EXHIBIT 3

Incremental After-Tax Cash Flows of Increasing-the-Basis-Above-Par Strategy

The bond has 10% annual coupon, three-year maturity, is purchased at par, and the yield changes from 10% at the beginning of the Year 1 to 5% at the end of Year 3. Panel A shows that the after-tax yield to maturity equals 7.20% if the investor chooses not to sell at the end of the first year. Panel B shows that the after-tax yield rises to 7.37% if the investor realizes capital gain and amortizes the premium, using it to reduce the tax burden on the coupon income. An ordinary income tax rate of 28% and capital gains rate of 20% are assumed.

	Year 0	Year 1	Year 2	Year 3
PANEL A				
Before-tax cash flow (CF)	($1,000)	$100	$100	$1,100
Basis	$1,000	$1,000	$1,000	$1,000
Taxes on coupons		($28)	($28)	($28)
After-tax CF	($1,000)	$72	$72	$1,072
After-tax yield (IRR)	7.20%			
PANEL B				
New basis		$1,092.97	$1,047.62	$1,000
Amortization			($45.35)	($47.62)
Amortization tax shield			$12.70	$13.33
Capital gain		92.97		
Capital gains tax		($18.59)		
After-tax CF	($1,000)	$53.41	$84.70	$1,085.33
After-tax yield (IRR)	7.37%			
Incremental after-tax CF		($18.59)	$12.70	$13.33