Internal Revenue Code § 1014 provides a step-up basis for property inherited.  This allows the heirs the benefit of the fair market value at the time of death to be their basis in the property, which results in no capital gain and thus no capital gains tax to be paid.

IRC § 2036 defines the gross estate as "the value of all property ... of which the decedent has at any time made a transfer ... under which he has retained for his life ... the possession or enjoyment, or the right to the income from, the property."  Thus, when a decedent had transferred ownership to others, such as his/her children, and retained a life estate, the children get the benefit of the step-up basis in the decedent's estate.

IRC § 2035 provides that a release of a life estate is ineffective for federal tax purposes for three (3) years.  Thus, if the life tenant released the life estate within three years of his/her death, this brings the property back into the estate and results in the step-up basis.

In instances where the owner of the property has deeded the property to others but did not retain a life estate in the deed, but nevertheless continued to live in the property as a life tenant, see IRC § 2036 which uses the word "retained" not "reserved".  It has been successfully argued in the past that a right can be retained without being reserved, and that the continued occupancy of the home after the transfer of title, without paying fair market rent, is evidence of an implicit agreement, understanding or assumption of the parties of the transaction.  *Estate of Linderme v. Commissioner*, 52 T.C. 305 (1969).