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**DOES TAX ADVANTAGE OF DEBT CAPITAL DETERMINE THE
RELATIONSHIP BETWEEN FINANCIAL LEVERAGE AND
VALUE OF THE FIRM?**

Abstract

There are a lot of empirical evidences that show the positive relationship between financial leverage and value of the firm, but there is a question, since the work of Modigliani and Miller (1963) whether this relationship is due to the tax advantage of corporate tax on the debt capital. This paper investigates whether the positive relationship between financial leverage and value of the firm is due to the tax advantage of debt capital. Fifty three listed companies were sampled from five sectors (i.e Banking, Finance and Insurance, Manufacturing, Diversified Holding, Beverage, Food & Tobacco, Hotels and Travels) traded in the Colombo Stock Exchange. The study used the data extracted from the audited financial statements of sample companies for five years from 2001 to 2005. Data were analyzed using Descriptive and Multiple Regressions Statistical Techniques. The multiple Regression model consisted of value of the firm after eliminating tax advantage of debt capital as dependent variable and financial leverage, growth, firm's size and dividend payout ratio as independent variables. According to the results, it is significant only for manufacturing sector. Therefore, the value of the firm depends on financial leverage but not due to the tax advantage of debt capital. This finding will help to financial decision makers and researchers in the field.

Key words:

Financial leverage, Value of the firm, tax advantage, Interest rate, Corporate Tax