

721 Exchange vs. 1031: Tax-Smart Real Estate Investing

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Discover the benefits of a 721 exchange for retirement planning. Explore how this strategy addresses debt, cash flow, and market volatility.

By Meng Lee

For many real estate investors, particularly retirees, selling a property comes with significant financial implications. Buying and holding real estate has long been a reliable investment strategy, but today's market conditions present new challenges. As of February 2025, the Federal Funds Effective Rate was 4.3%, down from 5.3% in 2024, but still much higher than the near-zero levels seen after the 2008 global financial crisis. This has left many real estate owners with floating-rate debt or looming debt maturities facing cash flow shortfalls, pressure from lenders to pay down loans and limited exit or refinancing options due to sluggish capital markets. On top of this, rising property taxes, insurance costs and operating expenses like utilities, payroll and repairs have exacerbated the plight of many real estate owners.

Given the challenges of the current market, alternative solutions like the 721 exchange are growing in interest among investors. Through the 721 exchange, investors can defer capital gains taxes (including depreciation recapture taxes, which can be significant for long-term owners) while transitioning from active property management to a passive role in a diversified real estate investment vehicle.

1031 vs. 721: Understanding the Difference

For many years, real estate investors have relied on the [1031 exchange](#), which lets them defer capital gains taxes by reinvesting sales proceeds in like-kind properties. However, this strategy comes with several challenges in today's environment:

Investors face tight deadlines to find a suitable replacement property and have ongoing management responsibilities of the new asset. Finding and closing on a replacement

property within tight deadlines can often be difficult in today's sluggish markets, with investors having 45 days to identify a replacement asset after selling their property and 180 days to close on the replacement asset after closing on the relinquished asset. Financing the acquisition of the replacement asset is also more complicated due to today's high-interest rates, with many lenders and once-prolific regional banks tightening standards and reducing commercial real estate allocations.

The 1031 exchange also requires the owner to arrange for the management of the replacement asset after the exchange is effectuated, whereas in a 721 exchange, the property is contributed to a professionally managed vehicle.

Within the 721 exchange model, investors contribute their real estate assets in exchange for shares or Operating Partnership (OP) units. OP units offer ownership to a diversified set of assets, increased liquidity and freedom from the headaches and complexities of direct management and ownership.

The 721 exchange and its passive investment structure are especially helpful for investors approaching retirement, as it provides exit liquidity without the immediate tax consequences of a traditional sale or the burden of managing a 1031 replacement asset. Additionally, there is an estate planning benefit: upon inheritance of shares, the heirs can enjoy a step-up in basis which eliminates the deferred tax liability and maximizes wealth transfer.

The 721 exchange is suitable for a variety of situations. For owners simply looking to retire while still preserving depreciation and cash flow benefits, as well as the future appreciation potential of real estate investments, they can exchange their assets for an equal value of shares. The 721 exchange is also a powerful tool when dealing with debt, cash flow and management issues, as it provides an avenue to right-size leverage and improve management and operations. But the unifying key benefit across all situations is tax deferral.

Why Market Trends Favor a 721 Exchange

Several economic factors have made 721 exchanges more attractive in today's real estate environment:

- **Debt Burdens & Unexpected Tax Liabilities** – With interest rates at record highs, refinancing without adding more equity may no longer be possible for assets with debt issues. Even handing a property with non-recourse debt back to the lender can result in unexpected tax liabilities, as the IRS treats forgiven debt like a sale and taxes the owner

accordingly. A 721 exchange helps investors avoid this double-whammy situation by deferring capital gains taxes and providing exit liquidity. It also allows for a smooth transition into a more liquid investment without immediate financial burdens from taxes, debt paydown or cash-in refinancing.

- **Shifting Market Conditions** – Today’s market has led to reduced property values in some asset classes, resulting in the creation of distress situations. Investors looking to reduce capital calls or diversify their holdings can utilize a 721 exchange to transition from these assets into a diversified portfolio of professionally managed assets.

- **Operational Cost Pressures** – Investors managing properties face increasing operating costs due to rising insurance premiums, property taxes and inflation’s impact on operating expenses such as utilities. By exchanging their assets into a larger pool of professionally managed assets, owners can benefit from potential cost savings and more efficient expense management.

When a 721 Exchange May Not Be the Best Fit

While a 721 exchange offers many advantages, it is not suitable for every investor. Once a property is exchanged, the investor no longer manages the asset or has decision-making power over its future use. This could be unattractive for those who prefer active involvement and discretion in their investments.

Short-term investors who frequently buy and sell properties for profit may also find that a 721 exchange does not align with their goals. The tax deferral benefits are most valuable for long-term wealth preservation and estate planning, which makes the 721 exchange a better fit for those with a multi-year investment horizon.

Weighing the Pros and Cons

A 721 exchange presents a strategic alternative to direct real estate ownership, but it is important for investors to weigh both the advantages and limitations.

Key Benefits:

- **Tax Deferral:** Investors can defer capital gains taxes, allowing more capital to remain invested.
- **Diversification:** Instead of being exposed to a single property, investors gain access to a professionally managed and diversified portfolio.
- **Passive Income:** Cash distributions can provide ongoing income without the responsibilities of property management.
- **Estate Planning Advantages:** Shares can be passed to heirs with a step-up basis, which permanently reduces tax liability.

Potential Drawbacks:

- **Loss of Control:** Investors no longer directly manage or make decisions about their properties.
- **Market Dependency:** Performance in the post-exchange investment vehicle is influenced by broader real estate and economic trends. Investors should conduct thorough due diligence on the investments that the new vehicle owns and will be targeting in the future.
- **Impact on Tax Strategy:** Some depreciation benefits may be reduced when transitioning to share ownership, depending on the contributed asset. A customized analysis from a tax advisor is highly recommended.

A Tax-Smart Strategy for Long-Term Wealth

For retirees, long-term investors, and those looking to simplify their real estate holdings, a 721 exchange provides a strategic way to transition into passive investing while preserving wealth and deferring taxes. By exchanging property for shares, investors can enjoy the benefits of diversification, professional management, and estate planning advantages without the hassles of direct property ownership.

As the real estate landscape continues to evolve, the 721 exchange remains a valuable tool for those seeking a tax-efficient, low-maintenance approach to real estate investing. By understanding its benefits and limitations, investors can make informed decisions about how to best structure their portfolios for financial flexibility and a pathway to long-term passive income.

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Meng Lee brings over 13 years of expertise in real estate, finance and capital markets to his role as vice president of Acquisitions at [Ballast](#). With a keen eye for identifying strategic opportunities, Meng plays a pivotal role in driving the firm's investment strategy and executing acquisitions across diverse asset classes.
