What is a Partnership Firm and 5 Essential Elements of a Partnership

Persons who have entered into partnership with one another to carry on a business are individually called “**Partners**“; collectively called as a “**Partnership Firm**”; and the name under which their business is carried on is called the “**Firm Name**”

A partnership firm is not a separate legal entity distinct from its members. It is merely a collective name given to the individuals composing it. Hence, unlike a company which has a separate legal entity distinct from its members, a firm cannot possess property or employ servants, neither it can be a debtor or a creditor. It cannot sue or be sued by others.

It is only for the sake of convenience that in commercial usage terms like “firm’s property”, “employee of the firm”, “suit against the firm” and so on are used, but in the eyes of the law that simply means “property of the partners”, “employees of the partners” and “a suit against the partners of that firm”.

It is relevant to state that for the purposes of levy of taxes, a partnership firm is an entity quite distinct from the partners composing it and is assessable separately. But for all other laws, they are treated as the same because a partnership firm does not have a separate legal entity of its own.

Definition of Partnership

Partnership Firms in India are governed by the Indian Partnership Act, 1932. As per Section 4 of the Indian Partnership Act:-

“Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all”

Thus as per the above definition, there are 5 elements which constitute of a partnership namely: (1) There must be a contract; (2) between two or more persons; (3) who agree to carry on a business; (4) with the object of sharing profits and (5) the business must be carried on by all or any of them acting for all.

5 Essential Elements of a Partnership Firm

All of 5 elements mentioned above must co-exist in order to constitute a partnership. If any of these is not present, there cannot be a partnership. These 5 essential elements of a partnership firm are explained below in detail.

1. Contract for Partnership

Partnership is the result of a contract. It does not arise from status, operation of law or inheritance. Thus, at the time of death of the father, who was a partner in the partnership firm, the son can claim share in the partnership property but cannot become a partner unless he enters into a contract for the same with other persons concerned.

Similarly, the members of a [HUF](https://www.charteredclub.com/how-to-save-taxes-by-forming-huf/%22%20%5Ct%20%22_blank) carrying on a family business cannot be called partners for their relation arises not from any contract but from status. Thus, a “contract” is the very foundation of partnership.

2. Maximum No. of Partners in a Partnership is 20

Since partnership is the result of a contract, at least two people are necessary to constitute a partnership. The [Indian Partnership Act, 1932](http://www.mca.gov.in/Ministry/actsbills/pdf/Partnership_Act_1932.pdf%22%20%5Ct%20%22_blank) does not mention anything about the maximum no. of partners in a partnership firm but as per the Companies Act, a partnership consisting of more than 10 persons for a banking business and more than 20 persons for any other business would be considered as illegal. Hence, these should be regarded as the maximum limits to the number of partners in a partnership firm.

Only, the persons competent to contract can enter into a contract of partnership. Persons may be natural or artificial. A Company may, being an artificial legal person, enter into a contract of partnership, if authorized by its Memorandum of Association to do so. There could even be a partnership between 2 companies (Steel bros & Co. Ltd. Vs Commissioner of Income Tax)

A partnership firm, since it is not recognized as a legal person having a separate legal entity from that of its partners cannot enter into contract of partnership with another partnership firm or individuals ([Duli Chand vs Commissioner of Income Tax](https://indiankanoon.org/doc/1718643/))

When a partnership firm (under a firm name) enters into a contract of partnership with another partnership firm or individual, in that case, in the eyes of the law the members of the firms or firm become partners in their individual capacity (Jadavji Narsidas & Co. Vs Commissioner of Income Tax)

3. Carrying on of Business in a Partnership

The third essential element of a partnership is that the parties must have agreed to carry on a business.  The term “business” is used in its widest sense and includes every trade, occupation or profession. Therefore, if the purpose us to carry on some charitable work, it will not be a partnership.

Similarly, if a number of persons agree to share the income of a certain property or to divide the goods purchased in bulk amongst them, there is no partnership and such persons cannot be called partners because in neither case they are carrying on a business.

 Thus, where A and B jointly purchased a tea shop and incurred additional expenses for purchasing pottery and utensils for the job, contributing the money in equal proportions and then leased out the [shop on rent](https://www.charteredclub.com/tds-rent/%22%20%5Ct%20%22_blank) which was shared equally by them , it was held that they are only co-owners and not partners as they never carried on any business.

4. Sharing of Profits

This essential element provides that the agreement to carry on business must be with the object of sharing profits amongst all the partners. Thus, there would be no partnership where the business is carried on with a philanthropic motive and not for making a profit or where only one of the persons is entitled to the whole of the profits of the business. The partners may however, agree to share the profits in any ratio they like.

Sharing of losses not necessary

To constitute a partnership, it is not essential that the partners should agree to share the losses (Raghunandan vs Harmasjee). It is open to one or more partners to agree to bear all the losses of the business.

Moreover, the manner in which the profits/losses are to be shared should be expressly stated in the partnership deed. In the absence of this being mentioned in the partnership deed, the provisions of the Partnership Act, 1932 would apply which state that the profits/losses should be distributed equally among all partners.

However.  it must be noted that although a partner may not share in the losses of a business, yet his liability towards the outsiders shall be unlimited. In case the partners intent to limit their liability towards the outsiders, a new concept of partnership i.e. Limited Liability Partnerships have been introduced in India. In a Limited Liability Partnership, the liability of the partners towards the outiders is limited.

5. Mutual Agency in a Partnership

The fifth element in the definition of partnership provides that the business must be carried on by all the partners or any (one or more) of them acting for them all, i.e. there must be a mutual agency.

Thus, every partner, is both an agent and principal for himself and other partners, i.e. he can bind by his acts the other persons and can be bound by the acts of other partners. The importance of the element of mutual agency lies in the fact that it enables every partner to carry on the business on behalf of others.