improve decision-making, particularly where PIK features, payment deferrals, distressed pricing or potentially publicly traded debt instruments are involved.

As refinancing and restructuring activity continues to increase across the private credit market, tax analysis should be viewed as a core transaction workstream rather than a post-closing consideration.

Contact Us

At PKF O'Connor Davies, our tax, valuation, transaction advisory and restructuring professionals work with sponsors, lenders, private credit funds and portfolio companies to evaluate these issues before transactions are executed. Understanding the potential tax consequences early in the process can help stakeholders avoid surprises, preserve value and make more informed decisions in a rapidly evolving market.

To discuss our services or learn more about this topic, please reach out to your PKF O'Connor Davies client service team or:

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