

5. *How are liabilities allocated?* In determining the extent to which the contribution of encumbered property is treated as a disguised sale, nonqualified liabilities encumbering the property are allocated under a special set of rules. To the extent such a liability is nonrecourse (within the meaning of §752), the debt is allocated among the partners in accordance with their interests in the partnership, taking account of all facts and circumstances. Temp. Reg. §1.707-5T(a)(2) (Oct. 5, 2016). To the extent such a liability is recourse (within the meaning of §752), the liabilities are first allocated according to the recourse §752 rules and then recomputed, treating the liability as if it were nonrecourse and allocating it in accordance with the partners' interest in the partnership, taking account all of facts and circumstances. Having determined the debt allocation two ways, the partnership must then use whichever of the two ways creates the greatest disguised sale (that is, whichever way maximizes the amount of the debt shifting to other partners). *Id.* (as corrected by TD 9788 (Nov. 17, 2016)).

Determining the partners' interest in the partnership is the lynchpin of these rules. How is it done? There is a little guidance of the subject despite the essential role that it plays. There are some examples in the regulations that use the partners' shares of profit under section 704(b), but these examples only include fact patterns in which all partnership profits are allocated in a fixed set of percentages or obviously abusive allocations. See Temp. Reg. §1.707-5T(f). There is no guidance covering partnerships that specially allocate some or all partnership profits or whose profit shares change over time. And while the examples each ignore built-in gain in the contributed property despite the requirement that "all the facts and circumstances" must be considered, we have no idea whether forward and reverse 704(c) layers in other partnership assets are ignored. Compare the regulations under §706(b)(1)(B)(iii) in which partnership profits explicitly include 704(c) gain. See Regs. §1.706-1(b)(4)(ii)(C).